

## **CONTROLLED AND AFFILIATED SERVICE GROUPS – A QUICK OVERVIEW**

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### I. **WHY MUST YOU DETERMINE CONTROLLED GROUP (“CG”) OR AFFILIATED SERVICE GROUP (“ASG”) STATUS?**

- A. In general if two or more entities are part of either a CG or ASG, they must be aggregated for qualified retirement plan purposes.
- B. Areas where it is pertinent:
  - 1. 401(g) contribution limit – the maximum deferral limit for 401(k) plans
  - 2. Top heavy testing – all plans of a CG or ASG are counted in the determination of top heavy status and if the group of plans are top heavy, minimum contributions are required for all of those plans.
  - 3. 415 contribution limits – maximum contribution or benefit limits must be determined for participants who participate in more than one plan for CGs or ASGs.
  - 4. 401(k) safe harbor compliance – 401(k) safe harbor contributions required for all 401(k) participants in 401(k) plans of a CG or ASG.
  - 5. Generally, all service for eligibility and vesting credit must be counted for employees who move between members of a CG or ASG.

6. Employees may not be eligible for distributions from a 401(k) plan or pension plan when they move from one member of a CG or ASG.
7. Limits of loans (i.e., \$50,000) - are aggregated among all plans of a CG or ASG.
8. Minimum coverage rules and other types of discrimination testing must be conducted using all members of a CG or ASG.

## II. WHAT ARE CONTROLLED GROUPS?

- A. The rules apply to both corporations and other entities:
  1. Proprietorships.
  2. Partnerships.
  3. Limited Liability Companies.
- B. There are two types of CGs:
  1. Parent–Subsidiary.
  2. Brother–Sister.
- C. What are parent-subsidiary CGs?
  1. One or more entities connected through ownership with a common parent.
    - a. The parent entity must own at least 80% of at least one other entity.
    - b. The group also includes all other entities that are owned at least 80% by other entities in the group.

2. Example 1

Alpha Corporation owns:

95% of the stock of Beta Corporation

85% of the stock of Gamma Corporation

75% of the stock of Delta Corporation

Unrelated persons own the percentage of stock not owned by Alpha Corporation

Alpha Corporation owns 80% or more of the stock of Beta and Gamma Corporation; therefore, Alpha Corporation is the common parent of a parent-subsidary CG consisting of Alpha Corporation, Beta Corporation and Gamma Corporation. Delta Corporation is not a member of the CG because Alpha Corporation's ownership is less than 80%.

3. Example 2

Assume the same facts as Example 1 and assume further that Gamma Corporation owns a 90% profits interest in Epsilon Partnership.

Alpha Corporation is the common parent of a parent-subsidary CG consisting of Alpha Corporation, Beta Corporation, Gamma Corporation and Epsilon Partnership. Note that the results would be the same if Alpha Corporation, rather than Gamma Corporation owned the 90% interest in Epsilon Partnership.

D. What are brother-sister CGs?

1. Groups of two or more entities with common ownership.

- a. The same five or fewer owners must:
  - i. have some ownership interest in each entity;
  - ii. have at least 80% ownership in each entity; and
  - iii. have identical ownership of more than 50% in each entity.
- b. Note that there can also be CGs made up of both a parent-subsidary group and a brother-sister group.

2. Example 3

Mash Corporation and 4077, Inc. are owned by four shareholders, in the following percentages:

<u>Shareholder</u>	<u>% of Mash Corporation</u>	<u>% of 4077, Inc.</u>
H. Pierce	80%	20%
TJ McIntyre	10%	50%
M. Klinger	5%	15%
M. Houlihan	5%	15%
Total:	100%	100%

To meet the first part of the test for a brother-sister CG, the same five or fewer common owners must own at least 80% of the stock or some interest in all members of the CG.

In this example, the four shareholders together own 80% or more of the stock of each corporation and the first test is met, since the shareholders own 100% of the stock of each corporation.

3. Example 4

Assume the same facts as is Example 3.

To meet the second part of the test for brother-sister CGs the same five or fewer common owners must own more than 50% of each Corporation, taking into account the stock ownership of each person only to the extent such stock ownership is identical with respect to each such corporation.

<u>Shareholder</u>	<u>Identical Ownership Percentage In Both Corporations</u>
H. Pierce	20%
TJ McIntyre	10%
M. Klinger	5%
M. Houlihan	5%
Total:	40%

In this example, although four shareholders together own 80% or more of the stock of each corporation, they do not own more than 50% of each corporation, taking into account only the identical ownership of each corporation as demonstrated above.

4. Example 5

Eight individuals each own 12%-13% of the stock of Tiger Corporation and also Briggs, Inc.

<u>Shareholder</u>	<u>% of Tiger Corporation</u>	<u>% of Briggs, Inc.</u>
Al K.	12%	12%
Mickey L.	12%	12%
Justin V.	12%	12%
Miggy C.	12%	12%
Norm C.	13%	13%
Jack M.	13%	13%
Lou W.	13%	13%
Alan T.	13%	13%
Total:	100%	100%

Any group of five shareholders will own more than 50% of the stock in each corporation and all shareholders in any grouping will own identical amounts, but Tiger and Briggs, Inc. are not members of a brother-sister CG because the same five or fewer individuals do not own at least 80% of each of the corporation's stock.

E. Attribution Rules for CGs.

1. Generally they use the attribution rules contained in IRC §1563(a).

2. Family Attribution.

a. Generally there is attribution of ownership among spouses, with the exception of:

i. Spouses that are legally separated, or

ii. The other spouse (x) has no direct ownership, (y) has no participation as an employee or in management and (z) no more than 50% of the gross income of the entity is from passive sources.

iii. Example 6

Wilma and Fred are married. Fred is a doctor owning 100% of his medical practice. Wilma is also a doctor and owns 80% of a separate medical practice (the other 20% is owned by Barney).

Fred is not an employee or owner of a direct interest in Wilma's practice and less than 50% of

the gross income in Wilma's practice is from passive investments. Fred, however, is in charge of significant management activities for his wife's practice.

Wilma does not directly own an interest or participate in Fred's practice and less than 50% of the income from Fred's practice is from passive investments.

Fred has attributed the 80% that Wilma owns in her practice (due to his participation in Wilma's practice). Additionally, Wilma is not attributed to any ownership interest in Fred's practice. Also note that the practices are members of a brother-sister CG due to Fred's ownership/deemed ownership of at least 80% of each practice.

- b Children to parents.
  - i. Parent is deemed to own their child's interest if child is under age 21.
  - ii. Parent is deemed to own their child's interest if parent already controls more than 50% of the entity.
- c. Parents to children.
  - i. Child is deemed to own their parent's interest if child is under age 21.
  - ii. Child is deemed to own their parent's interest if the child already controls more than 50% of the entity.

d. Example 7

Little Ricky, age 25 is the son of Lucy. Lucy owns 75% of Tropicana Corporation and Little Ricky owns the remaining 25%.

Since Lucy owns more than 50% of Tropicana Corporation, her ownership is attributed to Little Ricky.

Since Little Ricky does not own more than 50% of Tropicana Corporation, his ownership is not attributed to Lucy.

e. Example 8

Sam and Diane are dentists and each own 100% of their own dental practice. Neither Sam nor Diane has any involvement with the other's practice. Sam and Diane also have a baby son, Norm, who's four months old. Because Norm is a minor, he is deemed to own 100% of Sam's practice and 100% of Diane's practice. As such, Sam's practice and Diane's practice are considered to be a CG.

f. Example 9

The facts are the same as Example 11 except Norm is now ten and Sam and Diane divorced (Sam marries Rebecca and Diane marries Frasier). Because Norm is still a minor, he is still deemed to own both practices and, as such, both continue to be members of a CG.

3. Corporation to shareholder.
  - a. Only if the shareholder owns at least 5% of the corporation.
  - b. The shareholder will be attributed its proportionate share of the ownership.
  - c. Example 10

George owns 70% of the stock of Vanderlay Industries, Inc. Jerry owns 20% of the stock and four other individuals (Kramer, Elaine, Newman and Kenny) each own less than 5% of the remaining 10%. Vanderlay Industries, Inc. has a 30% stock ownership in KramERICA Industries, Inc.

The KramERICA Industries, Inc. stock is attributed to George and Jerry in proportion to their ownership interest in Vanderlay Industries, Inc. as follows:

George is treated as 21% owner of KramERICA Industries, Inc. 70% (George's interest in Vanderlay Industries, Inc.) times 30% (Vanderlay Industries Interest in KramERICA Industries, Inc.).

Jerry is treated as a 6% owner of KramERICA Industries, Inc. 20% (Jerry's interest in Vanderlay Industries, Inc.) times 30% (Vanderlay Industries, Inc. interest in KramERICA Industries, Inc.).

Kramer, Elaine, Newman and Kenny are not treated as owning any interest in KramERICA Industries, Inc. inasmuch as they own less than 5% of Vanderlay Industries, Inc.

4. Partnership to partners and trusts to beneficiaries.
  - a. Generally the rules work the same as corporations where the 5% threshold is exceeded.
  - b. Partners and trust beneficiaries will receive a proportionate share of the ownership.

### III. WHAT ARE AFFILIATED SERVICE GROUPS?

- A. There are three types of ASGs.
  1. A-Organization Groups (“A-Orgs”)
  2. B-Organization Groups (“B-Orgs”)
  3. Management Service Groups (“MSGs”)
- B. What are A-Orgs?
  1. It is comprised of a First Service Organization (“FSO”) and at least one A Organization.
  2. The first component member is a FSO.
    - a. The entity must be a service organization.
    - b. Capital may not be a material income producing factor.
    - c. Certain organizations are deemed to be a service organization including: accounting, actuarial science, architecture, consulting, engineering, health, insurance, law and performing arts.
  3. The second component member is an A Organization.
    - a. This organization must also be a service organization.

- b. This organization must have an ownership interest in the FSO (regardless of its percentage of ownership).
  - c. This organization must regularly perform services for the FSO or with the FSO in performing services for third parties.
4. Example 11

Lonee Anderson, CPA, a certified public accountant, is incorporated as Lonee Anderson, P.C. and this professional corporation is a partner in Anderson and Arthur, CPAs. Lonee Anderson and Lonee Anderson, P.C. are regularly associated with Anderson and Arthur, CPAs in performing accounting services for third parties.

Anderson and Arthur, CPAs is an FSO. Lonee Anderson, P.C. is an A-Org because it is a partner in the accounting firm and is regularly associated with Anderson and Arthur, CPAs in performing accounting services for third parties.

Accordingly, Lonee Anderson, P.C. and Anderson and Arthur, CPAs would constitute an ASG.

As a result, the employees of Lonee Anderson, P.C. and Anderson and Arthur, CPAs, must be aggregated and treated as if they were employed by a single employer.

C. What are B-Orgs?

- 1. It is comprised of a FSO and at least one B Organization.

2. An entity is a B Organization if:
  - a. A significant portion of its business is performing services for an FSO.
    - i. This is determined on a facts and circumstance basis.
    - ii. The safe harbors are: (x) if less than 5% - not significant and (y) if more than 10% - it is significant.
  - b. The services are the type historically performed by employees.
  - c. At least 10% of the B Organization must be owned by Highly Compensated Employees (as defined in Core Section 414(q) of the FSO.
  
3. Example 12

Drysdale Industries is a financial service organization that has two 50% partners, Jed and Jethro. Jed and Jethro also own all of the stock of Ellie May Services, Inc. Jed owns 95% of Ellie May Services, Inc. and Jethro owns 5%. Ellie May Services, Inc. provides services to Drysdale Industries of a type historically performed by employees in the financial services field. A significant portion of the business of Ellie May Services, Inc. consists of providing services to Drysdale Industries.

Considering Drysdale Industries as an FSO, Ellie May Services, Inc. is a B-Org because:

- i. A significant portion of its business is the performance of services for Drysdale Industries of a type historically performed by employees in the financial services field, and
- ii. More than 10% of the interests in Ellie May Services, Inc. is held by a highly compensated employee of the FSO (Jed).

Accordingly, Drysdale Industries and Ellie May Services, Inc. constitutes an ASG. Therefore, the employees of Drysdale Industries and Ellie May Services, Inc. must be aggregated and treated as if they were employed by a single employer.

D. What are Management Organizations?

1. It is comprised of two organizations.
  - a. The first organization performs management functions for the second organization.
  - b. The principal business of the Management Organization is:
    - i. Performing management functions on a regular and continuing basis.
    - ii. To a recipient organization.
2. There is no need to have overlapping or common ownership.
3. Examples of management functions include:
  - a. Running daily business operations.
  - b. Hiring and firing of employees.

- c. Determining compensation benefits and conditions of employment.
    - d. Critical future planning.
  - 4. How is the “principal business” of the organization determined?
    - a. Generally on a “facts and circumstances basis.”
    - b. In withdrawn IRS regulations, the test was based upon:
      - i. A two year rolling average.
      - ii. The performance of management functions constituted at least 50% of its activities during that period.
- E. Attribution Rules for ASGs.
  - 1. Generally they use the attribution rules contained in IRC §318 (differences exist between attribution for ASGs and CGs).
  - 2. Family attribution.
    - a. Generally there is attribution of ownership among spouses - no exception for limited involvement.
    - b. Generally parents are deemed to own their children’s interest - no exception for age or ownership interest.
    - c. Generally children are deemed to own their children’s interest - no exception for age or ownership interest.
  - 3. Corporation from shareholder.
    - a. If a shareholder owns directly or indirectly at least 50% of the stock of a corporation.

- b. The corporation is deemed to own the stock of such shareholder.
- 4. Stock owned by a partner or beneficiary of an estate is deemed to be owned by the partnership or the estate.
- 5. Generally stock owned by a beneficiary of a trust is deemed to be owned by the trust.
- 6. Stock owned by a corporation (where a shareholder owns at least 50% of the stock), a partnership or trust shall be deemed to be owned proportionately by its shareholders, partners or beneficiaries. [CML review this.]
- 7. Example 13

Marcus Welby, M.D. is the sole shareholder of Marcus Welby, P.C. Dr. Welby personally holds a 2% ownership interest in Kiley Surgical Center. Dr. Welby regularly refers his patients to the surgical center for surgical procedures.

Dr. Welby's 2% interest in Kiley Surgical Center is attributed to Marcus Welby, M.D., P.C., and as such, an ASG exists in this case. Kiley Surgical Center is the FSO. Marcus Welby, P.C. is an A-Org since it is deemed to own the 2% interest in Kiley Surgical Center (through attribution of the interest owned by Dr. Welby) and is regularly associated with Kiley Surgical Center in performing services for patients. Note that there is no minimum interest that must be owned by Dr. Welby for attribution to have occurred.