

Controlled & Affiliated Service Group Basics

Background

The Internal Revenue Code originally established its Controlled Groups Provisions as part of the Revenue Act of 1964. In 1974, the Employee Retirement Income Security Act (ERISA) added sections to existing rules that require that all employees of commonly controlled organizations be treated as employees of a single organization for a number of benefits-related issues. Simply setting up different companies under separate tax ID numbers does not relieve related employers from being treated as a single employer under these rules.

There are two types of aggregated group arrangements addressed in §414 rules. The concept of a “controlled group” relies on the relative ownership structure of two or more entities, whereas the concept of an “affiliated service group” exists when one organization provides certain management or business support services to another entity.

Why Controlled Group and Affiliated Service Group Status Matters

Employers must understand their organization’s status as a part of a controlled group or an affiliated service group for a number of important reasons, including (but not limited to) the following:

- §125 and §105(h) benefit nondiscrimination rules apply on a controlled group basis. In other words, when testing an employer plan for discrimination in favor of highly compensated individuals and key employees, all organizations that are part of a controlled group or an affiliated service group must be considered.
- Applicable large employer (ALE) status for purposes of compliance with the §4980H “employer mandate” requirements is determined based on employees in all organizations that are part of a controlled group or an affiliated service group.
- A multiple employer welfare arrangement (MEWA) is created when employees from separate organizations that are not part of a controlled group are covered by a common health plan.
 - Status as a MEWA raises a number of compliance issues, including M-1 filing requirements, group insurance contract issues, and compliance with state laws that may restrict or prohibit self-insured MEWAs.
 - Note that to avoid plan MEWA status, the employers covered by the plan must form a controlled group. Employers who are part of an affiliated service group would still constitute a MEWA if they participate in the same group health plan(s).

Controlled Groups

Generally, a “controlled group” includes all organizations having common ownership in accordance with the description of either Type A or Type B in the table that follows. Although some ownership structures are simple enough to allow the determination of controlled group status to be made relatively easily, in other cases the complex web of ownership requires a detailed (and sometimes time-consuming) analysis of all the facts and circumstances.

Type A in the following table is referred to as a “parent-subsidiary” controlled group. Type B is referred to as a “brother-sister” controlled group. Businesses in either Type A or Type B relationships are sometimes referred to as “trades or businesses under common control, or aggregated employers.”

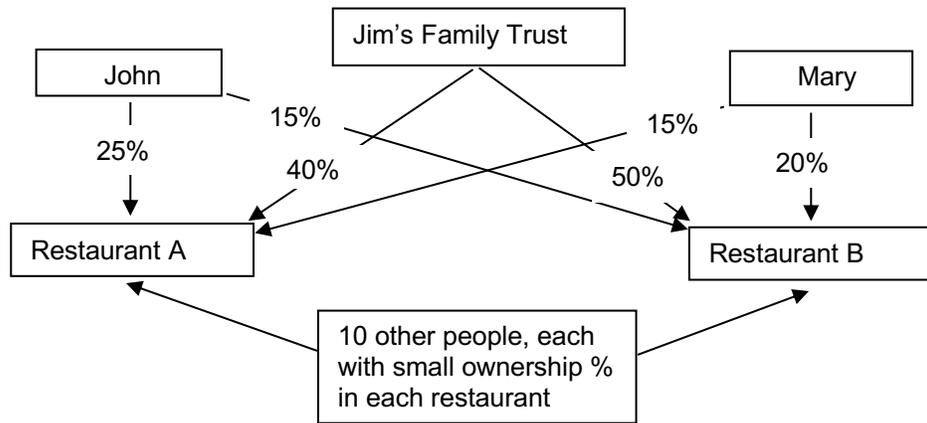
In a basic initial analysis, a parent-subsidiary controlled group exists if one company owns at least 80% of another organization. A brother-sister controlled group can exist if five or fewer owners own at least 80% in each of two organizations.

Controlled Group Examples

| CONTROLLED GROUPS | |
|--|---|
| TYPE | DESCRIPTION OF OWNERSHIP STRUCTURE |
| <p>Type A – Parent-Subsidiary Group</p> | <p>Core group required: A “parent” company must directly own at least 80% of one or more other entities in the group. Basic examples:</p> <div style="display: flex; justify-content: space-around; align-items: flex-start;"> <div style="text-align: center;"> <pre> graph TD P[PARENT] --> A[SUBSIDIARY A] P --> B[SUBSIDIARY B] </pre> <p>Parent owns 80% directly in each of A & B</p> </div> <div style="text-align: center;"> <pre> graph TD P[PARENT] --> A[SUBSIDIARY A] A --> B[SUBSIDIARY B] </pre> <p>Parent owns 80% directly in A</p> <p>A owns 80% directly in B</p> </div> </div> <p>The shaded entities, above, represent the “core group” in a parent-subsidiary group, i.e., the parent and each entity 80% owned by the parent. Subsidiary B, in the right diagram, is not in the core group, but is in the controlled group (see diagram below).</p> <p>Non-Core Group Members: Additional members of a parent-subsidiary group include entities that are 80% directly owned by one or more entities in the group other than the parent company. In the diagrams below, the additional controlled group members other than the “core group” are shaded.</p> <div style="display: flex; justify-content: space-around; align-items: flex-start;"> <div style="text-align: center;"> <pre> graph TD P[PARENT] --> A[SUBSIDIARY A] P --> B[SUBSIDIARY B] A --> C[SUBSIDIARY C] B --> C </pre> <p>Parent owns 80% directly in each of A & B</p> <p>A owns 40% of C directly</p> <p>B owns 40% of C directly</p> </div> <div style="text-align: center;"> <pre> graph TD P[PARENT] --> A[SUBSIDIARY A] A --> B[SUBSIDIARY B] </pre> <p>Parent owns 80% directly of A</p> <p>A owns 80% of B directly</p> </div> </div> |

**Type B –
Brother-Sister
Group**

5 or fewer individuals, estates, or trusts own together, directly or by attribution, at least 80% of the stock or other control of two or more companies. We will refer to this group of owners as the “controlling owners.”



Note: In this example, 2 individuals and 1 trust own 80% of Restaurant A and 85% of Restaurant B; consequently, the two restaurants would be considered under common control if the “Special Brother-Sister Ownership Rule,” described below, is met.

Special Brother-Sister Ownership Rule: In addition to the 80%, the brother-sister relationship requires that, when considering the smallest percentage interest of each of the controlling owners among the companies, the sum of the smallest interests must exceed 50%.

In the example, John’s smallest interest is 15%, the Trust’s smallest interest is 40%, and Mary’s smallest interest is 15%, so the total of the smallest interests is easily more than 50%, making the two restaurants a brother-sister controlled group.

Other Controlled Group Rules

Ownership Control: For corporations, the type of control that is examined is the voting control of the shareholders or the percentage value of the outstanding shares. If there is 80% or more common ownership considering either the voting control or percentage value of the outstanding share, a controlled group is formed. For partnerships, the percentage of capital or profits interest is used. For LLCs, partnership rules apply unless an election was made to be treated as a corporation for tax purposes (in which case corporation ownership rules apply). For trusts and estates, beneficial or actuarial interest is used (based on IRS estate tax regulations).

Ownership Attribution: Only for the brother-sister form of controlled group, ownership might be attributed from and to parents, children, and grandchildren, as well as to grantors and beneficiaries of trusts and beneficiaries of estates. So if ownership or control is distributed among such persons or entities, a closer review of the arrangements and relationships would be required.

| OWNERSHIP INTERESTS OF: | ARE ATTRIBUTED TO: | |
|----------------------------|-----------------------|--|
| Spouse | Spouse | EXCEPTION: No attribution between spouses if there is no: • direct ownership, • participation in company, and • no more than 50% of business gross income is passive investments |
| Minor child (under age 21) | Parent or Grandparent | Always attributed to parent Only attributed to grandparent if grandparent owns >50% of that business |
| Adult child (21+) | Parent or Grandparent | Only attributed to parent or grandparent if parent or grandparent owns >50% of that business |
| Parent | Child | Always attributed to minor child (under age 21) Only attributed to adult child (21+) if adult child owns >50% of that business |
| Grandparent | Grandchild | Only attributed to grandchild if grandchild owns >50% of that business |
| Sibling | No attribution | |

Affiliated Service Groups

IRC §414(m) was enacted to expand the idea of control to separate, but affiliated, entities. Proposed Treas. Reg. §1.414(m) provides that all employees of the members of an affiliated service group shall be treated as if they were employed by a single employer. The purpose of the affiliated service group rules is to prevent circumvention of the controlled group rules by expanding the type of related companies that must be considered as a single employer.

Affiliated service groups can exist when there is either management control across organizations, or when an organization provides certain business services to a separate entity. Affiliated service group status can exist even in instances where there is little or no common ownership.

Management-Type Affiliated Service Groups

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. The recipient organization does not need to be a service organization.

Several methods can be used to determine whether providing management services is the "principal business" of the management organization. For example, the 50% of business test requires that management functions must make up more than 50% of the management organizations business during a two-year tax period. Other methods include a gross receipts test and an analysis based on all facts and circumstances.

Example of a management-type affiliated service group – Providing management services to restaurants A, B, C, and D makes up 60% of Managers-R-U's, Inc.'s business. None of the individuals affiliated with restaurants A, B, C, and D have any ownership in Managers-R-U's, Inc.

Service Relationship Affiliated Service Groups

Affiliated service group status also exists when one organization provides business services to what is called a "first services organization" (FSO). An FSO is an organization in which performance of services is the principal business of the organization. Examples of an FSO would include those whose principal business is in the field of law, accounting, consulting, healthcare, etc.

Two types of relationships between a service providing organization and an FSO will create an affiliated service group.

- "A-Organization" (A-Org) Relationships
 - The A-Org provides services to an FSO or works with an FSO to provide services to a third party.
 - The A-Org must be a partner or shareholder in the FSO.
- "B-Organization" (B-Org) Relationships
 - The B-Org provides services to an FSO or its affiliated A-Org.
 - The services are typically those performed by employees of the FSO or A-Org.
 - 10% or more of the interest in the B-Org must be held by highly compensated employees of the FSO or affiliated A-Org.

Example of a B-Org relationship – Good Doctors LLP is a clinic with 11 partner physicians. Each of the physicians owns 1% of an organization called Clinic Helpers Inc. Clinic Helpers Inc. provides clinic office management services to Good Doctors LLP and other clinics.

- Good Doctors LLP is an FSO.
- The services provided by Clinic Helpers Inc. are services typically provided by clinic employees.
- 10% or more of the interest in Clinic Helpers Inc. (11% in this example) is held by the physicians of Good Doctors LLP (all of the physicians are considered highly compensated).

Summary

The determination of controlled group or affiliated service group status can be extremely complex. In the case of a related organization with significant common ownership, sometimes the answer is very simple and clear. For example, if one person owns at least 80% in Company A and at least 80% in Company B, it would not be necessary to engage a lawyer to determine that the two companies must be treated as a single employer. However, often there are many different individuals involved, attribution rules to consider between family members, or shared services, making the analysis more complicated.

Any group of related organizations that wants to assume they will be treated as a single employer (e.g. for purposes of sharing benefit plans), or as separate entities (e.g. in order to avoid §4980H offer of coverage requirements) should carefully examine ownership interests and shared services to determine whether the entities form a controlled group or an affiliated service group under §414 rules. If they are not sure, they must seek the advice of a qualified advisor to make the determination.

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