Controlled and Affiliated Service Group Rules for Retirement and Cafeteria Plans

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Overview

This article presents an overview of the controlled group and affiliated service group rules as they apply to qualified retirement plans (defined benefit, cash balance, profit sharing, 401(k), SEP, SIMPLE) and cafeteria plans, a.k.a. Section 125 plans. These rules are extremely important, as they must be followed in order to maintain the tax favored status of a plan. For plan sponsors with U.S.-based operations and exclusively U.S. controlled groups, there is, generally, a healthy awareness of the rules, as operations are typically centralized in the U.S., and frequently a single third-party administrator is used for all retirement plans of the controlled group. For foreign-based corporations with U.S. subsidiaries, the level of awareness and compliance with these rules is frequently not very high. The primary reason is that a foreign-based corporation (or group of inviduals) may have wholly owned subsidiaries in other countries that in turn have wholly owned subsidiaries in the U.S., which are in fact part of a controlled group. Most often, these U.S. controlled groups do not have centralized operations and are not even aware that there are other related entities in the U.S. As a result, each company in the U.S. controlled group may have their own retirement plan and cafeteria plan with completely different benefits and separate third-party administrators, and none of the parties are aware that a controlled group exists.

Less familiar to many service-type companies (discussed below) are the rules treating affiliated (through ownership) service organizations as a single employer for retirement and cafeteria plan purposes. The ownership thresholds triggering application of these rules are much lower for this type of group than for controlled groups.

Background

The rule basically states that, if two or more corporations, trades, or businesses are part of a controlled group of businesses, then the controlled group members are treated as a single employer when applying certain employee benefit plan requirements under the Internal Revenue Code ("IRC"). Similarly, two or more employers who are members of an affiliated service group are also treated as a single employer for purposes of satisfying the IRC controlled group requirements.

The affected requirements are:

- The general nondiscrimination rules under IRC section 401(a)(4),
- The compensation dollar limitations under IRC section 401(a)(17),
- The minimum participation requirements under IRC section 401(a)(26),
- The eligibility requirements under IRC sections 401(a)(3) and 410(a),
- The mimimum coverage rules under IRC section 410(b),
- The vesting requirements under IRC sections 401(a)(7) and 411,
- The contribution limits under IRC section 415,
- The top-heavy rules under IRC section 416,
- The rules applicable to SEP and SIMPLE plans under IRC section 408, and
- The nondiscrimination rules applicable to cafeteria plans under IRC section 125 and dependent care under IRC section 129.

Plans that do not satisfy the applicable requirements, when taking into account all the members of the controlled group, could be disqualified resulting in additional taxable income, loss of tax deductions, and possible penalties.

Overview of Controlled Groups

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

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

Types of Controlled Groups

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

- Parent-subsidiary,
- Brother-sister, or
- Combination of the above types.

Parent-subsidiary Controlled Group

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

- 80 percent of the stock of each corporation (except the common parent) is owned by one or more corporations in the group; and
- The parent corporation must own 80 percent of at least one other corporation.

Brother-sister Controlled Group

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

- A "controlling interest" generally means 80 percent or more of the total control or value of each entity (but only if such common owners own equity in each entity); and

- "Effective control" generally means more than 50 percent of the voting power or value of each entity, but only to the extent such stock ownership is identical with respect to each entity.

Combined Group

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

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

Ownership Attribution Rules

Family member constructive ownership rules for controlled groups are covered under IRC section 1563(e), as outlined below. It should also be noted that there are constructive ownership rules for stock options owned and attribution from partnerships, estates, trusts and corporations under IRC sections 1563(e)(1), (2), (3) and (4), which are beyond the scope of this article, but must be considered if applicable to a specific situation.

Spouses

An individual is considered as owning stock in a corporation owned directly or indirectly by or for his/her spouse ***except*** for a corporation where all of the following conditions are satisfied for a taxable year:

1) The individual does not own directly any stock in the corporation;
2) The individual is not a director or employee and does not participate in the management of such corporation;
3) Not more than fifty percent of such corporation's gross income for such taxable year was derived from royalties, rents, dividends, interest and annuities; and
4) Such stock is not subject to conditions that substantially restrict or limit the spouse's right to dispose of such stock and that run in favor of the individual or his children who have not attained the age of twenty-one years.

Minor Children

A parent is considered as owning stock owned, directly or indirectly, by or for his/her children who have not attained the age of twenty-one. Conversely, if the individual has not attained age twenty-one, s/he is considered as owning stock owned, directly or indirectly, by or for his/her parents.

Adult Children, Parents and Grandparents

An individual who owns more than fifty percent of the voting power or fifty percent of the value of a corporation shall be considered as owning the stock in such corporation owned, directly or indirectly, by or for his/her parents, grandparents, grandchildren and children who have attained age twenty-one.

Overview of Affiliated Service Groups

The affiliated service group rules of IRC section 414(m) are very complex and are intended to preclude an entity from establishing an employee benefit plan for just one entity if there are two or more organizations that constitute an affiliated service group which, for employee benefit plan purposes, would be aggregated into a single employer. An affiliated service group is an entity (incorporated or unincorporated) that is either a service or management-type group (see below). It consists of a First Service Organization ("FSO") plus an 'A organization', a 'B organization' or, A and B organizations.

An 'A organization' is a shareholder or partner in the FSO and regularly performs services for the FSO, or is associated with the FSO in performing services for third parties. For purposes of the ownership test, it is sufficient for the 'A organization'

to have any ownership regardless of how small the percentage.

A 'B organization' is an organization (does not have to be a service organization) that provides services to the FSO or an 'A organization', which provides services their employees would normally perform. Additionally, at least ten percent or more of the interest in the 'B organization' must be owned by officers or highly compensated employees of the FSO or 'A organization'.

Service Organization Defined

The principal business of an organization will be considered the performance of services if capital is not a material income-producing factor for the organization, even though the organization is not engaged in a field listed in proposed Treasury Regulation section 1.414(m)-2(f)(2). Whether capital is a material income-producing factor must be determined by reference to all the facts and circumstances of each case. In general, capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business as reflected, for example, by a substantial investment in inventories, plant, machinery or other equipment. Capital is a material income-producing factor for banks and similar institutions. Capital is not a material income-producing factor if the gross income of the business consists principally of fees, commissions, or other compensation for personal services performed by an individual.

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

- Health
- Law
- Engineering
- Architecture
- Accounting
- Actuarial science
- Performing arts
- Consulting
- Insurance

Management-type Affiliated Service Group Defined

A management-type affiliated service group exists under IRC section 414(m)(5) 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 is:

- An organization for which management services are performed,
- Any organizations aggregated under IRC sections 414(b), 414(c), 414(m), and 414(o), and,

- All related organizations (for this purpose, a related organization has the same meaning as related person within the meaning of IRC section 144(a)(3)). The recipient need not be service organization.

There are several tests used under IRC section 414(m)(5) in the determination of principal business on a regular and continuing basis, which are listed below. Details of these tests may be found in the proposed regulations under IRC section 414(m).

- Two-Tax-Year Rolling Percentage
- Percentage of Gross Receipts
- Facts and Circumstances

Ownership Attribution Rules

In determining ownership for purposes of the affiliated service group rules, the principles of IRC section 318(a) apply. Under this section, an individual is considered to own stock owned by his spouse, children, grandchildren and parents. Additionally, IRC section 318(a)(3) provides that if fifty percent or more of the value of the stock in a corporation is owned, directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person.

Options for Compliance

There are essentially two options for compliance with the controlled group rules: a single employer-wide plan, or multiple plans. The approach to compliance is usually based on whether the companies that comprise the control group represent similar industries or diverse industries and/or geography.

Employer-wide Plan

If the companies that comprise a controlled group do not represent diverse industries, the simplest solution may be to cover all the employees of the controlled group under an employer-wide plan. By covering all employees under an employer-wide plan, the testing and administration of the plan should be more efficient and simpler.

Multiple Plans

If the companies that comprise a controlled group represent diverse industries and/or are geographically dispersed, then it may be necessary to maintain multiple plans with different levels of benefit. In such situations, the plans within the controlled group may be tested as a single plan, but it is unlikely that they will pass the annual nondiscrimination testing on an employer-wide basis. Alternatively, for larger and more diverse controlled groups, the employer should consider electing to be treated as operating Qualified Separate Lines of Business ("QSLOB") for purposes of their retirement plans and dependent care plans by establishing the QSLOBs pursuant to IRC section 414(r). This election requires a filing with the Internal Revenue Service ("IRS") on Form 5310-A. Once the QSLOBs are established, each QSLOB would conduct the nondiscrimination testing without regard to employees of the other QSLOB. This would facilitate the testing of a plan, and correction if the plan fails one of the testing requirements. The QSLOB election is valid until there is a substantial change in the demographics within the controlled group (hiring or firings) or there is a change in the members of the controlled group itself. At that point the QSLOB must be reviewed, retested and

reestablished, so that a revised election may be filed with the IRS.

Conclusion

Compliance with the various rules for qualified plans is difficult even for companies that are not part of a controlled group. It becomes even more difficult when operating multiple operations domestically. Adding foreign operations into the equation adds substantial additional complexity that companies need to recognize and address. The risk of noncompliance is too costly to ignore.

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