“The Health Care Law, The Effect of the Business Aggregation Rules on Small Business”

Testimony of:

Deborah Walker, CPA
National Director, Compensation & Benefits
Cherry Bekaert LLP
Washington, DC

Before the

Committee on Small Business
United States House of Representatives

December 4, 2013

The Honorable Sam Graves (R-MO), Chairman
The Honorable Nydia Velazquez (D-NY), Ranking Member

Good afternoon Chairman Graves, Ranking Member Velazquez and members of the Committee. Thank you for hosting this important hearing on the effect of the business aggregation rules on small business in applying the health care law. I am Deborah Walker, a CPA with over 35 years of experience in the Employee Benefits area. I am currently National Director of Compensation and Benefits for Cherry Bekaert LLP. I welcome this opportunity to discuss this important issue and offer an alternative approach

Executive Summary

In order to determine if an employer is subject to the shared responsibility rules of the Affordable Care Act, the employer must determine if at least 50 full time equivalents are employed on business days during the preceding taxable year. Prior to making this calculation, the business needs to determine what trades or businesses comprise the employer. The employer includes the business and related entities, including entities related by common ownership and by attribution of ownership from one party to another, and certain other businesses that provide services to the business. To make the determination, one needs detailed ownership rules and business relationships between the entities.

The rules used by the Affordable Care Act are the same rules used for determining if qualified retirement plan benefits are available on a nondiscriminatory basis to a fair cross section of employees. The use of bright line tests has enabled tax planners to structure arrangements to avoid the application of the rules. Because the rules have been developed over a number of years to counteract avoidance of the rules by tax planners, they are voluminous and extremely detailed.

In the health care context, this is a test that will only be used by businesses close exceeding the 50-employee limit and, as businesses grow or decline the need for applying the test evaporates. Such a complicated test for such few taxpayers is not warranted. In addition, one can expect that the employers close to exceeding the limit will make business decisions that would result in increased hiring by taking into account the increased cost of mandated health care.

An employer can choose to offer a retirement plan or not, and in so doing accepts the application of these rules. For mandated health benefits, the employer does not have a choice of whether to be involved with these rules. For this reason, these rules are not appropriate to define the employer for the Affordable Care Act. Applying the same business aggregation rules to a mandated benefit that exist for purposes of preventing discrimination for voluntary employer provided benefits can lead to inefficient and unwanted economic behavior. This behavior constrains a small business and may lead to unwanted and unwelcome business decisions including not hiring additional works that ensure the small business is not subject to the rules.

Many small employers who offer a retirement plan offer a safe harbor IRC Section 401(k) plan that does not require discrimination testing. Thus, many small employers do not have to make this determination except for determining the applicability of the shared responsibility rules of the Affordable Care Act and the groups of employees for whom minimum essential coverage is required to be provided. Because many small employers have never had to use these rules, avoiding them with the use of safe harbor qualified retirement plans or not offering a qualified retirement plan, the rules are not familiar to them. This is true for many of the advisers to small businesses. What we have here are rules that only a small subset of tax practitioners are familiar with and apply. Even those that apply the rules, as I and other benefits practitioners do, apply them on an infrequent basis, perhaps 4-5 times a year.

For determining who is the employer, I suggest an alternative, facts and circumstances test focused on the entities controlled by a specific individual. Investors who had no control of day-to-day operations of the business would not need to be aggregated. Examples include the individual who makes hiring and firing and purchasing decisions and sets sales prices. By focusing on day-to-day operations, the business would be defined by the industry or industries with which an individual is involved regularly. Similarly, if a spouse were not involved with day-to-day operations of the other spouse's business, the businesses of each spouse would not be aggregated.

The taxpayer would evaluate the facts and circumstances of each business and a determination would be made. By using a facts and circumstances determination, the opportunity to plan to avoid bright line tests is not available. A facts and circumstances test will use business activities and characteristics with which the small business operator is familiar. The statute or IRS guidance could outline a nonexclusive list of characteristics of control. This is similar to the rules used for determining whether an individual is an employee or independent contractor and parts of the rules that determine what is a separate line of business. As there is sometimes no clear-cut answer, many people may be more rather than less conservative in making a determination.

The determination would be subject to audit by the IRS. In addition, the IRS could establish a procedure whereby taxpayers could obtain certainty by applying to the IRS for a determination of whether 2 businesses should be aggregated given specified facts.

Finally, because the existing rule is the same rule used for qualified plan discrimination testing, some employers may want to continue using the existing bright line test rule, suggesting that a new facts and circumstances rule should be an alternative.

Background

Under the Affordable Care Act, employers with an average of at least 50 full-time employees on business days during the preceding taxable year are subject to shared responsibility assessable penalties if 1) minimum essential coverage is not offered to full employees (and their dependents) and at least one full-time employee enrolls in such coverage for which a tax credit or cost sharing reduction is allowed, or 2) minimum essential coverage is offered to full-time employees (and their dependents) but the coverage is not affordable or does not meet minimum value standards and at least one full-time employee enrolls in such coverage for which a tax credit or cost sharing reduction is allowed.

The Controlled Group Rules

To determine if an employer employs an average of at least 50 full-time employees on business days during the preceding year, all persons treated as a single employer under IRC Section 414 (b), (c), (m), (n) and (o) are treated as employed by 1 employer. This rule is known as the controlled group, affiliated service group and leased employee rule. Special rules apply for employers not in existence during the preceding year, for predecessor employers and for seasonal workers. In addition, full-time equivalent employees are treated as full-time employees.

The controlled group rules were originally enacted with ERISA in 1974, modeled after the controlled group rules for consolidated return purposes. In general, the employees of a controlled group of corporations or of commonly controlled partnerships or proprietorships are treated as if the same employer employed them all. The rules have been applied for many years to qualified retirement plans and even longer for other tax purposes. Because the purpose of the controlled group rules for benefit plan discrimination testing and coverage rules is broader than the purpose for the consolidated return rules, the rules apply to noncorporate trade or business entities using the same concepts as the corporate entities. In general, the rule was originally adopted to make it impossible for the qualified plan coverage and nondiscrimination rules to be circumvented by operating businesses through separate entities rather than as a single entity. Since that time, they have been used for defining the employer for testing discrimination for all types of benefit plans.

The controlled group rules include parent-subsidiary controlled groups, brother-sister controlled groups and combined groups.

Parent Subsidiary Controlled Group

A parent-subsidiary controlled group is one of more chains of corporations connected through stock ownership with a common parent corporation if

> (A) Stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value

of shares of all classes of stock of each of the corporations, except the common parent corporation, is owned (directly and through ownership of an option) by one or more of the other corporations; and

(B) The common parent corporation owns (directly and through ownership of options) stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of at least one of the other corporations, excluding, in computing such voting power or value, stock owned directly by such other corporations.

For determining stock ownership, attributions rules apply to attribute ownership to someone other than the legal owner of the stock. For purposes of determining whether a corporation is a member of a parent-subsidiary controlled group of corporations, stock owned by a partnership is considered owned proportionally by any partner that has an interest of five percent or more of the capital or profits of the partnership, whichever is greater. Similarly, in the case of an estate or trust, other than a trust holding qualified retirement plan assets, stock owned by the estate or trust is considered owned proportionally by a beneficiary who has an actuarial interest of five percent or more in such stock. To determine the five percent actuarial interest, one assumes the maximum exercise of discretion by the fiduciary in favor of the beneficiary and the maximum use of stock to satisfy the beneficiary's rights. In addition, the grantor of a grantor trust is considered to own the stock of the trust.

For example, assume P Corporation owns 80 percent of the only class of stock of S Corporation and S, in turn, owns 40 percent of the only class of stock of X Corporation. P also owns 80 percent of the only class of stock of Y Corporation and Y, in turn, owns 40 percent of the only class of stock of X. P is the common parent of a parent-subsidiary controlled group consisting of member corporations P, S, X, and Y.

Similarly, assume P Corporation owns 75 percent of the only class of stock of Y and Z Corporations; Y owns all the remaining stock of Z; and Z owns all the remaining stock of Y. Since intercompany stockholdings are not treated as outstanding for purposes of determining whether P owns stock possessing at least 80 percent of the voting power or value of at least one of the other corporations, P is treated as the owner of stock possessing 100 percent of the voting power and value of Y and of Z Also, stock possessing 100 percent of the voting power and value of Y and Z is owned by the other corporations in the group. P and Y together own stock possessing 100 percent of the voting power and value of Z, and P and Z together own stock possessing 100 percent of the voting power and value of Y. Therefore, P is the common parent of a parent-subsidiary con- trolled group of corporations consisting of member corporations P, Y, and Z.

When applying these rules to noncorporate entities, a parent-subsidy group of trades or businesses under common control include means one or more chains of organizations conducting trades or businesses connected through ownership of a controlling interest with a common parent organization if—

> (A) A controlling interest in each of the organizations, except the common parent organization, is owned (directly and through ownership of options) by one or more of the other organizations; and
>
> (B) The common parent organization owns (directly and through ownership of options) a controlling interest in at least one of the other organizations, excluding, in computing such controlling interest, any direct ownership interest by such other organizations.

For purposes of these rules, a controlling interest is defined as

> (A) In the case of an organization which is a corporation, ownership of stock possessing at least 80 percent of total combined voting power of all classes of stock entitled to vote of such corporation or at least 80 percent of the total value of shares of all classes of stock of such corporation;
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> (B) In the case of an organization which is a trust or estate, ownership of an actuarial interest of at least 80 percent of such trust or estate;
>
> (C) In the case of an organization which is a partnership, ownership of at least 80 percent of the profits interest or capital interest of such partnership; and
>
> (D) In the case of an organization which is a sole proprietorship, ownership of such sole proprietorship.

In determining ownership, only outstanding stock is taken into account. In addition, if the parent organization owns

> (A) In the case of a corporation, 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock of such corporation.
>
> (B) In the case of a trust or an estate, an actuarial interest of 50 percent or more of such trust or estate, and
>
> (C) In the case of a partnership, 50 percent or more of the profits or capital interest of such partnership,

certain other stock ownership is excluded, including that held in trust for the payment of deferred compensation, subsidiary stock held by principal owners, officers, partners or fiduciaries of the parent organization, subsidiary stock held by employees if subject to a substantial restriction which limits the employees right to dispose of the stock which runs in favor of the parent organization and subsidiary stock held by an exempt organization which is controlled by the parent or subsidiary organization, by an individual, estate, or trust that is a principal owner of the parent organization, by an officer, partner, or fiduciary of the parent organization, or by any combination thereof. Whether an exempt organization is controlled is a facts and circumstances determination.

As you can see, application of this rule involves knowing stock and option ownership of all entities, applying attribution rules for stock owned by partnerships, estates and trusts and then determining if the 80% rule is met. Note that, if stock ownership is 79%, then a parent subsidiary controlled group is not formed. Corporate tax planning often involves owning 79% rather than 80% of a corporation for this reason.

Brother-Sister Controlled Group

A brother-sister controlled group is a group of two or more corporations if the same five or fewer persons who are individuals, estates, or trusts own (directly and through the ownership of options) stock possessing

> (A) At least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock of each corporation (the 80 percent requirement);
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> (B) More than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation (the more-than-50 percent identical ownership requirement); and
>
> (C) The five or fewer persons whose stock ownership is considered for purposes of the 80 percent requirement must be the same persons whose stock ownership is considered for purposes of the more-than-50 percent identical ownership requirement.

For determining stock ownership, attributions rules again apply to attribute ownership to someone other than the legal owner. For purposes of determining whether a corporation is a member of a brother-sister controlled group of corporations, stock owned by a partnership is considered owned proportionally by any partner that has an interest of five percent or more of the capital or profits of the partnership, whichever is greater. Similarly, in the case of an estate or trust, other than a qualified retirement plan, stock owned by the estate or trust is considered owned proportionally by a beneficiary who has an actuarial interest of five percent or more in such stock. To determine the five percent actuarial interest, one assumes the maximum exercise of discretion by the fiduciary in favor of the beneficiary and the maximum use of stock to satisfy the beneficiary's rights. In addition, the grantor of a grantor trust is considered to own the stock of the trust. One also needs to attribute stock held by a corporation proportionally to any five percent or more owner of the corporation.

Finally, in the case of family attribution, stock owned by a spouse is considered owned by the other spouse unless each of the following is true:

a) the spouse owns no stock directly at any time during the taxable year,

b) the spouse is not an employee or director or participate in management of the corporation at any time during the taxable year,

c) no more than 50% of the corporation's gross income was derived from rents, royalties, dividends, interest and annuities during the year, and

d) the stock of the corporation is not, at any time during the taxable year, subject to conditions which substantially limit or restrict the owner's right to dispose of such stock which run in favor of the spouse or children who have not attained age 21.

Stock owned directly or indirectly by a child that has not attained age 21 is attributed to the parents and if an individual has not attained age 21, stock owned by the parents is attributed to the child. In addition, if an individual owns more than 50% of the total voting power or value of all classes of stock (after applying all attribution rules other than this rule and attribution from children under age 21), stock owned directly or indirectly by parents, grandparents, grandchildren and children over age 21 are attributed to the individual.

For determining a brother-sister controlled group of corporations, one needs to again determine stock and option ownership, attributed stock ownership and also common ownership (including that through attribution) and then apply the 80% and 50% test. Again, with the bright line stock ownership rules, individuals can structure ownership to avoid the rules. When applying these rules to noncorporate entities, adjustments are made which highlight that only trade or business entities are considered.

Again, certain stock ownership can be excluded for purposes of determining ownership. If five or fewer persons who are individuals, estates, or trusts own (directly and through the ownership of options) own

(A) In the case of a corporation, 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock or such corporation,

(B) In the case of a trust or an estate, an actuarial interest of 50 percent or more of such trust or estate, and

(C) In the case of a partnership, 50 percent or more of the profits or capital interest of such partnership,

certain stock ownership is excluded, including that held in a qualified retirement plan trust, subsidiary stock held by employees if subject to a substantial restriction which limits the employees right to dispose of the stock which runs in favor of the parent organization and subsidiary stock held by an exempt organization which is controlled by the by the organization, by an individual, estate, or trust that is a principal owner of the organization, by an officer, partner, or fiduciary of the parent organization, or by any combination thereof. Whether an exempt organization is controlled is a facts and circumstances determination.

The term "brother-sister group of trades or businesses under common control" means two or more organizations conducting trades or businesses if

(A) the same five or fewer persons who are individuals, estates, or trusts own (directly and through attribution as described above) a controlling interest in each organization, and

(B) taking into account the ownership of each such person only to the extent such ownership is identical with respect to each such organization, such persons are in effective control of each organization.

The five or fewer persons whose ownership is considered for purposes of the controlling interest requirement for each organization must be the same persons whose ownership is considered for purposes of the effective control requirement.

For purposes of these rules, a controlling interest is defined as

(A) In the case of an organization which is a corporation, ownership of stock possessing at least 80 percent of total combined voting power of all classes of stock entitled to vote of such corporation or at least 80 percent of the total value of shares of all classes of stock of such corporation;

(B) In the case of an organization which is a trust or estate, ownership of an actuarial interest of at least 80 percent of such trust or estate;

(C) In the case of an organization which is a partnership, ownership of at least 80 percent of the profits interest or capital interest of such partnership; and

(D) In the case of an organization which is a sole proprietorship, ownership of such sole proprietorship.

For purposes of these rules, effective control is defined as

> (A) In the case of a corporation, such persons own stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of such corporation;
>
> (B) In the case of a trust or estate, such persons own an aggregate actuarial interest of more than 50 percent of such trust or estate;
>
> (C) In the case of a partnership, such persons own an aggregate of more than 50 percent of the profits interest or capital interest of such partnership; and
>
> (D) In the case of a sole proprietorship, one of such persons owns such sole proprietorship.

For example, assume X corporation is owned by 8 unrelated shareholders, A, B, C and D each own 12% and E, F, G and H each own 13% and Y Corporation is owned by the same 8 shareholders with A, B, C and D each owning 13% and E, F, G and H each own 12%. Any group of five of the shareholders will own more than 50 percent of the stock in each corporation, in identical holdings. However, X and Y are not members of a brother-sister controlled group because at least the same five or fewer persons do not own 80 percent of the stock of each corporation.

Alternatively, assume Corporation X and Y both has voting and nonvoting stock outstanding. Individual A owns 100% of the voting stock and 60% of the value of Corporation X and 75% of the voting stock and 60% of the value of Corporation Y. Unrelated individual B owns no voting stock and 10% of the value of Corporation X and 25% of the voting stock and 10% of the vale of Corporation Y. No other shareholder of X owns (or is considered to own) any stock in Y. X and Y are a brother-sister controlled group of corporations. The group meets the more-than-50 percent identical ownership requirement because A and B own more than 50 percent of the total value of shares of all classes of stock of X and Y in identical holdings. The group also meets the more-than-50 percent identical ownership requirement because of A's voting stock ownership. The group meets the 80 percent requirement because A and B own at least 80 percent of the total combined voting power of all classes of stock entitled to vote.

These examples highlight the detail needed for determining whether a brother sister controlled group exists. When one considers that attribution of stock ownership must be taken into account before this test is performed, it is evident how complicated the rule can be. Most tax practitioners would agree that a non tax professional would not likely be able to make a correct determination of controlled group status in situations in which a number of entities are involved or where there is significant stock attribution that needs to be considered.

Combined Group

A combined group is any group of three or more corporations if

> (A) Each such corporation is a member of either a parent-subsidiary controlled group of corporations or a brother-sister controlled group of corporations; and
>
> (B) At least one of such corporations is the common parent of a parent-subsidiary controlled group and also is a member of a brother-sister controlled group.

A combined group of trades or businesses under common control" means any group of three or more organizations, if

> (1) each such organization is a member of either a parent-subsidiary group of trades or businesses under common control or a brother-sister group of trades or businesses under common control, and
>
> (2) at least one such organization is the common parent organization of a parent-subsidiary group of trades or businesses under common control and is also a member of a brother-sister group of trades or businesses under common control.

Affiliated Service Group Rules

As noted above, provisions that use bright line tests provide practitioners and their clients with the opportunity to structure ownership to avoid the rules. That is precisely what Dr. Kiddie and Dr. Garland did when they formed a partnership owned 50% by each of them. The partnership employed nurses and other staff who, as a result of plan provisions, did not participate in the benefit plans in which the doctors participated. The IRS challenged this arrangement, but the Tax Court upheld it. As a result, Congress expanded the controlled group rules by adding the affiliated service group rules in 1980. Thus, the controlled group rules were supplemented by affiliated service group rules that focus on business relationships and activities rather than stock ownership. In subsequent years, more statutory changes expanded the definition to include groups of management organizations and the organizations managed, even if there was no stock ownership, and broadened the attribution rules that apply. For instance, if one entity provides management services to another entity, the two entities would be part of an affiliated service group.

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. An affiliated service group can fall into one of three categories.

1. A-Organization groups (referred to as “A-Org”) consist 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”) consist of a FSO and at least one “B organization”.
3. Management groups.

An FSO must be a "service organization", a corporation, partnership or other entity whose principal business is the performance of services. Proposed regulations state that the principal business of an organization is considered the performance of services if capital is not a material income-producing item. This is a facts and circumstances determination, although the proposed regulations specify that capital is a material income-producing item for banks and similar institutions. In addition, the proposed regulations note that 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 instance, by a substantial investment in inventories, plant, machinery or other equipment. 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. In addition to non-capital intensive organizations, an organization engaged in health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting or insurance are all considered service organizations.

To be an A-Org, an organization must satisfy an ownership test and a working relationship test. The ownership test is met if 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. The working relationship test is the organization "regularly performs services for the FSO," or □s "regularly associated with the FSO in performing services for third parties. Facts and circumstances are used to determine if a working relationship exists.

To be a B-Org, the organization does not need to be a service organization. Rather, it 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 highly-compensated employees of the FSO or A-Org.

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.

For example, assume 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.

Similarly, assume that 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.

Similarly, assume 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.

A management-type affiliated service group exists when an organization performs management functions, and the management organization's principal business is performing management functions on a regular and continuing basis for a recipient organization. There does not need to be any common ownership between the management organization and the organization for which it provides service. Any person related to the organization performing the management function is also to be included in the group that is to be treated as a single employer.

A recipient organization does not need to be a service organization. It is as organization for which management services are performed, any organization aggregated with the service organization under these controlled group and affiliated service group rules and all related organizations.

For example, assume Anson and Branch Corporations are a brother sister corporation and Crockett and Duval Corporations constitute an affiliated service group. Assume Crockett or Duval (or both) perform management functions and other services for Anson or Branch (or both) and the performance of these management functions or services satisfy the requirements of a principal business on a regular and continuing basis. Crockett and Duval are treated as a single management organization and Anson and Branch are treated as a single recipient organization. Anson, Branch, Crockett and Duval would constitute an affiliated service group.

The affiliated service group rules are very difficult to apply, because there are so many different iterations of possible structures that need to be considered. In fact, the IRS has not issued any final regulations providing guidance for applying these rules. Proposed regulations were issued in 1983 and 1987 and portions of those were withdrawn, presumably because they were broader than intended and thus unworkable, in 1993.

Leased Employees

At the same time that the affiliated service group rules were enacted, employee leasing rules were also enacted, which required the inclusion in the controlled group of employees leased to entities. In general, a leased employee is any person who is not an employee of the recipient and who provides services to the recipient if--

> (A) such services are provided pursuant to an agreement between the recipient and a leasing organization,
>
> (B) such person has performed such services for the recipient (or for the recipient and related persons) on a substantially full-time basis for a period of at least 1 year, and

(C) such services are performed under primary direction or control by the recipient.

These rules were designed to prevent employers using independent contractors to avoid the inclusion of individuals in benefit plans.

Finally, Congress gave the IRS broad regulatory authority to issue guidance to treat other relationships as controlled groups.

The Effect of the Rules on Small Employer

Many businesses develop as an entrepreneur sees an opportunity to provide a product or service. Often the businesses do not develop within the same industry and thus industry norms regarding the provision of employee benefits, including employer provided health care, are not the same. For instance, software engineers often enjoy employer provided healthcare, while retail workers and restaurant workers typically do not. It is easier to remain competitive in an industry if compensation and benefit arrangements conform to industry norms. Thus, as the entrepreneur expands into different industries it is often difficult if not impossible to use a compensation structure different than the majority of the industry.

In addition, small employers cannot as easily negotiate the purchase of health benefits for workers or self-insure benefits as they have fewer covered lives. This limits the entrepreneur's ability to provide health care.

A Better Alternative

Any time a test consists of specific levels, percentages or amounts, such as certain ownership percentages, there are two consequences: (1) complexity and (2) planning to avoid the "bright line" tests. With the requirement that qualified plans meet certain nondiscriminatory coverage and benefits rules, "bright line" teats make sense from a tax point of view. . The tests contained in sections 414 (b), (c), (m) and (o) have become increasingly complicated as Congress and the IRS have sought to prevent taxpayers from circumventing the qualified plan rules by changing stock ownership percentages. After the Tax Court upheld the structuring of arrangements to avoid aggregation, Congress adopted the affiliated service group rules and granted the IRS the authority to adopt any other rules necessary to eliminate the opportunity for taxpayers to avoid the rules. It is not appropriate to apply this test is to determine the size of a business and which employees must be offered minimum essential coverage under the health care law.

Applying these controlled group rules, affiliated service group rules and leased employee rules to determine whether an employer is subject to the shared responsibility rules would appear to be a convenient approach because it is an existing set of rules. These rules, however, are exceedingly complicated and well understood by only a small subset set of tax practitioners. Applying the qualified plan aggregation rules does not take into account the different purpose of the

Affordable Care Act employer mandate from the retirement plan coverage and discrimination rules. Offering retirement plans is not mandated and thus, when the entrepreneur decides to offer a retirement plan, it is understood that the business aggregation rules will apply. The shared responsibility rules mandate the provision of health benefits. Applying the same business aggregation rules to a mandated benefit that exist for purposes of preventing discrimination for voluntary employer provided benefits can lead to inefficient and unwanted economic behavior. This behavior constrains a small business and may lead to unwanted and unwelcome business decisions including not hiring additional works that ensure the small business is not subject to the rules. This is the same behavior that has been exhibited by larger businesses, attempting to limit workers to less than 30 hours per week.

By its very nature, this is a rule that employers will be clearly under or clearly over, something that by its very nature changes continually as businesses grow or decline. While the test has to be applied every year, it is only relevant for businesses that are not clearly above the at least 50 employee threshold. Those clearly above or below do not need to make any calculations. Thus, for any year, the test only affects a limited number of taxpayers and the taxpayers affected each year change as businesses develop or decline. However, as noted above, taxpayers that are approaching the 50 full time equivalent employee mark may decide to delay hiring to delay application of this rule.

A facts and circumstances test, focusing on a specific individual's (or group of individuals) control of business decisions is a better aggregation test for mandated employer provided health benefits. With a facts and circumstances test, the employer will be able to determine whether the 50 full time equivalent test is met and which employees need to be covered without having to know detailed ownership information of investors and related parties, and without the cost of having to hire expensive outside consultants . Differences in industry norms can also be taken into account. The statute can include a non-exclusive list of items that need to be considered in determining who is in control of the business. Investors who had no control of day-to-day operations of the business would not need to be aggregated. Examples include the individual who makes hiring and firing and purchasing decisions and sets sales prices. By focusing on day-to-day operations, the business would be defined by the industry or industries with which an individual is involved regularly. Similarly, if a spouse were not involved with day-to-day operations of the other spouse's business, the businesses of each spouse would not be aggregated.

As with a bright line test, with a facts and circumstances test, taxpayers and the IRS have the responsibility of making a determination of whether businesses should be aggregated. The taxpayer would evaluate the facts and circumstances of each business and a determination would be made. By using a facts and circumstances determination, the opportunity to plan to avoid bright line tests is not available. A facts and circumstances test will use business activities and characteristics with which the small business operator is familiar. As there is sometimes no clear-cut answer, many people will be more rather than less conservative in making a determination. That determination would be subject to audit by the IRS. IRS, through its enforcement process will need to understand the facts and circumstances that lead to a specific conclusion and taxpayers will need to support their conclusions.

Facts and circumstances tests, by their very nature, are less likely to be applied abusively than bright line tests. With a facts and circumstances test, individuals would understand the situation and make a determination regarding the whether the employer should be aggregated as an employer operating a business or whether 2 business operations should be viewed separately. The Employee Stock Ownership Plan (ESOP) rules offer a good example of rules intended to limit abuses that were circumvented as never expected. Under those rules determining whether the ESOP is structuring arrangements to avoid the payment of taxes involved the conversion of benefits to synthetic equity and an understanding of ownership including synthetic equity.

Facts and circumstances tests are used in many situations for determining the application of tax rules. One that comes to mind readily are the worker classification rules, determining whether someone is a common law employee or independent contractor. Those rules are set forth in regulations and other IRS guidance. In general, an employer has the right to control not only the amount of work to be done by an employee, but also how it is to be performed. This is not the case with an independent contractor. The name given to a service provider, the number of hours worked, how an individual is paid are not important.

Revenue Ruling 87-41 outlines 20 factors that need to be considered in determining whether a service recipient exercises enough control over a service provider for an employee or independent contractor relationship to exist. The ruling specifically states that not all of the factors have equal weight and that not all need to be present. Rather the factors are guides to help in determining the likelihood that someone is more closely characterized as an employee or independent contractor. While tax practitioners do structure arrangements with workers so that the classification is more likely to be certain, there is no bright line test or assurance that can be applied. Since Revenue Ruling 87-41 was issued, the IRS has outlined three categories of factors that should be considered in conjunction with the revenue ruling. These factors are behavioral control, financial control and relationship of the parties.

While this is a facts and circumstances determination, the IRS does have a process whereby either service providers or service recipients can file a request for determination of worker status by filing a Form SS-8. This form asks a number of questions regarding the relationship. In making the determination, IRS requests information from both parties and makes a final, binding decision regarding worker status. If a facts and circumstances test is applied for determining the employer for providing minimal essential coverage, a similar determination process could also be developed to all workers and service recipients to have certainty with respect to the determination.

The IRS had to address the definition of employer under these rules in the tax-exempt context. Because tax exempt organizations do not have owners, an alternative rule was devised and this test gives some examples of the types of activities that are viewed as indicators of control. Notice 89-23 specified, among other things, that in the tax exempt arena, the controlled group included each entity that provides directly or indirectly at least 80% of the contributing employer's operating funds and there is a degree of common management or supervision between the entities. A degree of common management or supervision exists if the entity providing the funds has the power to appoint or nominate officers, senior management or members of the board of directors (or other governing board) of the entity receiving the funds. A degree of common management or supervision also exists if the entity providing the funds is involved in the day-to-day operations of the entity.

Final regulations adopting the rules detailed in this guidance have since been adopted. Specifically those regulations provide, among other things, that common control exists between an exempt organization and another organization if at least 80 percent of the directors or trustees of one organization are either representatives of, or directly or indirectly controlled by, the other organization. A trustee or director is treated as a representative of another exempt organization if he or she also is a trustee, director, agent, or employee of the other exempt organization. A trustee or director is controlled by another organization if the other organization has the general power to remove such trustee or director and designate a new trustee or director. Whether a person has the power to remove or designate a trustee or director is based on facts and circumstances. To illustrate, if exempt organization A has the power to appoint at least 80 percent of the trustees of exempt organization B (which is the owner of the outstanding shares of corporation C, which is not an exempt organization) and to control at least 80 percent of the directors of exempt organization D, then entities A, B, C, and D are treated as the same employer. While these rules have a bright line 80% test, they also indicate the type of activities that could be considered in determining whether control exists.

The qualified separate line of business rules also use a similar rule, allowing employers to determine that certain businesses qualified as separate lines of businesses and thus do not have to be aggregated for determining qualified plan coverage and discrimination testing. In general, a line of business is a portion of an employer that is identified by the property or services it provides to customers of the employer. The employer is permitted to determine the lines of business it operates by designating the property and services that each of its lines of business provides to customers of the employer.

A separate line of business is a line of business that is organized and operated separately from the remainder of the employer. The determination of whether a line of business is organized and operated separately from the remainder of the employer is made on the basis of objective criteria. These criteria generally require that the line of business be organized into one or more separate organizational units (e.g., corporations, partnerships, or divisions), that the line of business constitute one or more distinct profit centers within the employer, and that no more than a moderate overlap exist between the employee workforce and management employed by the line of business and those employed by the remainder of the employer. There are rules for determining whether a line of business is organized and operated separately from the remainder of the employer and thus constitutes a separate line of business. These rules include an optional rule for vertically integrated lines of business.

A qualified separate line of business must satisfy the three statutory requirements including a notice requirement and a requirement to pass administrative scrutiny. A separate line of business may satisfy this administrative scrutiny rule by using a regulatory safe harbor or by requesting and receiving an individual determination from the IRS that the separate line of business satisfies the requirement of administrative scrutiny.

Finally, some small businesses may be making annual determinations of the employer for qualified plan purposes and could easily use that for determining the employer for health care reform. The facts and circumstances test could be offered as an alternative to the mechanical tests used for qualified plan purposes. For those businesses already relying on this test, certainty would exist.

To summarize, the mechanical tests used for qualified plan discrimination testing are overly complex and understood for only a limited number of tax professionals. A small business would not be able to apply those rules without professional help and many of the advisers to small business would not be familiar with the rules. In addition, the definition of employer for determining whether an employer has at least 50 employees and which workforce needs to be offered minimal essential coverage is a test that most businesses will only need to run for a few years during their life cycle. It is a mandated test and not a test that is voluntarily assumed when a retirement plan is offered to workers. As businesses come close to the 50-employee limit, the additional cost of mandated health benefits will be considered in evaluating business expansion. For these reasons,, a facts and circumstances test, focusing on the businesses that an individual operates on a day-to-day basis makes more sense. The statute or committee reports could list characteristics of management control and taxpayers would be able to make a judgment regarding what operations should be considered part of the employer. This determination would be subject to audit by the IRS, as all tax determinations are.