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Controlled Group and Affiliated Service Group Rules

The Internal Revenue Code (Code) contains controlled group rules and affiliated service group rules that are used to determine if two or more employers must be grouped together and treated as a single employer for certain purposes. To determine their compliance with employee benefit laws, it is important for employers to know whether they are sufficiently linked with one or more businesses to form a controlled group or an affiliated service group.

The controlled group and affiliated service group rules apply to many employee benefit laws, such as nondiscrimination testing and COBRA compliance, in order to discourage employers from setting up multiple companies to avoid the laws' requirements. Also, under the health care reform law, all employees of a controlled group of businesses or an affiliated service group must be taken into account to determine if an employer is an "applicable large employer" subject to the "pay or play" rules.

Determining whether two or more organizations must be treated as a single employer under the controlled group or affiliated service group rules involves a complex analysis of ownership interests, including constructive ownership. This Legislative Brief provides a general overview of these rules.

Because these rules are so complex, an employer's controlled group or affiliated service group status should be reviewed by legal counsel.

WHAT IS A CONTROLLED GROUP?

The definition of "controlled group" is contained in Code sections 414(b) and (c). A controlled group exists if two or more corporations, trades or businesses (including partnerships and proprietorships) have one of the following relationships:

- Parent-subsidiary;
- Brother-sister; or
- Combination of parent-subsidiary and brother-sister.

In addition, constructive ownership, or attribution, rules apply for purposes of determining whether a group of organizations is a controlled group under Code sections 414(b) and (c). These rules treat a person as owning an interest in an organization that is not actually owned by that person. Attribution may result from family or business relationships.

Parent-subsidiary Controlled Group

A parent-subsidiary controlled group exists when one or more chains of organizations are connected through ownership of a controlling interest with a common parent organization if:

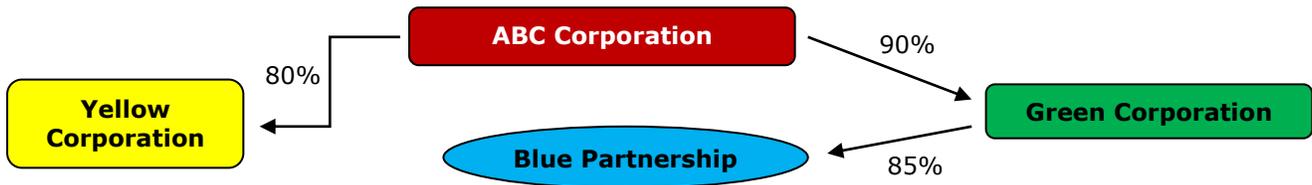
- A controlling interest in each of the organizations (except the common parent) is owned by one or more of the other organizations in the group; and
- The common parent organization owns a controlling interest in at least one of the other organizations.



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For a corporation, a “controlling interest” means ownership of stock having at least 80 percent of total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock. For a partnership, a “controlling interest” means ownership of at least 80 percent of the profits interest or capital interest of the partnership.

Example—ABC Corporation owns 90 percent of the stock of Green Corporation and 80 percent of the stock of Yellow Corporation. Green Corporation owns 85 percent of the profits of Blue Partnership.



ABC Corporation is the common parent of a parent-subsidary controlled group consisting of ABC Corporation, Green Corporation, Yellow Corporation and Blue Partnership. (The result would be the same if ABC Corporation, rather than Green Corporation, owned the 85 percent interest in Blue Partnership.)

Brother-sister Controlled Group

A brother-sister controlled group exists when five or fewer individuals, estates or trusts **own a controlling interest** (80 percent or more) in each organization and **have effective control**. “Effective control” generally means more than 50 percent of the organization’s stock or profits, but only to the extent the ownership is identical with respect to each such organization.

Example—ABC Corporation and XYZ Corporation are owned by four shareholders in the following percentages:

Shareholder	ABC Corporation	XYZ Corporation
A	80%	20%
B	10%	50%
C	5%	15%
D	5%	15%
TOTAL	100%	100%

In this example, the four shareholders together own 80 percent or more of the stock of each corporation. However, under the second component, the shareholders do not own more than 50 percent of the stock of each corporation, taking into account only the identical ownership in each corporation as demonstrated below:

Shareholder	Identical Ownership in Both Corporations
A	20%
B	10%
C	5%
D	5%
TOTAL	40%



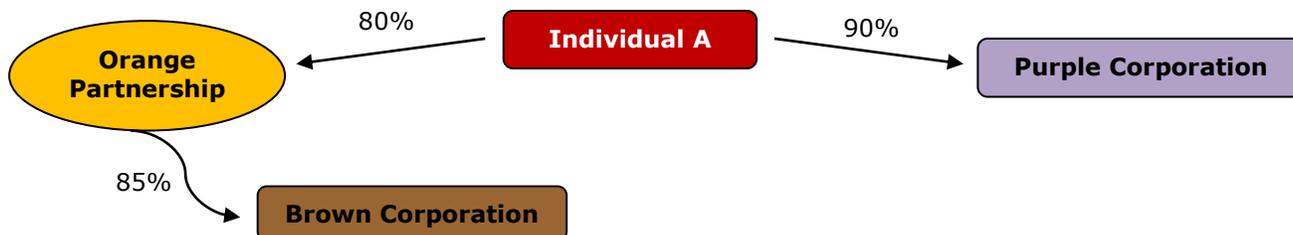
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Combined Controlled Group

A combined controlled group exists of three or more organizations that are structured in the following way:

- Each organization is a member of either a parent-subsidary or brother-sister controlled group; and
- At least one organization is the common parent organization of a parent-subsidary controlled group and is also a member of a brother-sister controlled group.

Example—A is an individual owning 80 percent of the profits in Orange Partnership and 90 percent of the stock in Purple Corporation. Orange Partnership owns 85 percent of the stock of Brown Corporation.



Orange Partnership, Purple Corporation and Brown Corporation are part of a combined controlled group because they are each members of either a parent-subsidary or a brother-sister group, and Orange Partnership is the common parent of the parent-subsidary group consisting of Orange Partnership and Brown Corporation and a member of a brother-sister group consisting of Orange Partnership and Purple Corporation.

Constructive Ownership

Constructive ownership principles apply to the controlled group rules that treat an individual as owning an interest in an organization based on a family or business relationship. These attribution rules contain many complex elements.

For example, an individual will be considered to own an interest, owned directly or indirectly, by his or her children under age 21 or by his or her spouse, unless legally separated or divorced. An exception applies if there is no direct ownership, no participation in the organization (for example, as a director, officer or employee) and if no more than 50 percent of the organization's gross income is from passive investments.

In addition, an interest owned, directly or indirectly, by or for a partnership, corporation or trust is treated as owned by any individual having an interest of five percent or more in the organization, in proportion to the individual's interest in the organization. For example, if an individual owns 60 percent of the stock of ABC Corporation and ABC Corporation owns 50 shares of XYZ Corporation, the individual is considered to own 30 shares of XYZ Corporation (60 percent x 50).

WHAT IS AN AFFILIATED SERVICE GROUP?

The affiliated service group rules are contained in Code section 414(m). They were enacted to supplement the controlled group rules and directed at professionals (for example, doctors, attorney and accountants) and other service organizations that were attempting to evade the controlled group rule's aggregation requirements through the use of separate service companies or management companies.

An affiliated service group means a group of two or more organizations that have a service relationship and, in some cases, an ownership relationship. There are three categories of affiliated service groups:

- A-Organization groups, which consist of a "First Service Organization" (FSO) and at least one A-Organization;



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- B-Organization groups, which consist of an FSO and at least one B-Organization; and
- Management groups.

An “organization” means a sole proprietorship, partnership, corporation or any other type of entity regardless of its ownership format.

In addition, constructive ownership, or attribution, rules apply for purposes of determining whether a group of organizations is an affiliated service group under Code section 414(m). These rules treat a person as owning an interest in an organization that is not actually owned by that person.

Service Organization

The principal business of an organization will be considered the performance of services if capital is not a material-income producing factor for the organization, even if the organization is not engaged in a field listed below. An organization engaged in any one or more of the following fields is a service organization: health; law; engineering; architecture; accounting; actuarial science; performing arts; consulting; and insurance.

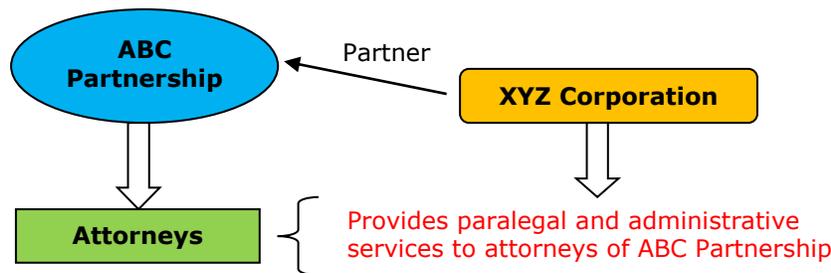
A corporation, other than a professional service corporation, is not treated as an FSO for purposes of the A-Organization affiliated service group rules. A professional services corporation is a corporation organized under state law for the principal purpose of providing professional services and has at least one shareholder who is licensed or otherwise legally authorized to render the type of services for which the corporation is organized. “Professional services” include services by certified or other public accountants, actuaries, architects, attorneys, chiropractors, chiropodists, medical doctors, dentists, professional engineers, optometrists, osteopaths, podiatrists, psychologists and veterinarians.

A-Organization Groups

An A-Organization group consists of an FSO and at least one A-Organization. A service organization is an A-Organization if:

- The organization is a partner or shareholder in the FSO (regardless of the percentage interest it owns in the FSO but determined by applying the constructive ownership rules); and
- The organization regularly performs services for the FSO or is regularly associated with the FSO in performing services for third parties. The working relationship test involves reviewing the facts and circumstances of each relationship.

Example—ABC Partnership is a law partnership. XYZ Corporation is a partner in the law firm. XYZ provides paralegal and administrative services for the attorneys in the law firm.



The law firm is an FSO. XYZ is an A-Organization because it is a partner in the FSO and it is regularly associated with the law firm in performing services for third parties. Thus, ABC Partnership and XYZ Corporation are an affiliated service group.



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B-Organization Groups

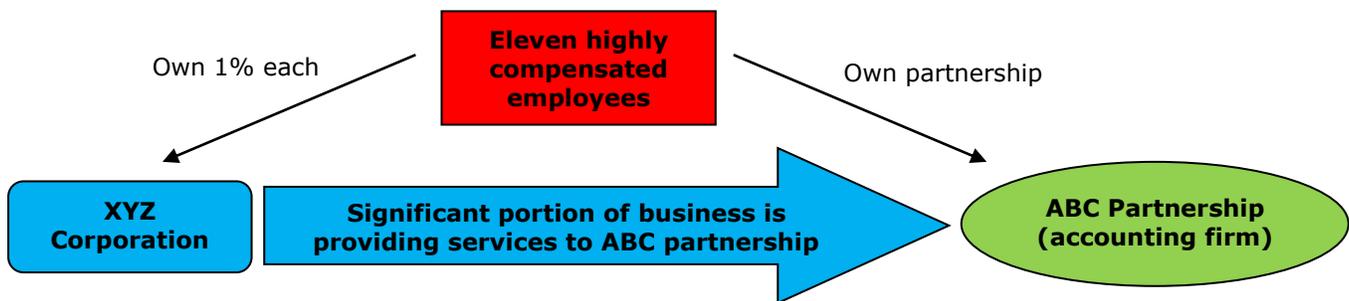
A B-Organization group consists of an FSO and at least one B-Organization. An organization qualifies as a B-Organization if:

- A significant portion of its business is the performance of services for the FSO, for one or more A-Organizations or for both;
- The services are of a type historically performed by employees in the service field of the FSO or the A-Organizations; and
- Persons who are highly compensated employees (as defined in Code section 414(q)) of the FSO or the A-Organizations hold (in the aggregate) 10 percent or more of the interests in the organization.

A B-Organization does not need to be a service organization.

IRS regulations provide that a facts and circumstances analysis applies to determining whether providing services is a “substantial portion” of the business of an organization. The regulations describe two tests that may be used to substantiate the facts and circumstances—a service receipts safe harbor test and a total receipts threshold test.

Example—ABC Partnership is an accounting firm with 11 partners, who are highly compensated employees under Code section 414(q). Each partner owns 1 percent of the stock of XYZ Corporation. XYZ provides services to ABC of a type historically performed by employees in the accounting field. A significant portion of XYZ’s business consists of providing services to ABC.



ABC is an FSO. XYZ is a B-Organization because a significant portion of its business involves performing services for the accounting firm of a type historically performed by employees in the accounting field. Also, more than 10 percent of the interests in XYZ are held by highly compensated employees of the FSO. Thus, ABC Partnership and XYZ Corporation are an affiliated service group.

Constructive Ownership

In determining ownership for purposes of the affiliated service group rules, the complex aggregation rules of Code section 318 apply. Under these rules, an individual is considered to own stock owned by his spouse, children, grandchildren and parents. Additionally, Code section 318 contains attribution rules for business relationships. For example, in certain cases, a corporation’s or partnership’s ownership interests are attributed proportionately to the organization’s shareholders or partners.

Management Groups

A management-type affiliated service group exists when:

- An organization performs management functions; and



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- 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 services.

A recipient organization is:

- An organization for which management services are performed;
- Any organizations aggregated under the controlled group or affiliated service group rules; and
- All related organizations (for this purpose, related organization has the same meaning as related person under Code section 144(a)(3)).

Also, a recipient organization does not need to be a service organization.

In addition, IRS regulations describe the following tests that may be used to determine a management organization's principal business on a regular and continuing basis:

- Tax-year rolling percentage test;
- Percentage of gross receipts test; and
- Facts and circumstances test.

Example—Red and Yellow Corporations are part of the same controlled group under Code section 414(b). Blue Corporation performs management functions for Red Corporation on a regular and consistent basis and this constitutes Blue Corporation's principal business. Red and Yellow Corporations are treated as the service recipient under Code section 414(m). Thus, Red, Yellow and Blue Corporations are an affiliated service group.

