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Our next Trucker Huss Webinar:

TITLE: Mental Health Parity

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Maintaining Control: Controlled Groups and What They Mean for Your Retirement

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INTRODUCTION TO CONTROLLED GROUPS

Background

- A controlled group is a group of related employers.
- The controlled group rules were initially developed to prevent employers from dividing their businesses in order to circumvent certain IRC requirements.
- Related employers are required to be treated as a single employer for certain IRC requirements, including retirement plan qualification requirements.
- Prior to the controlled group rules, employers were able to divide their businesses to circumvent nondiscrimination testing rules and favor HCEs.
- To address this loophole, ERISA and the IRC were amended to require coverage and nondiscrimination testing be conducted on a controlled group basis.

Impact of Being in a Controlled Group

- Employees of all employers are deemed employed by a single employer for the following purposes:
  - eligibility and coverage (IRC §410);
  - participation (IRC §401(a)(16);
  - vesting (IRC §411);
  - the nondiscrimination rules under IRC §401(a)(4) (including the ADP and ACP tests under IRC §§401(k) and (m), respectively);
  - Compensation limits (IRC §401(a)(17);
  - Limitations on benefits and contributions (IRC §415); and
  - Top-heavy rules (IRC §416).

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Types of Entities That Can Be In a Controlled Group

- Incorporated entities, including C corporations and S corporations can be in a controlled group.
  - Governed by IRC § 414(b).
- Unincorporated entities, including partnerships, LLCs, sole proprietorship, trusts and estate can be in a controlled group.
  - Governed by IRC § 414(c).
- Tax-exempt entities, including non-profits, governments and churches can be in a controlled group.
  - Governed by IRC § 414(c).

TYPES OF CONTROLLED GROUPS

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Parent-Subsidiary Controlled Groups

- Parent-subsidiary Controlled Groups: Exists when one business owns at least 80% of one or more other businesses.
  - One-parent and one-subsidiary: The parent owns 80% or more of one subsidiary.
    - Ex. Corp. A owns 100% of Corp. B. Corp. A and Corp. B are in a parent-sub controlled group.
  - Multiple subsidiaries: The parent owns 80% or more of more than one subsidiary.
    - Ex. Corp. A owns 100% of Corp. B and 80% of Corp. C. All three are in a controlled group.
  - Multiple tiers of subsidiaries: Subsidiaries of a parent own 80% or more of one or more subsidiaries.
    - Ex. Corp. A owns 100% of Corp. B and 100% of Corp. C. Corp. C owns 80% of Corp. D. All four corporations are in a controlled group.

Parent-Subsidiary Controlled Groups, cont'd

- Foreign Parent/Subsidiary: U.S. subsidiaries of a foreign parent can be in a controlled group. Similarly, a foreign subsidiary of a U.S. parent can be part of a controlled group.
  - Less attention is paid to foreign entities, as foreign employees are unlikely be included in applicable compliance testing (e.g., coverage, nondiscrimination testing) given non-resident alien exclusion.

Brother-Sister Controlled Groups

- Brother-Sister Controlled Groups: Exists if five or fewer "common owners," satisfy an 80% controlling interest test <u>and</u> a 50% identical ownership test.
  - Controlling Interest Test: If five or fewer individuals own at least 80% of the ownership interests or voting power of the business.
    - *U.S. v. Vogel Fertilizer Co.*, 455 U.S. 16 (1982): To be counted towards the Controlling Interest Test, the owner must have at least some ownership (directly or by attribution) in each business being tested.
    - Any degree of ownership is sufficient.
    - The rule in *Vogel Fertilizer* often prevents establishment of brother-sister controlled groups.

Brother-Sister Controlled Groups, cont'd

- Identical Ownership Test: Five or fewer individuals have identical ownership of two or more organizations if they own more than 50% of the voting power or more than 50% of the value of the business of the two corporations, "considering each person's ownership only to the extent such stock ownership is identical with respect to each such corporation."
  - In other words, you limit each person's ownership in each company to the lowest level of interest.

Brother-Sister Controlled Groups, cont'd

- Brother-Sister Controlled Group Illustrations

Shareholder	Corp. A	Corp. B	Corp. C
Adam	60%	40%	50%
Bill	40%	60%	0%
Carol	0%	0%	50%

Corps. A and B are in a controlled group. No other controlled groups.

Shareholder	Corp. A	Corp. B	Corp. C
Adam	59%	40%	50%
Bill	40%	60%	1%
Carol	1%	0%	49%

Corps. A and B and Corps. A and C are in a controlled group, but not Corps. B and C.

Brother-Sister Controlled Groups, cont'd

- Similar to parent-subsidiary controlled groups, foreign companies can also be in a brother-sister controlled group for qualified plan purposes.
- Brother-sister controlled groups tend to occur more frequently with small businesses than larger businesses.

Combined Groups

- Combined Group: Combines a parent-subsidiary controlled group and a brother-sister controlled group into one controlled group.
  - Occurs when the parent of a parent-subsidiary controlled group is part of a brother-sister controlled group.
  - Does not occur when the subsidiary of a parent-subsidiary controlled group is part of a brother-sister controlled group. This results in two separate controlled groups.

Non-Profit Organizations

- For non-profit organizations, the 80% test is based on control over the directors or trustees of the organization.
  - If at least 80% of the directors or trustees of one organization are either representatives of, or directly or indirectly controlled by, the other organization.
  - The individual is a representative of another organization if they are a trustee, director, agent or employee of another organization.
  - The individual is “controlled by” an organization if the organization has the power to remove a director or trustee and designate a replacement.
- For-profit and non-profit organizations can be in a controlled group.
- Anti-Abuse Rule: The IRS may treat non-profit and for-profit entities as a controlled group, if it determines the structure of the organizations has the effect of avoiding or evading the controlled group rules.

Non-Profit Organizations, cont'd

- Permissive Aggregation: Two or more non-profit organizations may choose to be aggregated if they maintain a single plan and the organizations regularly coordinate their day-to-day activities.

INCORPORATED ENTITIES VERSUS UNINCORPORATED ENTITIES

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Controlled Groups Under IRC § 414(b) V. IRC § 414(c)

- The rules and impact of under § 414(b) for corporations and the rules under § 414(c) for unincorporated entities are almost the same.
- Key difference: IRC § 414(c) only applies to an entity that operates a “trade or business.”
- “Trade or business” is not defined in the IRC or the regulations.
- One important exception involves private equity/investment firms organized as an unincorporated entity (e.g., partnership).

Private Equity and Controlled Groups

- *Sun Capital v. New England Teamsters & Trucking Industry Pension Fund*
  - Two Sun Capital funds owned a portfolio company, one fund owned 70% and the other fund owned 30%.
  - Portfolio company declared bankruptcy and stopped making contributions to the plan.
  - The plan sued Sun Capital alleging it was joint and severally liable for withdrawal liability as a related employer under the controlled group rules.

Private Equity and Controlled Groups, cont'd

- Issue: Were the private equity funds a "trade or business" or "merely investors"?
  - Key Holding: If a private equity fund had sufficient control over a portfolio company, then it could be considered a controlled group and held liable for unfunded pension liability.
- Whether or not a fund is engaged in a "trade or business" is a facts and circumstances analysis into whether there is significant management of the portfolio company.
  - Ex. Is the fund involved in day-to-day management?
- Private equity funds may want to avoid becoming too involved in day-to-day activities.
- If the fund is a corporation, the determination of whether they are a trade or business is irrelevant.

Private Equity and Controlled Groups, cont'd

- In addition, to potential withdrawal liability, can also create issues with coverage and nondiscrimination testing with the plans directly sponsored by the private equity fund and also the portfolio companies.
  - If private equity funds can be treated as a controlled group (i.e., the private equity fund and portfolio companies), coverage and nondiscrimination testing can become complicated.

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When is Controlled Group Status Determined?

- A controlled group can be formed any time the requirements under the IRC are satisfied (i.e., parent-sub and brother-sister controlled group ownership requirements).
  - No single date in a plan year for determining when a controlled group exists (e.g., first or last day of the plan year).
- Snapshot testing date (Rev. Proc. 93-42) can be used where ownership fluctuates during the year.

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OWNERSHIP

Ownership

- Ownership interest is determined by reference to the type of business:
  - Corporation = Stock
  - Partnership = Capital interest or profits interest
  - LLC = Membership interest
- Ownership for controlled group purposes can be based on the percentage of the value of the ownership interest or voting power.
  - If based on voting power, only voting shares count.
  - If based on value, all shares count.
- Excluded Interests: Treasury stock and nonvoting preferred stock are excluded for both parent-subsidiary and brother-sister controlled groups.
  - Interests excluded for parent-subsidiary controlled groups (e.g., qualified and non-qualified plans).
  - Interests excluded for brother-sister controlled groups (e.g., qualified plans).

Attribution

- The attribution rules for controlled groups can be found in IRC § 1563 (different attribution rules apply to ASGs and HCEs).
- Requires attribution of ownership to individual/entity even if they do not directly have ownership.
- Attribution should not be applied to take employers out of a controlled group.
- Brother-sister controlled groups are subject to a couple additional attribution rules.

Option Attribution

- Option Attribution: Generally, if an individual has on option to purchase an ownership interest in an entity, they are deemed to have ownership.
  - Ex. Individual owns 40% of the stock of a corporation and also has an option to acquire 40% of a corporation, he is considered to own 80%.
- Applies to both parent-subsidiary and brother-sister controlled groups.

Attribution from Business Organizations

- Attribution from Partnerships/Corporations: If a partnership or corporation has ownership in another organization, a partner/shareholder is deemed to own his pro-rata share of the organization unless it is less than 5%.
  - Ex. In partnership XYZ, X owns 60%, Y owns 36% and Z owns 4%. XYZ owns 60% of Corp. A. X is attributed 36% (60% X 60%), Y is attributed 21.6% (36% X 60%) and Z is attributed no ownership in Corp. A.
  - Attribution from corporations only applies to brother-sister controlled groups.

Attribution from Trusts and Estates

- Attribution from Trusts/Estates: If a trust or estate has an ownership interest in an organization, a beneficiary is deemed to own his pro-rata share of the trust/estate unless his ownership interest is less than 5%.

Family Attribution

- Family Attribution: Ownership can be attributed to spouses, parents, children, and grandchildren.
- Only applies to brother-sister controlled groups.
- Spousal Attribution: Generally, ownership is attributed to spouses, unless divorced or separated.
  - Exception: If spouse has no direct ownership, does not participate in the business, the business earns more than 50% of its income from passive investments and the ownership interest is not subject to disposition restrictions running in favor of the spouse.

Family Attribution, cont'd

- Attribution to Children: Any interest held by a parent is attributed to their child, unless the child is age 21 or over.
  - Exception: If the child has 50% or more ownership, then the child is attributed any ownership the parent has in the business regardless of age.
- Attribution to Parent: Any interest held by a child is attributed to their parent, unless the child is age 21 or over.
  - Exception: If the parent has 50% or more ownership, the parent is attributed ownership regardless of age.
- Grandparent and grandchildren: Generally, no attribution to the grandchild, unless the grandchild owns 50% or more, regardless of age.
  - Same rule for attribution from grandchild to grandparent.
- No attribution between siblings.

COVERAGE AND NONDISCRIMINATION TESTING IN CONTROLLED GROUPS

Coverage/Nondiscrimination Testing

- If an employer is part of a controlled group, all members of such group are treated as a single employer for coverage and nondiscrimination testing.
- Plans must pass on their own if not permissively aggregated (or cannot be permissively aggregated).
- Permissive Aggregation: Plan in a controlled group may choose to permissively aggregate to pass coverage testing/nondiscrimination testing.
  - Must have same plan year (e.g., December 31).
  - Must use same testing method (i.e., current-year or prior-year testing).
- If plans permissively aggregate for coverage, generally must also permissively aggregate for nondiscrimination testing (and vice versa).

Coverage/Nondiscrimination Testing, cont'd

- Safe Harbor Plans: Limited ability to permissively aggregate safe harbor plans.
  - Cannot permissively aggregate safe harbor plan with non-safe harbor plan.
  - To permissively aggregate a safe harbor plan, the plans must satisfy the safe harbor rules (i.e., must both be safe harbor and have same contribution formula).
  - If cannot permissively aggregate, must be able to satisfy coverage testing on their own.

Coverage Transition Rule

- Coverage Transition Rule: If a company becomes a member of a controlled group, coverage is deemed satisfied during a transition period by any plan maintained by an employer involved in the transaction (e.g., merger, stock/asset acquisition, etc.).
- The transition period begins when the controlled group's membership changes and ends at the <u>end</u> of the first plan year beginning <u>after</u> the change.
- Transition period also ends when there is a significant change in coverage or benefits.
- The following requirements must be met in order to qualify for the coverage transition rule:
    1. The plan met the requirements under Code Section 410(b) immediately before the transaction.
    2. Coverage and benefits under the plan must not change significantly during the grace period, other than by reason of the change.
    3. Coverage and benefits under the plan must not change significantly during the grace period, other than by reason of the change.

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Coverage Transition Rule, cont'd

- The coverage transition rule also indirectly provides relief on nondiscrimination testing.
  - The plans are still required to pass nondiscrimination testing but can perform nondiscrimination testing on their own.
- If the plans permissively aggregate to pass coverage testing, then they must also permissively aggregate for nondiscrimination testing (and vice versa).

Coverage Transition Rule, cont'd

- Advantages in Relying on Transition Rule:
  - Allows companies to strategize on how to pass coverage and nondiscrimination testing once the transition period ends.
  - Make any necessary plan design changes, such as:
    - Align plans for testing method (i.e., current year or prior year testing method) if the plans cannot pass testing on their own.
    - Align plans on plan-year end.
    - Eliminate/add safe harbor contribution, change contribution formula, align plans for benefits, rights, and features.
    - Determine if other disaggregation methods are available (e.g., QSLOBs).

Coverage Transition Rule, cont’d

- Disadvantages in Relying on Transition Rule:
  - Limited in making plan design changes relating to eligibility and benefits during the transition period.
  - Reliance is only temporary.
  - Potential for “false” sense of eligibility for transition rule, which could result in coverage/nondiscrimination testing failures.
- Overall, mostly beneficial.

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QUESTIONS?

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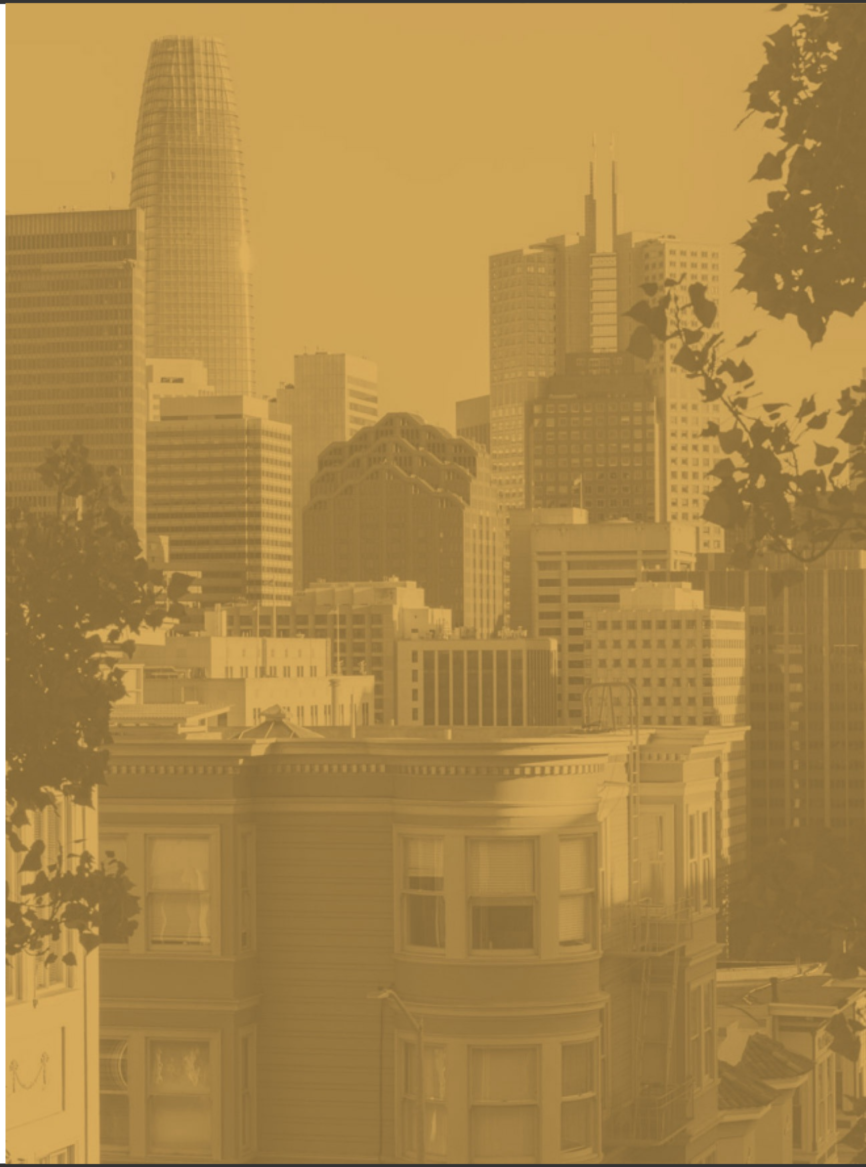

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