Benefit Insights

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A non-technical review of qualified retirement plan legislative and administrative issues

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Under Control or Out of Control

In today's business climate, it seems it is becoming increasingly common for businesses of all sizes to be structured using multiple companies. Maybe a business person is pursuing multiple ventures with different groups of co-owners. Perhaps a company decides to offer a new product or service and that is best accomplished via a separate entity. Sometimes it makes sense to create a separate company for each of a business's locations. Still other times the owner of one company decides to buy another business.

Regardless of the reason for structuring a business in this way, there are some complex IRS rules that must be considered when it comes to the retirement benefits being offered.

Background

During the mid-1980s, Congress created a series of complex rules designed to prevent companies from transferring employees to separate but related companies as a way to provide reduced or even no benefits without running afoul of the nondiscrimination rules. Generally speaking, those rules describe two types of related groups–the affiliated service group and the controlled group. For the sake of brevity throughout the rest of this article, we will occasionally refer to these as ASGs and CGs.

In short, these rules require that all companies in a related group must be combined when performing annual nondiscrimination testing on the retirement plan(s). While this requirement can be a limitation at times, with some careful planning it can also be used to provide retirement benefits to multiple companies more cost effectively than if the related companies were treated as separate entities. Before we look at some examples, it is first necessary to dive a little bit into the weeds to understand the gist of the rules themselves.

Affiliated Service Group

The ASG rules focus on the nature of the relationship between the entities in question. Some of the key variables in determining whether an ASG exists include the following:

- **Working Relationship:** Does one entity provide services to the other that are customarily provided by the recipient's employees?

Alternatively, do the entities involved join together to provide services to the same clients?

- **Ownership:** Is there any common ownership among the entities? In some instances, as little as 10% common ownership is enough to trigger an ASG.
- **Management:** Does one entity provide management oversight over the other entity? If so, an ASG may exist even if there is no common ownership.

While ASG relationships can exist in many different industries and entity types, it is not unusual for them to occur in professional settings such as medical practices and law firms. Consider two examples illustrating relatively common professional business structures.

Example #1

A law firm is organized as a partnership and each attorney creates his or her own professional corporation (P.C.). Rather than the attorneys being the partners of the law firm, their respective P.C.s are the partners. The partnership and the individual P.C.s join together to provide legal services to the firm's clients. As a result, the firm and the P.C.s form an ASG.

Example #2

Several physicians own a medical practice and they have no other employees. However, they also own part of a billing office that includes a number of employees who handle administrative functions for the practice. Since the billing office provides services to the practice that are customarily provided by employees, and there is some overlapping ownership, the two potentially form an ASG.

Controlled Group

The remainder of this article will focus primarily on controlled groups. Unlike affiliated service groups, controlled group determinations are based solely on overlapping ownership. There are two general types of controlled groups–the parent/subsidiary group and the brother/sister group.

Parent/Subsidiary Controlled Group

This type of group is the more straightforward of the two and exists when one entity owns **80% or more** of another entity. For example, if Company A owns 80% or more of Company B, the two companies are part of a parent/subsidiary controlled group.

Brother/Sister Controlled Group

This type of group is a little more complicated to explain. In broad terms, there are two thresholds to meet:

- **Common Ownership:** The same five or fewer individuals must own **at least 80%** of each company under consideration.
- **Identical Ownership:** The sum of the identical ownership of the five or fewer owners from the first step must be **greater than 50%**. The best way to explain identical ownership is via an example. If John Doe owns 10% of one company and 5% of another company, his identical ownership among the two is 5%.

When both of these requirements are met, there is a brother/sister controlled group.

Attribution of Ownership

As we described above, ownership is a key variable in these determinations, and there is a series of additional rules that discuss ownership. Specifically, there are instances in which the ownership held by one person or entity must be attributed to another person or entity. While we will spare you the gory details, it is important to briefly touch on these rules.

Attribution from Company to Individual

In simple terms, this essentially means that a person who owns at least 50% of a business is deemed to own a proportionate share of whatever that business owns. For example, if John Doe owns 75% of ABC Company, and ABC owns 60% of XYZ Company, John is deemed to own 45% of XYZ (75% × 60%). There are a number of variations and exceptions, but remember…we promised to spare you the gory details.

Attribution Among Family Members

This is when one person's ownership is attributed to certain family members. Specifically, an individual's ownership is attributed to his or her spouse as well as lineal ascendants and descendants. In this case, we do need to journey a little further down the rabbit hole to consider some of the very important exceptions:

1. Spousal attribution generally does not apply if the owner's spouse does not hold direct ownership in his or her own right **and** the spouse does not participate in the owner's company. The spouse need not formally be an employee in order to "participate" in the business.

2. There is limited attribution between parents and children over the age of 21, based on the amount of direct ownership held by the child.

3. There is no attribution between siblings.

4. Certain attribution to ascendants and descendants extends only to one generation, while other times it extends to multiple generations.

Putting it Together

Assuming you've made it this far without either falling asleep or running screaming from the room, it's time to look at some examples that might pull all of this craziness together. We will do this using a couple of simplified case studies, and our cast of characters will include John, Paul, George, Ringo, Yoko (John's wife) and Julian (John and Yoko's 18-year-old son).

Case Study #1

Our characters hold the following ownership in two companies:

	Beatlemania, Inc.	Yellow Sub, Inc.
John	40%	30%
Paul	40%	30%
George	10%	0%
Ringo	10%	0%
Yoko	0%	20%
Julian	0%	20%

At first glance, it does not appear that the same five people own at least 80% of both companies. However, once we consider family attribution, John's total ownership in Yellow Sub is 70% (30% direct +20% attributed from Yoko +20% attributed from Julian). Together, John and Paul own 80% of Beatlemania and 100% of Yellow Sub and their identical ownership is greater than 50%, making the two companies part of the same controlled group.

Case Study #2

John and Yoko each own 100% of Imagine, LLC and Silver Horse, Inc., respectively, and neither one is at all involved in the company owned by the other. Under one of the exceptions noted above, their ownership would not be attributed to each other, so it appears there would not be a controlled group. However, since Julian is under the age of 21, he is attributed the ownership from each of his parents, making him the 100% owner of both companies and causing the two to form a controlled group.

Making Sense of it All

So, what does all of this really mean? Basically, it means that when there is a controlled group (or an affiliated service group), all of the related companies are treated as a single employer for purposes of the retirement plan. In other words, the employees of all the related companies must be included in the annual nondiscrimination testing. That might sound onerous but it doesn't have to be.

Keep in mind that the annual testing compares the benefits provided to highly compensated employees (HCEs) to those provided to non-HCEs. If two companies in the same controlled group have similar numbers of HCEs and non-HCEs, it is completely plausible that the tests would still pass even if the employees of one of the companies don't receive any plan benefits.

If the goal is to provide similar benefits to the employees of several companies, a controlled group/affiliated service group relationship can make it more cost-effective to do so. The reason is that since all of the companies in the group must be treated as a single employer for purposes of testing, it is perfectly acceptable to have a single plan covering all of the employees. Through the use of more complex forms of nondiscrimination testing, it might even be possible to provide different benefits to the various companies in the group via a single plan. That means only one plan document to maintain, only one plan to administer and only one Form 5500 to file each year.

Conclusion

Before considering how to plan around/take advantage of related group status, the first step is to be sure which companies are/are not "related" based on the rules we have highlighted in this article. There are many facts and circumstances that can affect controlled group and affiliated service group determinations and even seemingly slight nuances can be game changers. As a result, it is usually worth spending a few dollars to hire someone who is knowledgeable and experienced in this area to assist with the analysis.

With some due diligence and careful planning, your controlled group can be under control rather than out of control.

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