

**Congress of the United States**  
**U.S. House of Representatives**  
**Committee on Small Business**  
2361 Rayburn House Office Building  
Washington, DC 20515-6315

**Memorandum**

To: Members, Committee on Small Business  
From: Committee Staff  
Date: December 2, 2013  
Re: Hearing: "The Health Care Law and the Business Aggregation Rules"

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On December 4, 2013 at 1:00 p.m., the Committee on Small Business will meet in Room 2360 of the Rayburn House Office Building for the purpose of receiving testimony on the health care law's use of the business aggregation rules, and their effect on small businesses.

**I. Background**

Under the health care law,<sup>1</sup> a small business owner may have many responsibilities. One of the first is to determine whether he or she is considered under the law and regulations to be a "large employer" and, therefore, required to offer full-time employees health insurance (the "employer mandate").<sup>2</sup> To do that, the employer calculates the number of full-time or full-time equivalent employees. According the law, in totaling the employees, the employer must use the controlled group (or common ownership) principles<sup>3</sup> embodied in the Internal Revenue Code and the Employee Retirement Income Security Act (ERISA).<sup>4</sup> This language was included to prevent businesses from dividing into smaller ones to avoid the employer mandate's requirement that employers with 50 or more workers offer health insurance to their full-time employees.

These rules are complex and can be confusing for small business owners, who often do not have in-house human resources departments, accountants or attorneys.<sup>5</sup> However, the calculations are critical, and may mean the difference of hundreds or thousands of dollars to a small firm. This hearing will provide an opportunity for Members to learn more about the controlled group rules and how they affect the employer mandate.

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<sup>1</sup> Pub. L. No. 111-148, 124 Stat. 119 (2010).

<sup>2</sup> I.R.C. § 4980H(a), (b).

<sup>3</sup> 29 U.S.C. § 414(b), (c).

<sup>4</sup> Pub. L. No. 93-406, 88 Stat. 829 (1974).

<sup>5</sup> *Delay of the Employer Mandate: Hearing before the House Committee on Ways and Means Health Subcommittee*, 113<sup>th</sup> Cong. 2, 4 (July 10, 2013) (testimony of William J. Dennis, Jr., Senior Research Fellow, National Federation of Independent Business), available at [http://waysandmeans.house.gov/uploadedfiles/071013\\_hl7\\_dennis\\_testimony\\_final.pdf](http://waysandmeans.house.gov/uploadedfiles/071013_hl7_dennis_testimony_final.pdf).

## II. The Employer Mandate

The health care law requires businesses with 50 or more full-time or full-time equivalent (FTE) employees to offer minimum affordable health insurance to all full-time employees or pay a penalty.<sup>6</sup> A full-time employee is one who works an average of 30 hours per week,<sup>7</sup> and an FTE is a part-time employee who works a total number of hours sufficient to be considered full-time.

The total number of employees in a business may be difficult enough to tally, but when an entrepreneur holds an ownership interest – even a very small one – in another business, then the calculation becomes even more challenging.

## III. Ownership of Multiple Businesses

According to the National Federation of Independent Business (NFIB), 24% of employing small business owners also own at least 10% of one or more other business.<sup>8</sup> And 56% of those multiple business owners own at least one additional business.<sup>9</sup> In sum, this means that about 13% of small employers have a 10% or more interest in at least three employing businesses.<sup>10</sup>

Small business owners have expressed concern about how the employees of these secondary businesses are accounted for in determining if they are to be considered a “large business” under the health care law. Are those workers to be counted as part of their employee total? Are they counted as part of another partial owner’s total? Are they somehow shared? What is the definition of “business”? These are critically important questions, because they could mean the difference in an employer being considered a “large employer” under the law, being required to offer health insurance or not, or being required to pay a penalty for not offering insurance.

Under the health care law and its regulations, the Internal Revenue Code’s (IRC) business aggregation rules are to be used for the purpose of counting the number of employees.<sup>11</sup> The IRS posted a guidance document on its website to assist employers in determining their employee count, but that document has been removed, reportedly for updating.<sup>12</sup> In a September 6, 2013 letter to

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<sup>6</sup> 124 Stat. 119, 253.

<sup>7</sup> I.R.C. § 54.4980H-1(a)(18). *See also* DETERMINING FULL-TIME EMPLOYEES FOR PURPOSES OF SHARED RESPONSIBILITY FOR EMPLOYERS REGARDING HEALTH COVERAGE, INTERNAL REVENUE SERVICE, Notice 2012-58, *available at* <http://www.irs.gov/pub/irs-drop/n-12-58.pdf>.

<sup>8</sup> Comment Letter on Shared Responsibility for Employers Regarding Health Coverage Proposed Rule from National Federation of Independent Business to Internal Revenue Service, March 18, 2013. *See also* Memorandum from William J. Dennis, Jr., Senior Research Fellow, National Federation of Independent Business, (2013) (on file with the Committee), *citing* 12 BUSINESSES WITHIN FAMILIES, NATIONAL SMALL BUSINESS POLL, NFIB RESEARCH FOUNDATION, WILLIAM J. DENNIS, JR., ED. (2012).

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> I.R.C. § 4980H(c)(2) (C)(1). *See also* Shared Responsibility for Employers Regarding Health Coverage, 78 Fed. Reg. 221 (January 2, 2013) (to be codified at 26 C.F.R. pts. 1, 54 and 301).

<sup>12</sup> Internal Revenue Service, Questions and Answers on Employer Shared Responsibility Provisions Under the Affordable Care Act, formerly *available at* <http://www.irs.gov/uac/Newsroom/Questions-and-Answers-on-Employer-Shared-Responsibility-Provisions-Under-the-Affordable-Care-Act>.

Acting IRS Commissioner Werfel, Chairman Graves express concern that the business aggregation rules are extremely complicated, small business owners may not be aware of them, and even if they are, they may not have the expertise to determine precisely how they apply.<sup>13</sup> Chairman Graves also requested that the IRS issue guidance soon to clarify the rules for small business owners.<sup>14</sup>

In his response of October 17, 2013, Acting Commissioner Werfel said, "We understand that although the section 414 employer aggregation rules are complicated and confusing to many small business owners...."<sup>15</sup> "[T]he section 414 employer aggregation rules, including the regulations, have been effective for many years, [and] small business owners who do not sponsor qualified retirement plans may be unfamiliar with how they operate. Therefore, we intend to update the Frequently Asked Questions (FAQs) on our website to help small business owners in interpreting the requirements of the section 414 employer aggregation rules."<sup>16</sup> At the time of this memorandum's writing, the FAQs had not been updated.

To better understand how the business aggregation rules may apply to small employers, we will now take a closer look at the rules themselves.

#### **IV. The Business Aggregation Rules**

The health care law states that all persons treated as a single employer under the business aggregation rules of the Internal Revenue Code shall be treated as one employer.<sup>17</sup> Similarly, the IRS's proposed rule on the employer mandate provides that all entities owned by an individual be treated as a single employer. The proposed rule goes on to say that all employees of a controlled group or affiliated service group are taken into account when determining whether the member of the controlled group or affiliated service group together constitute an applicable large employer.<sup>18</sup> Generally, a controlled group is a collection of two or more corporations with common stock ownership that are connected in one of several ways.

##### **A. Controlled Groups**

The Revenue Act of 1964<sup>19</sup> established controlled groups as a part of the Internal Revenue Code.<sup>20</sup> Originally, these provisions were adopted to encourage the formation of small businesses, which at the time generally operated in the corporate structure.<sup>21</sup>

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<sup>13</sup> Letter from Sam Graves, Chairman, Committee on Small Business, U.S. House of Representatives, to Daniel Werfel, Acting Commissioner, Internal Revenue Service 2 (September 6, 2013) (on file with the Committee).

<sup>14</sup> *Id.*

<sup>15</sup> Letter from Daniel Werfel, Acting Commissioner, Internal Revenue Service, to Sam Graves, Chairman, Committee on Small Business, U.S. House of Representatives 2 (October 17, 2013) (on file with the Committee).

<sup>16</sup> *Id.*

<sup>17</sup> Pub. L. No. 111-148, 124 Stat. 119, 254 (2010).

<sup>18</sup> 78 Fed. Reg. 221.

<sup>19</sup> Pub. L. No. 88-272, 78 Stat. 20 (1964).

<sup>20</sup> I.R.C. § 1563.

<sup>21</sup> LARRY LAWSON AND JEFF NELSON, TAX-EXEMPT AND GOVERNMENT ENTITIES, INTERNAL REVENUE SERVICE, CONTROLLED AND AFFILIATED SERVICE GROUPS, available at <http://www.irs.gov/pub/irs-tege/epchd704.pdf> [hereinafter Controlled and Affiliated Service Groups].

The Employee Retirement Income Security Act of 1974 (ERISA)<sup>22</sup> added sections 414(b) and 414(c). These two sections require all employees of corporations, trades or businesses that are commonly controlled be treated as employees of a single entity.<sup>23</sup>

There are three types of controlled groups: 1) parent-subsidary groups; 2) brother-sister groups; and 3) a combination of the first two groups. A parent-subsidary group exists when a parent organization owns at least 80% of one or more of the subsidiary corporations, and 80% of at least one other corporation.<sup>24</sup> EXAMPLE: Corporation A owns 90% of Blue Corporation, 80% of Yellow Corporation, and 65% of Orange Corporation. The remaining stock is owned by unrelated entities. A parent-subsidary group exists because Corporation A owns 80% or more of Blue Corporation and Yellow Corporation.<sup>25</sup>

A brother-sister group exists when two or more corporations, with five or fewer common owners,<sup>26</sup> 1) own directly or indirectly a controlling interest of each group; and 2) have "effective control."<sup>27</sup> Effective control typically means control of more than 50% of the voting stock of each corporation.<sup>28</sup> EXAMPLE: Blue Corporation and Red Corporation are owned by four shareholders:

	Ownership Percentage	
	Blue Corporation	Yellow Corporation
Shareholder A	75%	30%
Shareholder B	5%	60%
Shareholder C	5%	5%
Shareholder D	10%	5%

The first test of controlling interest is met, because five or fewer shareholders own more than 80% of stock in the controlled group. For the second test, assume the shareholders have the following holdings:

	Ownership Percentages in Blue Corporation and Yellow Corporation	
	Blue	Yellow
Shareholder A	10%	10%
Shareholder B	5%	5%
Shareholder C	5%	5%
Shareholder D	5%	5%
Total	25%	25%

<sup>22</sup> Pub. L. No. 93-406, 88 Stat. 829 (1974).

<sup>23</sup> I.R.C. §§ 414(b),(c).

<sup>24</sup> CONTROLLED AND AFFILIATED SERVICE GROUPS at 7-5.

<sup>25</sup> A similar example is provided in CONTROLLED AND AFFILIATED SERVICE GROUPS at 7-5.

<sup>26</sup> A common owner must be an individual, a trust or an estate. CONTROLLED AND AFFILIATED GROUPS at 7-6.

<sup>27</sup> CONTROLLED AND AFFILIATED GROUPS at 7-6.

<sup>28</sup> 26 C.F.R. § 1.414(c)-2(c)(2).

A brother-sister group does not exist. Although together the four shareholders own 80% or more of the stock of each corporation in the first test, they do not own more than 50% of the stock of each corporation to meet the second test.<sup>29</sup>

A combined group is a combination of a parent-subsidary and a brother-sister group, with the parent company also a sibling in the brother-sister group.<sup>30</sup>

#### *B. Attribution Rules*

Attribution occurs when a person is treated as though he owns an interest in a business when it is not actually owned by him.<sup>31</sup> This attribution may be the result of family or business relationships;<sup>32</sup> for example, if an individual owns stock in an incorporated or unincorporated business, has an interest in a partnership, or is the beneficiary of an estate.

Generally, under the attribution rules, for brother-sister controlled group situations, the ownership interests of a spouse have been attributed to the other spouse.<sup>33</sup> The interests of a parent have been attributed to a minor or adult child, and the interests of an adult child have been attributed to a parent.<sup>34</sup> Some experts and small business owners believe that these rules, which, along with their regulations, have been in place for many years, are outmoded and no longer workable, particularly for small businesses.

### **V. The Business Aggregation Rules and Small Businesses**

The proposed rule issued by the Department of the Treasury earlier this year<sup>35</sup> gives an example of how the business aggregation rules are to be used:

[I]f an applicable large employer is comprised of a parent corporation and 10 wholly owned subsidiary corporations, each of the 11 corporations, regardless of the number of employees, is an applicable large employer member.

78 Fed. Reg. 221.

Unfortunately, not every business structure fits neatly into these parameters. This can be particularly true for small business structures. For example, today, men and women now own and operate businesses that are completely separate and unrelated to their spouse's business, when that may not have been the case years ago. Some small business owners have expressed confusion and

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<sup>29</sup> A similar examples are provided in CONTROLLED AND AFFILIATED SERVICE GROUPS at 7-7 and 7-8.

<sup>30</sup> CONTROLLED AND AFFILIATED SERVICE GROUPS at 7-10.

<sup>31</sup> CONTROLLED AND AFFILIATED SERVICE GROUPS at 7-11.

<sup>32</sup> *Id.*

<sup>33</sup> There are exceptions to the general rule if there is no direct ownership, participation in the company or if more than 50% of the business's gross income is passive in nature. CONTROLLED AND AFFILIATED SERVICE GROUPS at 7-12.

<sup>34</sup> CONTROLLED AND AFFILIATED SERVICE GROUPS at 7-12.

<sup>35</sup> Shared Responsibility for Employers Regarding Health Coverage, 78 Fed. Reg. 218 (Jan. 2, 2013), *available at* <http://www.gpo.gov/fdsys/pkg/FR-2013-01-02/pdf/2012-31269.pdf>.

concern that with the health care law's application of the attribution rules to the employer mandate, an interest they maintain in their business may be wrongly construed as owned by their spouse, or vice versa.<sup>36</sup> Incorrect attribution of the employees in a spouse's or family member's firm may work to tip their business over the 50 employee threshold and subject it to the employer mandate's requirement to offer employees health insurance. In addition, some small business owners own a single firm, but also own a portion of another or multiple other businesses, many of which may involve multiple family members as co-owners.<sup>37</sup>

The employer mandate proposed rule stated that the use of the rules is "consistent with longstanding standards that apply for other tax and employee benefit purposes."<sup>38</sup> However, as the National Federation of Independent Business (NFIB) mentioned in its comment letter on the proposed rule, these rules have traditionally not been applied to smaller businesses, because many of them do not have the retirement savings vehicles or other benefits to which the rules apply.<sup>39</sup> Furthermore, as NFIB went on to say, typically small business owners lack the specific technical knowledge needed to ascertain the full effect of the rules.<sup>40</sup>

## **VI. Conclusion**

The business aggregation rules can be complicated and difficult even for experts to decipher. The health care law's employer mandate provision applies these rules to help determine to which business employees should be attributed. Because many entrepreneurs own multiple businesses, or share ownership of multiple businesses, sometimes with family members, it can be confusing for small business owners to determine how to account for the employees. Some small business owners and experts feel the rules are outdated and should be replaced.

This hearing will provide an opportunity for Committee members to learn more about the rules, their application, and possible solutions to these issues.

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<sup>36</sup> National Federation of Independent Business Affordable Care Act Survey 10, October 31, 2013.

<sup>37</sup> *Id.*

<sup>38</sup> Shared Responsibility for Employers Regarding Health Coverage, 78 Fed. Reg. 218, 221 (Jan. 2, 2013), *available at* <http://www.gpo.gov/fdsys/pkg/FR-2013-01-02/pdf/2012-31269.pdf>.

<sup>39</sup> Comment Letter from the National Federation of Independent Business to the Internal Revenue Service, Shared Responsibility for Employers Regarding Health Coverage, Proposed Rule 2, March 18, 2013.

<sup>40</sup> *Id.*