Overview of Controlled Group Rules and Retirement Plans

Plans Impacted
This white paper applies to entities sponsoring tax qualified defined benefit and defined contribution retirement plans under § 401(a) and certain tax exempt entities sponsoring § 401(a) or § 403(b) plans.

History
Controlled group provisions were added to the Internal Revenue Code (“Code”) in 1964 with the intention of providing tax incentives for small businesses operating as corporate entities. Code §§ 414(b) and (c) were added to the Code at the time the Employee Retirement Income Security Act of 1974 (“ERISA”) was enacted. This was done to correct a problem with certain medium and large size employers who took advantage of lower tax rates by organizing their corporate structures into multiple corporate entities. These additional provisions added a requirement that all employees of commonly controlled corporations, trades or businesses be treated as employees of a single corporation, trade or business.

Final regulations under § 414(c) were issued in 2007 (with a 2009 plan year effective date) regarding rules for certain tax exempt entities.

Importance
Identifying the employer is critical for retirement plans. When a controlled group exists, all employees of all the employers are considered/treated as working for a single employer for key Code provisions – including coverage, nondiscrimination and top heavy tests, as well as the Highly Compensated Employee determinations.

Definition and Types of Controlled Groups
A controlled group is a combination of two or more corporations and/or unincorporated businesses that are under common control as defined in Code § 1563, and it includes ownership tests to determine if a controlled group situation exists.

If a controlled group exists, the employees of the employers within these groups are considered as employed by one single employer for certain Code sections. See our section, Controlled Groups and Qualified Plans for details.
The three types of controlled groups include parent-subsidiary, brother-sister or a combination of these two groups.

- A **parent-subsidiary controlled group** exists when a “parent” business owns more chains of corporations connected through stock ownership with a common parent corporation if:
  (A) 80% of the stock of each corporation, other than the common parent corporation, is owned by one or more of the other corporations; and
  (B) the common parent corporation owns at least 80% of the stock of at least one of the other corporations.

- A **brother-sister controlled group** exists when a group of two or more corporations in which five or fewer common owners own directly or indirectly a “controlling interest” of each group, and have “effective control”. A common owner must be an individual, a trust, or an estate. The term “persons” includes individuals, estates or trusts. It does not include corporations.

  Controlling interest generally means 80% or more of the stock of each corporation. Effective control is more complicated, and generally means ownership of more than 50% of the stock of each corporation. However, in determining the ownership percentage for each owner, you have to look at each company he owns and determine an identical common ownership percentage for each corporation.

  Example: Tom owns 70% of Company A and Ann owns 10% of Company A. Tom owns 10% of Company B and Ann owns 70% of Company B. They meet the controlling interest requirement for both companies because their combined ownership of each company is 80%. However, they do not meet the 50% threshold for effective control. Ann only owns 10% of Company A, so her identical common percentage of Company B is only 10%. Tom only owns 10% of Company B, so his identical common percentage for Company A is only 10%. For each company, their combined common ownership percentage is only 20%. Since the effective control requirement is not met, this would not be a brother-sister controlled group.

- A **combined controlled group** consists of three or more organizations where:
  (A) each organization is a member of either a parent-subsidiary or a brother-sister controlled group; and
  (B) at least one corporation is the common parent of a parent-subsidiary controlled group and that parent is also a member of a brother-sister controlled group.

Ownership is based on the type of business. For a corporation, determining ownership is based on the percentage of company’s stock owned. The ownership percentage is based on voting power or value of the stock. For a sole proprietorship, the sole proprietor is treated as the 100% owner. For a trust or estate, ownership is based on the actuarial value of the estate or trust.
Overlapping Groups

If a corporation is a member of more than one controlled group with respect to any taxable year, the corporation is treated as a member of only one controlled group for tax purposes.

Generally, if on December 31 a corporation is a member of a controlled group by possessing at least 80% of the total value of shares of all classes of stock of the corporation, and if on that same date the corporation is also a member of another controlled group by owning other stock that is not used to satisfy the 80% total value test, then the corporation is treated as only being a member of the controlled group of which it is a member by satisfying the 80% total value test.

However, if on December 31 a corporation is a member of more than one brother-sister controlled group, the corporation may elect the controlled group in which it is to be included by filing a statement with its income tax return for the taxable year. The election is irrevocable and is effective until a change in the stock ownership of the corporation results in termination of membership in the controlled group in which the corporation has been included. If no election is made, the IRS will determine the controlled group in which the corporation is to be included. The determination will be binding for all subsequent years, unless the corporation files a valid election with respect to any subsequent year, or until a change in the stock ownership of the corporation results in termination of membership in the controlled group in which the corporation has been included.

Attribution Rules

Attribution is the concept of treating a person as owning an interest in a business that is not actually owned by that person. Attribution may result from family or business relationships. Code § 1563 contains the rule of attribution used to determine control for a controlled group of corporations (§ 414(b)), or for trades or businesses – whether or not incorporated – which are under common control (§ 414(c)). It is not our intent to discuss attribution rules in detail in this white paper, but we wanted to note that these rules also come into play.

Excluded Members and Additional Members

A corporation that is a member of a controlled group on its “testing date” (the date which is used for determining the status of controlled group members as component members or excluded members) is treated as an excluded member of the controlled group for the taxable year if that corporation is:

(A) a member of the controlled group for less than half the year;
(B) exempt from taxation in that taxable year;
(C) taxed as a foreign corporation for the taxable year;
(D) an insurance company subject to other taxation rules under the Code;
(E) a franchised corporation.

A corporation that is not a member of the controlled group on the testing date of any taxable year is treated as an additional member of a controlled group for the taxable year if it was a member of the controlled group for one-half (or more) of the taxable year and it is not
excluded as a tax exempt corporation, a foreign corporation, insurance company or franchised corporation for any of the reasons outlined above.

**Controlled Groups and Qualified Plans**

As we noted earlier, the determination of whether there is a controlled group situation is a critical analysis that impacts the plan (or plans) as a whole. If the sponsor of a tax qualified retirement plan is part of a controlled group, all employers of the controlled group must be treated as a single employer to satisfy the general qualification requirements of Code § 401 as well as numerous plan tests, including:

- Nondiscrimination rules under § 401(a)(4), including the general test;
- ADP*/ACP nondiscrimination tests under § 401(k) and § 401(m);
- Compensation limitation test under § 401(a)(17);
- Minimum participation requirements under § 401(a)(26) (for defined benefit plans);
- Eligibility requirements under § 401(a)(3) and § 410(a);
- Minimum coverage rules under § 410(b);
- Vesting requirements under § 401(a)(7) and § 411;
- Determination of Highly Compensated Employees under § 414(q);
- Maximum benefit and contribution limits under § 415 (the 80% ownership requirement becomes more than 50% for this provision); and
- Top-heavy test under § 416.

*403(b) plan elective deferrals are not subject to the ADP test.

**Determination Letter** – This is a submission of information to the IRS that enables the IRS reviewer to make and then issue a determination regarding the plan document. A request for IRS determination letters (using either Form 5300, 5307 or 5310) by a sponsor who is a member of a controlled group requires the plan sponsor to attach a statement that provides detailed information on the following:

- all members of the controlled group;
- the relationship of each member of the controlled group to the plan sponsor;
- the type(s) of plan(s) maintained by each employer;
- retirement plans common to all controlled group members; and
- whether the plan sponsor is a foreign entity and whether the plan sponsor is a member of the controlled group that includes a foreign entity.

**Form 5500 Annual Return/Report (“Form 5500”)** - Electronically filed with the Department of Labor which reports when the plan’s sponsor is a member of a controlled group. Generally, only one Form 5500 is required for a “single-employer” plan maintained by a controlled group.

**Funding Deficiencies** - For a defined benefit plan, the controlled group members may become liable for the funding deficiencies of other controlled group members whose employees are participants in the plan.

**Controlled Groups for Tax Exempt Entities**

The IRS issued final regulations in 2007 (effective in the 2009 plan year) that include updated guidance on
controlled group rules for certain tax exempt entities sponsoring § 401(a) or § 403(b) plans.

**Controlled Group Rules for Tax Exempt Entities**

**Effective in 2009** - Tax exempt entities under Code § 501(c)(3) (such as charitable trusts or foundations) that sponsor § 401(a) or § 403(b) plans are treated as a single employer under the controlled group rules. This can apply to multiple § 501(c)(3) organizations that are under common control or to a § 501(c)(3) organization and a non-§ 501(c) organization that are under common control. Common control exists between a tax exempt organization and another 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 (i.e., the other organization has the authority to appoint and remove directors or trustees which is based on facts and circumstances).

Permissive aggregation to be treated as a single employer is available for tax exempt organizations if they maintain a plan covering one or more employees from each organization and if these organizations regularly coordinate their “day-to-day” activities. As an example, an entity that provides a type of emergency relief within one geographic location and another exempt organization that provides that service within another geographic region may treat themselves as under common control if they have a single plan covering employees of both entities and regularly coordinate their day-to-day exempt activities.

If a tax exempt sponsor of a § 401(a) plan is part of a controlled group, all employees of the controlled group must be treated as a single employer and must satisfy the same requirements as outlined under the prior section, Controlled Groups and Qualified Plans.

**Governmental and Church Tax Exempt Entities under Code § 3121(w)(3) Remain under the Old Rules** – While the final 2007 regulations reserve the right to issue additional regulations, they currently specifically exclude governmental entities and churches (meaning a church, a convention or association of churches, or an elementary or secondary school that is controlled, operated or principally supported by a church or convention or association of churches) from the new rules. The final regulations explain that these entities can continue to apply a reasonable and good faith interpretation of the controlled group rules that were outlined in IRS Notice 89-23.

Notice 89-23 provides that the controlled group includes each entity of which at least 80% of the directors, trustees or other individual members of the entity’s governing body are either representatives of, or directly or indirectly controlled, or are controlled by, the contributing employer. In addition, an entity is included in the same controlled group as the contributing employer if such entity provides directly or indirectly at least 80% of the contributing employer’s operating funds and there is a degree of common management or supervision between the entities. A degree of common management or supervision exists if the entity providing the funds has the power to appoint or nominate officers, senior management or members of the board of directors (or other governing board) of the entity receiving the funds. A degree of common management or supervision also exists if the entity providing the funds is involved in the day-to-day operations of the entity.
For an educational organization which is part of a governmental entity, the “employer” includes any other educational organization that has the power to levy tax to provide funds to the contributing employer or to set or review the contributing employer’s budget, and also includes any educational organization that receives tax disbursements pursuant to the same tax levy.

Example: If a two year college and a university each receive 80% or more of their tax disbursements pursuant to a tax or taxes levied by a state and each of their budgets is reviewed by an educational organization, then both educational organizations are treated as one employer.

**Controlled Group Rules Are Complicated**

There are more in-depth rules relating to controlled groups that are not addressed in this white paper. Plan sponsors should work closely with their attorney and, if applicable, their actuary to ensure that they are complying with the rules affecting controlled groups.

You may also want to read our article, *Overview of Affiliated Service Group Rules for Retirement Plans.*