

Overview of the IRS Controlled Group Rules and How They May Apply to Your Company Regarding the Employer Mandate

Beginning in 2015, employers with 50 or more full-time or full-time equivalent employees will be subject to the employer shared responsibility provision of the Affordable Care Act (ACA), or what is very commonly referred to as the ACA's employer mandate. Very generally, these employers will need to offer certain qualifying coverage to each full-time employee (generally 130+ hours per month) and his/her non-spouse dependent or risk certain financial penalties.

It Is Important to Understand If and How Certain Internal Revenue Service Controlled Group Rules May Apply to Your Company

The Internal Revenue Code (IRC) includes a series of controlled group rules. These rules, which can be found in IRC section 414, are used for numerous purposes under the IRC, including, most notably, with respect to federal tax-qualified retirement plans. These rules generally look to see whether multiple entities share sufficient direct or indirect control to require that they be considered together as a single entity.

With respect to the employer mandate, it is very important that companies understand how the controlled group rules work (or have access to legal or tax advisors who can help you understand how they may apply to your company).

In determining whether an employer has at least 50 full-time or full-time equivalent employees – such that the employer mandate could then apply to the employer – an employer is required to take into account all of its full-time and full-time equivalent employees as well as those of any affiliated entities within the meaning of IRC section 414.

EXAMPLE: If Acme Co. has 40 full-time or full-time equivalent employees, measured by itself, it does not have the requisite number of full-time or full-time equivalent employees to be subject to the employer mandate. However, it has a 100%-owned subsidiary called Beta Co., which has 20 of its own full-time or full-time equivalent employees. Because under the IRS rules these two companies need to be treated as a single entity for determining any employer mandate obligations, and because measured together the two companies together have at least 50 full-time or full-time equivalent employees, both Acme Co. and Beta Co. will be subject to the employer mandate (note: that special transition relief may be available to controlled groups with 50-99 full-time or full-time equivalent employees).

Overview of the IRS Controlled Group Rules

In general, the controlled group rules as set forth in IRC section 414 provide that a company and any controlled group members are treated as one employer.

A controlled group can be:

- A chain of corporations or partnerships under common control (“parent-subsidary” controlled group),
- A group of corporations or partnerships owned by the same five or fewer individuals (“brother-sister” controlled group), or
- An “affiliated service group.”

Below, we briefly summarize the complex rules that determine whether entities are part of a controlled group.

PLEASE NOTE: The following summary is for educational purposes only and is not intended as tax or legal advice. The rules (as you will see from the discussion below) are quite complex. Companies that think these rules may apply to them should consult their tax or legal counsel for advice on these rules.

Parent-Subsidiary Controlled Group

The first way in which a company may be part of a controlled group under the IRS' rules is if the company is part of a parent-subsubsidiary controlled group.

Corporations and partnerships are considered part of such a controlled group if they are part of a parent-subsubsidiary chain of entities, where an entity higher up on the chain (i.e., a "parent") owns a "controlling interest" in an entity below it (i.e., a "subsidiary").

A controlling interest is defined for this purpose as follows:

- For corporations, control is defined generally as ownership of at least 80% of the total value of shares of all classes of the corporation's stock;
- For partnerships, control is defined as ownership of at least 80% of the profits interest or capital interest of the partnership; and
- For a trust or estate, control is defined as ownership of an actuarial interest of at least 80% of such trust or estate.

EXAMPLE: If Company A owns 100% of the stock of Companies B and C, and Company B owns 100% of the stock of Company D, then Companies A, B, C, and D are part of a controlled group, with Company A being the parent company.

There is a special rule for when a parent company only has a 50% interest. If this rule is satisfied, then the requisite controlling interest will be found to exist notwithstanding that the parent's direct controlling interest is not at least 80%.

Under this special rule, if a parent company owns "50%" – instead of "80%" – then, in determining whether the parent owns a controlling interest (80%) in a subsidiary, the following ownership interests are disregarded:

- An interest in the subsidiary held by the trust of a deferred compensation plan;
- An interest in the subsidiary owned by an individual who is a principal owner, officer, partner, or fiduciary of the parent organization;
- An interest in the subsidiary owned by an employee of the subsidiary if the employee's right to dispose of the interest is substantially restricted; and
- An interest in the subsidiary owned by an IRC section 501 organization (other than the parent organization) that is controlled directly or indirectly by the parent or subsidiary, or an entity or employee related to the parent or subsidiary.

By reducing the interests taken into account, the interests of a parent with only a 50% interest in a subsidiary (taking into account all interests), *might* be increased to at least 80%.

EXAMPLE: If Company A owns 60% of Company B, and 30% of the stock of Company B can be disregarded pursuant to the previous bullets, Company A's ownership interest might increase from 60% to 86%.

Companies should also be aware that in determining ownership interests, special rules regarding constructive ownership apply:

- An option to acquire an outstanding interest in an organization is considered to be actual ownership;
- An interest owned, directly or indirectly, by a partnership is considered to be owned by any partner having an interest of 5% or more in either the profits or capital of the partnership, in proportion to the partner's interest in the profits or capital, whichever is greater;
- An interest owned, directly or indirectly, by a corporation is considered to be owned by any shareholder owning 5% or more in value of all the corporations' stock;
- **An individual is considered to own an interest owned, directly or indirectly, by his or her spouse and children under 21, unless certain conditions are met.**

Additionally, shares of unrelated entities may be aggregated for the purpose of meeting the 80% controlling interest requirement if the entities comprise a joint venture. The elements of a joint venture are (a) a contract (express or implied) showing that it was the intent of the parties that a business venture be established, (b) an agreement for joint control and proprietorship, (c) a contribution of money, property, and/or services by the prospective joint venturers, and (d) a sharing of profits.

Lastly, in determining whether a parent-subsidary controlled group exists, the IRS rules provide that a partnership will be considered part of a parent company's controlled group only if the partnership is engaged in a "trade or business."

The determination of whether a partnership is engaged in a trade or business is based on the facts and circumstances and focuses on (1) whether there is a profit motive (there can be no trade or business unless the entity expects in good faith to make a profit) and (2) the scope of the activities. Generally, a trade or business involves providing goods or services to the public with continuity and regularity. In contrast, passive investment, e.g., managing securities investments and collecting the income therefrom, is not a trade or business.

Brother-Sister Controlled Group

As mentioned above, another way to have a controlled group for purposes of the IRS' rules is if two or more trades or business constitute a "brother-sister" group.

Under the IRS' rules, two or more trades or businesses will be treated as constituting a "brother-sister" controlled group if the same five or fewer individuals, estates, or trusts own:

1. At least a controlling interest (i.e., 80%) in the trade or business, and
2. At least 51% of the trade or business, taking into account only the individuals' smallest interest in all the trades or businesses.

EXAMPLE: Based on the ownership interests reflected in the following chart, Companies 1, 2, and 3 would be members of a controlled group, while Company 4 would not.

Individuals/Trusts/Estates: Ownership Interests in Companies 1-4

	Person A	Person B	Trust C	Estate D	Person E
Company 1	50%	40%			10%
Company 2	40%	40%	10%		10%
Company 3	60%	30%	10%		
Company 4	20%	50%	10%	20%	

Persons A and B own a controlling interest (at least 80%) in Companies 1, 2, and 3. In addition, they own at least 51% of these three Companies, taking into account their smallest interest in any of these Companies: for Person A, that is 40% and for Person B, that is 30%. Company 4 cannot be part of this controlled group because (a) Persons A and B only own 70% of Company 4 and (b) taking into account Company 4 would lower the ownership interest of Person A that could be taken into account from 40% to 20%, resulting in the failure of Companies 1, 2, and 3 to meet the "51%" requirement.

Affiliated Service Group

The third way to have a controlled group for purpose of the IRS rules is if two or more companies are determined to be members of what is termed an "affiliated service group." These rules quite often have most applicability to service entities, such as law firms and doctors' offices, or management services companies with respect to investment funds.

Under the IRS rules, an affiliated service group can exist if:

1. There is an organization the principal business of which is performing, on a regular and continuing basis, management functions for another organization (as well as other related organizations), **and**
2. The management functions are a type historically performed by employees in the same business field.

Management functions will be considered to be of a type historically performed by employees if, in other organizations in the same business field, it is not unusual for such functions to be performed by employees.

Whether the organization's principal business is management functions for another organization on a regular and continuing basis is based on the facts and circumstances, including the gross receipts from management functions and the length of time spent performing these functions.

An example of this type of affiliated service group might be where a law firm hires an outside management organization to provide HR or accounting functions that historically have been performed by employees.

An affiliated service group can also exist is what is called a "First Service Organization" and an "Other Service Organization", and the following criteria are met:

1. A significant portion of the business of the Other Service Organization is the performance of services for the First Service Organization;
2. These services are of a type historically performed by employees; and
3. At least 10% of the interests in the Other Service Organization are held by officers, highly compensated employees, and "common owners" of the First Service Organization. These requirements are discussed in the following bullets.

Generally, to constitute a "First Service Organization", the entity must be engaged in one of the following fields: (i) health, (ii) law, (iii) engineering, (iv) architecture, (v) accounting, (vi) actuarial science, (vii) performing arts (viii) consulting; and (ix) insurance.

Regarding what is a "significant portion" of the Other Service Organization's Business, this determination is based on the relevant facts and circumstances, although there are two numerical tests as follows, one of which must be met:

- **Test #1** – Services Historically Performed by Employees: The services performed by the Other Service Organization will be considered to be a type historically performed by employees if it was not unusual for the services to be performed by employees of U.S. organizations in that field on December 13, 1980.

An example of this type of affiliated service group might be a doctors' office (the "First Service Organization") that utilizes the services of employees of a hospital to perform nursing/ administrative services for the doctors' office (the "Other Service Organization"), where the doctors own at least 10% of the ownership interest of the hospital.

- **Test #2** – Performance of Services Test: An affiliated service group exists where (1) there is a First Service Organization and (2) an Other Service Organization, where the Other Service Organization is (a) a partner or shareholder in the First Service Organization and (b) regularly performs services for the First Service Organization, or is regularly associated with the First Service Organization in performing services for third parties. An example of this might be an incorporated partner (the "Other Service Organization") in a law firm who performs services for the law firm (the "First Service Organization").

Next Steps In Determining Controlled Group Status and Employer Mandate Obligations

As demonstrated from the above discussion, the IRS' controlled group rules are very complicated. Nonetheless, it is very important that companies take the time to understand and apply these rules when determining their employer mandate compliance obligations. This is because failure to take account of U.S.-based employees could lead to an incorrect determination that a given enterprise is not subject to the employer mandate provisions of the ACA – when, in fact, it is by reason of these controlled group rules.

For your education and convenience, please find attached a checklist that can be used by your company to get a better sense as to whether the controlled group rules might apply to your company. Please keep in mind that the checklist is not providing legal or tax advice and should not be relied upon as such. Companies should consult with their tax and legal counsel to determine the extent to which the IRS controlled group rules may apply.

Checklist to Help You Better Understand Whether the IRS Controlled Group Rules May Apply to Your Company

PLEASE NOTE: This is being provided solely for educational purposes and cannot be relied upon as tax or legal advice. Also, prior to using this checklist, you should review the attached document, "Overview of the IRS Controlled Group Rules and How They May Apply to Your Company Regarding the Employer Mandate." The document provides an overview of the rules and includes numerous terms and definitions that are relevant to this checklist.

In determining your company's size and compliance obligations for purposes of the ACA's employer mandate, you may need to take account of certain other companies (and their employees), if your company is a member of any of the following:

- Parent-Subsidiary Controlled Group
- Brother-Sister Controlled Group
- Affiliated Service Group

□ **STEP 1: Consider whether your company might be part of a parent-subsidiary controlled group.**

For more information on the rules regarding parent-subsidiary controlled groups, please see pages 2-4 of the attached document titled, "Overview of the IRS Controlled Group Rules and How They May Apply to Your Company Regarding the Employer Mandate." Factors to consider in determining whether your company might be part of a parent-subsidiary controlled group include:

- Whether your company has any direct or indirect ownership interests in another enterprise (including direct and indirect equity or profits interests and options for such interests).
- Whether your company is owned directly or indirectly by one or more other enterprises.
- Whether your company may be owned in part by family members that may also have ownership interests in other business enterprises

□ **STEP 2: Consider whether your company might be part of a brother-sister controlled group.**

For more information on the rules regarding brother-sister controlled groups, please see page 4 of the attached document titled, "Overview of the IRS Controlled Group Rules and How They May Apply to Your Company Regarding the Employer Mandate." Factors to consider in determining whether your company might be part of a brother-sister controlled group include:

- Whether a small number of persons, trusts or estates (generally less than five) own a controlling interest in your company (especially where such persons, trusts or estates also have other business enterprises that may have employees).

□ **STEP 3: Consider whether your company might be part of an affiliated service group.**

For more information on the rules regarding brother-sister controlled groups, please see pages 5-6 of the attached document titled, "Overview of the IRS Controlled Group Rules and How They May Apply to Your Company Regarding the Employer Mandate." Factors to consider in determining whether your company might be part of an affiliated service group include:

- Whether the principal business of the company is performing, on a regular and continuing basis, management functions for other organizations
- Whether a company is receiving management services from another business of the type historically performed by employees in the same business field.

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