

# The Ins and Outs of Controlled and Affiliated Service Groups

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## Agenda

- Controlled Groups
- Affiliated Service Groups
- Family Attribution
- Why Do We Care?

## CONTROLLED GROUPS

### Types of Controlled Groups

- Parent-Subsidiary
- Brother-Sister
- Combination
- Not-For-Profit

## Parent-Subsidiary Controlled Group: Definitions

- The parent entity owns “a controlling interest” in at least one subsidiary AND
- “A controlling interest” in each subsidiary is owned by the parent entity and/or another subsidiary

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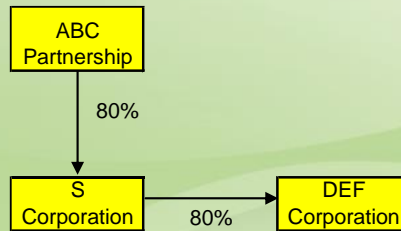
## Parent-Subsidiary Controlled Group: Definitions

- “A controlling interest” means
  - For a corporation – ownership of stock possessing at least 80% of total combined voting power of all classes of stock entitled to vote OR at least 80% of the total value shares of all classes of stock
  - For a trust or estate – ownership of an actuarial interest of at least 80% of the trust or estate (based on exercise of discretion by a fiduciary in favor of a beneficiary)
  - For a partnership – ownership of at least 80% of the profits interest or capital interest of the partnership
  - For a sole proprietorship – ownership of the sole proprietorship

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## Parent-Subsidiary Controlled Group: Example

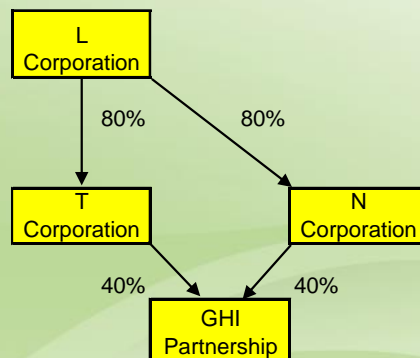
- ABC Partnership owns 80% of the voting power of the stock of S Corp. and S Corp. owns 80% of the profits interest of DEF Corp.
- Is this a controlled group?



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## Parent-Subsidiary Controlled Group: Example

- L Corp. owns 80% of the stock of N Corp. and T Corp.
- N Corp. and T Corp. each own 40% of the capital interest of GHI Partnership
- Is this a controlled group?



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## Brother-Sister Controlled Group: Definitions

- The same 5 or fewer individuals, estates or trusts have “effective control” of and a “controlling interest” (defined above) in all members of the group
- “Effective control” means
  - For a corporation – ownership of stock possessing more than 50% of total combined voting power of all classes of stock entitled to vote OR more than 50% of the total value shares of all classes of stock
  - For a trust or estate – ownership of an aggregate actuarial interest of more than 50% of the trust or estate
  - For a partnership – ownership of an aggregate of more than 50% of the profits interest or capital interest of the partnership
  - For a sole proprietorship – one of the persons owns the sole proprietorship
- Ignore anyone whose effective control is zero

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## Brother-Sister Controlled Group: Examples

- A, B, C, D and E (all unrelated) own an interest in sole proprietorship F, a capital interest in GHI Partnership, and stock of corporations M, W, X, Y and Z as follows:

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## Brother-Sister Controlled Group: Examples

	F	GHI	M	W	X	Y	Z
A	100%	50%	100%	60%	40%	20%	60%
B		40%		15%	40%	50%	30%
C					10%	10%	10%
D				25%		20%	
E		10%			10%		
Total	100%	100%	100%	100%	100%	100%	100%

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## Brother-Sister Controlled Group: Examples

	F	GHI	M	W	X	Y	Z
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C					10%	10%	10%
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E		10%			10%		
Total	100%	100%	100%	100%	100%	100%	100%

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E		10%			10%		
Total	100%	100%	100%	100%	100%	100%	100%

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## Brother-Sister Controlled Group: Examples

	F	GHI	M	W	X	Y	Z
A	100%	50%	100%	60%	40%	20%	60%
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C					10%	<del>10%</del>	10%
D				25%		<del>20%</del>	
E		10%			10%		
Total	100%	100%	100%	100%	100%	100%	100%

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## Brother-Sister Controlled Group: Examples

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Total	100%	100%	100%	100%	100%	100%	100%

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## Combination Controlled Group: Definition

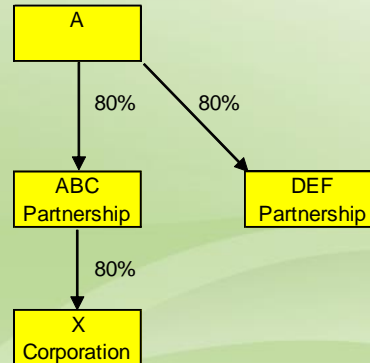
- A controlled group that consists of a parent-subsidary controlled group and a brother-sister controlled group

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## Combination Controlled Group: Example

- A (an individual) owns a controlling interest in ABC Partnership and DEF Partnership
- ABC Partnership owns a controlling interest in X Corporation
- Is this a combination controlled group?



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## Not-For-Profit Controlled Group: Rules

- Applies to organizations that are exempt from taxation under Code Section 501(a)
- Does not apply to any church or any qualified church-controlled organization
- The “employer” in a plan (e.g., 401(k), 403(b)) includes a not-for-profit entity whose employees participate in a plan and any other organization under common control with the not-for-profit entity
- Common control exits if at least 80% of the directors or trustees of one organization are either representatives of, or directly or indirectly controlled by, the other organization

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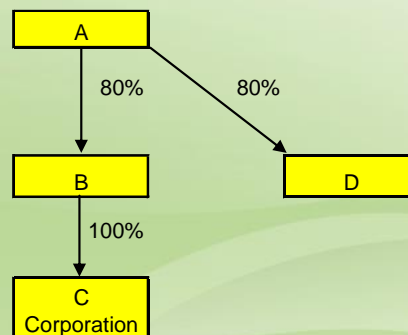
## Not-For-Profit Controlled Group: Rules

- A trustee or director is treated as a representative of another not-for-profit entity if he or she is also a trustee, director, agent or employee of the other not-for-profit entity
- 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 determined on the facts and circumstances

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## Not-For-Profit Controlled Group: Example

- Not-for-profit entity A has the power to appoint at least 80% of the trustees of not-for-profit entity B and to control at least 80% of the directors of not-for-profit entity D
- Not-for-profit B owns 100% of the outstanding stock of C Corporation (a for-profit entity)
- Are all of these entities the same “employer” for a plan sponsored by A?



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## Not-For-Profit Controlled Group: Aggregation

- Not-for-profit organizations that maintain a plan that covers employees from each organization may treat themselves as under common control (even if they would not otherwise be in a not-for-profit controlled group) if each of the organizations regularly coordinates their day-to-day activities

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## Not-For-Profit Controlled Group: Aggregation Example

- M is a not-for-profit hospital
- N is a not-for-profit medical clinic
- N is located in a city and M is located in a nearby suburb
- The entities have a history of regularly coordinating day-to-day activities
  - Periodic transfer of staff
  - Coordination of staff training
  - Common sources of income
  - Coordination of budget and operational goals
- A single 403(b) plan covers employees of M and N
- There is less than 80% overlap in board members

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## Not-For-Profit Controlled Group: Aggregation Example

- Are M and N in a not-for-profit controlled group?
- If not, can they choose to treat themselves as being under common control so the employees of each organization can participate in a single 403(b) plan?

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## Controlled Groups: Foreign Entity

- What if one of the subsidiaries is a foreign entity?
  - Would it be in the controlled group?
- That depends... is it an “excluded member” under Code Section 1563(B)(2)(C)?
  - It is excluded if – as of December 31 of the taxable year – it is a foreign corporation subject to taxation under Code Section 881 for that taxable year

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## Controlled Groups: Foreign Entity

- A foreign corporation is subject to tax under Code Section 881 equal to 30% of amounts received from sources in the US as
  - Interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income
  - Gains from the disposal of timber, coal or domestic iron ore

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## Controlled Groups: Foreign Entity

- A sale or exchange of (or a payment on) an original issue discount obligation
- Gains from the sale or exchange of patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like property, or of any interest in any such property, to the extent such gains are from payments which are contingent on the productivity, use, or disposition of the property or interest sold or exchanged
- But only to the extent the amount so received is not effectively connected with the conduct of a trade or business within the US

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## Affiliated Service Groups

### Affiliated Service Groups: Introduction

- Affiliated service group means a group consisting of a service organization (first service organization or FSO) and
  - One or more A organizations (A Org)
  - One or more B organizations (B Org)
  - One or more A Orgs and one or more B Orgs
- Bonus group – management functions

## Affiliated Service Groups: FSO Definition

- An organization will be considered a “service organization” if it is a noncapital intensive organization
  - The principal business of the organization will be considered performance of services if capital is not a material income-producing factor
    - Determined by reference to all facts and circumstances
    - Capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to employment of capital in the business
      - Substantial investment in inventories, plant, machinery, etc.

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## Affiliated Service Groups: FSO Definition

- Any organization engaged in any of the following fields is considered a “service organization”

Actuarial Science

Engineering

Architecture

Health

Accounting

Insurance

Consulting

Law

Performing Arts

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## Affiliated Service Groups: A Org Definition

- A service organization is an A Org if it
  - Is a partner or shareholder in an FSO (no matter how small the ownership) and
  - Regularly performs services for the FSO or is regularly associated with the FSO in performing services for 3<sup>rd</sup> parties
    - It is not necessary for employees of the A Org to directly perform services for the FSO

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## Affiliated Service Groups: A Org Definition

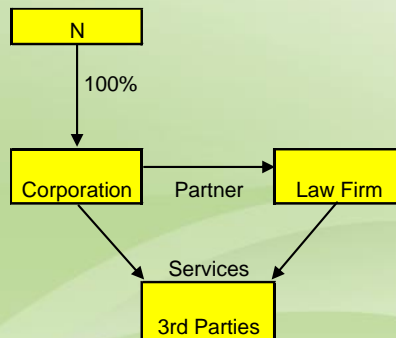
- “Regularly performs services for” is determined on the facts and circumstances
  - One factor is the amount of earned income that the A Org derives from performing services for the FSO or from performing services for persons associated with the FSO

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## Affiliated Service Groups: A Org Example

- Attorney N is incorporated
- Attorney N's corporation is a partner in a law firm
- Attorney N and her corporation are regularly associated with the law firm in performing services for 3<sup>rd</sup> parties
- Are Attorney N's corporation and the law firm an A Org affiliated service group?



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## Affiliated Service Groups: B Org Definitions

- A service organization is a B Org if
  - A significant portion of the business of the organization is the performance of services for the FSO, for one or more A Orgs (determined with regard to the FSO), or both
  - Those services are of a type historically performed by employees in the service field of the FSO or the A Orgs

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## Affiliated Service Groups: B Org Definitions

- A service organization is a B Org if
  - 10% or more of the interests in the B Org is held, in the aggregate, by officers, HCEs or the common owners of the FSO or of the A Orgs (using constructive ownership rules)
    - A person is a common owner if at least 3% of the interests in the organization, in the aggregate, is held by persons who are owners of the B Org
- The B Org does not need to be a service organization

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## Affiliated Service Groups: B Org Definitions

- “Significant portion” is determined on the facts and circumstances
  - The performance of services by the B Org for the FSO or for one or more A Orgs, or for both, *will not* be considered “significant” if the *service receipts percentage* is less than 5%
    - The ratio of the gross receipts derived from performing services for the FSO or for one or more A Orgs, or for both, to the total gross receipts of the B Org for performing services

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## Affiliated Service Groups: B Org Definitions

- “Significant portion” is determined on the facts and circumstances
  - The performance of services by the B Org for the FSO or for one or more A Orgs, or for both, *will be* considered “significant” if the *total receipts percentage* is 10% or more
    - The ratio of the gross receipts derived from performing services for the FSO or for one or more A Orgs, or for both, to the total gross receipts of the B Org (regardless of whether they are for performing services)

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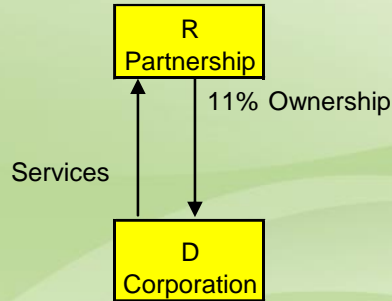
## Affiliated Service Groups: B Org Definitions

- “Historically performed”
  - Services will be considered of a type historically performed by employees in a particular service field if it were not unusual for the services to be performed by employees of organizations in that service field in the US on December 13, 1980

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## Affiliated Service Groups: B Org Examples

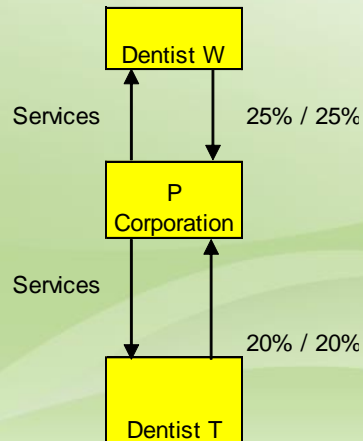
- R Partnership is a service organization with 11 partners
- Each of R's partners owns 1% of D Corporation's stock
- D Corporation provides services to the partnership of a type historically performed by employees in the service field of R Partnership
- Are R Partnership and D Corporation a B Org affiliated service group?



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## Affiliated Service Groups: B Org Examples

- P Corporation provides secretarial services to unrelated dentists
- Dentist T owns 20% of P Corporation and accounts for 20% of its gross receipts
- Dentist W owns 25% of P Corporation and accounts for 25% of its gross receipts
- Are there any B Org affiliated service groups?



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## Affiliated Service Groups: Management Functions

- An additional type of affiliated service group includes
  - An organization the principal business of which is performing, on a regular and continuing basis, management functions for 1 organization (or for 1 organization and other organizations related to such organization) and
  - The organization (and related organizations) for which such management functions are performed

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## FAMILY ATTRIBUTION\*

## Spouses

- Spouse A is deemed to own the stock which is owned by Spouse B, unless
    - The couple is legally separated or divorced
- OR

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## Spouses

- All of the following are satisfied
  - Spouse A does not own directly any interest in the company
  - Spouse A is not a director or employee of the company
  - Spouse A does not participate in the management of the company
  - No more than 50% of the company's gross income is derived from royalties, rents, dividends, interest or annuities
  - The stock is not subject to restrictions in favor of Spouse A or his children under age 21

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## Spouses

- But, what about spouses that live in a community property state?
- By law, each spouse owns  $\frac{1}{2}$  of the stock owned by the other spouse
- Therefore, the “All of the following are satisfied” rule above does not apply

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## Children and Parents

- A person is deemed to own the interest owned (directly or indirectly) by his or her children who have not attained age 21
- Children who have not attained age 21 are deemed own the interest owned (directly or indirectly) by their parents
- Also applies to adopted children

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## Children, Grandchildren, Parents and Grandparents

- A person who is in “effective control” of an organization is considered to own an interest in the organization this is owned (directly or indirectly) by or for his or her
  - Parents
  - Grandparents
  - Grandchildren
  - Children who have attained age 21
- Also applies to adopted children

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## Family Attribution: Example

- F owns directly 40% of the profits interest of DEF Partnership
- M, who is F's 20 year-old son, owns directly 30% of the profits interest of DEF Partnership
- A, who is F's 30 year-old son, owns directly 20% of the profits interest of DEF Partnership
- An unrelated person owns directly
  - 10% of the profits interest of DEF Partnership
  - 100% of the capital interest of DEF Partnership

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## Family Attribution: Example

- How much of DEF Partnership's profits interest does F own? **90%**
  - 40% that she owns directly
  - 30% that she is deemed to own through M (her 20 year-old son)
  - 20% that she is deemed to own through A (her adult son) due to her "effectively controlling" 70% of DEF (40%+30%)

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## Family Attribution: Example

- How much of DEF Partnership's profits interest does M own? **70%**
  - 30% that he owns directly
  - 40% that he is deemed to own through F (his mother)
- M is not deemed to own the 20% owned by A (his brother) because "double attribution" is not permitted
  - To get there, you would have to link M's interest with A's interest through their mother

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## Family Attribution: Example

- How much of DEF Partnership's profits interest does A own?  
**20%**
  - 20% that he owns directly
- A is not deemed to own the 30% owned by M (his brother) because direct family attribution does not work between siblings
- A is not deemed to own the 40% owned by F (his mother) because he is over 21 and family attribution in that situation only occurs through "effective control" prior to the attribution

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## WHY DO WE CARE?

## Retirement Plan Issues

- All employees generally must be included when performing nondiscrimination testing under Code Sections
  - 410(b) (eligibility and participation)
  - 401(a)(4) (benefits, rights and features)
  - 401(k) and 401(m) (employee deferrals and matching contributions)
- May be able to get around this if establish “qualified separate lines of businesses” (QSLOBs)

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## Retirement Plan Issues

- Service with all members is considered when determining eligibility and vesting service
- Distributions permitted only upon “termination” of employment
- Members of the controlled group may be liable for pension obligations of another member that terminates an underfunded pension plan
  - Can also apply to withdrawal liability in relation to a multiemployer plan
- All plans in the controlled group are considered when determining limits on 401(k) plan loans

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## Retirement Plan Issues

- In order to have a “catch-up” contribution feature in a 401(k) plan, all 401(k) plans in the controlled group must offer it
- Benefits earned by an employee in multiple plans in the same controlled group are considered to be earned in one plan
  - Applies to the Code Section 415 limits (reducing the 80% ownership requirement to 50% - for parent-subsiary controlled group only)

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## Retirement Plan Issues

- Top-heavy testing is performed on a controlled group basis
- HCE determination is performed on a controlled group basis
  - All plans must use or not use the top 20% election
- Distributions from 401(k) plans upon termination may not be permitted if another 401(k) plan exists

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## Retirement Plan Issues

- Determination of which company's employees can participate in the plan is important
  - What happens if you include employees that the plan document does not include?
  - What happens if you don't include employees that the plan document includes?

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## Retirement Plan Issues

- What happens if an employee changes companies mid-year (and they both sponsor 401(k) plans with different terms)?
- Deduction limits under Code Section 404 for a jointly-sponsored plan
  - Controlled group – calculate together
  - Affiliated service group – calculate separately if the plan was created after 1988

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## Retirement Plan Issues

- Transition period after an acquisition, merger, etc.
  - Code Sections 401(a)(26) and 410(b)
  - Begins on date of transaction
  - Ends on earlier of
    - End of following plan year
    - Change in coverage or benefits

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## Retirement Plan Issues

- For affiliated services groups
  - For some purposes, the plan will be treated as a single employer plan
    - Eligibility
    - Non-discrimination
    - Vesting
    - Limits on contributions and benefits

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## Retirement Plan Issues

- For affiliated services groups
  - For some purposes, the plan will be treated as a multiple employer plan
  - Exclusive benefit rule
  - Funding
  - Liability for funding tax
  - Deductions

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## QUESTIONS?