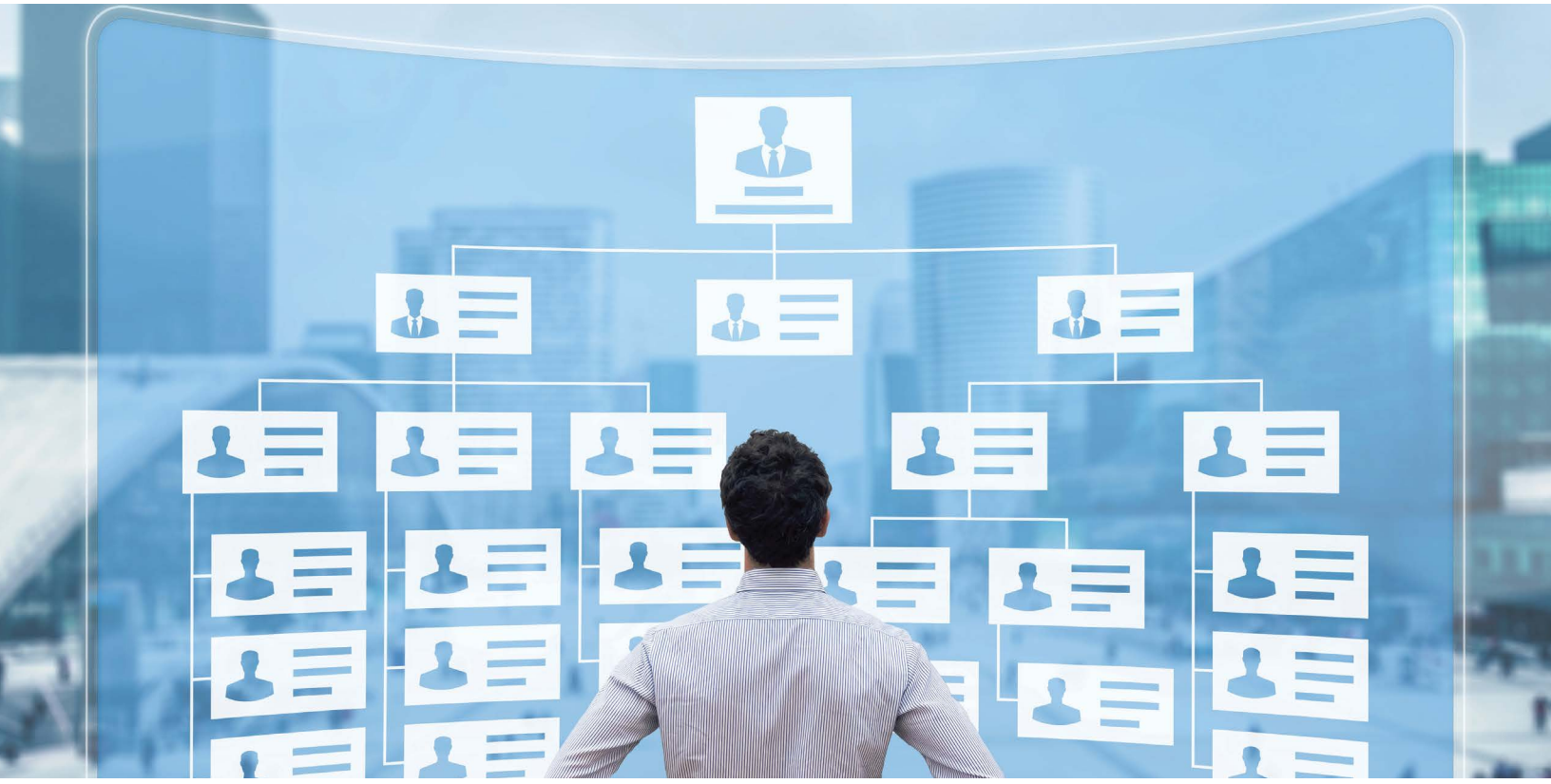
McGriff EMPLOYEE BENEFIT SOLUTIONS | COMPLIANCE Q&A

Are You Part of a Controlled Group, Common Control or Affiliated Service Group?

McGriff Employee Benefits Compliance Team
National Specialty Practices



Questions: When dealing with both our qualified retirement plans, as well as our other employee benefit plans, we are constantly asked by service providers whether we are in a controlled group, under common control, or in an Affiliated Service Group (ASG) with other employers. They sometimes refer to this as whether we have any "related employers." What are the implications of being a member of a group of related employers for employee benefit plan purposes? How do I know if one employer is related to another under these rules?

Summary:

Controlled group, common control, and ASG rules are some of the most complex aspects of employee benefit plan compliance. For controlled groups, there are brother-sister controlled groups, parent-subsidiary controlled groups, and combined groups.[1] Controlled-group rules apply to corporations, but there are similar "common control" rules for non-corporate entities such as partnerships, limited liability companies (LLCs) taxed as partnerships, trusts, etc.

The ASG rules are often, but not exclusively, associated with professional service organizations (e.g., doctors, lawyers, architects, engineers, accountants, insurance agents) or management companies, and can take a number of forms including A-Org ASGs, B-Org ASGs, and management function group ASGs.[2]

There are complex stock attribution rules and rules for

Determining whether employers are related under the controlled group/common control/ASG rules is almost always a complex and fact-specific matter.

excluding stock in making related employer determinations for employee benefit purposes.[3] Certain related employer rules only apply for employee benefit purposes, such as inclusion of foreign entities and franchise corporations, as well as inclusion of an employer who is related for only a partial year.[4]

In addition to the coverage and nondiscrimination rules for qualified retirement plans, related employer status also affects the following:

- Cafeteria plan nondiscrimination testing under Internal Revenue Code (Code) Section 125[5]
- Code Section 105(h) nondiscrimination testing for self-insured group medical plans, which also includes health flexible spending accounts (health FSAs) and health reimbursement arrangements (HRAs)[6]
- Code Section 129 nondiscrimination testing for dependent care assistance plans[7]
- Determining whether an employer is an "applicable larger employer" under the Affordable Care Act (ACA) and therefore subject to the "pay or play rules"[8]
- Code Section 79 group term life insurance[9]
- Comparability rules for health savings accounts (HSAs)[10]
- COBRA, in determining employer size for COBRA applicability,[11] as well as issues on COBRA responsibility in mergers and acquisitions[12]
- Whether a plan is a multiple-employer welfare arrangement (MEWA) (controlled group and common control only)[13]
- Employer size for applicability of the mental health parity rules[14] and Medicare secondary payer rules[15]

Detail:

Determining whether employers are related under the controlled group/common control/ASG rules is almost always a complex and fact-specific matter - where some degree of legal judgment is required to apply the law to specific factual circumstances. Because of this complexity, always consult your legal counsel when making these determinations. Below, you will find further detail regarding related-employer status and the most common ways that status implicates employee benefit plans outside of the context of qualified retirement plans.

A. Controlled Groups/Common Control

There are three types of related organizations under both Code Sections 414(b) (controlled group) and 414(c) (common control - which applies to non-corporate entities).

1. Parent-subsidiary groups: Groups that pick up related employers connected by an 80-percent or more downstream ownership affiliation.[16]

2. Brother-sister controlled groups: These groups exist when five or fewer individuals, estates, or trusts own a controlling interest (80 percent or more) in each organization and also have "effective control."[17] Effective control generally means

those same individuals own more than 50 percent of the organization's stock or profits, but only to the extent the ownership is identical with respect to each such organization. In other words, there are two components in testing for a brother-sister controlled group - a controlling interest and an effective control requirement. The following example is useful in showing an instance where there is a controlling interest, but not effective control, and therefore is no brother-sister controlled group:

Example - ABC Corporation and XYZ Corporation are owned by four shareholders in the following percentages:

Shareholder	ABC Corporation	XYZ Corporation
A	80%	20%
B	10%	50%
C	5%	15%
D	5%	15%
TOTAL	**100%**	**100%**

In this example, the four shareholders together own 80 percent or more of the stock of each corporation and satisfy the controlling interest component. However, under the effective control component, the shareholders do not own more than 50 percent of the stock of each corporation, taking into account only the identical ownership in each corporation as demonstrated below:

Shareholder	Identical Ownership in Both Corporations
A	20%
B	10%
C	5%
D	5%
TOTAL	**40%**

3. Combined group: Involves both brother-sister and parent-subsidiary groups.[18]

In determining ownership, there are special attribution/ constructive ownership provisions.[19] For parent-subsidiary groups, these include option attribution, attribution from estates and trusts, and attribution from partnerships.[20] Those same attribution provisions also apply to brother-sister groups, but there is additional attribution from corporations and ***attribution from certain family members***.[21] Each of these attribution provisions then have their own subset of rules on when attribution will and will not apply, and whether they can be "stacked" upon each other. In particular, family attribution can be very fact-intensive.

There is also stock that is excluded in the determination. For example, in a parent-subsidiary group determination, stock in qualified plans may be excluded, certain stock owned by an officer or principal stock holder of a parent may be excluded, certain stock owned by an employee of a subsidiary may be excluded, and certain stock owned by tax-exempt entities may be excluded.[22] For brother-sister groups, similar rules apply with slight modifications. Like with attribution, whether these categories of stock must be excluded is determined by a complex subset of rules for each category.[23] Also, the exclusion rules only operate to create common control/controlled groups; they do not operate to destroy common control/controlled groups.[24]

Finally, some exclusions from common control/controlled groups that apply for corporate income taxes do not apply for employee benefit purposes. For example, the exclusion for "component members" does not apply. For employee benefit plan purposes, this brings in foreign corporations, franchise corporations, tax-exempt organizations, and other entities that may not be considered part of a controlled group for corporate income tax purposes.[25] For corporate tax purposes, there is a "half of a taxable year" test to determine if an entity is in a controlled group or common control for a year.[26]

For employee benefit plan purposes, however, the controlled group determination is made on a day-by-day basis.[27] The definition of a brother-sister controlled group has been simplified for corporate income tax purposes, but the definition described above remains for employee benefit plan purposes.[28]

There is another set of rules for determining common control of tax-exempt entities that is not covered under this Q&A. Common-control issues can also arise for non-federal governmental entities, churches, qualified church-controlled organizations and non-qualified church-controlled organizations and, again, those rules are not

For employee benefit plan purposes, however, the controlled group determination is made on a day-by-day basis.

covered by this Q&A.

As illustrated by the abbreviated discussion above, controlled group/common control rules are complex. If an employer does not know the controlled group/common control status of its related entities, the employer needs to retain legal counsel to help with this fact-specific determination.

B. ASGs

As complex as the controlled group/common control rules are, the ASG rules are even more intricate. ASGs are defined in Section 414(m) of the Code. There can be A-Org ASGs, B-Org ASGs, or management function ASGs.[29]

The A-Org ASG and B-Org ASG rules require a determination of whether an employer is a "service organization," as well as whether the service organization is a "first services organization" (FSO). To complicate matters further, the FSO definitions differ for A-Org ASGs and B-Org ASGs.

ASGs are also subject to a set of attribution and constructive ownership rules that are different from those applied for controlled group/common control discussed above.[30] ASG rules are used for most employee benefit purposes, but do not apply for all. Multiple-employer welfare arrangements (MEWAs) are a prime example. Two employers in an ASG can adopt a single employer qualified retirement plan, but if they jointly adopt a single group medical plan (and they are not otherwise in a controlled group or under common control) they will have established a MEWA rather than a single-employer plan.[31]

Technical terms and definitions dominate any ASG analysis and you should consult legal counsel. The following is a brief overview of ASGs and some examples.

1. A-Org ASG: Probably the most common ASG associated with medical doctors, lawyers, engineers, insurance brokers, architects, and other professionals is an A-Org ASG.

The basic rule is an A-Org ASG exists where both are true:

- A service organization (the A-Org) has an ownership interest (or is deemed to have an ownership interest) in the second services organization (the FSO).
- The A-Org either regularly performs services for the FSO or is regularly associated with the FSO in performing services for third parties. [32]

In the first component of the test, the extent of the ownership interest is irrelevant - even less than one-percent ownership will do. There are constructive ownership rules in making the ownership determination. For example, with certain exceptions, an entity is deemed to own any stock held by that the entity's shareholders.[33]

A simple example would be a doctor who owns 100 percent of her own S. Corporation medical practice. That doctor, along with 50 other investors, open up an ambulatory surgery center as an LLC, taxed as a partnership. The doctor, however, only has a one-percent interest in the ambulatory surgery center. The doctor regularly provides medical services to patients at the ambulatory surgery center that are billed through her S. Corporation.

This example is a classic A-Org ASG. The doctor's S. Corporation, as the A-Org, is deemed to own the doctor's one-percent share in the ambulatory surgery center. So the ownership component is satisfied. Remember, any ownership interest, no matter how small, will suffice in an A-Org analysis.

The doctor's S. Corporation and the ambulatory surgery center, as the FSO, are also regularly associated in performing services for patients (third parties). So, the second component of the A-Org analysis is also satisfied.

2. B-Org ASG: A B-Org ASG consists of an FSO and at least one B-Org. An organization qualifies as a B-Org if all of the following are true:

- A significant portion of the B-Org's business is the performance of services for the FSO and/or its A-Orgs.
- The services performed by the B-Org are of a type historically performed by employees in the service field of the FSO or its A-Orgs.
- At least 10 percent of the B-Org is owned by one or more highly compensated employees (as defined in Code Section 414(q)) of the FSO or its A-Orgs.[34]

A B-Org does not need to be a service organization (but the FSO must be). In determining whether a significant portion of the B-Org's business is the performance of employee services for FSO, there are two tests that may be used: a service receipts safe harbor test and a total receipts threshold test.

The following is an example of a B-Org ASG:

John owns one-third of an employee benefit consulting firm (EB Consulting). John also owns one-third of an insurance agency (Acme Insurance) and is a highly compensated employee (HCE) of Acme Insurance due to his ownership. A significant portion of the business of EB Consulting consists of assisting Acme Insurance in developing employee benefit packages for sale to third persons and providing services to Acme Insurance in connection with employee benefit programs sold to other clients of Acme Insurance. Additionally, EB Consulting frequently provides services to clients who have purchased insurance arrangements from Acme Insurance for the employee benefit plans those clients maintain. Acme Insurance frequently refers clients to EB Consulting to assist those clients in the design of their employee benefit plans. The percentage of the total gross receipts of EB Consulting that represent gross receipts from the performance of these services for Acme Insurance is 20 percent.

Considering the Acme Insurance as an FSO, EB Consulting is a B-Org because a significant portion of the business

of EB consulting (as determined under the total receipts percentage threshold test) is the performance of services for Acme Insurance of a type historically performed by employees in the service field of insurance, and more than 10 percent of the interests in EB Consulting is held by HCEs of Acme Insurance. Thus, Acme Insurance and EB Consulting constitute a B-Org ASG.

3. Management Function Group ASG: Management function groups are the third type of ASG, and exist when both are true:

- An organization performs management functions (the management firm).
- The management firm's principal business is performing management functions on a regular and continuing basis for one client organization and/or organizations related to the client (the client).[35]

There is another set of complex rules to determine the client's related organizations for a management function group ASG analysis.[36] For a management function group ASG, there does not need to be any common ownership between the management firm and the client, and the client does not have to be a service organization. Both the client or management firm can be any type of organization (e.g., corporation, sole proprietorship, LLC, partnership).

There were proposed regulations, which were later withdrawn, that provided guidance and tests on how to determine the "principal business" and "regular and continuing basis" components of the management function group ASG analysis. Those regulations were withdrawn in 1993 and likely do not carry any legal weight, although the IRS still references them in training material.

As an example, Dr. John wants to continue to practice

medicine, but is tired of managing his medical practice (Dr. John, Inc. (DJI)). He has an acquaintance, Pete, who is skilled in medical office management, such as negotiating contracts with insurance companies, managing nurses and staff, setting compensation for employees, determining needed office space and future equipment needs, marketing, business planning, etc. Pete forms Pete's Medical Management, Inc. (PMMI), and Dr. John turns all of these management functions for his medical practice over to PMMI. Neither Dr. John nor DJI has any ownership interest in PMMI. DJI is the sole client of PMMI. In this example, there is a management function group ASG between PMMI and DJI, even though they share no common ownership.

Now, let's say Pete is very successful, and Dr. Susan, LLC, Dr. Dan, Inc., and Dr. David, LLP, all retain PMMI to perform similar services for their medical practices. None of these medical practices are "related organizations" to each other or a related organization to DJI. PMMI's staff dedicates approximately 25 percent of its time to each medical practice and each medical practice represents approximately 25 percent of PMMI's revenue. There is no longer a management function group ASG because PMMI's primary business is no longer providing services to one client and its related entities.

C. Related-Employer Rules and Employee Benefit Plans

The related employer rules are used for a variety of employee benefit plan purposes, in addition to the qualified retirement plan coverage and nondiscrimination rules. Here are some of the applications we see:

- The eligibility nondiscrimination test for Code Section 125 plans (cafeteria plans) is performed on a related-employer basis.[37] Therefore, if you have two entities that are related employers and both entities do not participate in the same cafeteria plan, there could be eligibility testing issues under Code Section 125.
- The eligibility nondiscrimination test for self-insured group medical plans under Code Section 105(h) is performed on a related-employer basis.[38] This includes not only self-insured major medical plans, but also health reimbursement arrangements (HRAs) and health flexible spending accounts (health FSAs). This test can be particularly influenced by related-employer issues because of the more expansive view of who is a highly compensated individual and the definition of "benefitting" means actually participating instead of merely being able to participate.
- The eligibility nondiscrimination test for dependent care FSAs under Code Section 129 is performed on a related-employer basis.[39]
- Testing to see whether employer contributions to a health savings account (HSA) when made outside of a cafeteria plan are "comparable" under Code Section 4980G is done on a related-employer basis.[40]
- Related-employer issues are also relevant for many plan document issues. If multiple related employers are covered under a single cafeteria plan or a single wrap plan, then there should be some evidence that all related employers have adopted the plan by use of joinder or participation agreements. For example, if only a parent company has adopted a cafeteria plan and there is no evidence a separate subsidiary has adopted the plan (or has its own plan), the IRS could take the position that the employees of the subsidiary are not allowed pre-tax benefits.
- On the other hand, if there a multiple employers who are not related employers and adopt a single cafeteria plan document, the law is unclear on whether you could even have a multiple-employer cafeteria plan or the testing implications of such an arrangement. This question often arises in Professional Employer Organization (PEO) arrangements.
- Knowing controlled group/common control status for purposes of two employers sponsoring the same welfare plan is also crucial for MEWA purposes. Two employers who are not under common control/ controlled group that sponsor the same plan have likely created a MEWA.[41] There are a host of issues with regard to MEWAs. For example, in some states, operating a self-insured MEWA without meeting stringent registration and financial conditions set under state law can be a felony.[42]
  - There are specific MEWA questions on the Form 5500 as well, so knowing controlled group/common control is necessary for accurately completing this annual return.
- Related-employer issues also arise in Consolidated Omnibus Budget Reconciliation Act (COBRA) administration. Determining whether an employer qualifies for the small employer exemption from COBRA is done on a related-employer basis.[43] Whether other related employers exist can also determine if there is a COBRA obligation and who has that obligation in mergers and acquisitions.[44] Knowing the identity of related employers is also important in determining whether there has been a COBRA-qualifying event. For example, transferring between related employers, even going from a related employer that sponsors a group health plan to one that does not, would likely not be a COBRA-qualifying event.
- Under the Affordable Care Act (ACA), determining

whether an employer is an applicable large employer (ALE) and therefore subject to the employer mandate (also known as employer shared responsibility or "pay or play") is done on a related-employer basis.[45]

- For the small employer exception to the Medicare secondary payer provisions, the ASG rules apply, and a modified and broader version of the controlled group/common control rules apply.[46]
- Related-employer rules apply to the small/large group market determinations under the ACA[47] and the Health Insurance Portability and Accountability Act (HIPAA).[48]
- Related-employer rules apply to determine whether an employer qualifies for the ACA small business tax credit.[49]
- Related-employer rules apply in determining the small employer exception under mental health parity.[50]
- Related-employer rules are also applicable to the following benefits: group term life insurance, adoption assistance, educational assistance, qualified employee discounts, qualified moving expenses, qualified transportation plans, and working condition fringe benefits.[51]

Conclusion:

Related-employer determinations are often extremely complex and should only be made with guidance from a knowledgeable professional. The related-employer rules touch almost every fringe or employee benefit an employer offers to its employees. Any time there is a merger or disposition among a related-employer group, or any time there is a sale or transfer of substantial stock interests, employers should revisit any prior related-employer determination.

Professional groups and management firms should pay special attention to the ASG rules. Substantial common ownership is not always determinative. A management function group ASG can exist with no common ownership and an A-Org ASG can exist with any common ownership, no matter how small.

References

1 - Internal Revenue Code (Code) §414(b) and (c) and Code §1563(a).
2 - Code §414(m).
3 - Code §§1563(c), 1563(e), 414(m)(6)(B) and 318.
4 - 26 CFR §1.414(b)-1(a).
5 - Code §125(g)(4).
6 - Code §105(h)(8).
7 - Code §129(t).
8 - Code §4980H(c)(2)(C).
9 - Code §79(d)(3) and §414(t); 26 CFR §1.79-4T, Q&A 9; 26 CFR §1.1502-1(a).
10 - 26 CFR §54.4980G-3, Q&A 4.
11 - 26 CFR §54.4980B-2, Q&A 5.
12 - 26 CFR §54.4980B-9, Q&As 2 and 3.
13 - ERISA §3(40)(A) and (B).
14 - See DOL Reg. § 2590.712(f)(2).
15 - 42 CFR §411.106.
16 - Code §1563(a)(1).
17 - Code §1563(a)(2).
18 - Code §1563(a)(3).
19 - Code §1563(d) and (e).
20 - Code §1563(d)(1).
21 - Code §1563(e).
22 - Code §1563(c)(2)(A.)
23 - Code §1563(c)(2)(B).
24 - Code §1563(f)(3).
25 - 26 CFR 1.1414(b)-1(a).
26 - See Code §1563(b).
27 - 26 CFR 1.414(b)-1(a).
28 - Code §1563(f)(5).
29 - Code §414(m).
30 - Code §414(m)(6)(B) incorporating the attribution rules of Code §318.
31 - 2004 DOL Information Letter.
32 - Code §414(m)(2)(A).
33 - Code §318(c)(3).
34 - Code §414(m)(2)(B).
35 - Code §414(m)(5).
36 - Code §414(m)(5)(B) (treating related organizations in the same manner as related persons under Code §144(a)(3)).
37 - Code §125(g)(4).
38 - Code §105(h)(8).
39 - Code §129(t).
40 - 26 CFR §54.4980G-3, Q&A 4.
41 - ERISA §3(40)(A) and (B).
42 - See, e.g., N.C. Gen. Stat. §58-49-35 (Any MEWA operating in North Carolina is an unauthorized insurer) and N.C. Gen. Stat. §58-33-95 (Class H felony to know or should have known that insurer is an unauthorized insurer).
43 - 26 CFR §54.4980B-2, Q&A 5.
44 - 26 CFR §54.4980B-9, Q&As 2 and 3.
45 - Code §4980H(c)(2)(C).
46 - 42 CFR §411.106.
47 - Public Health Services Act 2791(e)(6).
48 - Code §4980D(d)(2).
49 - Code §45R(e)(5)(A).
50 - See DOL Reg. § 2590.712(f)(2) and Code §9812(c)(1)(B).
51 - Code §414(t).

McGriff

McGriff.com

REV_021722