Formal Written Statement

United States House of Representatives -- Small Business Committee

Health Reform's "Applicable Large Employer" Standards

&

Effect of Controlled Group Rules on Small Business

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Focus: Use of Tax Code Aggregation Rules to Determine Size for Application of the Play or Pay Requirement under PPACA

The health reform law applies existing Tax Code rules on controlled groups when determining employer size. The health reform law only applies to an "Applicable Large Employer" (some refer to them as "ALE") which is generally any employer "who employed an average of at least 50 full-time employees on business days during the preceding calendar year.... All persons treated as a single employer under subsection (b), (c), (m), or (o) of section 414 of the Internal Revenue Code of 1986 shall be treated as 1 employer." Those Section 414 rules, in turn, use the definition of controlled groups under Internal Revenue Code Section 1563(a).

The health reform law included this reference to controlled group rules for two main reasons:

1. To prevent employers from separating companies to avoid health reform requirements, and
2. To make certain companies subject to the law while smaller ones are exempt (an employer size rule is usually necessary, as you know).

This discussion is very high-level as its purpose is to create an awareness of the issue of controlled groups in the context of health reform. For additional reference, attached at the end are excerpted pages from a Tax Exempt and Government Entities discussion on "Controlled and Affiliated Service Groups" posted by the Internal Revenue Service on its website and available in its entirety at the following address: http://www.irs.gov/pub/irs-tege/epchd704.pdf The pages shared here as excerpts here are representative of the issues the controlled group rules will raise, and omission of certain pages is simply for ease of reference and brevity in printed materials. Review of the complete item at the website is encouraged.

Commentary on Awareness, Complexity, and Confusion

Awareness: While setting a size rule is necessary, as noted above, the controlled group rules continue to catch many smaller businesses unaware. These rules do apply to businesses in other contexts, but typically that is because of an action the employer has itself undertaken, such as creation of a 401(k) retirement plan. Why is the application of the rule different here?

- As with many provisions of the Tax Code, *public policy often requires businesses to "agree" to a trade off when voluntarily offering an employee benefit*; if they want to take advantage of the tax treatment for retirement plan contributions, the related employers must consider common control within the group and must treat the employees fairly across the entire group to the extent the law and regulations require. To state the effect of the main rules very simply, the controlled group rules affect which employers are considered for discrimination testing, and whether enough non-highly compensated employees are covered.
- The dynamic is different in the health reform context…these rules will apply due to a federal *requirement to provide a benefit*. The application of the controlled group rules means many small companies that have been created, maintained, and operated separately – as permitted by current tax ID numbers and the operation of other federal rules – now must be considered together.

Larger employers and some groups of smaller employers with complex corporate structures will tend to have advisors that identify the issue for them: in-house counsel, outside counsel, tax advisors such as Certified Public Accountants, or sophisticated employee benefits consultants or brokers.

However, employer awareness among small employers is lacking if they do not have these relationships. These employers may not have had the need to retain legal counsel, even via a law firm, except for specific projects, and those projects may not have involved persons with the right sort of experience to readily identify and resolve a complex tax issue.

Smaller employee benefits consulting and brokerage firms simply do not have the revenue to justify either retention of a law firm or employment of a compliance officer who might identify the issue for their clients. With the delays in the law and challenges, many advisors and employers similarly have delayed investing the capital and effort to address these issues, with many expecting at various times (including at present) that the rules would be repealed or delayed yet again.

Complexity: The complexity involves the somewhat mechanical application of the law. Many well-advised employers have sought the opinion of legal or tax counsel. Analysis of a simple corporate design or ownership arrangement might require 2-3 hours of work by experienced advisors, costing roughly $1,200 based on estimates provided by a range of private law firm attorneys. More complex arrangements might be addressed with more time required, perhaps at a cost of $2,000 to $3,000.

The challenge is not so much the cost as ***identification*** of the issue. Most small employers are not aware of the issue. As noted above in the awareness discussion, we encounter small and even large businesses on a weekly basis who are unaware of the need to consider whether separate companies, divisions, etc. should be counted for purposes of determining employer size and applicability of the law.

The law applies to determine if seemingly separate employers would be treated as one employer for purposes of counting the number of employees to determine if the health reform Play or Pay rules apply. The decision is made to combine certain entities using rules under Tax Code Section 414(b), (c), (m), and (o), respectively:

- A controlled group of corporations
- A group of trades or businesses under common control
- An affiliated service group
- Certain other arrangements described in regulations

The first two bullets are often called the controlled groups rules even though they form just part of the picture, and include a parent-subsidiary analysis under Section 414(b) and brother-sister control analysis under 414(c), as well as a determination of whether there is a combination of the two types of control. Affiliated service group rules (the third bullet point, above) in 414(m) were added later to capture other employment relationships created by other arrangements. Finally, the last bullet point is a catch-all of sorts, written in part to address whether certain arrangements like employee leasing should affect retirement plans and other controlled group issues.

The controlled group rules apply differently under the four different Section 414 subparagraphs. The factors generally include percentages of ownership of either shares of voting stock or total value. (Once the status of the group as a single organization is determined, then the number of employees – full-time employees and part-time equivalents – must be counted; that issue is addressed later in this discussion on pages 5 & 6.)

A Controlled Group of Corporations (Section 414(b)

One of the easier situations is a controlled group of corporations via ***stock ownership with a common parent*** (Section 414(b)), but even this analysis requires an outside advisor. There is common control if:

- One or more of the corporations in the group owns (either directly or indirectly) 80% or more of the total combined *voting power* of all voting classes of stock (or 80% or more of the *total value* of all shares of all classes of stock) of each of the corporations, except the common parent corporation; and

- The common parent corporation owns, directly or indirectly, at least 80% of the total combined voting power of all classes of stock entitled to vote (or 80% or more of the total value of shares of all classes of stock) of at least one of the other corporations.

Ownership analysis is complicated by sub-rules which often make it more likely the group will be held in common control, such as disregarding stock held by other subsidiaries when determining if the parent owns the required percentage of stock of one subsidiary.

A Brother-Sister Controlled Group Arrangement (Section 414(c))

The rules become more complex under ***brother-sister controlled group rules.*** Again, an outside advisor is needed.

Brother-sister firms are companies that meet a two-part test:

- First, five or fewer individuals, estates, or trusts own (directly or indirectly) stock with at least 80% of the total combined voting power of all classes of stock entitled to vote or at least 80% of the total value of all shares of all classes of stock.
- If that threshold is met, then one must determine if those same five or fewer individuals, estates, or trusts have stock with at least 50% of the total voting power of all classes of stock or at least 50% of the total value of all shares of all stock. The stock ownership of each owner for the 50% rule is taken into account only to the extent the owner's ownership interest is identical with respect to each corporation.

These two sets of rules on stock ownership with a common parent and brother-sister controlled groups are also applied together (called a ***combined group of corporations***) if each employer is in one of the two types of groups and one of them is a common parent of the parent-subsidiary controlled group and also is in the brother-sister controlled group.

<u>Related Rules on Attribution of Ownership</u>: Sometimes ownership is attributed to (counted toward) the ownership interests of someone else. For corporations, ownership of at least 5% in stock value means the corporation is owned by that person. Options to own stock are treated as actual ownership. According to experts in the area of controlled group rules and employee benefits, addressing ownership options is one of the trickiest areas of actual application of the law, requiring analysis of the underlying agreements relating to those options. As with so many other aspects of the controlled group rules, these arrangements and their formalizing documentation were not written or structured to address their impact other aspects of the business. The smaller the business, the more likely that is to be the case.

Similar rules and challenges apply to partnerships relative to interests in profits or capital, whichever is greater.

Family businesses create more complexity, especially when children or other descendents of the founders begin to have ownership interests. An individual is treated as also having any ownership interests of his children under 21 and (usually) of his or her spouse. If an individual has "effective control" of an organization, then he or she is considered to own interests of his parents, grandparents, grandchildren, and children (even if over age 21).

Then, at this point in the analysis, certain ownership interests are excluded but only if the result is to increase (not decrease) the ownership interests in another entity: ownership by certain employees, retirement plans, exempt organizations, deferred compensation plans, and certain interests in subsidiaries of 5% owners, officers, partners, or fiduciaries of the parent organization.

Affiliated Service Groups (Section 414(m))

As with the above rules, all employees of an affiliated service group under Tax Code Section 414(m) must be treated as employed by the same employer. The impact of these rules extends beyond retirement plan rules to welfare benefits such as life insurance, health plans, fringe benefits, cafeteria plans (employee pre-tax benefit plans), and continuation coverage (called COBRA) just to name a few. The affiliated service group rules were enacted to prevent circumvention of the two other controlled group rules when ownership of related companies was arranged in an artificial manner.

These related companies might perform services for another organization in the same group, or may provide management functions such as managing operations or human capital.

Attribution rules also apply to affiliated service groups; they are similar to those discussed for the more basic controlled group provisions. These additional attribution rules are beyond the scope of this discussion.

Side Notes on Specific Types of Employers

Tax Exempt Organizations: These entities are generally treated as under common control if at least 80% of the directors or trustees of one organization are either representatives of or are directly or indirectly controlled by the other organization.

Foreign Parents: U.S. corporations owned by a foreign parent would be considered part of the same controlled group for tax purposes under final regulations to Section 1563(a) which affects the analysis under Tax Code Section 414 subparagraphs as noted above. As a result, for example, if a French firm, group of investors, or family has sufficient ownership interests in 8 small businesses in the United States, the employees of those U.S. employers would be counted together for determining whether the employer as a whole has 50 or more employees and whether health reform applies to those 8 businesses.

Confusion: Even employers that do identify controlled group issue and have the requisite analysis performed still are met with many barriers to compliance. As with other aspects of health reform, these pitfalls arise because of the complexity of the systems addressed by reform, practical impacts of the law that policymakers did not foresee, and the loopholes the current law leaves open for either avoidance or interpretation.

No Coordination of Payroll, Time Tracking, and Other Systems: Many small businesses that health reform will impact do not have the existing infrastructure or any sort of coordinated systems to correctly and consistently track the required information necessary to determine if the group has 50 or more employees, much less to offer benefits across the population on a consistent basis.

Small businesses with different but related employers will not have a common HR department, a common payroll system, a common way to track and count employee hours, or even a single person who has access to all such information across the group. They can usually work out the designation of a person, who then becomes the central point person responsible for requesting and compiling the information.

In the case of the health reform Play or Pay rules, the controlled group as a whole will need to have a determination made of which employees across the group are truly full-time (expected to work 30 or more hours a week) and which employees are not expected to be full-time but whose hours must be counted to determine full-time equivalents). The full-time equivalent determination requires an employer subject to the law to add all the hours worked by non-full-time employees in a month, then divide by 120 to determine the number of full-time employees it would have needed to work the same number of hours. That number of full-time equivalents is then added to the number of true full-time employees to determine if the employer or controlled group of employers is subject to the law.

If a group of employers is treated as one employer and is determined to be subject to the requirement to offer coverage, the practicalities noted below affect any given entity's ability to do. Diligent members of these combined small employers worry about whether the health benefits *can* be and *will* be offered consistently across the group. Some of our clients have met with outright resistance from other owners of related companies. ***Common control under the tax rules does not really equate to actual control over another firm within the same controlled group.*** Again, the level of cooperation is usually higher in the context of retirement plans, which the different employers often all wish to offer. Thankfully, the penalties, if imposed, will be isolated to that employer tax identification number (EIN). Small employers still fear the impact of a group-wide audit triggered by an uncooperative commonly "controlled" employer.

Inability to Comply with Other Federal and State Laws: The current guidance will put many employers in an untenable position: comply with one law (health reform) but to do so, you must violate another federal law and potentially some state requirements.

The controlled group rules under health reform (as they apply through Sections 4980H and 414 of the Tax Code and discussed above) are not consistent with Department of Labor rules and interpretations regarding control concepts and the status of an employer as a single entity or a multiple employer entity. While the above IRS rules are complex, the DOL rules are old and quite incomplete. While there are federal agency approval processes in place for retirement plans which provide employers with a greater sense of security, there are no similar processes for welfare plans like group health plans offered by employers. (Health plan coverage through an employer is considered a "welfare" plan because it provides for the well-being of a covered employee and his or her family members.)

Under other federal rules, health plans must only provide health insurance or health plan coverage to employees of related companies; otherwise, the plan is considered a MEWA, or Multiple Employer Welfare Arrangement as defined in Section 3(40) of ERISA. The DOL has not yet issued proposed regulations under that long-standing section of the law. While at times the DOL has indicated an intent to follow the Tax Code rules, they have cited different levels of required common ownership and also, for example, have alluded to a need for a substantial business purpose for common control. The uncertainty associated with the lack of guidance leaves employers at risk if they are to comply with Tax Code and health reform rules, but if they must do so in a manner that appears to be at odds with DOL interpretations.

Self-funded plans face even greater risks from state insurance regulators. Quite often, states will declare MEWAs to be illegal or will require them to be capitalized and licensed as insurance companies. We are now seeing groups with very few employees self-fund their plans, and that certainly now includes small businesses. State laws often say that it is illegal for employers that are not closely related enough to provide benefits to all of their employees under a single plan. Many states have taken that position in part because of firms that promise to self-fund health plan benefits for unrelated employers, often through arrangements that sound legitimate such as "unions," but which are not ever intended to pay the promised benefits.

Inability to Obtain Insurance: Insurance carriers have already refused to offer insurance to groups that the law would treat as a single, or commonly controlled, employer.

Despite all the market reforms of health care reform, insurance carriers retain significant leeway to not offer insurance to small employers that collectively are subject to the health reform requirement.

Insurance carriers remain able to impose their own traditional – or new – rules regarding common ownership/control. Many insurance carriers already are refusing to provide insurance to groups of technically related smaller businesses based on the insurance carrier's internal rules regarding which groups they will or will not write. The health insurance carriers may do so based on a number of factors (a practice which the health reform law neither addresses nor forbids), such as business ownership levels and location.

A proposed solution is not offered at the agency level because a regulatory fix likely is not possible without a change to statutory wording.

Inability to Provide Insurance Once Offered: Insurance carriers impose participation requirements at present. These following concerns affect small and large businesses alike, but the impact is worse for small employers – especially when they are connected as part of a controlled group where they may not operate jointly for other matters. A participation requirement means an insurance carrier may let the employer offer their insurance company's health plan policy, but if not enough employees sign up, the insurance carrier has the right, contractually, to "pull the policy." The carrier is under no obligation to actually provide the offered insurance.

Conversely, the insurance carrier may require the employer to pay a certain percentage of the total premium costs for the employee-only coverage or for family coverage or both. In some cases, the insurance carrier may require the employer to pay for the entire cost of single coverage, which is significantly more than the 9.5% rule and related safe harbors would require an employer to pay under the law.

Employees with other coverage often don't count against either requirement, but because of the family glitches in the law, many employers will not provide spouses with health insurance on the same basis as in the past, and in some cases, employers won't offer coverage to spouses at all. (The law does not allow coverage for family members to be affordable, and only children must be offered coverage with the employee, not spouses.)

In the small group context, the federal agencies have stated in regulatory and other guidance that the carriers may still impose participation requirements. The answer is expected to be the same in the context of the large group market (defined as the market for insurance for groups with 50 or more employees or over 100 employees, depending on how the state defines the market size). Treasury Department attorneys have indicated informally they believe they have identified a way to prevent this result, but the statutory "hook" appears to be absent.

If an employer offers a policy as required by the law and the insurance carrier will not actually issue the policy because of a low level of employee participation, is the employer (small or large) subject to the fine when it is impractical / impossible to provide the coverage? Many benefits attorneys fear the answer is the penalties under the Play or Pay rules would still apply. Relief from this result would be very welcome.

Discrimination: The new health reform law requires the Treasury Department / IRS to issue and impose nondiscrimination rules on fully-insured plans similar to those imposed on self-funded group health plans. Smaller employers tend to have insured health plans and will be subject to those rules once issued, presumably on a controlled group basis. However, as noted above, insurance carriers tend to have significant leeway to interpret the rules under health reform and are not themselves subject to the discrimination rules. Depending on the location and specific situation of an employer, compliance with these to-be-issued rules across a controlled group should prove unwieldy, especially if there is common ownership but a lack of cooperation which unfortunately is often the case with very independent entrepreneurs and distantly related family members.

Additional Questions Suggested for Discussion:

What Else in Health Reform Raises Grave Concerns fro Employers?

For Individuals?

Are Employers Modifying Their Ownership to Avoid Health Reform?

Do Employers have the Guidance they Need to Prepare for 2015? What is the Timing for that Compliance?

Definition: Controlled Group

Section 414(b) and (c)

The controlled group definition is found in section 414(b) & (c). Section 414(b) covers controlled group consisting of corporations and defines a controlled group as a combination of two or more corporations that are under common control within the meaning of section 1563(a).

All employees of companies in the controlled group must be considered to determine if a plan maintained by a controlled group member meets the requirements of sections 401, 408(k), 408(p), 410, 411, 415, and 416.

Section 414(c) applies to controlled group of trades or businesses (whether or not incorporated), such as partnerships and proprietorships. Since section 1563 was written only for corporations, Treasury Regulations 1.414(c)-1 through 1.414(c)-5 mirror the section 1563 controlled group principles.

The definitions and examples used in this chapter refer to both section 414(b) and 414(c) controlled groups.

Three Types of Controlled Groups

A control group relationship exists if the businesses have one of the following relationships:

– Parent-subsidiary,

– Brother-sister, and

– Combination of the above

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Definition: Controlled Group, Continued

Parent-subsidiary Group

A parent-subsidiary controlled group exists when one or more chains of corporations are connected through stock ownership with a common parent corporation; and

– 80 percent of the stock of each corporation, (except the common parent) is owned by one or more corporations in the group; and

– Parent Corporation must own 80 percent of at least one other corporation.

Sections 1563(a) and 414(b) and (c).

Sections 1563(a) and 414(b) and (c)- Example 1

The following examples illustrate the parent-subsidiary rules:

Example 1

Redwood Corporation owns:

– 90% of the stock of Bond Corporation,
– 80% of the stock of Greene Corporation, and
– 65% of the stock of Teller Corporation.

Unrelated persons own the percentage of stock not owned by Redwood Corporation.

Redwood Corporation owns 80% or more of the stock of the Bond and Greene Corporations. Therefore, Redwood Corporation is the common parent of a parent-subsidiary group consisting of Redwood, Bond, and Greene. Teller Corporation is not a member of the group because Redwood Corporation's ownership is less than 80%.

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Definition: Controlled Group, Continued

Sections 1563(a) and 414(b) and (c)- Example 1 (continued)- Example 2

Example 2

Assume the same facts as in the previous example and assume further that Greene Corporation owns 80% of the profits interest in XYZ Partnership.

Redwood Corporation is the common parent of a parent-subsidiary group consisting of Redwood, Bond, Greene and XYZ. The results would be same if Redwood Corporation, rather than Greene Corporation owned the 80% interest in XYZ.

Brother- Sister Group

A brother-sister controlled group is a group of two or more corporations, in which five or fewer common owners (a common owner must be an individual, a trust, or an estate) own directly or indirectly a controlling interest of each group and have "effective control".

- Controlling interest - 1.414(c)-2(b)(2) – generally means 80 percent or more of the stock of each corporation (but only if such common owner own stock in each corporation); and

- Effective control – 1.414(c)-2(c)(2) – generally more than 50 percent of the stock of each corporation, but only to the extent such stock ownership is identical with respect to such corporation.

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Definition: Controlled Group, Continued

Example-Brother-Sister Ownership Test

Adams Corp and Bell Corp are owned by four shareholders, in the following percentages:

Percentage of Ownership

Shareholder	Adams Corp	Bell Corp
A	80%	20%
B	10	50
C	5	15
D	5	15
TOTAL	100%	100%

To meet the first part of the test in section 1563(a)(2)(A), the same five or fewer common owners must own more than 80% of stock or some interest in all members of the controlled group.

In this example, the four shareholders together own 80% or more of the stock of each corporation, the first test is met, since the shareholders own 100% percent of the stock.

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Definition: Controlled Group, Continued

50 Percent Test-Example

Shareholder	Identical Ownership Percentage in both Corps.
A	20%
B	10
C	5
D	5
TOTAL	40%

To meet the second part of the test in Section 1563(a)(2)(B), the same five or fewer common owners must own more than 50% of each corporation, taking into account the stock ownership of each person only to the extent such stock ownership is identical with respect to each such corporation.

In this example, although the four shareholders together own 80% or more of the stock of each corporation, they do not own more than 50% of the stock of each corporation, taking into account only the identical ownership in each corporation as demonstrated above.

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Definition: Controlled Group, Continued

Example-Brother-Sister Group not established

The following individuals each own 12% to 13% of the stock in Tate Corp and also Ward Corp.

Individual Corp	Percentage of Tate Corp	Percentage of Ward
A	12	12
B	12	12
C	12	12
D	12	12
E	13	13
F	13	13
G	13	13
H	13	13

Any grouping of five of the shareholders will own more than 50% of the stock in each corporation and all shareholders in any of the groupings will own identical amounts.

But, Tate and Ward are not members of a brother-sister group because, the same five or fewer individuals do not own at lease 80% of each corporation's stock.

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Definition: Controlled Group, Continued

Combined Group

A combined group consists of three or more organizations that are organized as follows:

- Each organization is a member of either a parent-subsidiary or brother-sister group; and
- At least one corporation is the common parent of a parent-subsidiary; and is also a member of a brother-sister group.

Combined Group-Example

A is an individual owning:

- 80% in York Partnership; and
- 90% in Sharp Corporation

York Partnership owns 85% of Tripp Corporation

York Partnership, Sharp Corporation and Tripp Corporation are each members of the same combined group of trades or businesses under common control because

- York Partnership, Sharp Corporation, and Tripp Corporation are each members of either a parent-subsidiary or a brother–sister group, and
- York is:
  - ➢ the common parent of the parent-subsidiary group consisting of York and Tripp; and
  - ➢ A member of a brother-sister group consisting of York and Sharp.

Attribution Rules

Introduction

Attribution is the concept of treating a person as owning an interest in a business that is not actually owned by that person. Attribution may result from family or business relationships. Section 1563 attribution is used in determining a controlled group of businesses, under section 414(b) and (c).

Important Note

Although the following attribution rules are written in terms of stock ownership, the same principles are applied for organizations that are not incorporated.

In the case of a:	Ownership relates to the:
Trust or estate	Actual interest
Partnership	Capital or profits
Sole proprietorship	Sole proprietorship

When calculating ownership interests, use the greater of:

– Corporate ownership – voting stock or value of stock

– Partnership ownership – capital or profits

Section 1563 Attribution

Section 1563 contains the rules of attribution used to determine "control" for the following:

– Controlled groups of corporations (section 414 (b)); and

– Trades or businesses, whether or not incorporation, which are under common control (section 414 (c)).

Also see Treas. Reg. § 1.414(c)-4.

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Attribution Rules, Continued

General Rules for Family Attribution

The following table is a general description of how the family attribution rules are applied to controlled groups.

Note: the following family attribution rules only apply to a brother-sister controlled group and do not apply to a parent-subsidiary controlled group.

THE OWNERSHIP INTERESTS OF:	Are attributed to:	
Spouse	Spouse	EXCEPTION: No attribution between spouses if there is no: • direct ownership, • participation in company, and • no more than 50% of business gross income is passive investments. See 1.414(c)-4(b)(5)(ii).
Minor child (under age 21)	Parent	
Parent	Minor child (under age 21)	
Parent	Adult child (age 21 or older)	ONLY IF: Adult child owns greater than 50% of that business.
Adult child	Parent	ONLY IF: Parent owns greater than 50% of that business.
Grandparent	Minor or Adult child	ONLY IF: Minor/Adult child owns greater than 50% of that business.
Minor or Adult child	Grandparent	ONLY IF: Grandparent owns greater than 50% of that business.
Sibling	None	None

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Attribution Rules, Continued

Examples-family attribution

The following examples illustrate the family attribution rules:

Example 1-family attribution

Ada and Barton are married. Barton is a doctor owning 100% of his medical practice. Ada is also a doctor and owns 50% of a separate medical practice (the other 50% is owned by an unrelated doctor).

Barton is not an employee or owner of a direct interest in Ada's practice and less than 50% of the gross income in Ada's practice is from passive investments. Barton, however, is in charge of significant management activities for his wife's practice.

Ada does not directly own an interest or participate in Barton's practice and less than 50% of the gross income from Barton's practice is from passive investments.

- Barton is attributed the 50% interest that Ada owns in her practice (due to his participation in Ada's practice).
- Ada is not attributed any ownership interest in Barton's practice.

Example 2

Clare, age 25 is the daughter of Dana. Dana owns 75% of XYZ Corporation and Clare own the remaining 25%.

Since Dana owns more than 50% of XYZ, her ownership is attributed to Clare.

Since Clare does not own more than 50% of XYZ, her ownership is not attributed to Dana.

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Attribution Rules, Continued

General Rules for Organizational. Attribution

The following table is a general description of how the attribution rules for organizations are applied to controlled groups.

The ownership interest:	Are attributed to:
From a corporation to its shareholder • Applicable to brother-sister controlled group only.	Corporate ownership interests attributed, proportionately *, to shareholders (owning at least 5% of corporate stock).
From a partnership to its partners • Applicable to brother-sister controlled group only.	Partnership ownership interests attributed, proportionately *, to partners having at least 5% or more capital or profits interest.
From a trust to its beneficiaries • Applicable to brother-sister and parent-subsidiary controlled groups.	Trust ownership interests attributed, proportionately *, to beneficiaries having 5% or more actuarial interest.
To an organization	None

General Rules – Orginazational Attribution

* The interest owned is proportionate to the individual's share of the organization's value.

For example, a shareholder's interest in a corporation is proportionate share of the total stock value of the corporation.

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Attribution Rules, Continued

Organizational Attribution Rules

The following examples illustrate the organizational attribution rules:

Example 1

Elliott owns 70% of the stock in the Fairfield Corporation. Grant owns 20% of the stock and four other individuals who each own less than 5% own the remaining 10%. The Fairfield Corporation has a 30% stock ownership in the Hale Corporation.

The Hale stock is attributed to Elliott and Grant in proportion to their ownership interests in the Fairfield Corporation as follows:

Elliott is treated as a 21% owner of Hale Corporation.

- 70% (interest in Fairfield) x 30% (Fairfield's interest in Hale)

Grant is treated as a .06 % owner of Hale Corporation.

- 20% (interest in Fairfield) x 30% (Fairfield's interest in Hale)

Since each of the four remaining shareholders of Fairfield Corporation own less than 5%, they are not treated as owning any interest in Hale Corporation.

Example 2

The Isanti Group is a partnership. Jay owns a 70% interest in Isanti, and Kendall owns a 30% interest. The Isanti Group owns 50% of the stock of Lake Investments Corporation.

The Lake stock is attributed to Jay and Kendall in proportion to their partnership interests in Isanti as follows:

Jay is treated as a 35% owner of Lake Corporation (70% x 50%).

Kendall is treated as a 15% owner of Lake Corporation (30% x 50%).

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Attribution Rules, Continued

Other Rules under Section 1563

After an individual is attributed the ownership of a family member, the interest *does not get attributed from the individual to another family member.*

However:

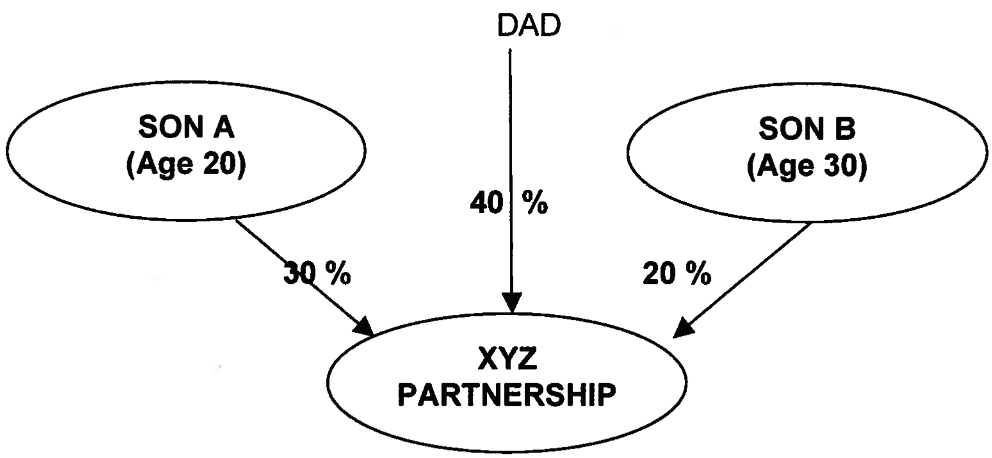
1. The ownership interests of an individual may be attributed *to more than one family member.*

2. After an individual is attributed the ownership of a corporation, partnership or trust, the interest may then be taken into account under other attribution rules.

Options to acquire stock are, generally, treated as stock ownership under IRC section 1563. Refer to Rev. Rul. 68-601 and *North American Industries, Inc. v. Commissioner*, 33 TCM 1275 (1974) for further information.

Example-Attribution to More than One Family Member-facts

The following example illustrate attribution to more than one family member



An unrelated person owns the remaining interest in XYZ.

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Attribution Rules, Continued

Dad-Ownership percentage

Dad is considered to own a total of 90% of the profits interest in XYZ Partnership as follows:

- He directly owns 40% of XYZ Partnership,
- He is considered as owning the 30% interest owned by minor Son A, and
- He is also considered as owning the 20% interest of XYZ that is owned by his adult son. Note that generally, the stock ownership of family members who are 21 or older are not attributed to an individual. However, such attribution is required if the individual has effective control. Dad has more than a 50% ownership of XYZ. See 1.414(b)-4(b)(6).

Son A

Son A is considered to own a total of 70% of the profits interest in XYZ:

– He directly owns 30%, and

– He is considered to own the 40% profits interest owned directly by Dad.

Son A is not, however, considered to own the 20% owned directly by Son B (and attributed to Dad).

Son B

– Son B is considered to own a total of 20% of the profits interest in XYZ:

– He directly owns 20%, and

– He is not considered to own the 40% interest of XYZ that is owned by his father. This is because Son B owns only 20% and he would have to own more than 50% in order for his father's interest to be attributed to him.

Continued on next page

Attribution Rules, Continued

Other Rules for Spousal Attribution under Section 1563

The following examples illustrate other spousal attribution rules

<u>Example 1</u>

Marian and Mitchell are the parents of Norton, age 25, and Oliver, age 20. Mitchell has a 45% interest in the Pitkin Corporation and his son, Norton, has a 55% interest.

ATTRIBUTION BETWEEN SPOUSES:

Marian is treated as owning Mitchell's 45% interest in Pitkin, assuming the spousal exception described above is not applicable.

FAMILY ATTRIBUTION IS NOT FURTHER ATTRIBUTED TO ANOTHER FAMILY MEMBER:

The 45% interest attributed to Marian is not further attributed to Oliver.

This rule would not prevent Mitchell's interest from being attributed to Oliver (see below).

Example 2

FAMILY ATTRIBUTION RULES MAY BE APPLIED <u>TO</u> MORE THAN ONE FAMILY MEMBER:

In addition to attributing Mitchell's 45% interest in Pitkin to his wife, Marian, using the rule for attribution between spouses, Mitchell's 45% interest is also attributed to Norton. Since Norton is over age 21 and owns more than 50% of Pitkin, Mitchell's ownership is attributed again to Norton under the family attribution rule for parents and adult children.

Since Oliver is under age 21, Mitchell's 45% interest may be attributed again to Oliver under the family attribution rule for parents and minor children.

NO ATTRIBUTION BETWEEN SIBLINGS:

The 55% interest owned by Norton is not treated as owned by Oliver.

Continued on next page

Attribution Rules, Continued

Example - Other Rules for Organizational Attribution under Section 1563

Assume the same facts as in Example 2. In addition, the Pitkin Corporation has a 50% interest in Rich and Riley, Inc. and Norton is married to Shannon.

ATTRIBUTION RULES APPLIED AFTER ORGANIZATIONAL ATTRIBUTION:

Norton is considered to own a 50% (100% x 50%) interest in Rich and Riley, Inc.

- Norton is treated as owning 100% of Pitkin (55% directly and 45% attributed from his father).
- Shannon is attributed the 50% interest in Rich and Riley, Inc.

Determination Letter Program: Controlled Group Plans

Background

The Employee Plans (EP) Determination Letter Program provides a means whereby plan sponsors may submit their plans to the Service for review. The Service reviews the form of the plan and, if the plan sponsor elects, reviews certain operational features as well. If the plan meets the qualification requirements under 401(a) of the Internal Revenue Code (Code), a favorable determination letter is issued to the plan sponsor. The letter gives the employer reliance on the form of plan.

Controlled Group Pension Plans

When the sponsor of a qualified retirement plan is part of a controlled group, all employers of the group must be treated as a single employer to determine if a plan meets the requirements of sections 401, 408(k), 408(p), 410, 411, 415, 416, and 417.

Rev. Proc 2004-6 : Required Information

When a plan sponsor submits a determination letter application (Forms 5300, 5307, 5310 and 6406), question 6 on the applications, asks if the employer is a member of a controlled group or affiliated service group.

If question 6 is answered "Yes", Rev. Proc. 2004-6 provides certain information about the controlled group. The EP Specialist should secure for review the following information (if not present with the application):

1. All members of the group;
2. Their relationship to the plan employer;
3. The type(s) of plan(s) each member has; and
4. Plans common to all members.

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Overview: Affiliated Service Group

Introduction

As you have learned, section 414(b) and (c) require that all employees of commonly controlled corporations or trades or businesses be treated as employees of a single corporation or trade or business.

By arranging the ownership of related business entities in an artificial manner, the definition of "control" under section 414(b) and (c) and the aggregation rules established by ERISA could be circumvented. In addition, the basic rule that employee plans provide an exclusive benefit for employees or their beneficiaries could be violated.

Section 414(m) was enacted to prevent such circumvention by expanding the idea of control to separate, but affiliated, entities. Proposed Treas. Reg. § 1.414(m) provides that all employees of the members of an affiliated service group shall be treated as if a single employer employed them.

Objectives

At the end of this section, you will be able to identify situations where the plan sponsor is a member of an affiliated service group and recognize the impact on qualified plans. Therefore, you will be able to:

1. Describe the relationship between employers and determine if an affiliated service group exists.

2. Describe the relationship between a first service organization and an A-Organization and determine whether an affiliated service group exists.

3. Describe the relationship between a first service organization and a B-Organization and determine whether an affiliated service group exists.

4. Describe a management organization situation and determine whether an affiliated service group exists.

5. Determine how these relationships affect the status of qualified plans.

6. Describe the procedure for processing a affiliated service group determination letter request.

Describe other employer/employee relationships, such as leased employees, impendent contractors, professional employee organization and management organization

Affiliated Service Group

History

The *Kiddie* v. *Commissioner* 69 T.C. 1055 (1978)) and *Garland* v. *Commissioner* 73 T.C. 5 (1979)) cases addressed the issue of control. The Tax Court held that where a controlled group situation did not exist, it would not be necessary to aggregate employees for purposes of testing for coverage and discrimination.

IRC § 414(m) was enacted to expand the idea of control to separate, but affiliated, entities. Proposed Treas. Reg. § 1.414(m) provides that all employees of the members of an affiliated service group shall be treated as if they were employed by a single employer.

Definition

An affiliated service group is one type of group of related employers and refers to two or more organizations that have a service relationship and, in some cases, an ownership relationship, described in IRC section 414(m). An affiliated service group can fall into one of three categories:

1. A-Organization groups (referred to as “A-Org”), consists of an organization designated as a First Service Organization (FSO) and at least one “A organization”,

2. B-Organization groups (referred to as “B-Org”), consists of a FSO and at least one “B organization”, or

3. Management groups.

First Service Organization

An FSO must be a "service organization":

– Performance of services is the principal business of the organization as defined in section 414(m)(3), and Proposed Treas. Reg. § 1.414(m)-2(f) .

– “Organization” refers to a corporation, partnership, or other organization.

Continued on next page

Affiliated Service Group, Continued

A-Org

To be an A-Org, an organization must satisfy a two-part test:

– Ownership Test

The organization is a partner or shareholder in the FSO (regardless of the percentage interest it owns in the FSO) determined by applying the constructive ownership rules as specified in section 318(a), and

– Working Relationship Test

- The organization "regularly performs services for the FSO," or
- Is "regularly associated with the FSO in performing services for third parties.

Facts and circumstances are used to determine if a working relationship exists. See Proposed Treas. Reg. § 1.414(m)-2(b).

See section 414(m)(2)(A).

Continued on next page

Affiliated Service Group, Continued

B-Org

To be a B-Org, the organization must meet the following requirements:

- A significant portion of its business must be the performance of services for a FSO, for one or more A-Org's determined with respect to the FSO, or for both,
- The services must be of a type historically performed by employees in the service field of the FSO or the A-Org's, and
- Ten percent or more of the interests in the organization must be held, in the aggregate, by persons who are highly-compensated employees (pursuant to IRC § 414(q)) of the FSO or A-Org.

A B-Org **need not** be a service organization.

See IRC § 414(m)(2)(B).

Performance of Services

The principal business of an organization will be considered the performance of services if capital is not a material income-producing factor for the organization, even though the organization is not engaged in a field listed in Proposed Treas. Reg. § 1.414-(m)-2(f)(2) .

Whether capital is a material income-producing factor must be determined by reference to all the facts and circumstances of each case. In general, capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business as reflected, for example, by a substantial investment in inventories, plant, machinery or other equipment.

Capital is a material income-producing factor for banks and similar institutions.

Capital is not a material income-producing factor if the gross income of the business consists principally of fees, commissions or other compensation for personal services performed by an individual.

Continued on next page

Affiliated Service Group, Continued

Specific fields

Regardless of whether the above subparagraph applies, an organization engaged in any one or more of the following fields is a service organization:

– Health,

– Law,

– Engineering,

– Architecture,

– Accounting,

– Actuarial science,

– Performing arts,

– Consulting, and

– Insurance.

An organization will not be considered as performing services

An organization will not be considered as performing services merely because:

- It is engaged in the manufacture or sale of equipment or supplies used in the above fields,
- It is engaged in performing research or publishing in the above fields, or
- An employee provides one of the enumerated services to the organization or other employees of the organization, unless the organization is also engaged in the performance of the same services for third parties.

Continued on next page

Affiliated Service Group, Continued

Commissioner may determine other specific fields

The Commissioner may determine that a specific business field, not enumerated in the proposed regulations, is engaged in performing services. In this case, the above list will be expanded, but only prospectively.

"Organization" defined

The term "organization" includes a sole proprietorship, partnership, corporation or any other type of entity, regardless of its ownership format.

A bona fide expense-sharing arrangement, in which the parties involved share the cost of the office overhead but are not working in unison for common business purposes, would not be considered an organization. These costs would include rent, supplies, maintenance and employees' salaries.

Historically Performed

Services will be considered of a type historically performed by employees in a particular service field if it was not unusual for the services to be performed by employees of organizations in that service field (in the United States) on December 13, 1980.

Professional Service Corporations

All the employees of professional service corporations that are members of an affiliated services group shall be aggregated together and treated as if they were employed by a single employer for purposes of the employee benefit requirements.

A professional service corporation:

- Is a corporation that is organized under state law for the principal purpose of providing professional services,

- Has at least one shareholder who is licensed or otherwise legally authorized to render the type of services for which the corporation is organized, and

- Provides the services performed by certified or other public accountants, actuaries, architects, attorneys, chiropodists, chiropractors, medical doctors, dentists, professional engineers, optometrists, osteopaths, podiatrists, psychologists and veterinarians. The Commissioner may expand the list of services.

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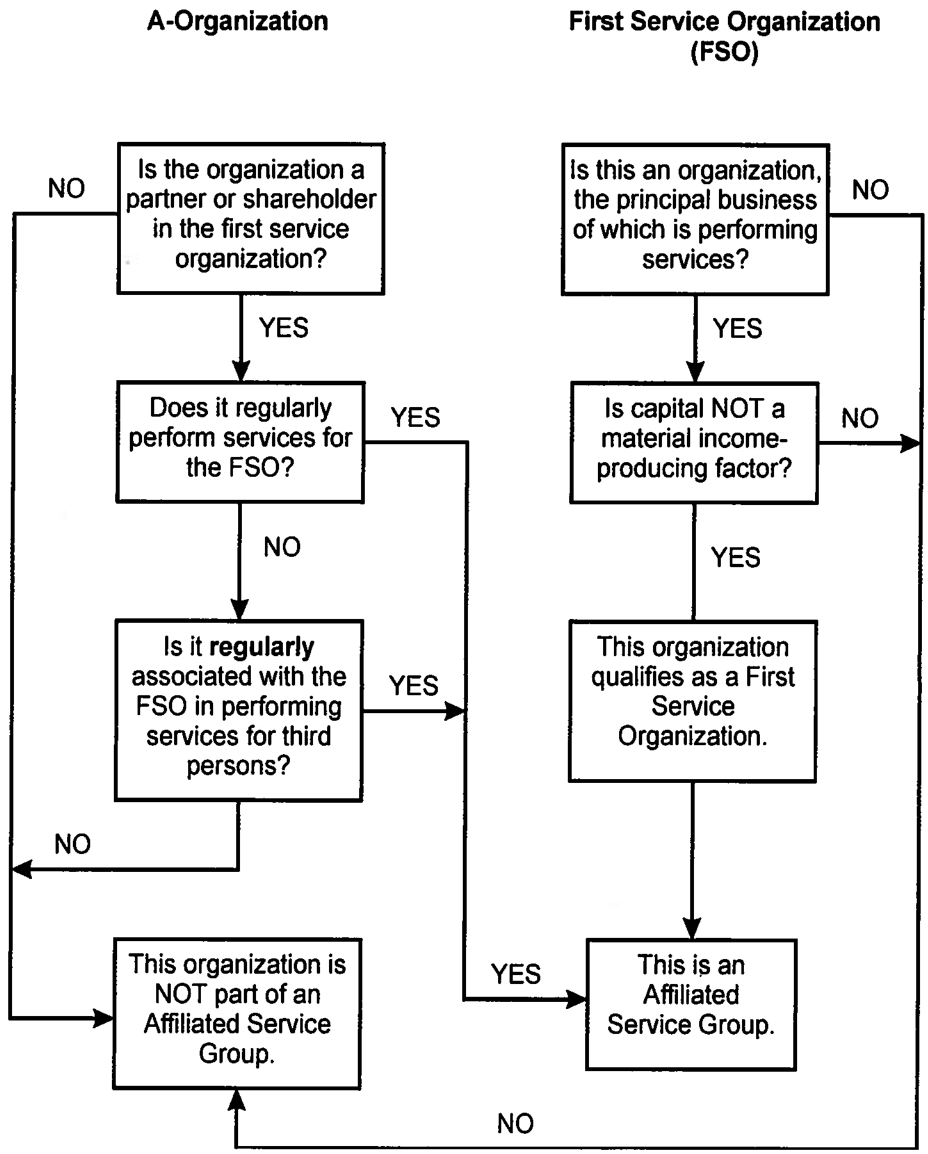
Affiliated Service Group, Continued

Flowchart

Affiliated Service Group



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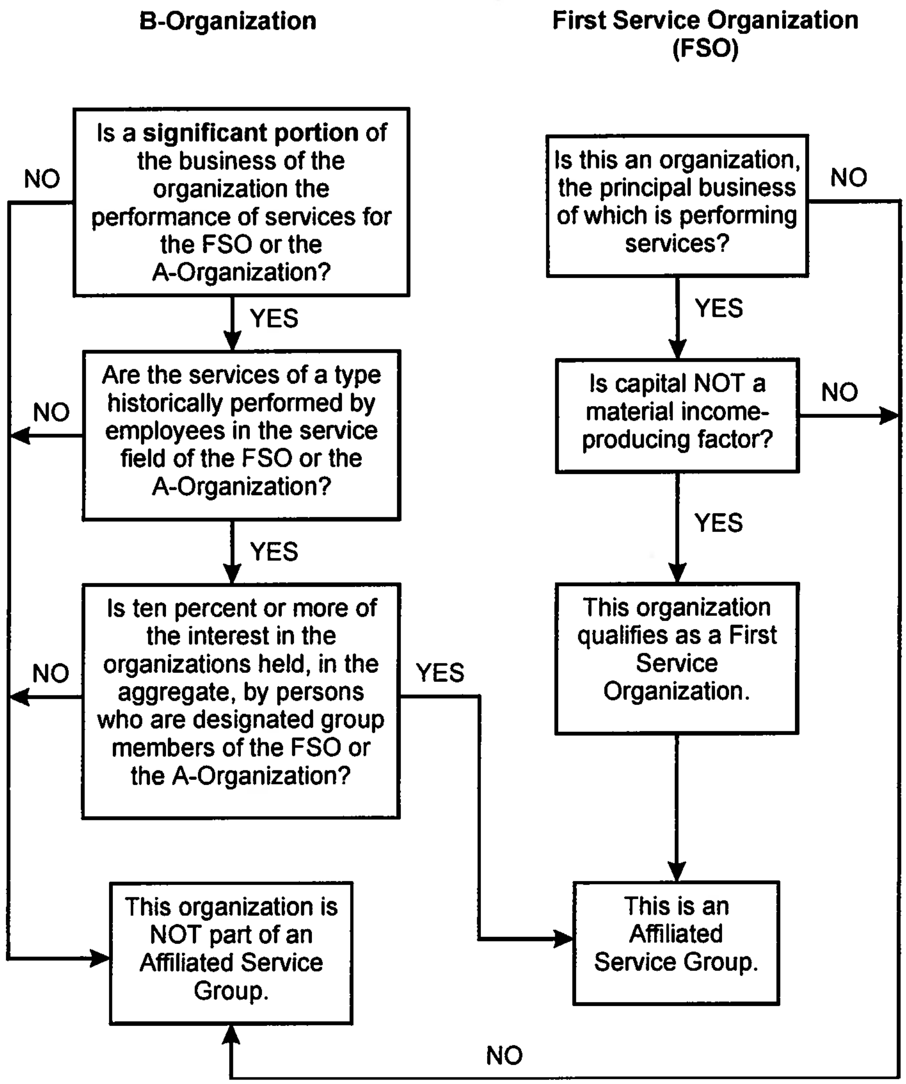
Flowchart

Affiliated Service Group



Affiliated Service Group, Continued

Section 414(m)- Example

Allen Averett, a doctor, is incorporated as Allen Averett, P.C. and this professional corporation is a partner in the Butler Surgical Group. Allen Averett and Allen Averett, P.C., are regularly associated with the Butler Surgical Group in performing services for third parties.

The Butler Surgical Group is an FSO. Allen Averett, P.C. is an A-Org because it is a partner in the medical group and is regularly associated with the Butler Surgical Group to perform services for third parties.

Accordingly, Allen Averett, P.C. and the Butler Surgical Group would constitute an affiliated service group.

As a result, the employees of Allen Averett, P.C. and the Butler Surgical Group must be aggregated and treated as if they were employed by a single employer per section 414(m).

First Service Organization and an A-Org- Example

The Everett, Furman and Guilford Partnership is a law partnership with offices in numerous cities. EFG of Capital City, P.C., is a corporation in Capital City that is a partner in the law firm. EFG of Capital City, P.C. provides paralegal and administrative services for the attorneys in the law firm. All of the employees of the corporation work directly for the corporation, and none of them work directly for any of the other offices of the law firm.

The law firm is an FSO. The corporation is an A-Org because it is a partner in the FSO and is regularly associated with the law firm in performing services for third parties.

The corporation and the partnership would together constitute an affiliated service group. Therefore, the employees of EFG of Capital City, P.C. and the employees of The Everett, Furman and Guilford Partnership must be aggregated and treated as if they were employed as a single employer per section 414(m).

Continued on next page

Affiliated Service Group, Continued

First Service Organization and a B-Org-Example

Reinhardt & Associates is a financial services organization that has 11 partners. Each partner of Reinhardt owns one percent of the stock in Asbury Corporation. Asbury provides services to the partnership of a type historically performed by employees in the financial services field. A significant portion of the business of Asbury consists of providing services to Reinhardt.

Considering Reinhardt &Associates as an FSO, the Asbury Corporation is a B-Org because:

1. A significant portion of its business is in the performance of services for the partnership of a type historically performed by employees in the financial services field. And,

2. More than 10% of the interests in the Asbury Corporation is held, in the aggregate, by the highly-compensated employees of the FSO (consisting of the 11 common owners of Reinhardt and Associates).

Accordingly, the Asbury Corporation & Reinhardt and Associates constitute an affiliated service group. Therefore, the employees of the Asbury Corporations and Reinhardt and Associates must be aggregated and treated as if they were employed by a single employer per section 414(m).

Non Service Organization-Example

Dade Properties, Inc. sells land that it has purchased and developed. Craig is a 25% shareholder of Dade and a 50% shareholder of Craig and Son Construction Company, Inc. Dade Properties regularly engages the services of Craig and Son. Although it appears that Dade Properties could be an FSO, the affiliated service group rules do not apply because Dade Properties is not a service organization.

Affiliated Service Group: Performance of Service

Significant Portion

Proposed Treas. Reg. § 1.414(m)-2(c)(2) specifies that whether providing services (for the FSO, for one or more A-Org's or for both,) is a "significant portion" of the business of an organization will be based on the facts and circumstances.

The following tests may be used to substantiate the facts and circumstances:

– Service Receipts Safe Harbor Test, and

– Total Receipts Threshold Test.

For additional information, see Proposed Treas. Reg. § 1.414(m)-(2)(c)(2).

Service Receipts Safe Harbor

The performance of services for the FSO, for one or more A-Org's, or for both, will not be considered a significant portion of the business of an organization if the "service receipts percentage" is less than five percent.

– The "service receipts percentage" is the ratio of:

1. Gross receipts of the organization derived from performing services for the FSO, for one or more A-Org's, or for both, to
2. Total gross receipts of the organization derived from performing services.

– This ratio is the greater of:

1. the ratio for the year for which the determination is being made, or
2. the ratio for the three-year period including that year and the two preceding years (or the period of the organization's existence, if less).

Continued on next page

Affiliated Service Group: Performance of Service, Continued

Total Receipts Threshold Test

The performance of services for the FSO, for one or more organizations, or for both, will be considered a significant portion of the business of an organization if the "total receipts percentage" is ten percent or more.

The "total receipts percentage" is calculated in the same manner as the service receipts percentage, except that gross receipts in the denominator are determined without regard to whether they were derived from performing services.

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Affiliated Service Group: Performance of Service, Continued

Service receipts-Example

The income of Cascade Corporation is derived from performing both services and other business activities. The amount of its total receipts and its receipts derived from performing services and its total receipts from Starr Corporation and from all customers is provided below:

	Origin of Income	All Customers	Starr Corp.
Year 1	Services	$ 100	$ 4
	Total	$120	
Year 2	Services	150	9
	Total	180	
Year 3	Services	200	42
	Total	240	

Service Receipts Percentage

In **Year 2**, the services receipts percentage is the greater of:

1. The ratio for that year ($9/$150, or 6%), or
2. For Years 1 and 2 combined ($13/$250, or 5.2 %).

= 6%

The total receipts percentage is the greater of:

1. The ratio for that year ($9/$180, or 5%), or
2. For Years 1 and 2 combined ($13/$300, or 4.3%).

= 5%

The services receipts percentage is greater than 5% and, therefore, the Service Receipts safe harbor is not met.

The total receipts percentage is less than 10% and, therefore, the Total Receipts threshold test is not met.

As a result, for Year 2, facts and circumstances is used to determine whether performing services for Starr Corporation constitutes a significant portion of the business of Cascade Corporation.

Affiliated Service Group: Performance of Service, Continued

Total Receipts Percentage

In **Year 3**, the services receipts percentage is the greater of:

1. the ratio for that year ($42/$200, or 21%), or
2. for Years 1, 2, and 3 combined ($55/$450, or 12.2%).

= 21%.

The total receipts percentage is the greater of:

1. the ratio for that year ($42/$240, or 17.5%), or
2. for Years 1, 2, and 3 combined ($55/$540, or 10.2%).

= 17.5%

Because the total receipts percentage is greater than 10% and the services receipts percentage is not less than 5%, a significant portion of the business of Cascade Corporation is considered to be the performances of services for Starr Corporation.

For Year 3, therefore, the Cascade Corporation and the Starr Corporation are part of an affiliated service group within the meaning of section 414(m), and the employees of both corporations must be aggregated and treated as if they were employed by a single employer.

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Affiliated Service Group: Performance of Service, Continued

Example-Total Receipts, Percentage Test

Marsha Mesa owns one-third of an employee benefits consulting firm, Benefits by Marsha. Marsha also owns one-third of an insurance agency, Mesa, Long and Toole Insurance Agency. A significant portion of the business of Benefits by Marsha consists of assisting the Mesa, Long and Toole Insurance Agency in developing employee benefit packages for sale to third persons and providing services to the insurance company in connection with employee benefit programs sold to other clients of the Mesa, Long and Toole Insurance Agency.

Additionally, Benefits by Marsha frequently provides services to clients who have purchased insurance arrangements from the Mesa, Long and Toole Insurance Agency for the employee benefit plans they maintain. Mesa, Long and Toole Insurance Agency frequently refer clients to Benefits by Marsha to assist them in the design of their employee benefit plans. Twenty percent of the total gross receipts of Benefits by Marsha represent gross receipts from the performance of these services for the Mesa, Long and Toole Insurance Agency.

Considering Mesa, Long and Toole Insurance Agency as a FSO, Benefits by Marsha is a B-Org because:

- A significant portion of the business of Benefits by Marsha (as determined under the total receipts percentage test) is the performance of services for Mesa, Long and Toole Insurance Agency of a type historically performed by employees in the service field of insurance, and

- More than 10% of the interests in Benefits by Marsha is held by owners of the Mesa, Long and Toole Insurance Agency.

Thus, Mesa, Long and Toole Insurance Agency and Benefits by Marsha constitute an affiliated service group, and the employees of both companies must be aggregated and treated as if they were employed by a single employer.

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Affiliated Service Group: Performance of Service, Continued

Example-Gross Receipts Derived from Performing Services

Calvin Cameron is a 60% partner in Decatur, a service organization, and regularly performs services for Decatur. Cameron is also an 80% partner in Fleming Brothers. A significant portion of the gross receipts of Fleming Brothers is derived from providing services to Decatur of a type historically performed by employees in the service field of Decatur.

If Decatur is an FSO, then Fleming Brothers would be a B-Org because:

- A significant portion of gross receipts of Fleming Brothers is derived from performing services for Decatur of a type historically performed by employees in that service field, and

- More than 10% of the interests in Fleming Brothers is held by a highly-compensated employee, Calvin Cameron (who is a common owner of Decatur).

Accordingly, Decatur and Fleming Brothers constitute an affiliated service group. Additionally, the employees of Decatur and Fleming Brothers are aggregated under the rules of section 414(c). Thus, any plan maintained by a member of the affiliated service group must satisfy the aggregation rules of section 414 (c) and 414 (m).

The aggregation rules of section 414(c) and 414(m) require all employees of the "employer" to be aggregated and treated as if they were employed by a single employer. The "employer" is Decatur and Fleming Brothers.

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