AssuredPartners

Controlled Group & Affiliated Service Group Rules

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Introduction

The Internal Revenue Code (IRC) originally established controlled group provisions as part of the Revenue Act of 1964. There are two types of aggregated group arrangements addressed in IRC §414 rules – controlled groups and affiliated service groups. The concept of a "controlled group" relies on the ownership structure of two or more entities, and the concept of an "affiliated service group" exists when one organization provides certain management or business support services to another entity. Detailed IRS guidance on IRC §414 rules can be found here - https://www.irs.gov/pub/irs-tege/epchd704.pdf

Various benefit statutes and regulations (e.g., ERISA, COBRA, §125, ACA) were updated to reference IRC §414 rules and require that all employees of commonly controlled organizations be treated as employees of a single organization for most benefit-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.

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 benefit compliance reasons, including (but not limited to) the following:

ERISA	All entities within the same controlled group can be covered under the same ERISA plan if the plan document contains language recognizing all entities and their relationship. Alternatively, the entities could be covered under separate plans subject to appliable benefit nondiscrimination rules (e.g., §125, §129 and §105(h)). A multiple employer welfare arrangement (MEWA) is created when employees from unrelated employers share benefit plans. This is also true when entities within the same affiliated service group share benefit plans (a MEWA is formed). However, entities within the same controlled group are permitted to share benefit plans as a single employer without forming a MEWA. Status as a MEWA raises a number of compliance issues, including M-1 filing requirements, group insurance contract issues, and state laws that may restrict or prohibit self-funded MEWAs.
Fully-Insured Market Size	Whether entities within the same controlled group share benefit plans or choose to offer separate plans, they are generally aggregated to determine small or large group for purposes of insurance rating, offering essential health benefits, etc.. It would be necessary to check with local carriers to best understand how this is handled in the applicable state.

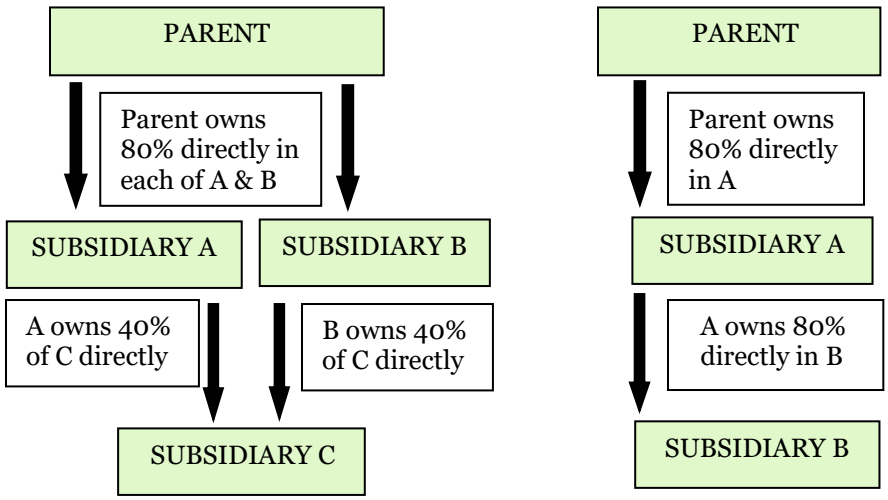
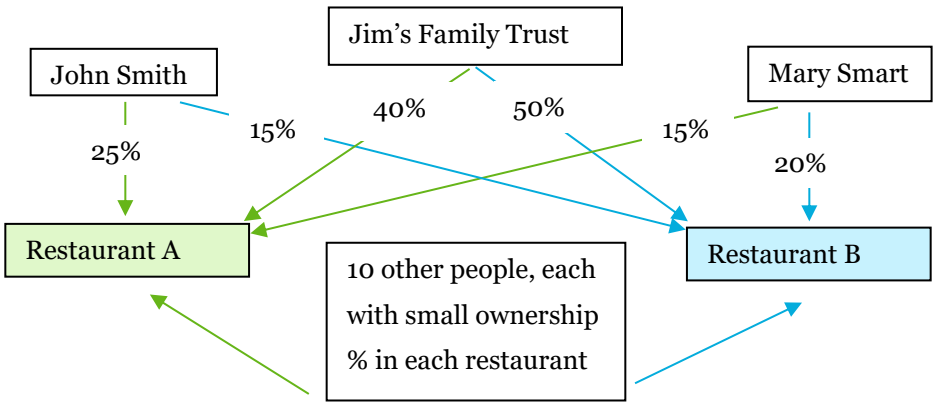
Benefit Nondiscrimination	Benefit nondiscrimination rules (e.g., §125, §129 and §105(h)) apply on a combined basis for all entities within the same controlled group or affiliated service group. Therefore, although there is nothing specifically prohibiting the entities from having different eligibility rules, benefit plans or employer contribution levels, the entities will be combined for purposes of discrimination testing and may not be able to pass based on the differences.
ALE Status	Applicable large employer (ALE) status for purposes of compliance with the §4980H "employer mandate" and §6056 employer reporting requirements is determined based on employee counts from all entities that are part of the same controlled group or affiliated service group (an "aggregated ALE group"). Although combined for purposes of determining ALE status, each entity within the aggregated ALE group is individually responsible for meeting §4980H offer of coverage requirements to full-time employees and §6056 employer reporting requirements. Form 1094-C and Form 1095-Cs should be prepared separately for each separate tax ID within the aggregated ALE group.
Medicare Secondary Payer (MSP)	When determining whether the employer's group health plan is the primary or secondary payer to Medicare, the small group exception (<20 employees for age-based Medicare and <100 employees for disability-based Medicare) allowing the employer's group health plan to be the secondary payer considers all employees across all related entities within the controlled group or affiliated service group. NOTE: The controlled definition in this case is slightly different, requiring only 50% common ownership (Code §52).
COBRA	When determining whether the employer is subject to federal COBRA continuation requirements (20 or more employees), it is necessary to consider all employees across all related entities within the controlled group or affiliated service group.

Controlled Groups

Generally, a "controlled group" includes all organizations having at least 80% common ownership. There are two types of controlled groups:

1. A **parent-subsidiary controlled group** exists when there is a "parent" entity which owns 80% or more of one or more "subsidiary" entities.
2. A **brother-sister controlled group** exists if the same 5 or fewer individuals, estates, or trusts commonly own 80% of each entity and the sum of the smallest percentage interest of each such owner exceeds 50%.

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.

CONTROLLED GROUP ILLUSTRATIONS	
TYPE	**DESCRIPTION OF OWNERSHIP STRUCTURE**
Parent-Subsidiary Controlled Group	 To form a parent-subsidiary controlled group, first of all, a "parent" entity must directly own at least 80% of one or more other entities in the group. Then additional entities can become part of the same controlled group if they are owned 80% or more by subsidiaries that are owned 80% by the parent. In the diagram on the left above, the Parent forms a controlled group with Subsidiaries A, B and C because each of the subsidiaries is either directly or indirectly owned 80% by the Parent. Similarly, in the diagram on the right, the Parent forms a controlled group with Subsidiaries A and B because each of the subsidiaries is either directly or indirectly owned 80% by the Parent.
Brother-Sister Controlled Group	 To form a brother-sister controlled group, the same 5 or fewer individuals, estates or trusts must own at least 80% of each entity. In addition, the sum of their smallest interests must exceed 50%. In this example, 2 individuals (John and Mary) and 1 trust own 80% of Restaurant A and 85% of Restaurant B. In addition, John's smallest interest is 15%, the Trust's smallest interest is 40%, and Mary's smallest interest is 15%, so the total is more than 50%, making the two restaurants a brother-sister controlled group.

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).

For nonprofits, common control exists between entities if at least 80% of the directors or trustees of one entity are either representatives of or controlled by the other entity. A director/trustee is a representative of the other entity if the director/trustee is also a director, trustee agent or employee of the other entity. A director/trustee is controlled by the other entity if the other entity has the power to remove and replace such director/trustee. In addition, when it's not clear that 80% common control exists, permissive aggregation (the ability to assume controlled group status) is an option if the entities share benefit plans and regularly coordinate day-to-day exempt activities.

For municipalities, school districts, and other public sector entities, common control can be viewed in at least a couple ways. Based on limited guidance in places such as IRS Notice 89-23, the analysis likely relies upon: (i) the degree of control/management/supervision of one entity over another, including control over the budget; as well as (ii) whether or not the entities receive 80% or more of their funding from another entity.

When there is a private equity firm involved, a private equity fund is generally not considered to be a "trade or business" itself and therefore would not form a controlled group with the entities funded, even if the private equity fund owns 80% or more of each entity. However, based on a court ruling from 2013, if there is more than passive investment ("investment plus") in the entities, the fund itself may then be considered a trade or business and a controlled group may be formed when there is 80% or more ownership. If there is both a degree of control plus ownership of 80% or more, it is possible a controlled group is formed.

Ownership Attribution

Solely for brother-sister controlled groups, ownership might be attributed from and to parents, children, and grandchildren, as well as to grantors and beneficiaries of trusts and estates.

OWNERSHIP INTEREST:	ATTRIBUTED TO:	
Spouse	Spouse	EXCEPTION: No attribution between spouses if: • No direct ownership; • No 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 organization's business during a two-year tax period. Other methods include a gross receipts test and an analysis based on all facts and circumstances.

Example – Management-Type Affiliated Service Group

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

Service Relationship Affiliated Service Group

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.

1 – "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.

2 – "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 – B-Org Relationship

Good Doctors LLP is a clinic with 11 partner physicians. Each of the physicians owns 1% of 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 entity 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. 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 entities 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., 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.