

What You Should Know About The Controlled Group, Affiliated Service Group, And Leased Employee Rules

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THE IRS CONTROLLED GROUP and affiliated service group rules provide the foundation for identifying whether two or more employers need to be grouped together and treated as one employer for many benefit plan purposes. For example, coverage testing under Internal Revenue Code of 1986 (“Code”) section 410(b) applies these rules for determining which employees should be tested together. When determining which workers to include as employees, section 414(n) includes “leased employees.” (All section references are to the Code unless otherwise indicated.)

WHAT TERMINOLOGY IS USED FOR EMPLOYER GROUPS?

- Under Form 5500, employers fall into the following general categories (IRS 2007 Instructions for Form 5500, available at <http://www.irs.gov/pub/irs-pdf/i5500.pdf> (last visited January 31, 2008)):

Single Employer (Other Than Multiple Employer)

According to the Form 5500 instructions, a “controlled group” generally is considered one employer for Form 5500 purposes. The instructions define a controlled group as a controlled group of corporations under section 414(b), a group of trades or businesses under common control under section 414(c), or an affiliated service group under section 414(m). (The term “controlled group” is not always defined so broadly. Watch for the definition used in a specific context. This article generally will use “controlled group” to refer only to section 414(b) and (c).)

Multiple Employer

A multiple employer plan is a plan that is maintained by more than one employer. (Keep in mind that a controlled group is treated as one employer.) Multiple employer plans can be collectively bargained and collectively funded, but if covered by PBGC termination insurance, must have properly elected before September 27, 1981, not to be treated as a multi-employer plan under section 414(f) (5) or Employee Retirement Income Security Act of 1974, as amended (“ERISA”) sections 3(37)(E) and 4001(a)(3). (Note that the Pension Protection Act of 2006 added ERISA section 3(37)(G) regarding multi-employer plan elections. Modifications to the 2006 changes were made by the U.S. Troop Readiness, Veterans’ Care, Katrina Recovery, and Iraq Accountability Appropriations Act, 2007.) If the employers maintaining a plan are members of the same controlled group, they are considered together as a single employer and the plan is not a multiple employer plan.

Multi-Employer

A plan is a multi-employer plan if:

- More than one employer is required to contribute (keep in mind that a controlled group is treated as one employer);

- The plan is maintained pursuant to one or more collective bargaining agreements between one or more employee organizations and more than one employer; and
- There has been no election not to be treated as a multi-employer plan (see above).

WHEN ARE THE CONTROLLED GROUP AND AFFILIATED SERVICE GROUP RULES APPLIED?

• Before jumping into the definitions, it is helpful to know when to watch for the controlled group and affiliated service group concepts.

The concept of controlled groups will come up in many different testing contexts, such as coverage testing under section 410(b). The section 410(b) test looks at whether an employer has covered “enough” non-highly compensated employees, but the test starts by examining whether you have included all of the required employers. Here are some of the areas that may be affected by the controlled group rules under sections 414(b) and 414(c):

- Section 410(b) (coverage testing);
- ADP/ACP nondiscrimination testing under sections 401(k) and 401(m);
- Section 401 (qualified retirement plans);
- Section 408(k) (simplified employee pension);
- Section 408(p) (simple retirement accounts);
- Section 410 (minimum participation);
- Section 411 (minimum vesting);
- Section 415 (annual addition limit—see section 415(h) (for purposes of applying sections 414(b) and (c) to section 415, the phrase “more than 50%” is substituted for the phrase “at least 80%” each place it appears in section 1563(a) (1)); and
- Section 416 (top-heavy limitation).

Except to the extent otherwise provided in regulations, all employees of the members of an affiliated service group must be treated as employed by a single employer. Section 414(m) lists the following areas that are affected:

- Section 401(a)(3) (minimum coverage under section 410(b));
- Section 401(a)(4) (nondiscrimination);
- Section 401(a)(7) (minimum vesting);
- Section 401(a)(16) (annual addition limit);
- Section 401(a)(17) (compensation limit);
- Section 401(a)(26) (participation limit);
- Section 408(k) (simplified employee pension);
- Section 408(p) (simple retirement accounts);
- Section 410 (minimum participation);
- Section 411 (minimum vesting);
- Section 415 (annual addition limit); and
- Section 416 (top-heavy limitation).

Section 414(t) gives a list of sections for which both the controlled group and affiliated service group rules apply (section 414(t) also provides that section 414(o) will apply):

Section 79 (group term life insurance);

- Section 106 (health coverage);
- Section 117(d) (qualified tuition reduction);
- Section 120 (group legal services);
- Section 125 (cafeteria plan);
- Section 127 (educational assistance);
- Section 129 (dependent care assistance);
- Section 132 (fringe benefits);
- Section 137 (adoption assistance);
- Section 274(j) (employee achievement awards);
- Section 505 (VEBA nondiscrimination testing); and
- Section 4980B (COBRA).

Section 414(o) provides for rules that may be implemented to prevent the avoidance of sections 414(m)(4) or 414(n)(3), *inter alia* through the use of separate organizations, employee leasing, or other arrangements. See also Prop. Treas. Reg. §1.414(o)-1. Section 414(o) was added by the Tax Reform Act of 1984, Pub. L. No. 98-369, section 526(d)(1), effective as of July 18, 1984.

For funding implications, see sections 414(b), 404(a), and 412.

Section 414(b) (or (c) or (m)) may be incorporated into another section. For example:

Section 414(v) incorporates the controlled group and affiliated service group definitions for special catch-up contribution aggregation purposes. §414(v)(2)(D).

- Highly compensated employees under section 414(q). See §414(q)(7). The 20 percent top paid group limitation must be made for all plans of the employer. Treas. Reg. §1.414(q)-1, Q&A-9(b)(2)(iii).

Determination letter filing cycles for a plan sponsor are addressed for a controlled group or affiliated service group. Rev. Proc. 2005-66 and Rev. Proc. 2007-44. An employer may request a determination letter with respect to affiliated service group status. See Rev. Proc. 2008-6, section 14.

This article does not specifically address similar concepts under ERISA, but note that common control and control groups are terms sometimes used in ERISA. See, for example, ERISA section 3(37) defining multi-employer plan, ERISA section 3(40) addressing multiple employer welfare arrangements (“MEWAs”), and ERISA section 4001. See Department of Labor (“DOL”) Information Letter (May 24, 2004), available at www.dol.gov/ebsa/regs/ILs/il052404.html, discussing affiliated service groups in the MEWA context. Note that the DOL had not issued regulations under ERISA section 3(40)(B), but under the May 24, 2004, Information Letter, the DOL relied on IRS rules. However, see also DOL Information Letter (March 1, 2006), available at www.dol.gov/ebsa/regs/ILs/il030106.html, which noted that the regulation under section 4001(b) of Title IV of ERISA relating to trades or businesses adopted the definition of common control set forth in the regulations under section 414(c), but required substantial business purpose for common control in MEWA context. See 29 C.F.R. Section 4001.3.

DEFINITION OF A CONTROLLED GROUP

- Under section 414(b), a “controlled group” includes all corporations that are members of a con-

trolled group of corporations (within the meaning of section 1563(a), determined without regard to sections 1563(a)(4) and 1563(e)(3)(C)). Section 1563(a) includes: parent-subsidiary controlled group; brother-sister controlled group; and combined group. Treas. Reg. §1.1563-1T(a)(1).

Treasury Regulation §1.414(b)-1 provides that “controlled group of corporations” has the same meaning as is assigned to the term in section 1563(a) and the regulations thereunder, except that:

- The term “controlled group of corporations” does not include an “insurance group” described in section 1563(a)(4); and
- Section 1563(e)(3)(C) does not apply. (Section 1563(e)(3)(C) provides that the attribution rules will not apply to stock owned by any employees’ trust described in section 401(a) which is exempt from tax under section 501(a).)

Also note that designation as a “component member of a controlled group” within the meaning of section 1563(b) does not affect section 414(b) controlled group status. If a corporation is a member of more than one controlled group of corporations, the corporation will be treated as a member of each controlled group. Brother-sister group percentages are different in sections 1563(a)(2) and 414(b) (section 1563(f)(5)).

Section 414(b) was originally added by the Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, section 1015, with subsequent amendments.

TRADES OR BUSINESSES UNDER COMMON CONTROL • Section 414(c) and Treas. Reg. §1.414(c)-2 generally refer to two or more trades or businesses “under common control.” They provide for a “parent-subsidiary group of trades or businesses under common control,” a “brother-sister group of trades or businesses under common control,” or a “combined group of trades or businesses under common control.” An “organization” can be a sole proprietorship, a partnership, a trust, an

estate, or a corporation. The rules for corporations under section 414(b) and for trades or businesses under section 414(c) are very similar. Thus, they will be discussed together in this article.

Section 414(c) was originally added by the Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, section 1015, with subsequent amendments.

“PARENT-SUBSIDIARY GROUP” • A “parent-subsidiary group” is one or more chains of corporations or organizations 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 organization, is owned (directly and with the application of constructive ownership of options) by one or more of the other organizations; and
- The common parent organization owns (directly and with the application of constructive ownership of options) a controlling interest in at least one of the other organizations, excluding, in computing such controlling interest, any direct ownership interest by such other organizations. See Treas. Reg. §§1.414(c)-2(b) and 1.1563-1T(a)(2). Watch for section 1563(d)(1) additional attribution rules.

For purposes of determining parent-subsidiary groups and brother-sister groups, a “controlling interest” means:

- For a corporation, ownership of stock having at least 80 percent of total combined voting power of all classes of stock entitled to vote of such corporation or at least 80 percent of the total value of shares of all classes of stock of such corporation;
- For a trust or estate, ownership of an actuarial interest of at least 80 percent of such trust or estate;

- For a partnership, ownership of at least 80 percent of the profits interest or capital interest of such partnership; and
- For a sole proprietorship, ownership of such sole proprietorship.

Example: The ABC partnership owns stock having 80 percent of the total combined voting power of all classes of stock entitled to voting of M corporation. ABC partnership and M Corporation are a parent-subsidiary group of trades or businesses under common control. ABC partnership is the common parent.

Example: Assume the same facts as in the immediately preceding example, and assume further that M owns 80 percent of the profits interest in the DEF Partnership. The ABC Partnership is the common parent of a parent-subsidiary group of trades or businesses under common control consisting of the ABC Partnership, M Corporation, and the DEF Partnership. The result would be the same if the ABC Partnership, rather than M, owned 80 percent of the profits interest in the DEF Partnership.

Example: L Corporation owns 80 percent of the only class of stock of M Corporation and M, in turn, owns 40 percent of the only class of stock of O Corporation. L also owns 80 percent of the only class of stock of N Corporation and N, in turn, owns 40 percent of the only class of stock of O. L is the common parent of a parent-subsidiary controlled group consisting of member corporations L, M, N, and O.

With respect to the above examples, see Treas. Reg. sections 1.414(c)-2(e) and 1.1563-1T(a)(2)(ii).

A “BROTHER-SISTER GROUP” IS A GROUP of two or more organizations if:

- The same five or fewer persons who are individuals, estates, or trusts own (directly and with application of the constructive ownership rules) a controlling interest (80 percent or more) in each organization; and
- Taking into account the ownership of each such person only to the extent such ownership is identical with respect to each such organization, such persons are in effective control (over 50 percent) of each organization. Treas. Reg. §§1.414(c)-2(c) and 1.1563-1T(a)(3).

The five or fewer persons whose ownership is considered for purposes of the controlling interest requirement for each organization must be the same persons whose ownership is considered for purposes of the effective control requirement. (A brother-sister group may take into account only individuals who have interests in all of the entities. See *U.S. v. Vogel Fertilizer Co.*, 455 U.S. 16 (1982).)

Example: Unrelated individuals Alice, Bret, Charlie, and Dianne own stock of corporations A, B, and C (each of which has only one class of stock outstanding) in the following proportions:

Individuals	A Corp.	B Corp.	C Corp.
Alice	100%	45%	40%
Bret	0%	40%	40%
Charlie	0%	15%	0%
Dianne	0%	0%	20%
Total	100%	100%	100%

Under these facts, the following brother-sister group exists: B and C. Alice and Bret together own a controlling interest in each organization because they own at least 80 percent of the total combined voting power of corporations B and C. Alice and Bret together have effective control of B and C because their combined identical ownership of B and C is greater than 50 percent. (Alice’s identical ownership of B and C is 40 percent because Alice owns at least a 40 percent interest in each organization. Bret’s identical ownership of B and C is 40 percent because Bret owns at least a 40 percent interest in

each organization.) Therefore, B and C comprise a brother-sister group. A is not a member of this group because the effective control requirement and the 80 percent controlling interest requirement are not met.

COMBINED GROUPS • A “combined group” means any group of three or more organizations, if:

- Each is a member of either a parent-subsidiary group or a brother-sister group; and
- At least one such organization is the common parent organization of a parent-subsidiary group and that parent is also a member of a brother-sister group. Treas. Reg. §§1.414(c)-2(d) and 1.1563-1T(a)(4).

Example: A, an individual, owns a controlling interest in ABC Partnership and DEF Partnership. ABC, in turn, owns a controlling interest in X Corporation. Since ABC, DEF, and X each is a member of either a parent-subsidiary group or a brother-sister group of trades or businesses under common control, and ABC is the common parent of a parent-subsidiary group of trades or businesses under common control consisting of ABC and X, and also a member of a brother-sister group of trades or businesses under common control consisting of ABC and DEF, ABC Partnership, DEF Partnership, and X Corporation are members of the same combined group of trades or businesses under common control.

EXCLUSIONS • When determining a “controlling interest” (80 percent or more) and “effective control” (over 50 percent), some interests are not included. They are treated as “not outstanding.” Treas. Reg. §§1.414(c)-3 and 1.1563-2.

Under Treas. Reg. §§1.1563-2 and 1.414(c)-3(a), some stock is excluded. “Stock” does not include nonvoting stock which is limited and preferred as to dividends, and Treasury stock. The exclusions are different for a parent-subsidiary group than for a brother-sister group.

Interests “Not Outstanding” In Parent-Subsidiary Group

If an organization (“parent organization”) owns a 50 percent or more interest, then for purposes of determining whether the parent organization or subsidiary organization is a member of a parent-subsidiary group, certain interests in the subsidiary organization will be treated as not outstanding.

A parent organization will be considered to own an interest in or stock of another organization which it owns directly or indirectly with the application of constructive ownership of options and:

In the case of a parent organization which is a partnership, a trust, or an estate, with the application of constructive ownership from partnerships, estates, trusts, and corporations; and

- In the case of a parent organization which is a corporation, with the application of constructive ownership rules for corporations.

Items that are treated as not outstanding if the parent has a 50 percent or more interest are:

- An interest in the subsidiary organization held by a trust which is part of a plan of deferred compensation (within the meaning of section 406(a)(3) (relating to employers of foreign affiliates) and the regulations thereunder) for the benefit of the employees of the parent organization or the subsidiary organization.
- An interest which is an interest in or stock of the subsidiary organization owned (directly and with the application of the constructive ownership rules) by an individual who is a principal owner, officer, partner, or fiduciary of the parent organization. (A principal owner is a person who owns (directly and with the application of the constructive ownership rules) a five percent or more interest.)
- An interest in the subsidiary organization owned (directly and with the application of the constructive ownership rules) by an employee of the subsidiary organization if such interest is subject to conditions which substantially restrict

or limit the employee's right (or if the employee constructively owns such interest, the direct or record owner's right) to dispose of such interest and which run in favor of the parent or subsidiary organization.

- An interest in the subsidiary organization if owned (directly and with the application of the constructive ownership rules) by an organization (other than the parent organization) ("controlled exempt organization"): to which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies; and which is controlled directly or indirectly by the parent organization or subsidiary organization, by an individual, estate, or trust that is a principal owner of the parent organization, by an officer, partner, or fiduciary of the parent organization, or by any combination thereof.

Interests "Not Outstanding" In Brother-Sister Group

If five or fewer persons ("common owners") who are individuals, estates, or trusts own (directly and with the application of the constructive ownership rules) a 50 percent or more interest, then for purposes of determining whether such organization (50% Org) is a member of a brother-sister group, certain interests will be treated as not outstanding. Items that are treated as not outstanding if the organization has a 50 percent or more interest are:

- An interest in a 50% Org held by an employees' trust described in section 401(a) which is exempt from tax under section 501(a) (exempt employee's trust) will be excluded if such trust is for the benefit of the employees of such 50% Org.
- An interest in a 50% Org owned (directly and with the application of constructive ownership rules) by an employee of such organization if such interest or stock is subject to conditions which run in favor of a common owner of such organization or in favor of such organization and which substantially restrict or limit the em-

ployee's right (or if the employee constructively owns such interest the direct or record owner's right) to dispose of such interest. See Treas. Reg. §1.414(c)-3(d)(6)(ii) for information regarding reciprocal rights.

- An interest in such 50% Org if owned (directly and with the application of constructive ownership rules) by an organization (controlled exempt organization) to which section 501(c)(3) (relating to certain educational and charitable organizations which are exempt from tax) applies; and which is controlled directly or indirectly by such organization, by an individual, estate, or trust that is a principal owner of such organization, by an officer, partner, or fiduciary of such organization, or by any combination thereof.

Example: Corporation R owns 70 of the 100 shares of the only class of stock of corporation L. The remaining shares of L are owned as follows: four shares by Jones (the general manager of R); and 26 shares by Smith (who also owns five percent of the total combined voting power of the stock of R). R satisfies the 50 percent stock ownership requirement with respect to L. Since Jones is an officer of R and Smith is a principal stockholder of R, the L stock owned by Jones and Smith is treated as not outstanding for purposes of determining whether R and L are members of a parent-subsidiary group. Thus, R is considered to own stock possessing 100 percent (70/70) of the total voting power and value of all the L stock. Accordingly, R and L are members of a parent-subsidiary group.

Exception

If an interest in an organization (including stock of a corporation) is owned by a person directly or with the application of the constructive ownership rules and such ownership results in the membership of that organization in a group under common control, then the interest will not be treated as an excluded interest if the result of applying such

provisions is that the organization is not a member of a group under common control.

Example: Corporation P owns directly 50 of the 100 shares of the only class of stock of corporation S. A, an officer of P, owns directly 30 shares of S stock which P has an option to acquire. If, under exclusion rules for officers, the 30 shares owned directly by A are treated as not outstanding, P would be treated as owning stock possessing only 71% ($50/70$) interest of S stock, and S should not be a member of a parent-subsidary group. However, because the 30 shares owned by A that P has an option to purchase are considered as owned by P under the option attribution rule, and that ownership plus P's direct ownership of 50 shares result in S's membership in a parent-subsidary group, the exception applies. Therefore, A's stock is not treated as an excluded interest and S is a member of a parent-subsidary group consisting of P and S.

CONSTRUCTIVE OWNERSHIP • Some interests are attributed under the controlled group rules. Refer to specific applications discussed in this article and generally to Treas. Reg. §§1.414(c)-4 and 1.1563-3.

Options

If a person has an option to acquire any outstanding interest in an organization, such interest is treated as owned by such person.

Attribution From Partnership, Trusts And Estates, And Corporations

An interest owned, directly or indirectly, by or for an organization is treated as owned by any individual having an interest of five percent or more interest in the organization in proportion to such individual's interest in the organization.

For a partnership, look at whether the partner has a five percent or more interest in the profits or capital, whichever proportion is greater.

Example: B, an individual, owns 60 of the 100 shares of the only class of outstanding stock of corporation P. C, an individual, owns four shares of the P stock, and corporation X owns 36 shares of the P stock. Corporation P owns, directly and indirectly, 50 shares of the stock of corporation S. B is considered to own 30 shares of the S stock ($60/100 \times 50$), and X is considered to own 18 shares of S stock ($36/100 \times 50$). Since C does not own five percent or more in the value of P stock, he is not considered as owning any of the S stock owned by P. If in this example, C's wife had owned directly one share of the P stock, C and his wife would each be considered as owning five shares of the P stock, and therefore C and his wife would be considered as owning 2.5 shares of the S stock ($5/100 \times 50$).

Children, Grandchildren, Parents, And Grandparents

An individual is considered to own an interest owned, directly or indirectly, by or for the individual's children who have not attained the age of 21 years, and if the individual has not attained the age of 21 years, an interest owned, directly or indirectly, by or for the individual's parents.

If an individual is in effective control (over 50 percent) directly and with the application of the constructive ownership rules without applying this family member rule, of an organization, then such individual is considered to own an interest in such organization owned, directly or indirectly, by or for the individual's parents, grandparents, grandchildren, and children who have attained the age of 21 years.

Example: Individual F owns directly 40 percent of the profits interest of the DEF Partnership. His son, M, 20 years of age, owns directly 30 percent of the profits interest of DEF, and his son, A, 30 years of age, owns directly 20 percent of the profits interest of DEF. The 10 percent remaining of the profits interest and 100 percent of the capital interest of DEF are owned by an unrelated person.

F owns 40 percent of the profits interest in DEF directly and is considered to own the 30 percent profits interest owned directly by M. Since, for purposes of the effective control test applied to attribution from family members, F is treated as owning 70 percent of the profits interest of DEF, F is also considered as owning the 20 percent profits interest of DEF owned by his adult son, A. Accordingly, F is considered as owning a total of 90 percent of the profits interest in DEF.

Minor son, M, owns 30 percent of the profits interest in DEF directly, and is considered to own the 40 percent profits interest owned directly by his father, F. However, M is not considered to own the 20 percent profits interest of DEF owned directly by his brother, A, and constructively by F because an interest constructively owned by F by reason of family attribution is not considered as owned by him for purposes of making another member of his family the constructive owner of such interest. Accordingly, M is considered as owning a total of 70 percent of the profits interest of the DEF Partnership.

Adult son, A, owns 20 percent of the profits interest in DEF directly. Since, for purposes of determining whether A effectively controls DEF under the rules for attribution from family members, A is treated as owning only the percentage of profits interest he owns directly, he does not satisfy the condition precedent for the attribution of the DEF profits interest from his father. Accordingly, A is considered as owning only the 20 percent profits interest in DEF which he owns directly.

Spouse

Except as provided below, an individual is considered to own an interest owned, directly or indirectly, by or for his or her spouse, other than a spouse who is legally separated from the individual under a decree of divorce, whether interlocutory or final, or a decree of separate maintenance.

“Hands Off” Exception

An individual is not considered to own an interest in an organization owned, directly or indirectly, by or for his or her spouse on any day of a taxable year of such organization, provided that each of the following conditions is satisfied with respect to such taxable year:

- Such individual does not, at any time during such taxable year, own directly any interest in such organization;
- Such individual is not a member of the board of directors, a fiduciary, or an employee of such organization and does not participate in the management of such organization at any time during such taxable year;
- Not more than 50 percent of such organization’s gross income for such taxable year was derived from royalties, rents, dividends, interest, and annuities; and
- Such interest in such organization is not, at any time during such taxable year, subject to conditions which substantially restrict or limit the spouse’s right to dispose of such interest and which run in favor of the individual or the individual’s children who have not attained the age of 21 years.

Operating Rules For Constructive Ownership

An interest constructively owned by an individual by reason of children, grandchildren, parents, grandparents, or spouse is not treated as owned by such individual for purposes of again applying the family attribution constructive ownership rules in order to make another the constructive owner of such interest.

If an interest may be considered as owned due to option attribution and the constructive ownership rules, such interest is considered as owned by such person due to option attribution.

Example: A, 30 years of age, has a 90 percent interest in DEF Partnership. DEF owns all the out-

standing stock of corporation X. X owns 60 shares of the 100 outstanding shares of corporation Y. The 60 shares of Y constructively owned by DEF are treated as actually owned by DEF. Therefore, A is considered as owning 54 shares of the Y stock (90 percent of 60 shares).

Example: Assume the same facts as in the immediately preceding example. Assume further that B, who is 20 years of age and the brother of A, directly owns 40 shares of Y stock. Although the stock of Y owned by B is considered as owned by C (the father of A and B), such stock may not be treated as owned by C for purposes of applying the family member rule again in order to make A the constructive owner of such stock.

SPECIAL ISSUES • Two or more corporations may become (or cease to be) a controlled group at any time they meet (or fail to meet) the requirements.

Tax-Exempt Organizations

Current proposed regulations (Prop. Treas. Reg. §1.414(c)-5) issued November 16, 2004, were effective for plan years beginning after December 31, 2005. New final regulations (Treas. Reg. §1.414(c)-5) issued on July 26, 2007, will be effective for plan years beginning after December 31, 2008. The proposed and final regulations are similar, but there are some differences that should be reviewed by those relying on the proposed regulations. The following discussion highlights the final regulations.

In the case of a tax-exempt organization under section 501(a) (“exempt organization”) whose employees participate in a plan, the employer with respect to that plan includes the exempt organization whose employees participate in the plan and any other organization that is under common control with that exempt organization. For this purpose, common control exists between an exempt organization and another organization (proposed regulations refer to two exempt organizations rather than an exempt organization and “any other organization”) if

at least 80 percent of the directors or trustees of one organization are either representatives of, or directly or indirectly controlled by, the other organization.

A trustee or director is treated as a representative of another exempt organization if he or she also is a trustee, director, agent, or employee of the other exempt organization. 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 based on facts and circumstances.

Example: If exempt organization A has the power to appoint at least 80 percent of the trustees of exempt organization B (which is the owner of the outstanding shares of corporation C, which is not an exempt organization) and to control at least 80 percent of the directors of exempt organization D, then entities A, B, C, and D are treated as the same employer with respect to any plan maintained by A, B, C, or D for purposes of the sections referenced in sections 414(b), (c), (m), (o), and (t).

Whether a person has the power to appoint and replace a trustee or director is based on facts and circumstances. For example, that power generally would not exist if that power was extremely limited due to the application of other laws, such as where a labor union is put under trusteeship pursuant to a court order, the trusteeship is for the sole purpose of correcting corruption, financial malpractice, or similar circumstances, and the replacement trustees were permitted to serve only for the time necessary for that purpose. Preamble to Revised Regulations Concerning section 403(b) Tax-Sheltered Annuity Contracts; Final Rule (includes Treas. Reg. §1.414(c)-5), 72 Fed. Reg. 41,128, 41,137-138 (July 26, 2007).

Permissive Aggregation With Entities Having A Common Exempt Purpose

Exempt organizations that maintain a plan to which section 414(c) applies that covers one or

more employees from each organization may treat themselves as under common control for purposes of section 414(c) (and, thus, as a single employer for all purposes for which section 414(c) applies) if all of the organizations regularly coordinate their day-to-day exempt activities. The regulation also contemplates future guidance that would allow controlled group treatment of exempt organizations where there are substantial business reasons.

The rules address permissive disaggregation between qualified church-controlled organizations and other entities.

The regulations include an anti-abuse rule. In any case in which the Commissioner determines that the structure of one or more exempt organizations or the positions taken by those organizations has the effect of avoiding or evading any requirements imposed under sections 401(a), 403(b), or 457(b), or any applicable section (as defined in section 414(t)), or any other provision for which section 414(c) applies, the Commissioner may treat an entity as under common control with the exempt organizations when there are substantial business reasons.

There are special rules for churches and qualified church-controlled organizations, as defined in section 3121(w)(3)(B). See also Treas. Reg. §1.410(b)-6(g), published July 21, 2006, regarding exclusions for certain tax-exempt entities.

AFFILIATED SERVICE GROUP • Section 414(m) provides rules that require, in some circumstances, employees of separate organizations to be treated as if they were employed by a single employer for purposes of certain employee benefit requirements.

History Of Section 414(m)

In the 1978 *Kiddie* decision, employees of a 50-50 partnership formed by professional medical corporations were properly excluded from the plan of the corporation. *Thomas Kiddie, M.D., Inc. v. Comm’r*, 69 T.C. 1055 (1978). There was a similar result in *Gar-*

land v. Comm’r, 73 T.C. 5 (1979) (partnership formed by professional medical corporation and doctor).

Section 414(m) was added by the Miscellaneous Revenue Act of 1980, Pub. L. No. 96-605, section 201(a), generally effective for the plan years beginning after November 30, 1980 (for plans not in existence, effective for plan years ending after November 30, 1980).

Section 414(m)(5) (management organizations) was added by the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, section 246(a), effective for plan years beginning after December 31, 1983. Subsequent amendments have been made to section 414(m).

On August 27, 1987, proposed regulations (52 Fed. Reg. 32,502) were issued under sections 414(m), (n), and (o). Prop. Treas. Regs. §§1.414(m)-5, 1.414(m)-6, 1.414(n)-1, 1.414(n)-2, 1.414(n)-3, 1.414(n)-4 and parts of 1.414(o)-1 were withdrawn by the Treasury on April 27, 1993 (58 Fed. Reg. 25,587).

Affiliated Service Group

An “affiliated service group” means a group consisting of a service organization (“First Service Organization” or “FSO”) and one or more A or B Organizations. An affiliated service group also may involve a Management Organization as described below.

If aggregation is required under sections 414(b) or 414(c) and also under section 414(m), the requirements with respect to all of the applicable provisions must be satisfied. Prop. Treas. Reg. §1.414(m)-1 contains some guidance, but has not been updated for changes in this law.

Professional Service Corporation

A corporation, other than a professional service corporation, is not treated as an FSO for purposes of an A Organization affiliated service group.

A professional service corporation is a corporation that is organized under state law for the prin-

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” includes services by certified or other public accountants, actuaries, architects, attorneys, chiropractors, chiropractors, medical doctors, dentists, professional engineers, optometrists, osteopaths, podiatrists, psychologists, and veterinarians. Prop. Treas. Reg. §1.414(m)-1(c).

Example. Corporation F is a service organization that is a shareholder in Corporation G, another service organization. F regularly provides services for G. Neither corporation is a professional service corporation. Neither corporation may be considered an FSO under the A Organization rules and, thus, aggregation will not be required by operation of the A Organization test. However, G or F may be treated as an FSO and the other organization may be a B Organization if the B Organization rules are met.

Organization

An “organization” includes a sole proprietorship, partnership, corporation, or any other type of entity regardless of its ownership format. Prop. Treas. Reg. §1.414(m)-2(e)(1).

Constructive Ownership

In determining ownership, the principles of section 318(a) apply. §414(m)(6)(B). Section 414(m)(6)(B) refers to section 318(a) attribution rules, but the proposed regulation still refers to the old citation, section 267(c). Prop. Treas. Reg. §1.414(m)-2(d). Caution: The old proposed rule (Prop. Treas. Reg. §1.414(m)-2(d)(3)) contains the following “special rules”:

- Stock or partnership interests owned, directly or indirectly, by or for a corporation, partnership, estate, or trust are considered as being owned proportionately by or for its shareholders, partners, or beneficiaries;
- An individual is considered as owning the stock or partnership interests owned, directly or indirectly, by or for his family;
- An individual owning (otherwise than by the application of the rule immediately above) any stock in a corporation or interest in a partnership is treated as owning the stock or partnership interests owned, directly or indirectly, by or for his partner;
- The family of an individual includes only his or her brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants; and
- Stock or partnership interests constructively owned by a person by reason of the application of the first bulleted rule above are, for the purpose of applying the first three bulleted rules above, treated as actually owned by such person, but stock or partnership interests constructively owned by an individual by reason of the application of the second and third bulleted rules above will not be treated as owned by him or her for the purpose of again applying either of such subdivisions in order to make another the constructive owner of such stock or partnership interests.

Service Organization (Prop. Treas. Reg. §1.414(m)-2(f).)

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 though the organization is not engaged in a specific 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 ORGANIZATIONS • A service organization is an A Organization if it is a partner or shareholder in the FSO (regardless of the percentage interest it owns in the FSO but determined with regard to the constructive ownership rules); and regularly performs services for the FSO, or is regularly associated with the FSO in performing services for third persons.

The determination of whether a service organization regularly performs services for the FSO or is regularly associated with the FSO in performing services for third persons is made on the basis of the facts and circumstances. It is not necessary that any of the employees of the organization directly perform services for the FSO; it is sufficient that the organization is regularly associated with the FSO in performing services for third persons. The amount of the earned income that the organization derives from performing services for the FSO, or from performing services for third persons in association with the FSO is relevant.

Example: Attorney N is incorporated, and the corporation is a partner in a law firm. Attorney N and his corporation are regularly associated with the law firm in performing services for third persons. Considering the law firm as an FSO, the corporation is an A Organization because it is a partner in the law firm and it is regularly associated with the law firm in performing services for third persons. Accordingly, the corporation and the law firm constitute an affiliated service group.

B ORGANIZATIONS • An organization is a B Organization if:

- A significant portion of the business of the organization is the performance of services for the FSO, for one or more A Organizations determined with respect to the FSO, or for both;
- Those services are of a type historically performed by employees in the service field of the FSO or the A Organizations; and
- Ten percent or more of the interests in the organization is held, in the aggregate, by persons who are highly compensated employees (“HCEs” as defined under section 414(q)) of the FSO or of the A Organizations.

Service Receipts Safe Harbor

Whether there is a “significant portion” is based on facts and circumstances. The performance of services for the FSOs, for one or more A Organizations, or for both, will not be considered a significant portion of the business of an organization if the service receipts percentage (gross receipts for the FSO and/or A Organizations divided by total service gross receipts) is less than five percent. This ratio is the greater of the ratio for the year for which the determination is being made or for the three-year period including that year and the two preceding years (or the period of the organization’s existence, if less).

Total Receipts Threshold Test

The performance of services for the FSO, for one or more A Organizations, or for both, will be considered a significant portion of the business of an organization if the total receipts percentage is 10 percent or more. Total receipts percentage is calculated in the same manner as the service receipts percentage, except that gross receipts in the denominator are determined without regard to whether they were derived from performing services.

Services will be considered of a type historically performed by employees in a particular service field if it was not unusual for the services to be performed by employees of organizations in that service field (in the United States) on December 13, 1980.

Non-Service Organization

An organization may be a B Organization even though it does not qualify as a service organization.

Example: R is a service organization that has five HCEs. Each HCE of R owns three percent of the stock in Corporation D. The corporation provides services to the partnership of a type historically performed by employees in the service field of the partnership. A significant portion of the business of the corporation consists of providing services to the partnership.

Considering the partnership as an FSO, the corporation is a B Organization because a significant portion of the business of the corporation is the performance of services for the partnership of a type historically performed by employees in the service field of the partnership, and more than 10 percent of the interests in the corporation is held, in the aggregate, by the HCEs. Accordingly, the corporation and the partnership constitute an affiliated service group.

MULTIPLE AFFILIATED SERVICE GROUPS •

Two or more affiliated service groups will not be aggregated simply because an organization is an A Organization or a B Organization with respect to each affiliated service group. However, if an organization is an FSO with respect to two or more A Organizations or two or more B Organizations, or both, all of the organizations are considered to constitute a single affiliated service group.

Example: Multiple First Service Organizations

Corporation P provides secretarial service to numerous dentists in a medical building, each of whom maintains his own separate unincorporated practice. Dentist T owns 20 percent of the secretarial corporation and accounts for 20 percent of its gross receipts. Dentist W owns 25 percent of the corporation and accounts for 25 percent of its gross

receipts. Dentists T and W are HCEs with respect to their practices.

Considering Dentist T as an FSO, the secretarial corporation, P, is a B Organization because 20 percent of the gross receipts of the corporation are derived from performing services for Dentist T of a type historically performed by employees of dentists, and 20 percent of the interests in the corporation is owned by Dentist T, an HCE. Accordingly, Dentist T and the corporation constitute an affiliated service group.

Considering Dentist W as an FSO, the secretarial corporation, P, is a B Organization, because 25 percent of the gross receipts of the corporation are derived from performing services for Dentist W of a type historically performed by employees of dentists, and 25 percent of the interests in the corporation is owned by Dentist W, an HCE. Accordingly, Dentist W and the corporation constitute an affiliated service group.

However, the Dentist P affiliated service group does not include Dentist T even though the secretarial corporation, P, is a B Organization with respect to both dentists. Thus, there are two affiliated service groups.

MANAGEMENT ORGANIZATION • Under section 414(m)(5), an “affiliated service group” also includes a group consisting of:

- An organization the principal business of which is performing, on a regular and continuing basis, management functions for one organization (or for one organization and other organizations related to such one organization); and
- The organization (and related organizations) for which such functions are so performed by the organization described immediately above.

“Related organizations” means “related persons” in section 144(a)(3). “Management functions” are not defined further. There were proposed regulations on this topic that were issued August 27, 1987 (52 Fed. Reg. 32,502), but then withdrawn ef-

fective April 27, 1993 (58 Fed. Reg. 25,587). These regulations give some idea of what the regulators had in mind for management organizations in the 1980s. See *Beals Bros. Management Corp. v. Comm’r*, 82 T.C.M. (CCH) 485 (2001), *aff’d*, 300 F.3d 963 (8th Cir. 2002).

LEASED EMPLOYEES • Section 414(n) provides that certain leased employees are treated as employees for certain purposes. The leased employee generally is treated as an employee of the recipient employer. However, any contributions or benefits provided by the leasing organization which are attributable to services performed for the recipient are treated as provided by the recipient employer.

Section 414(n) was first added by the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, section 248(a), effective for tax years beginning after December 31, 1983. Subsequent amendments have been made.

WHAT TERMINOLOGY IS USED FOR LEASED EMPLOYEES? • “Recipient” is any person for whom a leased employee performs services. §414(n)(1). A “leased employee” is any person who is not an employee of the recipient employer and who provides services to the recipient employer if:

- The services are provided pursuant to an agreement between the recipient employer and any other person (referred to as the “leasing organization”);
- The person has performed such services for the recipient employer (or for the recipient employer and related persons) on a substantially full-time basis for a period of at least one year; and
- The services are performed under primary direction or control by the recipient employer. §414(n)(2).

“Related persons” has the same meaning as when used in section 144(a)(3). §414(n)(6)(A).

For employees of entities under common control, the rules of sections 414(b), (c), (m), and (o) apply. §414(n)(6)(B).

WHEN ARE THE LEASED EMPLOYEE RULES APPLICABLE? • The leased employee rules apply to Group A and Group B, described below (§414(n)(3)):

Group A:

- Section 401(a)(3) (minimum coverage under section 410(b));
- Section 401(a)(4) (nondiscrimination);
- Section 401(a)(7) (minimum vesting);
- Section 401(a)(16) (annual addition limit);
- Section 401(a)(17) (compensation limit);
- Section 401(a)(26) (participation limit);
- Section 408(k) (simplified employee pension);
- Section 408(p) (simple retirement accounts);
- Section 410 (minimum participation);
- Section 411 (minimum vesting);
- Section 415 (annual addition limit); and
- Section 416 (top-heavy limitation).

Group B:

- Section 79 (group term life insurance);
- Section 106 (health coverage);
- Section 117(d) (qualified tuition reduction);
- Section 120 (group legal services);
- Section 125 (cafeteria plan);
- Section 127 (educational assistance);
- Section 129 (dependent care assistance);
- Section 132 (fringe benefits);
- Section 137 (adoption assistance);
- Section 274(j) (employee achievement awards);
- Section 505 (VEBA nondiscrimination testing); and
- Section 4980B (COBRA).

TIMING AND SERVICE CREDITING • A worker generally is considered a leased employee only for periods after the close of the one-year period of performing services. §414(n)(4)(A). Service is credited prior to regular employee status. If a

worker is an employee of the recipient employer (whether by reason of the leased employee rules or otherwise), years of service for the recipient employer are determined by taking into account any period for which such employee would have been a leased employee but for the one-year period described above. §414(n)(4)(B).

Leased employees may be excluded from participation if minimum coverage is not a problem. See *Abraham v. Exxon*, 85 F.3d 1126 (5th Cir. 1996) and *Clark v. E.I. DuPont de Nemours & Co.*, No. 95-2845, 1997 U.S. App. LEXIS 321 (4th Cir. Jan. 9, 1997), *cert. denied*, 520 U.S. 1259 (1997).

SAFE HARBOR • For purposes of the sections listed under Group A above, the leased employee rules will not apply to any leased employee with respect to services performed for a recipient employer if:

- The employee is covered by a plan which is maintained by the leasing organization and meets the safe harbor plan requirements below; and
- Leased employees (determined without regard to this safe harbor) do not constitute more than 20 percent of the recipient's nonhighly compensated work force. (See section 414(n)(5)(C) (ii) for a definition of the nonhighly compensated work force.)

Safe Harbor Plan Requirements

A plan meets the requirements of this safe harbor exclusion if:

- The plan is a money purchase pension plan with a nonintegrated employer contribution rate for each participant of at least 10 percent of compensation;
- Such plan provides for full and immediate vesting; and
- Each employee of the leasing organization (other than employees who perform substantially all of their services for the leasing organization) immediately participates in such plan. This rule does not apply to any individual whose compensation from the leasing organization in each plan year during the four-year period ending with the plan year is less than \$1,000.

Definitions

For purposes of the safe harbor exclusion, "Highly compensated employee" has the meaning given by section 414(q). "Compensation" has the same meaning as when used in section 415; except that such term shall include:

- Any employer contribution under a qualified cash or deferred arrangement to the extent not included in gross income under section 402(e)(3) or 402(h)(1)(B);
- Any amount which the employee would have received in cash but for an election under a cafeteria plan (within the meaning of section 125); and
- Any amount contributed to an annuity contract described in section 403(b) pursuant to a salary reduction agreement (within the meaning of section 3121(a)(5)(D)).

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