



# PENSION TRENDS

BY INDEPENDENT ACTUARIES, INC.

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## You Can't Choose Your Relatives *Related Employer Issues*

It happens each year: We work with a prospective client and their advisors to design a retirement plan that will help them meet their business goals, and everything appears to be on track. Then, an offhand comment is made about another business that the client has an ownership interest in, and things start to unravel. We've hit the dreaded related employer roadblock!

Why does it matter? Well, if two or more businesses are classified as related employers, they need to be treated as if they were a single employer for retirement plan compliance testing purposes. In other words, if one of the companies wants to establish a retirement plan, they would need to consider all of the employees of each related employer when performing nondiscrimination testing, minimum coverage testing, etc. This can potentially be a deal breaker, so it's much better to identify related employers before a plan is set up rather than sometime down the road.

There are two ways that employers can be related in the eyes of the IRS: They can form a Controlled Group or can form an Affiliated Service Group (ASG). In either situation the related employer rules can have a significant impact on the retirement plans sponsored by any of the employers.

### Controlled Group

The Controlled Group rules are found in Internal Revenue Code (IRC) Sections 414(b) and 414(c). These are "bright line" rules: Whether a Controlled Group exists depends entirely on the overlapping ownership of the businesses in question.

The simplest type of Controlled Group is a "parent-subsidiary" Controlled Group. A parent-subsidiary Controlled Group exists if one business owns at least 80% of one or more businesses. It's important to note that inserting a shell company into the mix doesn't avoid a parent-subsidiary situation. If Company A owns 100% of Company B, and Company B owns 80% of Company C, then all three companies form a Controlled Group.

"Brother-sister" Controlled Groups are a bit more complex, and exist if five or fewer common owners satisfy an 80% common ownership test and a 50% identical ownership test. For example, let's assume that we have two businesses, Acme Inc. and Beta LLC, with ownership structures as follows:

	Acme Inc.	Beta LLC	Identical Ownership
Andrea	60%	20%	20%
Betty	25%	80%	25%
Charles	15%	0%	0%
<b>Totals for common owners</b>	<b>85%</b>	<b>100%</b>	<b>45%</b>

Andrea and Betty are the "common owners" here, since they own portions of both companies. Between them, they own 85% of Acme Inc. and 100% of Beta LLC, so the 80% common ownership test is satisfied. Further, Andrea owns at least 20% of both companies and Betty owns at least 25% of both companies. Adding those together, we get 45% identical ownership, so the 50% identical ownership test is not satisfied.

Since both tests aren't satisfied, we do not have a Controlled Group. There could, however, still be an Affiliated Service Group. Read on!

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### **Author Profile:**

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## Affiliated Service Group

The ASG rules are found in IRC Section 414(m). Unlike the Controlled Group Rules, the ASG rules are somewhat subjective. An ASG may exist if there is any level of common ownership between the business entities.

The ASG rules get complicated quickly, but in general one of the business entities (the “First Service Organization”, or FSO) must be a service organization (i.e. – a business that derives the majority of its income from providing a service as opposed to a material good). The other business may potentially be an “A-Org” or a “B-Org”. An A-Org must be a service organization; there is no such requirement for a B-Org.

An FSO and an A-Org form an ASG if the A-Org (or its members) own some interest in the FSO, and the A-Org performs services for the FSO or is regularly associated with the FSO in providing services to third parties. For example, let’s say that a law firm is structured as a partnership with three partners, and that each partner is separately incorporated, with each corporation having a one-third ownership in the law firm. The law firm has employees, but the corporations are only composed of the individual partners. The partnership income is distributed among the corporate partners in accordance with the partnership agreement. In this situation, the law firm is the FSO and each of the three corporate partners is an A-Org. As a result, we cannot set up a retirement plan for an individual partner through his or her corporation without also covering some or all of the employees of the law firm.

An FSO and a B-Org form an ASG if a significant portion of the business of the B-Org is the performance of services for the FSA and/or its A-Orgs, if those services are a type historically performed in the field of the FSO or its A-Orgs, and if at least 10% of the B-Org is owned by one or more Highly Compensated Employees of the FSO and/or its A-Orgs. WHEW!

## Family Attribution Rules

So, you’ve gone through the analysis and have decided that the Controlled Group and ASG rules don’t apply. Not so fast! Have you considered family members who have ownership interests? Family attribution rules state that, for some purposes, stock owned by a spouse, parent, grandparent or child may be deemed to be owned by a single person.

Family attribution rules apply in related employer determinations, although there are exceptions in certain circumstances for Controlled Groups. In our example on the previous page, let’s assume that Betty and Charles are married, and that they have a minor child. Their ownership percentages would be combined in this case, and we’d get:

	Acme Inc.	Beta LLC	Identical Ownership
Andrea	60%	20%	20%
Betty/Charles	40%	80%	40%
<b>Totals for common owners</b>	100%	100%	60%

In this case, both the 80% identical ownership test and the 50% identical ownership test are satisfied, so we have a brother-sister controlled group.

In general, if a Controlled Group or ASG exists, it cannot be dissolved by simply setting up a shell company or having other corporate restructuring (short of changes in ownership). These rules are specifically designed to prevent those kinds of shenanigans.

As you can see, these rules are extremely complex. While we cannot offer a legal opinion about the existence of related employers, we are very familiar with the rules and can point you in the right direction, so feel free to contact an IAI Consultant if you have questions, or to call us at 503-520-0848.

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