5/18/2023 Employee Benefits Compliance

Understanding Controlled Group Rules

CAUTION: This is a simplified summary of complex rules. Controlled group status and associated concepts must be independently evaluated by tax counsel.

Background

The Internal Revenue Code (IRC) was amended to include Controlled Group Rules in 1964 to stop a practice where medium and large businesses took advantage of lower tax rates for small businesses by separating their structure into multiple "separate" entities. The Employee Retirement Income Security Act (ERISA) was later drafted to reference the IRC Controlled Group Rules so that employers could not combine or separate entities to avoid certain coverage rules and/or nondiscrimination requirements. As a result, under ERISA all employees of commonly controlled corporations are treated as employees of a single corporation or entity. Within ERISA, additional flexibility is afforded to retirement plans operated along separate lines of business (SLOB Rules). However, the SLOB Rules do not extend to health and welfare plans under ERISA.

Relevance to Health and Welfare Plans

Historically, employers sponsoring health and welfare plans needed to understand whether they were a part of a controlled group to avoid covering employees of a non-affiliated entity and inadvertently creating a Multiple Employer Welfare Arrangement (MEWA). Self-funded plans also need to understand their controlled group status to complete non-discrimination testing under IRC section 105(h). Employers that fund Health Savings Accounts and do not allow employees to make pre-tax salary reduction HSA contributions also need to apply complex Comparability Rules on a controlled group basis.

New Significance under the ACA

The Patient Protection and Affordable care Act (ACA) has made an entity's controlled group status a threshold question that cannot go unanswered. It is critical to determine Applicable Large Employer (ALE) status and understand potential Pay or Play risk. ALE status attaches to employers with at least 50 full time and full-time equivalent employees as determined over the prior calendar year and on a controlled group basis. This means that even an employer with only a few employees will be an ALE if there is sufficient common ownership to connect it to another entity or entities that, together, employ at least 50 full time and full-time equivalent employees. Each controlled group member with at least one full-time employee must then separately satisfy Pay or Play requirements. These individual controlled group members are called ALE members or member entities. Importantly, Pay or Play penalties are assessed on a member entity by member entity basis. As a result, required ACA reporting must also be done separately on a member entity by member entity basis. In reporting, each member entity must also identify all other entities in its controlled group, listing up to the first 30 by relative size.

How Do These Rules Work?

Most commonly, controlled group status is the result of either a parent-subsidiary relationship or a brother-sister relationship.

Parent-Subsidiary

A parent-subsidiary controlled group exists where entities are connected through stock or other ownership with a common parent. The common parent must own 80% or more of the total combined voting power of all classes of stock of the other entity. These same rules apply to other business structures, such as partnerships or proprietorships.

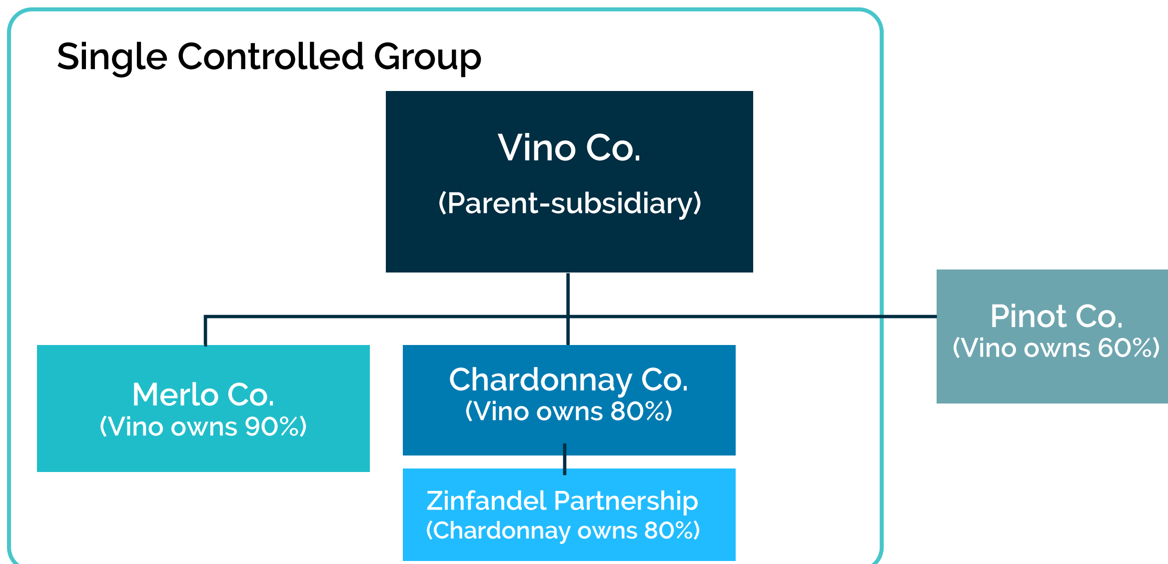
Parent-Subsidiary Example

Vino Corporation owns:

- 90% of the stock of Merlot Corporation,
- 80% of the stock of Chardonnay Corporation, and
- 60% of the stock of Pinot Corporation.

Unrelated persons own the stock not owned by Vino Corporation (10% of Merlot, 20% of Chardonnay, and 40% of Pinot). Because Vino Corporation owns 80% or more of the stock of the Merlot and Chardonnay Corporations, Vino Corporation is the common parent of a parent-subsidiary group consisting of Vino, Merlot, and Chardonnay. Pinot Corporation is not a member of the group because Vino Corporation's ownership is less than 80%.

If Chardonnay Corporation also owns 80% of the Zinfandel Partnership, Vino Corporation is also then the common parent of Zinfandel. The parent-subsidiary group then consists of Vino, Merlot, Chardonnay and Zinfandel.



Brother-Sister

Brother-sister controlled group determinations are a little trickier than parent-subsidiary determinations. A brother-sister controlled group exists where five or fewer individuals, corporations, estates, trusts, or other tax-recognized entities directly or indirectly own 80% or more of the total voting stock of each entity in the group. Those same individuals, corporations, estates, trusts, or other tax-recognized entities must own more than 50% of the total combined voting stock, but only taking into account each person's interest at the highest identical level.

Brother-Sister Example

Alpha Corp and Bentley Corp are owned by four shareholders (C, A, R, and S), in the following percentages:

Shareholder	Alpha Corp	Bentley Corp
C	80%	20%
A	10%	50%
R	5%	15%
S	5%	15%
TOTAL	**100%**	**100%**

To meet the first part of the test, the same five or fewer common owners must own more than 80% of stock or some interest in all members of the controlled group. Here, the first test is met because the shareholders own 100% of the stock of Alpha and Bentley. The next step is to determine whether the identical ownership interest totals more than 50%

Shareholder	Alpha Corp	Bentley Corp	Identical Interest
C	80%	20%	20%
A	10%	50%	10%
R	5%	15%	5%
S	5%	15%	5%
TOTAL	**100%**	**100%**	**40%**

Although the four shareholders together own 80% or more of the stock of each corporation (100%), they do not own more than 50% of the stock of each corporation, taking into account only the identical ownership in each corporation as shown above. Their combined identical ownership interest is only 40%

If shareholder C owned 40% of Bentley Corp. (instead of 20%) the identical ownership interest increases to 40% for shareholder C and increases the combined ownership of shareholders C, A, R, and S to 60%. Because this total is more than 50%, with this one change, Alpha and Bentley would be a brother-sister controlled group.

NOTE: A third type of "combined group" consists of three or more organizations where 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.

CAUTION: An entity created as the result of a joint venture will generally not be within the same controlled group of either partner company. With a joint venture there is usually a separate company that is jointly owned by two unrelated entities. The entities involved are not usually members of a controlled group. Neither entity generally owns 80% of the new company and because the partners to the joint venture do not typically have any ownership interest in each other there is no identical interest to create a brother sister relationship.

Affiliated Service Groups

The IRC was also amended to expand the idea of controlled groups to separate but affiliated entities. Under the revised rules, in addition to the controlled groups discussed above, all employees employed by members of "an affiliated service group" are also treated under the IRC as if they were employed by a single employer. Note, however, that this treatment may not extend to ERISA and DOL has cautioned that plans sponsored by affiliated service groups may still be MEWAs.

Affiliated service groups can be comprised of two or more employers engaged in a joint activity or with a combination of common ownership and joint activity. At least one employer must be a "service organization." Proposed regulations identify health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, and insurance as possible service organizations. An affiliated service group must also meet at least one of the following two conditions: (1) the company receiving services (or its highly compensated employees) within the group must be an owner of the service organization, or; (2) one group member must be a management organization whose principal business is to perform management functions on a regular and continuing basis for the other member(s).

Affiliated Service Group Example

Internal Medical Associates is a general medical practice with eleven physician owners. It has no other employees, except the eleven physicians, who are all highly paid. All of the nurses, reception staff, billing and cleaning employees used by Internal Medical Associates are employed by a separate entity, Medical Maintenance, Inc. Medical Maintenance is owned in large part by each of the eleven physician owners of Internal Medical Associates. A significant portion of the business of Medical Maintenance is providing services to Internal Medical Associates.

This is a common form of an affiliated service group. Under the IRC, all employees employed by Internal Medical Associates and Medical Maintenance are treated as employed by a single employer.

Attribution Rules

The controlled-group rules, as incorporated by ERISA, also provide for ownership attribution or constructive ownership. This occurs when an ownership interest is attributed to a party other than the actual owner for purposes of determining whether entities are affiliated.

An interest owned by a corporation is considered owned by any person who owns 5% or more in value of the corporation's stock in proportion to the total value of all the stock in the corporation. Ownership of an option is also treated as actual ownership.

An interest owned by a partnership is treated as owned by any partners that have an interest of 5% or more in the partnership, in proportion to the partner's interest in the profits or capital, whichever is greater.

An interest owned by an estate or trust is considered to be owned proportionately by beneficiaries who have actuarial interests of 5% or more in the estate or trust.

An individual is generally considered to own any interest owned by their spouse or children under age 21. If the individual is in effective control of an organization, then the individual also is considered to own an interest in the organization owned by the individual's parents, grandparents, grandchildren, and children who have attained the age of 21.

> **Attribution Rules Example**
> Alvin Adult, 30 years of age, has a 90% interest in Partnership P. Partnership P owns all of the outstanding stock of corporation X. Corporation X owns 60 shares of the 100 outstanding shares of corporation Y. The 60 shares of Y are constructively owned by the partnership. Therefore, Alvin is considered to own 54 shares of the Y stock (90% of 60 shares). If Alvin acquires an option to purchase an additional 20 shares of Y, Alvin would them be considered to own 74 shares of the Y stock (90% of 60 shares (54 shares) plus the direct option on the 20 additional shares).

Non-Profits and Governmental Entities

Tax-exempt organizations do not have stock or other ownership interests, which makes the controlled group rules difficult to apply. Regulations provide that tax-exempt organizations are under common control 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. These rules allow certain organizations to be combined or separated under specified circumstances. Similarly, there are challenges in applying controlled group rules to governmental entities. IRS has informally indicated that until guidance is issued, governments "may apply a reasonable, good-faith interpretation" of existing law in determining which entities must be aggregated.

Private Equity and Venture Capital

Venture capital (VC) and private equity (PE) both describe arrangements that pool capital to invest in private companies. Although there are differences in the types of companies PE or VC funds target and how much of an ownership interest they tend to acquire, a common concern is whether this type of investment-based ownership can create a controlled group. To the extent either one of these arrangements take certain levels of ownership in various portfolio companies, the controlled group rules discussed above would apply as it relates to the controlled group nature of those various portfolio companies. With respect to whether the VC or PE fund(s) themselves are members of the controlled group, this issue has been heavily litigated in recent years in order to hold those funds liable when portfolio companies have significant pension liabilities, generally under multi-employer pension plans. Specifically, exposure for multi-employer plan liability extends to the withdrawing participating employer and any entity within the controlled group of the withdrawing employer. The Pension Benefit Guaranty Corporation ("PBGC") has initial enforcement authority for underfunded pensions and multi-employer plan liability and has sought to hold investment funds liable for their portfolio companies on a controlled group basis under an "investment plus" standard. Under this standard, a fund is engaged in a trade or business that could be a controlled group member if it does anything beyond investing.

The seminal case on this issue, Sun Capital, started with an appeal of a 2007 ruling of the Appeals Board of the PBGC concluding that a private equity fund was a member of one of its portfolio companies' controlled group for purposes of pension liabilities. Although the district court rejected the PCBG's position, the landscape shifted on appeal. A 2013 decision from the U.S. Court of Appeals for the First Circuit reasoned that whether an investment fund was a trade or business that could be a controlled group member required looking at whether the fund had a significant role in managing the portfolio company. The court concluded that when investment is coupled with enough day to day management the fund becomes a trade or business and a controlled group is created. On remand, the district court determined that two separate private investment funds were exercising a high degree of management and that their co-investment in a portfolio company constituted a partnership-in-fact. This resulted in both funds being treated as part of the portfolio company's controlled group and created significant liability for the funds.

Ultimately, this litigation leaves questions about the degree of management investment funds can engage in with respect to portfolio companies when there is significant investment and whether they should employ other safeguards like holding ownership percentages below controlled group thresholds

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