

Related Employers

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INTERNAL REVENUE SERVICE
TAX EXEMPT AND GOVERNMENT ENTITIES

Introduction

Introduction

A controlled group of businesses is a group of related businesses that have common ownership. If a controlled group exists as defined by the applicable Code sections and associated Regulations, the employees of those businesses are considered together for certain qualified plan requirements. Code § 414(b) refers to controlled groups consisting of corporations and Code § 414(c) refers to all other controlled groups.

Affiliated service groups are also defined by applicable Code and Regulation sections, in this case Code § 414(m) and Proposed Regulations § 1.414(m)-1. These requirements exist to define relationships where entities have some common ownership attributes – less than otherwise required to form a controlled group – and perform services with or for each other.

Both of these Code sections exist to prevent employers from setting up multiple entities to avoid paying certain employees benefits they normally would have had to pay, in order to meet qualified plan requirements.

Objectives

Objectives

At the end of this chapter, you will be able to:

- Identify whether a controlled group exists;
 - as within a parent-subsidary group
 - as within a brother-sister group

- Identify and determine whether an affiliated service group exists:
 - as between a First Service Organization and an A-Organization, or
 - as between a First Service Organization and a B-Organization, or,
 - as involved with a Management Group

From these identifications, you will be able to determine how these relationships affect the status of qualified plans maintained by the entities involved, by knowing which source and submission documents are needed for these evaluations.

Prior reference material

Introduction Control groups and Affiliated service groups have been covered in prior CPE Chapters. The most recent EP Rulings and Agreements training material can be found in the text to 2004 CPE (See Chapter 7 – “*Controlled and Affiliated Service Groups*”). EP Examination covered these topics in 2007 CPE (see Chapter 11 – “*Controlled Groups* and Chapter 12 – “*Affiliated Service Groups*”). The topics are also covered in Phase IV for EP Examinations. See Chapter 2 for Controlled Group and Chapter 3 for Affiliated Service Groups.

Republished material This chapter contains republished material from those sources and has been updated to reflect subsequent changes in law and guidance.

This material was written before enactment of the Pension Protection Act of 2006 (PPA) and also precede installation of the staggered remedial amendment determination letter program. However, none of these statutory or procedural changes made widespread changes to coverage or affiliated service group compliance requirements, thus the core concepts discussed in prior textual material generally remain relevant.

Addressing all EP matters The content in this section is written generally to address all Employee Plans compliance matters, either on determination letter or voluntary compliance submissions, or in examination settings. Specific procedural instruction may also be found in your function’s processing guidelines. See also IRM § 7.11.1.28 for processing instructions for affiliated service group issues submitted in conjunction with a determination letter application. There is no corresponding IRM citation for the examination function.

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Controlled Group – Overview

IRC §§ 414(c) and 414(b)

IRC § 414(b) provides that for purposes of §§ 401, 408(k), 408(p), 410, 411, 415, and 416, all employees of all corporations that are members of a controlled group shall be treated as employed by a single employer. Section 414(b) refers to § 1563(a) to define a controlled group of corporations.

Treas. Reg. § 1.414(b)-1 generally provides that a “controlled group of corporations” has the same meaning as found in § 1563 and the associated regulations.

IRC § 414(c) provides that for purposes of §§ 401, 408(k), 408(p) 410, 411, 415, and 416, all employees of trades or businesses (whether or not incorporated) that are under common control are treated as employed by a single employer. Section 414(c) refers to the applicable regulations to define a controlled group of trades or businesses. Those regulations are found in Treas. Reg. § 1.414(c).

The principles outlined in § 1563 and the related regulations are similar to those found in Treas. Reg. § 1.414(c).

Non-corporate members of control groups

Treas. Reg. § 1.414(c)-2(a) provides that an “organization” for purposes of Treas. Reg. §§ 1.414(c)-2 through 1.414(c)-4 means a sole proprietorship, a partnership, a trust, an estate, or a corporation. Treas. Reg. § 1.414(c)-5 also shows how control group rules apply to certain tax-exempt organizations.

Types of Controlled Groups

A controlled group exists if there is either a:

- **Parent-subsidiary** controlled group (Code § 1563(a)(1) and Treas. Reg. § 1.414(c)-2(b)),
 - **Brother-sister** controlled group (Code § 1563(a)(2) and Treas. Reg. § 1.414(c)-2(c)), or
 - **Combination** of the above (Code §1563(a)(3) and Treas. Reg. §1.414(c)-2(d).
-

Controlled Group – Parent-Subsidiary Group

Parent-Subsidiary Group

Generally, a parent-subsubsidiary group exists when there is a “parent” business which owns 80% or more of a “subsidiary” business. There can be one subsidiary or multiple subsidiaries. There can also be multiple tiers of entities connected to a common parent. The parent company only needs to control one of the companies, since a lower level company could control other companies.

See IRC § 1563(a)(1) and Treas. Reg. § 1.414(c)-2(b).

Controlling Interest

For purposes of determining whether or not a parent-subsubsidiary group or brother-sister group (discussed later) exists, it is important to consider whether or not a parent company has a controlling interest in another organization. A controlling interest is defined by the type of company that is involved.

In the case of a corporation, ownership of stock having at least 80% of the total combined voting power of all classes of stock entitled to vote of such corporation or at least 80% of the total value of shares of all classes of stock of such corporation.

In the case of a trust or estate, ownership of an actuarial interest of at least 80% of such trust or estate.

In the case of a partnership, ownership of at least 80% of the profits interest or capital interest of such partnership.

In the case of a sole proprietorship, ownership of the sole proprietorship.

See IRC §1563(a)(1) and Treas. Reg. §1.414(c)-2(b)(2).

Controlled Groups: Parent-Subsidiary Examples

Example 1
Parent and
Subsidiary

Adams, Inc. owns 80% of the outstanding stock of Bates, Inc. Adams is the parent company and Bates the subsidiary company within a commonly controlled group.

Example 2
Parent and
Multiple
Subsidiaries

Clay, Inc. owns 100% of the shares of Dade, Inc., 80% of Evans, Inc., and 70% of Franklin, Inc. The remaining 30% of Franklin is owned by unrelated parties.

Clay is the common part of parent subsidiary group consisting of Clay, Dade, and Evans. Franklin is not a member of the group because Clay owns less than 80% of Franklin.

Example 3
Parent and
Multiple Tiers

The Grand Company owns 100% of the outstanding stock of Hand, Inc. Hand owns 90% of Jenkins, Inc. and 80% of the Kent Corporation. Jenkins owns 95% of Madison, Inc.

Grand is the common parent and Hand. Jenkins, Kent, and Madison are all part of the controlled group.

Controlled Groups: Brother-Sister Groups

Brother-Sister Group

A brother-sister group under common control exists if:

- The same 5 or fewer persons who are individuals, estates, or trusts own (directly and with the application of the attribution rules) a **controlling interest** (80%) in each organization, and
- Taking into account the ownership of each person only to the extent ownership is identical with respect to each organization; the persons are in **effective control** of (more than 50%) of each organization.
- The 5 or fewer persons whose ownership is considered for purposes of the controlling interest requirement for each organization must be the same persons whose ownership is considered for purposes of the effective control requirement.
- Ownership of stock and other interests are determined in the same way for this purpose as they are for purposes of determining whether a parent-subsiary group exists.

See IRC § 1563(a)(2) and Treas. Reg. § 1.414(c)-2(c)(1)

Effective Control – Definition

Persons are in effective control of an organization if:

- In the case of a corporation, if shareholders own more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of the corporation;
- In the case of a trust or estate, such persons own an aggregate actuarial interest of more than 50 percent of such trust or estate;
- In the case if a partnership, such persons own an aggregate of more than 50 percent of the profit interest or capital interest of such partnership; and
- In the case of an organization, which is a sole proprietorship, the sole proprietor owns a controlling interest.

See Treas. Reg. § 1.414(c)-2(c)(2)

Brother-Sister Groups - Examples

Example 4
Brother-Sister
Group Example

Dickinson Corp. and Guilford Corp are owned by four unrelated shareholders in the following percentages:

Shareholder	Percentage of Ownership	
	X Corp	Y Corp.
<i>Alfred</i>	80%	20%
<i>Benedict</i>	10%	50%
<i>Casper</i>	5%	15%
<i>Dale</i>	5%	15%
<i>Total</i>	100%	100%

Although the four shareholders together own 80% or more of the stock of each corporation, they do not own more than 50% of the stock of each corporation taking into account only the identical ownership. Therefore they don't have effective control of the companies. The identical ownership percentages is based on the least percentage owned by the person and is shown below for this example:

Shareholder	Identical Ownership Percentage
<i>Alfred</i>	20%
<i>Benedict</i>	10%
<i>Casper</i>	5%
<i>Dale</i>	5%
<i>Total</i>	40%

Therefore, Dickinson and Guilford do not constitute a controlled group of corporations.

Brother-Sister Groups Examples, Continued

**Example 5 –
Illustrating
Effective
Control, but
Not Common
Control**

The following individuals each own 12% to 13% of the stock in Athens Corp. and also Orleans Corp.

Individual	Ownership of ABC Corp.	Ownership of XYZ Corp.
<i>Anthony</i>	<i>12%</i>	<i>12%</i>
<i>Russell</i>	<i>12%</i>	<i>12%</i>
<i>Nash</i>	<i>12%</i>	<i>12%</i>
<i>Marian</i>	<i>12%</i>	<i>12%</i>
<i>Victoria</i>	<i>13%</i>	<i>13%</i>
<i>Winona</i>	<i>13%</i>	<i>13%</i>
<i>Hope</i>	<i>13%</i>	<i>13%</i>
<i>Lesley</i>	<i>13%</i>	<i>13%</i>

Any grouping of five of the shareholders will own more than 50% of the stock in each corporation, and all shareholders in any of the groupings will own identical amounts.

However, Athens and Orleans are not members of a brother-sister group because at least 80% of each corporation's stock is not owned by the same five or fewer individuals.

**Example 6
Illustrating
Both Effective
and Common
Control**

Assume the individuals Victoria, Winona, Hope and Lesley noted in the above example each owned 20% of both Athens and Orleans.

Regardless of the ownership percentages of Anthony, Russell, Nash, and Marian, or any other owners, Athens and Orleans are a brother-sister group.

Combined Groups – Controlled Groups

Combined Groups

A combined group is a group of three or more organizations, if:

- Each organization is a member of either a parent-subsiary or brother-sister group, and
- At least one organization is the common parent of a parent-subsiary group and is also a member of a brother-sister group.

See IRC § 1563(a)(3) and Treas. Reg. § 1.414(c)-2(d)

Example 7 - Combined Group

Mason, an individual, owns:

- *80% in Milligan Partnership, and*
- *90% in Norwich Corporation,*

Milligan Partnership owns 85% of Pike Corporation.

Milligan Partnership, Norwich Corporation, and Pike Corporation are members of the same combined group of trades or businesses under common control because:

- *Milligan Partnership, Norwich Corporation, and Pike Corporation are each members of either a parent-subsiary or a brother-sister group, and*
 - *Milligan is:*
 - *The common parent of the parent-subsiary group consisting of Milligan and Pike, and a member of a brother-sister group consisting of Milligan and Norwich.*
-

Controlled Groups – Tax Exempt Organizations

Tax Exempt Organizations

Common control exists between an exempt organization and another organization if at least 80 percent of the directors or trustees of one organization are either representatives of, or directly or indirectly controlled by, the other organization. A trustee or director is treated as a representative of another exempt organization if he or she is a trustee, director, agent, or employee of the other exempt organization. A trustee or director is controlled by another organization if the other organization has the general power to remove such trustee or director and designate a new trustee or director. Whether a person has the power to remove or designate a trustee or director is determined based on facts and circumstances.

Generally, the control group rules for tax exempt organizations do not apply to a church (as defined in IRC § 3121(w)(3)(A)) or any church- controlled organization (as defined in IRC § 3121(w)(3)(B).)

See Treas. Reg. §1.414(c)-5

Example 8 – Tax Exempt Organization

Exempt organization A has the power to appoint at least 80% of trustees of exempt organization B. Organization B is the owner of all the outstanding shares of corporation C, which is not an exempt organization. Organization A has the power to control at least 80% of the directors of exempt organization D. Then A, B, C, and D are treated as the same employer with respect to any plan maintained by A, B, C, or D for the purposes Code §§ 414(b), (c), (m), (o), and (t).

Controlled Groups – Foreign Companies

Foreign Companies

A foreign company can be part of controlled group.

Generally certain foreign corporations are excluded from the control group rules under IRC § 1563(b)(2)(C). However, Treas. Reg. § 1.414(b)-1(a) provides that the component member rules of §1563(b) are disregarded when determining whether or not a controlled group relationship exists. Therefore, a foreign company can be part of a controlled group. Also see PLR 200205050.

Although nonresident aliens are generally excluded from coverage testing under IRC § 410(b)(3)(C), the eligible employees of the businesses that are part of the controlled group would still need to be considered together.

Although many plans will probably exclude nonresident aliens, PLR 200205050 showed that a qualified plan could cover a nonresident alien employee.

For example, a Foreign parent company could control subsidiaries that operate in the United States and the eligible employees for those subsidiaries would be need to be considered as part of a single employer for the applicable plan requirements as shown in IRC §§ 414(b) and 414(c).

Also see Private Letter Rulings 8228116, 200237020 and 9135059.

Foreign Companies – Example 9

Company B is a foreign based company that owns 95% of Company C and Company D, both operated and based in the United States.

Companies B, C, and D are all part of a Parent-Subsidiary Controlled Group.

Although all employees of Company B are nonresident aliens without US-sourced earned income and are excluded from the coverage testing, the eligible employees of C and D are considered as employed by one employer for testing purposes.

Determining Ownership – Controlled Groups

Ownership

Ownership is based on the type of business.

For a corporation, the ownership interest is generally based the percentage ownership of the company's stock. The stock ownership percentage can be based on either voting power or value of the stock.

For a partnership, ownership is based on the capital interest or profits interest in the partnership.

For a sole proprietorship, the sole proprietor is treated as the 100% owner.

For a Trust or estate, ownership is based the actuarial interest in the Trust or Estate.

See IRC § 1563(d) and Treas. Reg. § 1.414(c)-4(a)

Actuarial Interest

For purposes of controlled group determinations, Treas. Reg. § 1.414(c)-2(b)(2)(D)(ii) shows that an "actuarial interest" is determined by assuming the maximum exercise of discretion by the fiduciary in favor of such beneficiary. The regulation refers to Treas. Reg. §§ 20.2031-7 and 20.2031-7A for use in ascertaining a beneficiary's actuarial interest.

Stock Options

If a person has an option to acquire stock, that stock shall be considered as owned by that person. An option to acquire an option, and each one of a series of such options, shall be considered as an option to acquire stock. This is applicable to brother-sister and parent-subsidiary controlled groups. See IRC § 1563(e)(1) and Treas. Reg. § 1.414(c)-4(b)(1)

Controlled Groups - Attribution

Attribution of Ownership

When determining ownership, constructive ownership in addition to direct ownership is considered. Constructive ownership generally includes options (as noted above) and amounts attributed from different sources. If two or more individuals would have been attributed the same ownership interest, the individual whose ownership would result in a control group is treated as the owner.

Although the attribution rules are written in terms of stock ownership, the same principles are applied for organizations that are not incorporated. In place of an interest in stock, the following interests in non-stock entities are as follows:

Entity	Ownership relates to the:
Trust or estate	Actuarial interest
Partnership	Capital or profits
Sole proprietorship	Sole proprietorship

Attribution Parent-Subsidiary Groups

For purposes of parent-subsubsidiary controlled groups, attribution is limited to attribution for options and attribution from organizations. See IRC § 1563(d)(1).

Attribution Brother-Sister Groups

For purposes of brother-sister controlled groups, family attribution does apply since all of the attribution rules apply as shown under IRC § 1563(e). See IRC § 1563(d)(2).

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Controlled Groups - Attribution, Continued

No Double Attribution

After an individual is attributed the ownership interest of a family member, that interest does not get attributed from the individual to another family member. However:

- The ownership interest of an individual may be attributed to more than one family member.
- After an individual is attributed the ownership of a corporation, partnership or trust, the interest may then be taken into account under other attribution rules.

See IRC § 1563(f)(2)(B) and Treas. Reg. § 1.414(c)-4(c)(2)

Attribution from Corporations

Stock owned, directly or indirectly, by or for a corporation is attributed proportionately to shareholders owning 5% or more in value of its stock. This only applies to brother-sister controlled group determinations. See IRC § 1563(e)(4) and Treas. Reg. § 1.414(c)-4(b)(4)

Attribution from Partnerships

Stock owned, directly or indirectly, by or for a partnership is attributed proportionately to shareholders owning 5% or more capital or profits interest of the partnership, whichever is greater. This applies to parent subsidiary controlled groups and brother-sister controlled groups. See IRC § 1563(e)(2) and Treas. Reg. § 1.414(c)-4(b)(2)

Attribution from Trust or Estates

Stock owned, directly or indirectly, by or for an estate or trust is attributed proportionately to beneficiaries having an actuarial interest of 5% or more of such stock. This applies to parent subsidiary controlled groups and brother-sister controlled groups. See IRC § 1563(e)(3) and Treas. Reg. § 1.414(c)-4(b)(3)

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Controlled Groups - Attribution, Continued

Family Attribution – Spouses

Generally the ownership interests of one spouse are attributed to the other. This does not apply to persons legally separated pursuant to a divorce decree or a decree of separate maintenance.

Additionally, there is no attribution between spouses if there is:

- No direct ownership or participation in the management of such corporation at any time during the taxable year. Additionally, the spouse cannot be a member of the board of directors, a fiduciary, or an employee of such organization at any time during such taxable year.
- No more than 50% of business gross income is from passive investments.
- Stock is not subject to conditions that restrict a spouse's right to dispose of the stock and that run in favor of the individual or his children under age 21.

See IRC § 1563(e)(5) and Treas. Reg. § 1.414(c)-4(b)(5).

Family Attribution – Controlled Groups

Family Attribution

The following table shows other family attribution rules:

The ownership interests of:	Are attributed to:	Only if:
Minor child (under age 21)	Parent	
Parent	Minor child (under age 21)	
Parent	Adult child (over age 21)	Adult child owns >50% of that business
Adult child	Parent	Parent owns >50% of that business
Grandparent	Minor or adult child	Minor/Adult child owns >50% of that business
Minor or adult child	Grandparent	Grandparent owns >50% of that business
Siblings	None	

See IRC § 1563(e)(6) and Treas. Reg. § 1.414(c)-4(b)(6)

Example 10 – Illustrating Family Attribution – Spouse

Brooks and Shannon are married. Brooks is a doctor and owns 100% of his medical practice. Shannon is also a doctor and owns 50% of a separate medical practice (the other 50% is owned by an unrelated doctor).

Brooks is not an employee or direct owner in Shannon's practice and less than 50% of the gross income for the practice is from passive investments. Brooks, however, is in charge of significant management activities for his wife's practice.

Shannon does not directly own an interest or participate in Brooks' practice, and less than 50% of the gross income from Brooks' practice is from passive investments. Therefore:

- *Brooks is attributed the 50% interest that Shannon owns in her practice since he participates in Shannon's practice.*
- *Shannon is not attributed any ownership interest in Brooks' practice.*

Proportionate Attribution under Controlled Group rules

Proportionate Attribution

Proportional attribution involves multiplying a shareholder's interest in one organization by the organization's interest in a second entity.

See Treas. Reg. § 1.414(c)-4(b)(2)(ii).

Example 12 – Proportionate Attribution

Elliot owns 70% of the stock in the Fairfield Corporation. Grant owns 20% of the stock and the remaining 10% is owned by four other individuals who each own less than 5%. The Fairfield Corporation has a 30% stock ownership of Hale Corporation.

The Hale stock is attributed to Elliot and Grant in proportion to their ownership interest in Fairfield Corporation as follows:

- *Elliott is treated as a 21% owner of Hale Corporation – 70% (interest in Fairfield) * 30% (Fairfield's interest in Hale)*
 - *Grant is treated as a 6% owner of Hale Corporation – 20% (interest in Fairfield) * 30% (Fairfield's interest in Hale)*
 - *Since each of the four remaining shareholders of Fairfield Corporation own less than 5%, they are not treated as owning any interest in Hale Corporation.*
-

Example 13 – Proportionate Attribution

The Mesa Group is a partnership. Jay owns a 70% interest in Mesa and Kendall owns a 30% interest. The Mesa Group owns 50% of the stock of Lake Investments Corporation.

The Lake stock is attributed to Jay and Kendall in proportion to their partnerships interests in Mesa as follows:

- *Jay is treated as a 35% owner of Lake Corporation (70% * 50%)*
 - *Kendall is treated as a 15% owner of Lake Corporation (30% * 50%).*
-

Controlled Group Attribution - Examples

Example 14 – Attribution

James, age 30, has a 90 percent interest in the capital and profits of Elmore Partnership. Elmore owns all the outstanding stock of Gibson Corporation, and Gibson owns 60 shares of the 100 outstanding shares of Barnard Corporation. The 60 shares of Barnard constructively owned by Elmore are treated as owned by Elmore. Therefore, James is considered as owning 54 shares of the Barnard stock (90 percent of 60 shares).

Example 15 – Attribution

Assume the same facts as in the example above. Assume further Charles is the father of James and Ben (20 years old), and Ben owns 40 shares of Barnard.

Attribution rules show that Ben's shares are attributable to the parent – Charles. Although the stock of Barnard owned by Ben is considered owned by Charles, the Barnard stock may not be treated as owned by Charles in order to make James the constructive owner of Barnard stock (after an individual is attributed the ownership of a family member, the interest does not get attributed from the individual to another family member).

Example 16 – Attribution

*Assume the same facts as above and further assume that Charles has an option to acquire the 40 shares of Barnard stock owned by his son, Ben. Charles is considered as owning the 40 shares by reason of option attribution and not by reason of family attribution. Therefore, since James is in effective control of Barnard, the 40 shares of Barnard stock constructively owned by Charles are attributed to James. James is considered as owning a total of 94 shares of Barnard stock (60 shares * 90% + 40 shares).*

Excluded Ownership Interests under Controlled Groups

Excluded Stock For control group purposes, only outstanding stock is considered.

The following types of stock are excluded when determining ownership:

- Non-voting stock which is limited and preferred as to dividends,
- Treasury stock, and
- Stock, which is treated as “**excluded stock**”.

Excluded stock has different meanings for Parent-Subsidiary Groups and Brother-Sister Groups.

Excluded Stock Parent-Subsidiary Groups When determining whether or not a Parent-Subsidiary Group exists, certain amounts are excluded if the Parent owns (directly or by attributions) at least 50% of the subsidiary.

If 50% or more is owned, then -

- Ownership held by a deferred compensation plan (whether qualified or not) is excluded. (IRC § 1563(c)(2)(A)(i) and Treas. Reg. § 1.414(c)-3(b)(3).)
- Ownership in a subsidiary that is owned by a principal owner, officer, partner, or fiduciary of the parent company is excluded. (IRC § 1563(c)(2)(A)(ii) and Treas. Reg. § 1.414(c)-3(b)(4). A principal owner owns at least 5% of the company.

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Excluded Ownership Interests under Controlled Groups, Continued

Excluded stock- parent sub- continued

- Stock in the subsidiary company owned by an employee, if the stock is subject to conditions that restrict or limit the employee's right to dispose the stock is excluded. This exclusion does not apply in the case of a reciprocal stock purchase agreement. An example of a condition which substantially restricts the right to dispose of the stock is a right of first refusal. (IRC § 1563(c)(2)(A)(iii) and Treas. Reg. § 1.414(c)-3(b)(5).)
 - Stock held by a 501 tax-exempt organization is excluded if the organization is controlled by the parent, the subsidiary, or a principal owner, officer, partner or fiduciary of the parent. (IRC § 1563(c)(2)(A)(iv) and Treas. Reg. § 1.414(c)-3(b)(6).)
-

Example 17 Excluded Stock Parent- Subsidiary

Park Corporation owns 70 percent of the only class of stock in Simmons Corporation. The remaining stock in Simmons is owned as follows: 4 percent by Alvin (an officer of Park), and 26 percent by Drake (a principal stockholder of Park).

- 1) *Park satisfies the 50-percent stock ownership requirement with respect to Simmons.*
 - 2) *Since Alvin is an officer and Drake is a principal stockholder, stock in Simmons owned by Alvin and Drake is "excluded stock" for purposes of determining whether Park and Simmons are members of a parent-subsubsidiary group. Thus, Park is considered to own 100 percent of the stock in Simmons. Accordingly, Park and Simmons are members of a parent-subsubsidiary group of trades or businesses under common control.*
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Excluded Ownership Interests under Controlled Groups, Continued

Excluded Stock Brother-Sister Groups

If five or fewer persons who are individuals, estates, or trusts own 50 percent or more of the total combined voting power of all classes of stock entitled to vote, or 50 percent or more of the total value of the shares of all classes of stock in a corporation, the stock of a corporation listed below shall be treated as excluded stock.

- Stock in a corporation held by a §401(a) plan for the benefit of the employees of such corporation.
- Stock in a corporation owned (directly or constructively) by an employee of the corporation, if the stock is subject to conditions which run in favor of any of such common owners or such corporation and which substantially restrict or limit the employee's right to dispose of such stock (this exclusion does not apply in the case of a reciprocal stock purchase agreement.) An example, which substantially restricts an employee's right to dispose of the stock, is a right of first refusal.
- Stock owned by a § 501 exempt organization which is controlled directly or indirectly by one of the following:
 - The corporation,
 - An individual, estate, or trust that is a principal stockholder of the corporation,
 - An officer of the corporation, or
 - Any combination of the above.

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Excluded Ownership Interests under Controlled Groups, Continued

**Example 18 –
Excluded Stock**

Adam owns 100% of Ventura, Corp. and 70% of Wells, Inc. The other 30% of Wells is owned by Barry, an employee of Wells. Barry's stock is subject to a right of first refusal in favor of Adam. The right of first refusal is not subject to a reciprocal stock purchase agreement.

Barry's stock is excluded stock for purposes of applying the brother-sister rules. Normally, Ventura and Wells would not be a brother-sister group because Adam, as the common owner, does not satisfy the 80% common ownership test. However, because Barry's stock is excluded stock, Adam's interest in Wells is treated as 100%. Therefore, Corporation Ventura and Wells are a brother-sister group.

**Other Rules
Applicable to
All Groups**

In addition to the specific rules for parent-subsidary and brother-sister groups, there are other special rules that also apply to both groups.

If the stock is owned by two or more persons, the stock shall be considered as owned by the person whose ownership of the stock results in the corporation being a member of a group. If this rule would cause the member to become a member of two controlled groups, the member shall be treated as a component member of one controlled group.

If stock is owned by a person and such ownership results in the corporation being a member of a group, such stock shall not be treated as excluded stock, if treating such stock as excluded stock results in the corporation not remaining a member of a group. This means that the excluded stock rules do not prevent a controlled group from existing if it otherwise would exist.

See IRC § 1563(f)(3)

Excluded Stock and Controlled Groups – Exceptions

Exception to Exclusions

Remember, the stock exclusion rules apply to cause the group to be a “controlled group.” The listed stock exclusions should not be excluded if the result is that the group is not a controlled group.

If:

- Stock of a corporation is owned by a person directly or constructively, and
- Such ownership results in the membership of that organization in a group of two or more trades or businesses under common control for any period,

Then that interest will not be treated as an excluded interest if the result of applying the excluded stock rules is that the organization is not a member of a group of two or more trades or businesses under common control for that period. See Treas. Reg. § 1.414(c)-3(f).

Plan Qualification and Controlled Groups

Plan Qualification and the Controlled Group

If a controlled group exists, the Code requires the consolidation of all employees in the group as if employed by one employer. Therefore, all employees of the companies that make up the controlled group must be considered to determine the plan's compliance with specified provisions in the Code, which include:

- General qualification requirements,
 - Coverage and nondiscrimination requirements,
 - Simplified employee pension qualification requirements,
 - Simple retirement account qualification requirements,
 - Minimum participation and vesting standards,
 - Limitations on benefits and contributions, and
 - Top-heavy plan requirements.
-

IRC § 410 Minimum Participation and Coverage

A qualified plan must meet the minimum participation and coverage standards. Additionally, a plan must satisfy the ratio percentage test and possibly the average benefits test.

All of the eligible employees in the controlled group must first be considered as if they were employed by one employer. The mandatory disaggregation and permissive aggregation rules are applied only after the controlled group employees are determined as a whole.

If a member's plan fails the ratio percentage test considering all controlled group members' employees, then the average benefit test must be performed. This test requires measuring the benefits provided to the participants of each member of the controlled group.

Continued on next page

Plan Qualification and Controlled Groups, Continued

Acquisition or Disposition

Under IRC § 410(b)(6)(C), if a controlled group acquires or disposes of a company or a company ceases to be a member of a controlled group, coverage shall be treated as having been met during the transition period if certain conditions are met. The transition period starts with the date of the acquisition or disposition and ends on the last day of the first plan year beginning after the date of such change.

The conditions are that the coverage requirements were met immediately before such a change, and the coverage under the plan did not significantly change during the transition period other than by reason of such a change.

Example 19 – Testing

An agent is assigned the Elko Profit Sharing Plan. The agent determines that Elko, Inc. and Fallon Inc. are controlled group members. The agent was only given information applicable to Elko. Only Elko employees participate in the plan, and all administrative work was performed without regard to Fallon employees. The agent must obtain and confirm Fallon's census information and perform the coverage test, including Fallon employees.

Continued on next page

Plan Qualification and Controlled Groups, Continued

**Example 20 –
Aggregation for
testing
purposes**

Greene and Forrest are controlled group members. Each sponsors its own plan, and the plans' terms specifically exclude the participation of the employees of the other company. Review of Greene's books and records shows that 18 of 20 eligible Highly Compensated Employees (HCEs) and 15 of 30 eligible Nonhighly Compensated Employees (NHCEs) participate in Greene's plan. Review of Forrest's books and records shows that 10 of 15 eligible HCEs and 80 of 100 eligible NHCEs participate in Forrest's plan.

Therefore, Greene's plan covers 51.4% of the HCEs (18/35) and 11.5% of the NHCEs (15/130), and its coverage ratio is 22.4%. Greene's coverage ratio is below the unsafe harbor percentage of 26.50%. Therefore, the plan fails the average benefits test and fails the coverage requirements of IRC § 410(b).

Forrest's plan covers 29% of the HCEs (10/25) and 61.5% of the NHCEs (80/130), and its coverage ratio is 212%. Forrest's plan meets the coverage and discrimination test. The qualified status of Forrest's plan will not be adversely affected if Greene's plan is not qualified for coverage.

**Non-
discrimination**

Contributions or benefits provided under a qualified plan may not discriminate in favor of who are highly compensated.

Since all employees of a controlled group are treated as employed by a single employer, any employee of the related business who is (or was) a five percent owner, is a Highly Compensated Employee (HCE) for purposes of the nondiscrimination requirements.

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Plan Qualification and Controlled Groups, Continued

Service The regulations under § 401(a)(4) provides rules for counting service with an employer. Note that if a controlled group is formed when Company A acquires Company B. Company A's plan does not have to recognize service performed by the employees of Company B prior to the acquisition. In addition, B's plan does not have to recognize service performed by employees of A prior to the acquisition.

Example 21 – Highly Compensated Employees *Allen Instruments, Inc. and Ashland Medical, Inc. are a controlled group of corporations. Sandy is a participant in the Allen Instruments, Inc. Profit Sharing Plan. Sandy has never had any ownership in Allen Instruments and is not a highly compensated employee. Prior to the buy-out of Ashland Medical, Inc. by Allen Instruments, Inc., Sandy was a 10% owner in Ashland. Ms Becker's ownership percentage does not change after the buyout.*

As a result of the controlled group relationship, Sandy is deemed to be a highly compensated employee in the Allen plan because she was a 10% owner in Ashland.

IRC § 401(a)(17) Compensation Limits A plan may only take into account a certain level of an employee's compensation for purposes of the qualification rules. The rule limits the amount of compensation that may be taken into account under Code § 401(a)(17).

Example 22 – IRC § 401(a)(17) *Page, Inc. and Owen, Inc are members of a controlled group. During 2010, he earned \$150,000 for Page, Inc. and \$200,000 from Owen, Inc. For allocation purposes, his compensation is limited to \$245,000 (the IRC § 401(a)(17) limit for 2010) because one employer is considered to pay his entire compensation.*

Continued on next page

Plan Qualification and Controlled Groups, Continued

**IRC §
401(a)(26)
Participation –
DB Plans**

A qualified defined benefit plan must benefit the lesser of 50 employees or 40% or more of all eligible employees of the controlled group members.

**Example 23 –
IRC §
401(a)(26)**

Caldwell Corporation and Alpine Partnership are a controlled group of businesses. Caldwell wants to set up a defined benefit plan for only Caldwell employees. Among other considerations, the Caldwell must make sure at least the lesser of 50 employees or 40% or more of the employee benefit under the plan.

**Vesting - IRC
§§ 401(a)(7)
and 411**

An employees' service with all controlled group members is aggregated to determine if the vesting requirements are satisfied under any plan maintained by one or more controlled group member.

**IRC § 415 -
Limitation on
Contributions
and Benefits**

There are limitations on a qualified plan's ability to provide for benefits or contributions. Benefits and contributions under all of the plans maintained by employers in a controlled group must be aggregated to determine the maximum amount allowed.

**Special rules
for Parent-
Subsidiary
Groups and
IRC § 415**

For purposes of applying the limitations as shown under IRC § 415, a parent-subsubsidiary group exists if the "parent" owns more than 50% of the subsidiary. This is lower than the 80% threshold normally required for there to be a parent-subsubsidiary group.

See Code § 415(h) and Treas. Reg. § 1.415(f)-1(j).

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Plan Qualification and Controlled Groups, Continued

**Example 24 –
IRC § 415**

Upton, Inc. and York, Ltd. are part of a controlled group. Each maintains their own money purchase plans.

During the 2010 plan year, Jane Steele earns \$100,000 from each employer and is a participant in each plan. She receives an allocation of \$30,000 in each, for a total of \$60,000.

Since the companies are part of a controlled group, the allocations are aggregated for testing purposes. In this case, the defined contribution limitation of the lesser or 100% of compensation or \$49,000 is exceeded.

**IRC § 416
Top Heavy**

All employees of the members of the controlled group are considered together in identifying key employees. For example if an employee is a 9% owner in one company and a 1% owner in the other member of the controlled group, that employee is considered a key employee since they have met the 5% ownership test in the first company.

The employers must aggregate all years of service and compensation earned by organization within a controlled group for purposes of:

- Top-heavy minimum vesting
 - Top-heavy minimum contributions and benefits
 - Determining if a plan is top-heavy
-

**SEP General
Rule**

Under a simplified employee pension plan (SEP), employers make contributions to traditional IRAs set up for employees, subject to certain limits. All employees in a controlled group are treated as if employed by one employer for purposes of the SEP rules.

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Plan Qualification and Controlled Groups, Continued

**IRC § 412
Minimum
Funding**

If an employer is a member of a controlled group, each member of such group is jointly and severally liable for payment of required contributions or required installments. If there are any violations of the requirements, the members of the controlled group are also jointly and severally liable for payment of excise taxes under IRC § 4971.

**Single Plan
Adopted by
Two or more
Controlled
Group
Members**

If two or more members of a controlled group of corporations adopt a single plan for a plan year, then the minimum funding standard provided in IRC § 412, the tax imposed by § 4971, and the applicable limitations provided by § 404(a) shall be determined as if such members were a single employer. In such a case, the amount of such items and the allocable portion attributable to each member shall be determined in the manner provided in regulations under §§ 412, 4971, and 404(a).

**IRC §
401(a)(30)
Elective
Deferrals
Limits**

If an employer is a member of a controlled group, the elective deferral limit under IRC § 401(a)(30) is applied in aggregate to the plans sponsored by the controlled group members.

Controlled Group Summary

Key Points

- The purpose of IRC § 414(b) and (c) is to eliminate the practice of excluding non-highly compensated employees from plan coverage through the creation of artificial business entities.
 - A plan that is maintained by an employer, within a group of employers that are under common control, must meet the requirements of IRC § 401(a) as if all employees of all the groups were employed by a single employer.
 - This lesson explains how to identify situations when a plan sponsor is a member of a controlled group and how to recognize the impact on qualified plans.
-

Affiliated Service Groups

Overview

Affiliated service groups present a simple concept which invariably requires a very complicated evaluation. They are simple in that if they exist, several unrelated employers are notwithstanding treated as if they are one single, combined entity for retirement plan purposes. They are difficult because the evaluation of entity ownership, common business transactions and services provided can be extremely complicated, requiring one to develop a comprehensive understanding of the business affairs of several entities, all seemingly unrelated to plan administration.

In our more routine work, we evaluate the plan, both from its written document and operational components, to determine whether they are compliant. When affiliated service groups are involved, we most first look at the entities involved, in order to make decisions about their potential relationships, before we can even begin looking at the plan itself. This extra step frequently involves reviewing organization or ownership charts, materials submitted with regard to levels of business activity, and the like.

Explain the affiliated service rules

The complexities involved with performing this review can be challenging, yet very often they are the most significant issues presented by the evaluation of the plan. In this section, we will explain the rules applicable to these groups and offer processing steps for evaluating them. This section will begin with a description of the relevant statutory sections, move into the implications of being an affiliated service group, and then offer steps for their evaluation.

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Affiliated Service Groups, Continued

History and statutory references

Codified law with regard to affiliated service groups exists at IRC § 414(m), which was enacted to broaden the element of “common control” – a concept that exists in controlled groups – to entities that are separate, but affiliated. Section 414(m) was added in 1980 largely in response to two shaping Tax Court decisions: *Kiddie v. Commissioner*, 69 T.C. 1055 (1978) and *Garland v. Commissioner*, 73 T.C. 5 (1979).

In these two unrelated cases, the Tax Court held that notwithstanding some common ownership and concurrent related business activity between and among a number of entities, a controlled group did not exist because the threshold common control percentages were not attained, and therefore the employers did not have to consider employees of the other entity, for coverage and discrimination testing.

Congressional response

In response, the Congress became concerned that business entities might segregate their work force between and among entities which work together but which are structured to avoid the minimum percentage threshold levels required to become a controlled group. This resulted in the addition of IRC § 414(m) effective for plan years ending after Nov. 30, 1980. Pieces of § 414(m) were added to the Code by duplicate amendments in § 201(a) of the Miscellaneous Revenue Act of 1980, Pub. L. 96-605, and § 5(a) of An Act To Make Miscellaneous Changes in the Tax Laws, Pub. L. 96-613, (1980).

Management functions

After issuance of § 414(m) – which at that time only addressed A- and B-Organization groups, the Tax Court rendered an opinion in *Achiro et al v. Commissioner*, 77 T.C. 881 (1981), a case which was started before these two 1980 Acts, but was decided afterwards. After that case – which was decided without considering the newly enacted § 414(m) changes – Congress became aware of the need to address groups of organizations which re-assign their management functions to other members, and added § 414(m)(5) as part of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. 97-248, in response.

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Affiliated Service Groups, Continued

Three possible affiliated service groups

These three possible affiliated service group compositions, the A- and B-Organization groups at § 414(m)(2) and the management group at § 414(m)(5) remain today.

Regulations

For various reasons, Treasury has never finalized implementing regulations under IRC § 414(m). Proposed Treas. Reg. § 1.414(m)-1 et seq. – on the books since 1984 - provides that all employees of the members of an affiliated service group shall be treated as if they were employed by a single employer for purposes of applying IRC § 414. It also supplies many of the definitional aspects of these groups which will be discussed in this chapter.

Consequences of being an affiliated service group

If two or more entities are found to comprise an affiliated service group, IRC § 414(m) applies to treat all of the entities as if they are one single employer for purposes of applying many of the rules contained at IRC § 401(a), specifically including:

- IRC § 401(a)(3) – Eligibility and coverage
- IRC § 401(a)(4) – Nondiscrimination
- IRC § 401(a)(7) – Vesting
- IRC § 401(a)(10) – Top heavy status determination
- IRC § 401(a)(16) – Section 415 testing
- IRC § 401(a)(17) – Compensation dollar limitation
- IRC § 401(a)(26) – Defined benefit minimum participation

Prop. Treas. Reg. § 1.414(m)-3 provides a list of other Code requirements implicated by affiliated service group status, but in general, all of the employees in the affiliated group have to be aggregated for purposes of testing for coverage, discrimination, vesting and various other compliance tests.

It does not mean that all of the employers must use a single plan document, nor that the employers may make controlled group elections for purposes of applying the remedial amendment requirements of § 10 of Rev. Proc. 2007-44.

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Affiliated Service Groups, Continued

**Affiliated
service group
example**

J. Simpson & Sons is an architectural firm, formed as a partnership with 10 partners. Each partner owns an equal share in J. Simpson, and also owns 5 percent of an insurance firm AppletonWhite that provides structural insurance for J. Simpson & Sons for the buildings that it designs, and some other insurance to other architectural firms' designs. Its sales are about 50-50 with regard to building that are and are not designed by J. Simpson & Sons. The remaining 50% of AppletonWhite is owned by another individual, not employed or otherwise affiliated with J. Simpson & Sons. Assume for this example that the providing of structural self-insurance is a service traditional provided by employees of an architecture firm in the industry at large.

If we treat J. Simpson & Sons as a “first service organization” – a term we will define later, AppletonWhite is a B-Org, because:

A significant portion of its business (50%) is the performance of services to or with J. Simpson, of a type historically performed by employees in the architectural field, and

50% of the ownership interests in AppletonWhite are held in aggregate by individuals who are highly compensated employees of J. Simpson & Sons.

This is actually a fairly common form of the B-Org group, where two entities are owned by common persons, and one performs a service to or on behalf of another, as we will work with later in this chapter.

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Affiliated Service Groups, Continued

Definitions

An affiliated service group is a group of 2 or more entities, one of which is a First Service Organization (referred to as “FSO”), and another of which is:

- an A-Organization (referred to as an “A-Org”, because it is described at IRC § 414(m)(2)(A).)
- a B-Organization (referred to as a “B-Org” because it is described at IRC § 414(m)(2)(B).)

Separately, an affiliated service group may also exist if one entity provides “management services” to the other(s). This would be referred to as a “Management Group.” The management group definition is supplied separately, at IRC § 414(m)(5).

Your primary responsibility in analyzing affiliated service groups under any of these three types will be to analyze the business structure presented by several entities, and determine whether they meet the rules for classifying them as described above.

A-Org affiliated service group

First Service Organization defined

IRC § 414(m)(2) refers to a “first organization”, but because this entity must be a “service organization”, it is commonly referred to as a “first service organization” or FSO. An FSO can exist as any form of business entity (i.e. corporation, partnership, etc.), but the performance of services is must be the principal business of the organization. If it is a corporation, the entity must be a professional service corporation (or PSC). Prop. Treas. Reg. Prop. Treas. Reg. § 1.414(m)-1(c).

A PSC is a corporation where (a) substantially all of its business activities involve the performance of services in the fields of health, law, engineering, etc. (referred to as the “function test” and covered later), and (b) substantially all of the ownership interests are held, directly or indirectly, by employees who perform the actual services in this field (referred to as the “ownership test”).

For corporate income tax filing purposes, certain corporations are denoted as “personal service corporations” as defined in IRC § 269A(b)(1). Although there is substantial overlap with the PSC definition, the two terms are not exactly the same. This will be discussed later.

A-org-two requirements

An A-Org exists if an organization must satisfies both an “ownership test” and a “relationship test”.

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A-Org affiliated service group, Continued

A-Org-ownership test

The *ownership test* is met if the organization is a partner or shareholder in the FSO. That means that the A-Org must, either by itself or through the principle of attribution, own a direct interest in the FSO.

For purposes of applying the attribution rules for constructive ownership, the rules specified at IRC § 318(a) are used with respect to A-Org and B-Org groups, but as will be discussed later, not for management groups. The reason for this is that although IRC § 414(m)(6)(B) suggests that § 318 attribution is to be used generally for affiliated service groups, IRC § 414(m)(5) (describing management groups) comes with its own attribution principle, suggesting that the attribution rules under IRC § 267 are to be used for these groups

This is important because attribution under IRC § 318(a) is generally less restrictive, and thus easier to wind up with an affiliated service group, especially with regard to partnerships, as will be discussed later. (Attribution for purposes of analyzing management groups will be discussed later.)

A org-relationship test

The *relationship test* is satisfied if the organization regularly performs services for the FSO or is regularly associated with the FSO in performing services for third parties, on the basis of all facts and circumstances. This relationship test is contained at Prop. Treas. Reg. § 1.414(m)-2(b).

Two entities constitute an affiliated service group

Therefore, in laymen's terms and by way of example, two entities constitute an affiliated service group if one provides services, and a second (which owns an interest in the first) provides services either to this entity or with this entity to a third party. More than two entities can of course meet these definable elements and comprise a multi-entity group.

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A-Org affiliated service group, Continued

Performance of Services As noted above, affiliated service groups – as the name implies – generally involve entities which perform services. This is because, again as noted above, Congress was concerned about service-oriented entities organizing in such a way as to avoid employee coverage requirements applicable to plans. This section of law is replete with reference to the provision of service, and service-providing organizations.

A org and FSO must be service organizations When analyzing A-Org groups, both the FSO and the A-Org must be service organizations. Prop. Treas. Reg. § 1.414(m)-2(f) provides that whether a business is primarily engaged in the performance of services is an inherently subjective decision.

An organization will not be considered to be primarily engaged in the performance of services if capital is a material income-producing factor for the organization. In turn, whether capital is a material income-producing factor must be determined on the basis of all relevant facts and circumstances. See Prop. Treas. Reg. § 1.414-(m)-2(f)(2).

Capital as a material income producing factor As a rule of thumb, capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business as reflected, for example, by a substantial investment in inventories, plant, machinery or other equipment.

Capital is a material income-producing factor for banks and similar institutions.

Capital not a material-income producing factor Capital is not a material income-producing factor if the gross income of the business consists principally of fees, commissions or other compensation for personal services performed by an individual.

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A-Org affiliated service group, Continued

Automatic service organizations

Under Prop. Treas. Reg. § 1.414-(m)-2(f)(2) an organization engaged in any one or more of the following fields is a service organization:

- Health
 - Law
 - Engineering
 - Architecture
 - Accounting
 - Actuarial science
 - Performing arts
 - Consulting, and
 - Insurance.
-

Exceptions for service organizations

This list is not all encompassing, and allows for some interpretation as far as other entities are concerned. Prop. Treas. Reg. § 1.414-(m)-2(f)(1) provides that banks and similar financial institutions are specifically not service organizations, even though they provide financial services.

Conversely, other entities whose primary business income consists principally of fees, commission or other compensation for services performed by an individual are considered service organizations, even they are not on this list.

Prop. Treas. Reg. § 1.414-(m)-2(f)(2) provides that an organization will not be considered as performing services merely because it is engaged in the manufacture or sale of equipment and/or supplies used in the above fields, it is engaged in performing research or publishing in the above fields or an employee provides one of the enumerated services to the organization or other employees of the organization, unless the organization is also engaged in the performance of the same services for third parties.

An employee provides one of the enumerated services to the organization or other employees of the organization, unless the organization is also engaged in the performance of the same services for third parties.

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A-Org affiliated service group, Continued

Determining A-Org status

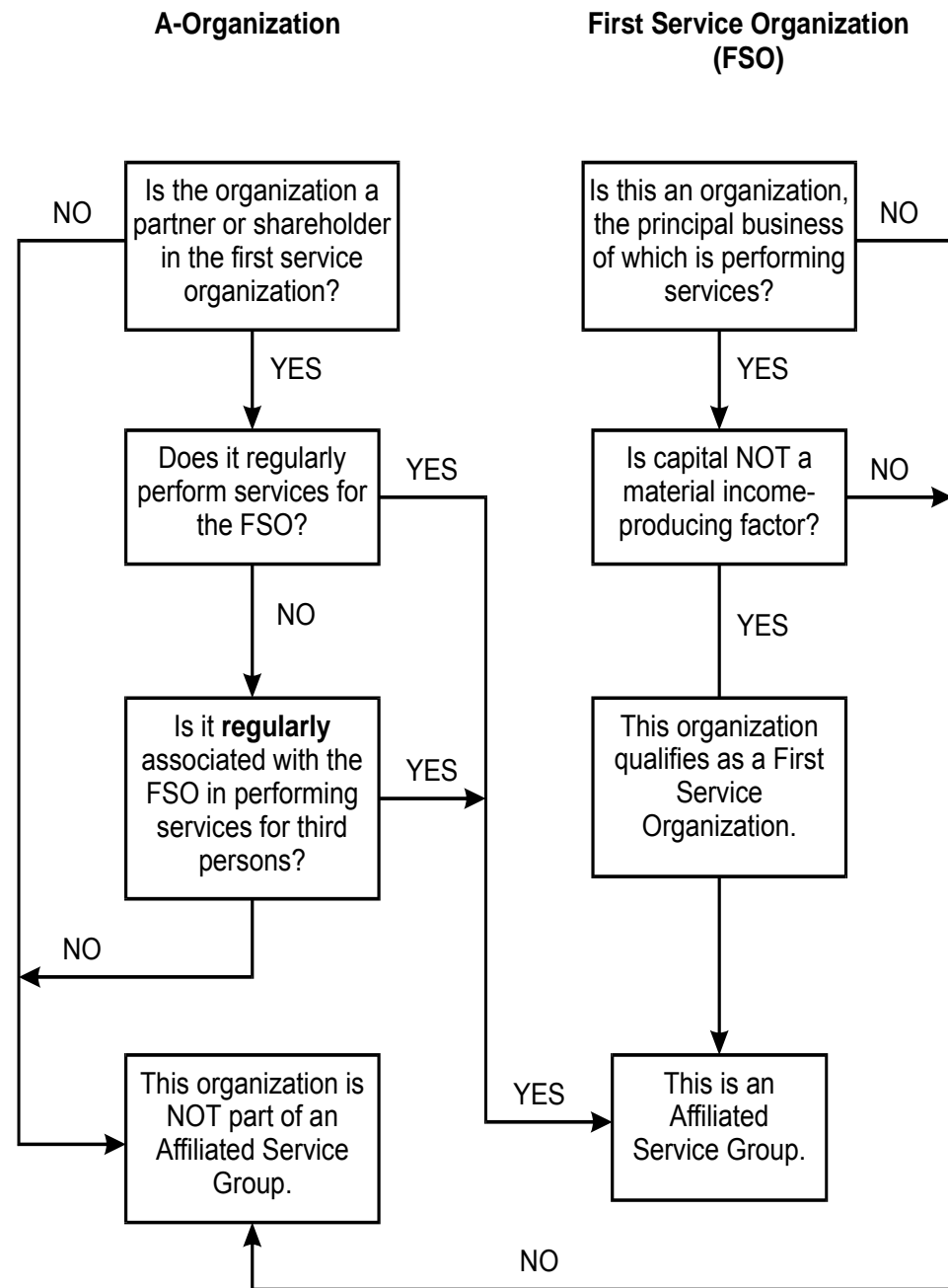
Determining whether two organizations are affiliated as comprising an A-Org group therefore requires considering several factors as described above: whether one owns the other, whether one organization performs services to another organization or with the other organization to third parties. The organization also has to be a service provider to customers. The following flowchart summarizes the steps to consider in this regard.

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A-Org affiliated service group, Continued

A-Org
flowchart

Affiliated Service Group



B org affiliated service group

B-Org IRC § 414(m)(2)(B) provides that a B-Org is an organization for which:

1. a significant portion of its business must be either the performance of services for an FSO, the performance of service for one or more A-Org's determined with respect to the FSO, or both of these; and
2. it performs services of a type historically performed by employees in the service field of the FSO or the A-Org's, (for this purpose, a B-Org does not have to be a service organization *per se*); and
3. ten percent or more of the ownership interests in the organization in aggregate, must be held by persons who are highly-compensated employees (as defined at IRC § 414(q)) of either the FSO or A-Org.

The same definition applies for an FSO for a B-Org test as for an A-Org test. A B-Org does not have to be a service organization.

For purposes of analysis, these are commonly referred to as the “significant portion test”, the “historically performed test” and the “common ownership test”, which are contained at Prop. Treas. Reg. § 1.414(m)-2(c)(i), (ii) and (iii). Each of these are discussed individually.

Significant portion test-introduction

Whether a significant portion of an organization's business is providing services to an FSO depends on all applicable facts and circumstances. However, applicable regulations provide a “service receipts” safe harbor test, and a “total receipts threshold” test. These are described at Prop. Treas. Reg. § 1.414(m)-2(c)(2)(i) through (v).

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B org affiliated service group, Continued

Significant portion test- service receipts safe harbor

Meeting the service receipts safe harbor test means that an organization will not be considered to be devoting a significant portion of its business to providing services to an FSO. In other words, if an organization provides services to an FSO, as long as that level does not reach a 5% safe harbor level, they will not be considered to form an affiliated group.

To perform this test, a service receipts percentage is determined by computing the ratio of:

- the gross receipts of the organization derived from performing services for the FSO, for one or more A-Org's, or for both

to

- the total gross receipts of the organization **derived from performing services.**

This ratio is calculated for the year for which the determination is being made, and for the three-year period including that year and the two preceding years (or the period of the organization's existence, if less). The highest computed result is used. If this ratio is 5% or more, the business provided is not within the safe harbor.

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B org affiliated service group, Continued

**Total receipts
safe harbor**

The second test applicable to determine whether a significant portion of an entity's business is providing services to an FSO is the determination of a total receipts threshold. The performance of services for an FSO, for one or more other organizations, or both, will be considered a significant portion of an entity's business if the "total receipts percentage" is 10% or greater.

This percentage is calculated in the same manner as the above-described service receipts percentage, except that gross receipts in the denominator of the equation above (in bolded text) are determined without regard to whether they were derived from performing services.

This test compares, then, the total receipts of the organization derived from performing services to the FSO to its total gross business receipts. If this ratio is under 10%, the entity does not receive a significant portion of its business in the conduct of service to the FSO or potential other affiliates.

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B org affiliated service group, Continued

Second requirement- historically performed test

The historically performed requirement is contained at Prop. Treas. Reg. § 1.414(m)-2(c)(3), and the Regulation does not provide much alliteration. It states only that services will be considered of a type historically performed by employees in a particular service field if it was not unusual for the services to be performed by employees of organizations in that service field (in the United States) on December 13, 1980 (the effective date of these initial regulations.)

In general terms, this is an inherently subjective evaluation, as to whether a particular service type is one that an organization's own employees would have performed in 1980, prior to the arise of terms and concepts such as "outsourcing" and "offshoring." The regulatory intent is to consider this test satisfied if in 1980, an organization would have its own employees perform this task rather than contracting with another entity to do it. An example might be payroll services for a small manufacturing concern, which prior to 1980 would have its own payroll staff, but which today outsources this responsibility to a payroll firm.

Third requirement- common ownership test

The common ownership requirement is contained at Prop. Treas. Reg. § 1.414(m)-2(c)(1)(iii). It provides that the B-Organization must be owned at least 10% in aggregate by persons who are highly compensated employees (HCEs) (as defined at IRC § 414(q)) of the FSO (or affiliated A-Orgs.)

As noted above, for purposes of determining whether A B-Org's HCE's own an interest in the FSO (or other A-Orgs), attribution is applied using the principles of IRC § 318. See IRC § 414(m)(6)(B).

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B org affiliated service group, Continued

Determining B- Org status

The IRC § 414(m)(2)(B) requirements contemplate that in order to be a B-Org, all three of these above-described tests must be met. That is, the B-Org must be owned by persons who are HCEs of the FSO, and a significant portion of the B-Org's business must be involved with the performance of services to the FSO, of a type historically performed by employees. If all three of these tests are met, the two (or more organizations) constitute a B-Org affiliated service group. If any one is not met, the organizations are not considered affiliated.

As noted above, the "historically performed" test is entirely subjective and perhaps the easiest to pass. In performing your evaluation of entities, your principal charge with respect to evaluating potential B-Org affiliated groups will be to:

1. look at the ownership of the potential B-Org, and determine whether 10% or more of its ownership interests can be attributed to HCEs of the FSO.
2. look at the services performed by the B-Org, and determine whether its service receipts constitute 5% of its service receipts or 10% of its total gross receipts. (In a service business – which you will encounter most often when testing for B-Orgs, you are generally trying to determine only whether 5% of its receipts are from the related entity, a fact frequently made known to you by the entity's representative.)

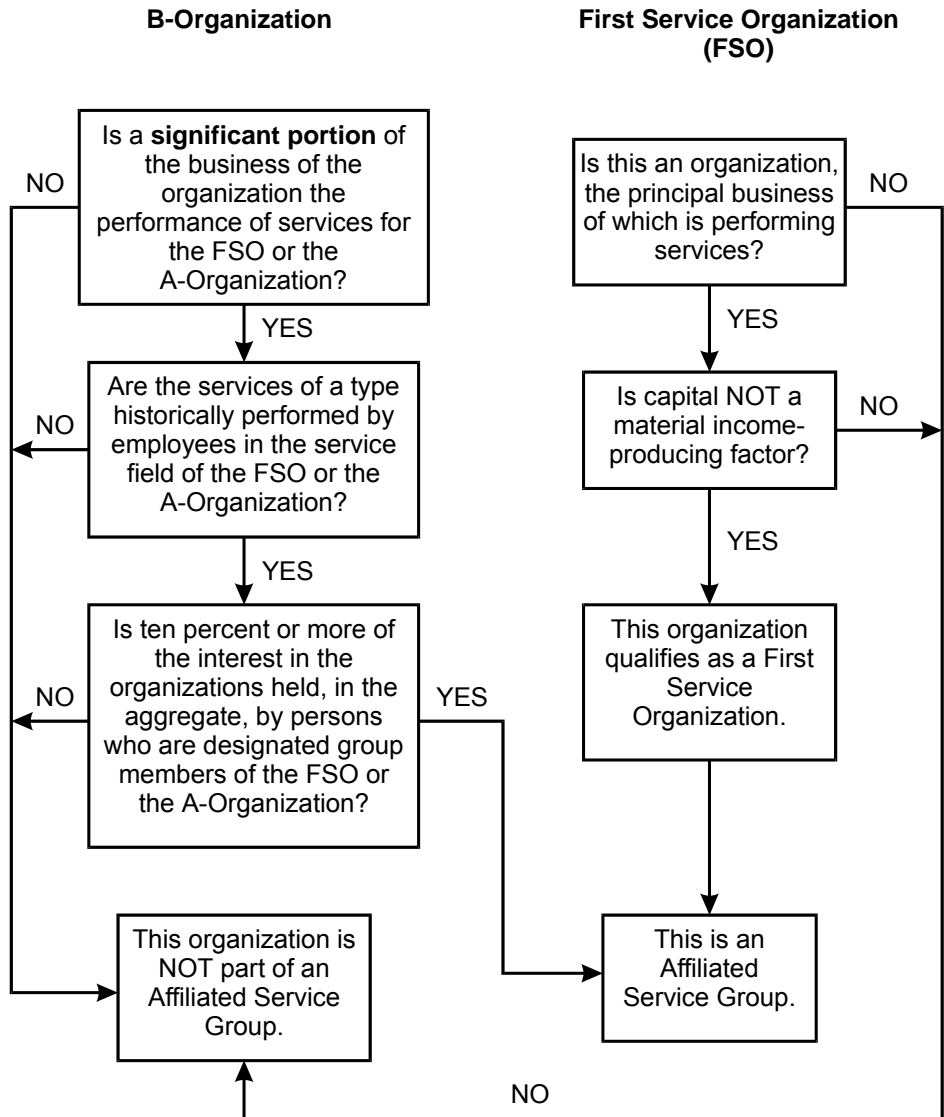
If both of these are met, the two (or more) entities constitute an affiliated service group. If either is not, they do not. The following flowchart summarizes the steps necessary to evaluate whether two organizations constitute a B-Org affiliated service group.

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B org affiliated service group, Continued

B-Org
flowchart

Affiliated Service Group



Examples-A org and B org

Example25
A-Org group

Internal Medical Associates is formed as small local general medical practice. It is formed as a partnership, and is owned 50% each by Doctors Sanford and Hopkins. The practice has no other employees, except Doctors Sanford and Hopkins. All the nurses, reception staff, billing and cleaning employees are employed by IMA-R, Inc. IMA-R is owned 25% by each of the two Doctors Sanford and Hopkins, and the remaining 50% by the Internal Medical Associates partnership itself.

This is a common form of an A-Org affiliated service group. IMA-R meets the definition of an FSO, because it is a service organization. Internal Medical Associates meets the definition of an A-Org, because it provides services in conjunction with the FSO to third parties, and it owns an interest in the A-Org.

When evaluating affiliated service groups, keep in mind that sometimes you have to look at all of the entities from several angles, to determine which can be properly classified as an FSO and which as, in this case, an A-Org. Sometimes you have to conceptually rotate them around to determine which appellation can be ascribed to which entity.

Continued on next page

Examples-A org and B org, Continued

Example 26
B-Org group

Denver & Howe is a law firm. It is owned 25% by a managing partner, 10% each by three senior partners, and the remaining 45% is owned equally by 9 partners. One of the senior partners, prior to coming to Denver, had formed and now owns 100% of LegalMatrix, a timekeeping and billing firm.

LegalMatrix was initially formed to try to do the billing for all the law firms in Denver's area, but business never really took off. Now, it really does only the billing and timekeeping services for Denver and maybe a handful of other clients. In fact, it does so much work for Denver, that the senior partner managed to lease space out of Denver's office so that LegalMatrix didn't have to pay to run a separate office.

This is a classic B-Org group. Denver is an FSO. Legal Matrix, owned totally by a 10% partner of Denver, provides billing services to Denver, of a type that would historically have been performed by Denver itself if not formed into a separate entity.

Attribution Rules for A- and B-Org groups

Attribution

As noted above for both the A-Org and B-Org tests, consideration of common ownership applies for determining whether two or more entities are affiliated. For the A-Org group, the A-Org must own an interest in the FSO. For the B-Org group, the highly compensated employees of the FSO must own at least 10% of the ownership interests in the B-Org. Without these common ownership interests, a group is not formed.

In determining common ownership, the principles of attribution apply. Attribution is a concept whereby ownership held by one person is deemed to be owned, or “attributed” to another. The Internal Revenue Code is replete with principles of attribution under a variety of circumstances, such as for filing consolidated returns, disposition of certain property, and in this chapter controlled groups. For affiliated service groups, the attribution requirements that are to be used to evaluate these groups is prescribed by IRC § 414(m)(6)(B), which invokes the rules at § 318, which in turn are used in many other places in the Code.

Section 318 is not the only place where attribution rules for affiliated service groups is discussed. In the originally issued proposed regulations described earlier, Prop. Treas. Reg. § 1.414(m)-2(d)(1) originally referred to IRC § 267(c) as the proper attribution rules to be used. However, with the Tax Reform Act of 1984, Pub. L. 98-369, (more commonly known as DEFRA – the “D” in “TDR” lexicon), Congress amended § 414(m) to refer to the § 318 attribution rules for A- and B-Org groups.

As mentioned earlier and as will be explained later, attribution under § 267 remains the proper consideration for management groups.

Continued on next page

Attribution Rules for A- and B-Org groups, Continued

Types of attribution

Under the § 318 attribution rules, there are two ways for attribution to occur, organizationally and to family members. If organizational attribution issues are involved, ownership held by an individual is attributed as if owned by an organization, or vice versa. For example, stock held by partner is frequently deemed to be owned by the partnership. Under family member attribution, stock owned by a member of a family is deemed to be owned by another family member. For example, under many attribution schemes, stock held by a minor child is generally attributed as if owned by a parent. Each of these will be discussed individually.

And, for purposes of considering whether attribution applies, ownership interests of any type are what is being considered as if it is owned by another entity or individual. This means generally stock or partnership interests. Options to acquire stock are generally treated as stock itself under the § 318 attribution rules. See Rev. Rul. 68-601, 1968-2 C.B. 124 and Rev. Rul. 89-64, 1989-1 C.B. 91, which deal with the degree to which an exercisable right is tantamount to control, and thus direct ownership.

Prohibition against double attribution

Under either of the attribution schemes – organizational or family – once ownership is attributed to a new individual, it is generally not re-attributed from that individual to others. For example, when dealing with organizational attribution, stock in Company X owned by a 50% owner of Corporation A (and thus attributed as if owned by Corporation A) would not be then reattributed as if it were owned by the other 50% owner of Corporation A, or to controlled group member Corporation B, or to owners of Corporation B. Additionally, when dealing with family attribution, after an individual is attributed ownership from one family member, the interest does not get reattributed from the individual to yet another family member. So, stock attributed from a son to a father would then be attributed as from the father to the father's sister.

Continued on next page

Attribution Rules for A- and B-Org groups, Continued

Reason for no double attribution

The reason against this so-called “double attribution” is two-fold, one practical and one legal. The practical reason is that if there were no limit on reattribution, an endless chain could ensue where one ownership is passed on-and-on to multiple organizations and relations of any original organization or individual *ad infinitum*. The legal reason is because of the 1982 Supreme Court decision *U. S. v. Vogel Fertilizer Co.*, 455 U.S. 16, which effectively bars continued reattribution of ownership.

Attribution to more than one person

This does not mean that ownership cannot be attributed to more than one person or entity. For example, stock held by a child is attributed both (and each) to the child’s father and mother. Also, after an individual is attributed the ownership of a corporation, partnership or trust (whether that interest is derived from a family member or an organization), the interest may then be taken into account under other attribution rules. So, a wife is generally treated as owning her husband’s attributed partnership interest.

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Attribution Rules for A- and B-Org groups, Continued

Organizational attribution

The following table gives a general description of how the attribution rules for organizations are applied to affiliated service groups using IRC § 318 attribution:

The ownership interests:	Are attributed to:
<i>From a corporation to its shareholders</i>	Corp ownership interests attributed proportionately to shareholders owning at least 50% of corporate stock
<i>From a partnership to its partners</i>	Partnership ownership interests attributed, proportionately to all partners
<i>From a trust to its beneficiaries</i>	Trust's ownership interests attributed, proportionately to all beneficiaries
<i>To a corporation</i>	Interest owned by individual owning at least 50% of corporation is attributed to the corporation
<i>To a partnership</i>	Interest owned by partner is attributed to the partnership
<i>To a trust</i>	Interest owned by trust beneficiaries is attributed to trust

Attribution in proportion to real ownership

Several points are worth emphasizing here. First note that the amount attributed is in proportion to real ownership. Thus, a $\frac{1}{3}$ trust beneficiary is deemed to own $\frac{1}{3}$ of any interest owned by the trust.

Continued on next page

Attribution Rules for A- and B-Org groups, Continued

For corporations, stock is attributed only to 50% or more shareholders

Secondly, note that for corporations, stock is attributed only to 50% or more shareholders. Thus, for example, a corporation is deemed to own only what its 60% shareholder owns, but not what is held by its 40% shareholder.

For partnerships, there is no minimum threshold of ownership. Thus, a 2% partner is deemed to own a 2% of whatever the partnership holds. Conversely, a partnership is deemed to own anything owned by its partner as if the partnership owned it directly.

This is perhaps the most important point to note with regard to § 318 attribution: as noted earlier it is easier for two entities to have common ownership under § 318 than any other Code-supplied attribution scheme, especially § 267. This is the reason why Congress changed the Code in DEFRA as also described earlier: to avoid entities from keeping otherwise affiliated groups apart by juggling ownership thresholds.

Partnership attribution

One of the easiest ways for an affiliated service group to be formed is when partnerships are involved. As noted above, there is no minimum threshold to be met prior to attributing partner or partnership interests. And this attribution is “two-way”, both to- and from- the partnership and its partners.

In many situations to be encountered, two or more entities are formed, and some amount of common ownership is shared between and among them. If partnerships are involved, it is very easy to meet either the A-Org or B-Org ownership tests.

A org ownership requirement-partnership

For an A-Org group, the ownership requirement is satisfied if the A-Org owns an interest, any interest, in the FSO. If the A-Org is a partnership, and its partners own any interest in the FSO (which usually will be the case when evaluating these groups), the ownership test is satisfied.

Continued on next page

Attribution Rules for A- and B-Org groups, Continued

**B org
ownership
requirement-
partnership**

For a B-Org group, the ownership requirement is satisfied if the B-Org is owned 10 or more percent by HCEs of the FSO. Again, if the B-Org is a partnership, and its partners are also highly compensated employees of the FSO, this ownership test is satisfied.

**Both A org and
B org**

Under both group compositions, the ownership tests are easily satisfied when partnerships are involved, because there is no minimum threshold level required before attributing, and because the attribution can be made either from or to the partnership from or to its partners.

**Limited
Liability
Company**

One of the most common organizational forms to be encountered when dealing with small professional or service-providing forms is the “Limited Liability Company” or LLC. LLCs are business forms that blend elements of partnership and corporate structures. They operate like partnerships for most purposes, but provide creditor and asset sheltering much like corporations. Indeed, this latter benefit is what spawned their invention in 1977, under State of Wyoming corporate law. The first recognized LLC for Federal tax purposes was a Wyoming LLC recognized in a private letter ruling, PLR 8106082 (Nov. 18, 1980), but due to some proposed regulations which suggested that Treasury might not look favorably upon these types of entities, they did not become popular until IRS issued affirming guidance in 1988, with Rev. Rul. 88-76, 1988-2 C.B. 360.

Unless it elects to be taxed as a corporation, an LLC’s default filing status is as a partnership. For IRC § 414(m) and 318 purposes, its entity status follows this tax filing status. Because partnerships are “flow through” entities, passing the tax liability on their income down to their partners without a tax at the partnership level without a “double tax” at the entity level, most LLCs will be treated as partnerships for affiliated service group purposes, and as noted above, when LLCs are involved, the ownership tests are more easily satisfied when attribution is involved.

Continued on next page

Attribution Rules for A- and B-Org groups, Continued

Organizational attribution examples

The following 2 examples summarize attribution under § 318 when A-Org and B-Org groups are involved.

Example 27 Attribution example

Empire LLP. and Garden LLP. are two entities which provide oil measurement services to refineries in the tri-state area. Empire provides depletion and method of accounting calculations for refineries in order to determine how much their inventory is worth, how much their cost of goods sold is, etc. All of this work is then rolled up into comprehensive financial statements prepared by one of the “Big 4” accounting firms. But in order to perform this accounting, the first step is to physically measure how much oil is present on site, in the giant oil tanks and silos surrounding the refinery.

For that purpose, Garden LLP. is called in. Garden has specialized equipment, like giant electronic “dip sticks” that go into tanks, measure their capacity, how much sludge is formed at the bottom and how much useable (and thus saleable) oil is in the tank. They add all this oil amount up, keep comparison records, make analyses which become reports, and then give a copy to the client – and to Empire.

Empire and Garden work well together, in fact they bundle their services. Good thing, because they are really the only two firms that can handle this type of work and have the specialized equipment and experience to do it. Oh, and although they were initially totally separate entities, over time and after several different acquisitions in the industry, they have come now to the point that they are each owned by the same three people. Robert, Allan and Mary are each 1/3 owners of each firm.

Continued on next page

Attribution Rules for A- and B-Org groups, Continued

Example 27- Analysis

In taking these facts to the A-Org flowchart presented earlier, your initial inclination as a reviewer would be to stop at the first decision box, because no matter which entity is ascribed as the FSO, neither owns any interest in the other.

However, applying the principles of organizational attribution under IRC § 318, we wind up with each organization being deemed to own each other, because as partnerships, each partner's ownership interests are attributed as if owned by the partnership itself. Empire is deemed to own 100% of Garden, and vice versa.

Because they are regularly associated in performing services to third parties (or it can be argued for each other), for qualified plan purposes, all of the employees of both entities are treated as if eligible for a single plan consisting of both sponsors.

Example 28 B-Org attribution

The Thurston Ballet is a small performing arts ballet troupe, that has called the town of Thurston its home for many years, even before going to the "big time" and nationally touring. Thurston Ballet was originally performed as a non-profit, but over time and for a variety of reasons, changed over to become a for-profit entity, formed as a limited liability company (LLC). Thurston Ballet LLC is fortunate to have as its two owners Roger and Denise Hale, each 50% partners. Fortunate because it was Roger who started the ballet years ago, and now his new (and young) wife Denise is the lead performer in the ballet herself. Although the ballet takes in all the gross receipts, Denise receives an astounding \$200,000 salary payments each year.

Continued on next page

Attribution Rules for A- and B-Org groups, Continued

**Example 28-
Facts cont'd**

Some time ago, the Ballet figured it could make extra money if it handled all its own bookings, agency, ticket sales and even web design, if it managed and maintained its own website with comprehensive “e-performance” online sales and inquiries. For this purpose, eBallet LLP was formed. eBallet is really like a giant online booking service set up to do all kinds of event booking. At one time, it was envisioned that it would compete with the major ticket vendors, but now it really is like the right arm of the Thurston Ballet only. eBallet LLP has only one partner/owner, which is the Ballet itself.

**Analysis-B org-
Example 28**

Again, if as a reviewer, you were using the B-Org flowchart, and got down a couple of decision boxes until queried whether the B-Org is owned by highly compensated employees of the FSO, your initial inclination again would be to stop, because eBallet LLP is not owned by any individual at all.

However, what is unique about § 318 is that it has “two-way” attribution, both from partners to partnerships and from partnerships to partners. In the prior example, the ownership interest held by the partners was attributed to the partnership. Here, because of this two-way attribution, the partnership interest in eBallet LLP, held by Thurston Ballet LLC, is attributed as if owned by Roger and Denise Hale, in proportion to their interests in Thurston Ballet LLC.

Thus, Roger and Denise Hale, who are both highly compensated employees of Thurston Ballet LLP, are deemed to own eBallet. The rest of the B-Org tests are met as well, and the two entities comprise an affiliated service group.

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Attribution Rules for A- and B-Org groups, Continued

Family Attribution

In addition to organizational attribution, the other common method of attributing ownership under § 318 is family attribution. The following table is a general description of how the family attribution are applied to affiliated service groups (other than management organizations).

The ownership interests of a:	are attributed to a:
<i>Spouse</i>	<i>Spouse</i>
<i>Parent</i>	<i>Child</i>
<i>Child</i>	<i>Parent</i>
<i>Grandchild</i>	<i>Grandparent</i>
<i>Sibling</i>	<i>None</i>

Several points are worth noting with regard to family attribution. First, note that there is no age of majority rule with respect to § 318 family attribution. Unlike some attribution schemes which limit attribution at the age of majority, under § 318, any ownership interest owned by a child is deemed owned by the child's parent. Conversely, any interest owned by parent is deemed owned by a child, irrespective of their relative ages.

Secondly, note that unlike the rule for parent-child, which permits attribution in either direction, there is no attribution from a grandparent to a grandchild: the attribution is possible in one direction only, from grandchild to grandparent. Finally, note that there is no attribution between and among siblings. IRC § 318 is concerned with lineal ascendancy and descendancy only, except as between spouses.

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Attribution Rules for A- and B-Org groups, Continued

Example 29
Family
attribution

The following example illustrates working with family attribution principles under IRC § 318.

Joseph, age 45, is the son of Robert, age 70. Joseph owns 25% of Tetra Partnership. Robert owns 5%, and his wife Sarah owns the remaining 70%.

In considering attributed ownership under § 318, Robert is deemed to own 100% of Tetra – 50% directly and 50% through attribution.

So, using this example, if we were evaluating whether a B-Org group were formed with Gamma Corporation, and Robert was also a 10% owner of Gamma in addition to being a 5% owner of Tetra, the ownership test for B-Org groups would be satisfied. Although his direct ownership interest is under the requisite statutory threshold of § 414(m)(2)(B), his additional attributed ownership puts him over the limit. His 10% Gamma ownership makes him a highly compensated employee of Gamma, and we would next look to see if Gamma and Tetra meet the other requirements for an FSO and a B-Org, respectively.

Multiple Member Groups

Introduction

Proposed Treas. Reg. § 1.414(m)-2(g) provides guidance on the treatment afforded to when multiple organizations are involved, all structuring their business affairs so that some provide service to each other, amid some commonality of ownership interests. The regulations provide that two or more affiliated service groups will not be aggregated simply because an organization is an A-Org or a B-Org with respect to each affiliated service group.

If an organization is an FSO with respect to two or more A-Orgs or two or more B-Or's, or both, all of the organizations shall be considered to constitute a single affiliated service group. In this case, all of the employees would have to be aggregated together as if they were all participating in a single plan for purposes of Treas. Reg. § 1.414(l)-1.

Continued on next page

Multiple Member Groups, Continued

Example 30
Multiple
member group

GKM Insurance Agency is, as its name implies, a local general insurance agent selling title insurance. GKM is owned 100% by George K. Marston. Secretarial services to GKM are provided by Ace Typing and Office Support. Ace is owned 25% by Mr. Marston and 80% by people he knows. About half of Ace's receipts are for secretarial services it provides to GKM – it also contracts out to some other firms in the local area as well.

As a part of selling title insurance, Mr. Marston formed a separate company called Marston Surveys, to provide site surveys for all the properties he insures. In fact, whenever land or buildings are sold, a comprehensive "assurance package" is sold, with a survey and title insurance at the same time. Mr. Marston owns 85% of Marston title, and his wife and children have the rest of the ownership put under their names. Marston Surveys earns about 50% of its revenue as part of this "assurance package" bundled with the GKM title insurance, and the rest of its business comes from "walk-ins", which are people who just approach Marston to do a survey only without involving a property sale, such as when the town does road repaving or widening.

Under this example, all three of these entities constitute one single affiliated service group. All of the employees of GKM, Ace and Marston Surveys would have to be treated as if they were eligible for participation in a single plan.

Continued on next page

Multiple Member Groups, Continued

**Analysis-
Example 30**

Taking these one at a time, GKM is an FSO. Ace Typing and Office Support is a B-Org, because in addition to being owned 25% by Mr. Marston, 50% of its gross receipts are derived from performing services for GKM, of a type historically that would have been performed “in-house” by employees of an insurance firm.

Marston Surveys is a B-Org for the same reasons, that half its income comes from service with or to GKM, and it is owned by Mr. Marston.

If an organization is an FSO with respect to two or more A-Orgs or two or more B-Orgs, or both, all of the organizations are considered to constitute a single affiliated service group.

Accordingly, for purposes of applying IRC § 414(m)(2), there would for plan purposes be considered one sponsor, consisting of the affiliated service group members GKM Insurance Agency, Ace Typing and Office Support and Marston Surveys.

Management Groups

Introduction

As noted earlier, the three types of affiliated service groups are A-Org groups, B-Org groups and Management groups. Thus far, this text has only dealt with the former two. Now it is time to turn our attention to the latter.

As also noted earlier, these components of IRC § 414 were largely enacted in response to litigation, as a means to combat groups which might be created to avoid employee coverage, but placing employees into an affiliated but not controlled entity. Management groups are an example.

A management group affiliated service group exists when:

1. One organization performs management functions for another, and
2. The performing organization's principal business is the performance of these functions on a regular and continuing basis for the recipient.

Unlike the A-Org and B-Org group requirements imposed by § 414(m)(2), there does not need to be any common ownership between the management organization and the recipient organization for which it provides service, in order to constitute a management group under § 414(m)(5). And, any person related to the organization performing the management function is also to be included in the group that is to be treated as a single employer.

Therefore, to invoke this test, consideration need be given to two separate concepts: “management functions” and “regular and continuing business.” Each of these terms will be discussed sequentially.

Continued on next page

Management Groups, Continued

Management functions

The term "management functions" includes two evaluations:

- "Management activities", and
- "Historically performed by employees."

Both must be satisfied to be considered a management function, however neither the Code nor the Regulations provide any definition on "management functions" for affiliated service group purposes. Accordingly, these terms are defined by lay usage.

Management activities are only those management activities and services historically performed by employees.

Management activities and services that include determining, implementing, or supervising in accomplishing any of the following:

1. Daily business operations (such as production, sales, marketing, purchasing, and advertising),
2. Personnel (such as staffing, training, supervising, hiring and firing.),
3. Employee compensation and benefits (such as salaries and wages, paid vacations and holidays, life and health insurance, and pensions),
4. Short-range and long-range business planning (such as product development, budgeting, financing, expansion of operations, and capital investment),
5. Organizational structure and ownership (such as corporate formation, stock issues, dividends, mergers, and acquisitions), and
6. Any other management activity or service.

Continued on next page

Management Groups, Continued

Management activities include professional services

Management activities and services also include professional services that relate to such services. In addition, professional services of the same type as the professional services performed by the recipient organization for third parties are deemed to be management activities and services, and are deemed to be management functions regardless of whether such professional services are historically performed by employees.

Historically performed by employees

When dealing with B-Org groups earlier, we discussed the requirement in Prop. Treas. Reg. § 1.414(m)-2(c)(3), that the B-Org must be performing services to the FSO of a type historically performed by employees of the FSO. That regulation specifies that for purposes of historical performance, it would be considered historically performed if it was not unusual for the services to be performed by employee of organizations in that service field on December 13, 1980 (the date of original introduction of the statute.)

Prop. Treas. Reg. § 1.414(m)-2(c)(3) implements only the § 414(m)(2) requirements. However, on this point, in absence of other guidance, it is instructive when evaluating (m)(5) management groups.

Accordingly, management activities and services are historically performed by employees in a particular business field if it was not unusual for management activities and services of such type to be performed by employees of organizations in that particular business field on September 3, 1982 (the effective date of the (m)(5) addition to the Code.

Continued on next page

Management Groups, Continued

Conference committee-historically performed

The Conference Committee reports to TEFRA indicate that Congress intended that § 414(m)(5) is to apply only where the management functions performed by one person for another are functions historically performed by employees as of this date. To the extent that particular business field did not exist on September 3, 1982, whether management activity or service will be considered historically performed by employees in that a particular business field will be determined by analogy to similar business fields in existence on September 3, 1982. In some situations, even if it is unusual for a particular management activity or service to be performed by employees of organizations in a particular business field, the activity or service may be considered "historically performed".

Period of management activity

If a particular management activity or service was ever performed by any employee of a particular organization in a business field, such activity or service is considered to be a management activity or service historically performed by employees for purposes of applying § 414(m)(5) to that particular organization for the period beginning on the date such activity or service was first performed and ending on the date five years after such activity or service is no longer performed.

Employee

For purposes of this section, the term "employee" also includes a self-employed individual as defined in § 401(c)(1). Services performed for a person other than as an employee of such person means services performed directly or indirectly for such person.

Continued on next page

Management Groups, Continued

Insubstantial management functions

A management organization shall not exist with respect to a particular recipient organization for a tax year of the management organization during which the performance of management functions for such recipient organization, in relation to all services performed for such recipient organization, is not substantial.

The performance of management functions for a recipient organization is not substantial for a tax year only if during such tax year less than 50 percent of the compensation provided by the management organization, with respect to services performed for the recipient organization (including services performed as employee of the management organization and in any other capacity), is provided to individuals who perform a significant amount of management functions for the recipient organization.

An individual performs a significant amount of management functions for the recipient organization if, during the tax year, at least 15 percent of the individual's service (including service performed as an employee and in any other capacity) for the recipient organization (based on time) is performing management functions for the recipient organization.

Recipient organization

The statute does not provide much by way of definition or requirement for the recipient in a management function group. A recipient organization is thus any organization for which management services are performed, including any other organizations aggregated under §§ 414(b), 414(c), 414(m), and 414(o). This would include all related organizations within the meaning of IRC § 144(a)(3) which will be discussed later. The recipient organization does not need to be a service organization, it just has to receive management services from a provider

Continued on next page

Management Groups, Continued

**Principal
business and
regular and
continuing
basis**

In whatever capacity performed, providing management functions must be the principal business of the managing organization. No precise test of what level of business activity is required before becoming the "principal" function of the organization is provided by either the statute or the regulations. In 1987, Treasury proposed – and later withdrew – an update to the 1984 extant Proposed Regulations, which would have required 50% of the provider's gross receipts be related to providing management services to the recipient as the threshold standard. Alternatively, a two year rolling percentage test would have been imposed. In absence of these regulations, there is no determined level, and this evaluation becomes a subjective interpretation. However, in order to assist with this evaluation, these two tests are herein presented as an example of Treasury's thinking in 1987.

**Two-Tax Year
Rolling
Percentage**

Under the withdrawn regulations, for an organization to be a management organization with respect to a recipient for a tax year of the management organization, the performance of management functions and other services for the recipient organization would have had to constitute more than 50 percent of the management organization's business activities during the two tax year period that includes such tax year and the prior tax year.

If the management organization was not in existence prior to the current tax year, the "more than 50 percent test" would apply only to the current tax year.

Continued on next page

Management Groups, Continued

**Two-Tax Year
rolling
percentage
cont'd**

Once the "more than 50 percent test" is met, the management organization will continue to be a management organization with respect to a particular recipient organization for each subsequent tax year during which the performance of management functions and other services for such recipient organization constitutes more than 40 percent of the management organization's business activities during the two tax year period that includes such subsequent tax year and the immediately preceding tax year, unless one of the following exceptions were met:

- The performance of management functions and other services for the recipient organization constitutes less than five percent of the management organization's subsequent tax year. In that case, the (continued) organization that had been a management organization with respect to the recipient organization is no longer a management organization.
- There is an intervening tax year for which the management organization and the recipient organization do not satisfy a "more than 40 percent test".
- The management organization satisfies a "more than 50 percent test" with respect to a different recipient organization for such subsequent year and the immediately preceding tax year. In that case, the second organization becomes the recipient organization and the first organization no longer has that status.

The principal business test would be made on the basis of the gross receipts derived from management functions, as compared with the gross receipts derived from all business activities.

Continued on next page

Management Groups, Continued

Gross receipts test

The gross receipts test would have made the determination of principal business on a regular and continuing basis on the basis of the percentage of gross receipts derived from management functions and other services performed for a recipient organization, as compared to the gross receipts derived from all business activities. If that percentage were 50% or above, the principal business of the provider would be deemed to be to provide management services to the recipient. If not at a 50% level, it would not be considered “primarily.” In determining the two tax year percentage, gross receipts for the combined two tax year period are compared. Thus, it is not permissible to average the percentages determined separately for each tax year.

Gross receipts derived from all business activities do not include gross receipts from the sale of any asset, just receipts from the performance of business activity.

Facts and circumstances Test

In absence of any definitive test in the regulations, whether providing management functions to a recipient organization is a provider’s primary business comes down to a facts and circumstances evaluation, by considering such factors as the amount of time actually spent by individuals in performing management functions and other services for a recipient organization.

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Management Groups, Continued

Attribution rules involved with respect to management groups

As noted earlier, IRC § 414(m)(5) comes with its own unique attribution reference, different from the A- and B-Org tests of § 414(m)(2). Section 414(m)(5) provides that for this purpose, the term “related organizations” has the same meaning as that term is used in IRC §144(a)(3) (related to qualified small issue bonds), which in turn invokes IRC §§ 267(c) and 707(b).

Section 267 contains the rules of attribution to determine “control” for management organizations under § 414(m)(5). Section 707(a) includes other organizations which would be in a controlled group relationship under § 1563(a), but with a reduced 50% threshold in place of the 80% level otherwise prescribed.

Section 267-organizational attribution

As was described earlier for purposes of § 318 attribution (for purposes of determining attribution for A- and B-Org groups), § 267 also invokes issues of organizational and family attribution, but with some significant differences.

First, in applying organizational attribution, for purposes of applying § 414(m)(5) only, related persons include:

1. an individual and a corporation, where the individual owns at least 50% of the value of the outstanding stock of such corporation,
 2. as described above, two corporations which are members of the same controlled group under IRC § 1563(a), but with “more than 50%” substituted for “at least 80%”
 3. a grantor and a fiduciary of a trust or of related trusts
 4. a person and a tax-exempt organization controlled by that person
 5. a corporation and a partnership if the same person owns more than 50% in each entity
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Management Groups, Continued

**Section 267-
family
attribution**

Secondly, in applying the family attribution rules, An individual is attributed interests owned by his spouse, siblings, ancestors and lineal descendants. (Of note, siblings are not included in § 318 attribution)

**Example 31
Management
group**

Matthews Inc. is an industrial scrap-metal recycling firm. All of its employees work in the various capacities in a scrap yard, either operating heavy machinery, moving or processing metals, etc. Davis Corp. oversees Matthews Inc., by providing its management services. All business contracts on behalf of Matthews are negotiated by Davis. Davis makes determinations on behalf of which metals Matthews will accept, and is responsible for purchasing and/or leasing the machinery used in Matthews yard.

Under this circumstances, Davis performs management functions for Matthews, and the performance of these management functions or services satisfy the requirements of a principal business on a regular and continuing basis.. The next step would be to evaluate what percentage of Davis's work is drawn from managing Matthews Inc. Assume for the moment it is 100%, that Davis is formed just to manage Matthews. Davis is treated as a management organization and Matthews is treated as a recipient organization for purposes of IRC § 414(m)(5). Accordingly, both entities are treated as if they are one employer for qualified retirement plan purposes. Any plan maintained by either entity would have to consider all of the other entity's employees as potentially eligible employees for plan compliance testing.

Information Contained in Determination Letter Filings and Processing steps for Controlled and Affiliated Service Groups

Overview Pursuant to the annual determination letter filing guidance – currently Rev. Proc. 2013-6 – applicants identify whether the employer-sponsor of the plan document submitted is part of either a controlled or affiliated service group, or both.

Controlled group For controlled group purposes, this application is made by a “yes” indication on line 6b of the current version of Form 5300. In addition to this identification, the applicant supplies information regarding the membership of the group, and customarily receives a ruling that extends the final determination letter to all members of the controlled group. There is no evaluation given to the “yes/no” response on the Form: the letter relies on the information supplied by the applicant. The only required information to be supplied is the name and relationship of each entity claimed to be under common control with the employer-sponsor submitting the application.

Affiliated service groups For affiliated service group purposes, this identification is made by a “yes” response on line 6a of Form 5300. In addition, applicants may request that the determination of the plan also rule on its affiliated service group status under § 414(m). Some submissions will ask the Service to opine that based on all the facts and circumstances, an affiliated service group does not exist – such as where entities share some common ownership and perform related services, but the sponsor seeks not to have to cover all the employees of all potentially related entities. Conversely, some will ask us to find that it does constitute such a group – such as where a sponsor specifically wants to cover employees in another entity.

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Information Contained in Determination Letter Filings and Processing steps for Controlled and Affiliated Service Groups, Continued

Section 14

Section 14 of the annual “-6” guidance describes submission procedures for affiliated service group rulings. The complete set of information required for an affiliated service group ruling actually goes back and is described more fully in Rev. Proc. 85-43, 1985-2 C.B. 501. This information is described more fully below.

Required information-A org and B org groups

Required information-introduction

A determination letter will be issued with respect to § 414(m) only if the employer requests such a determination and the application includes:

1. Description of business

A description of the nature of the business of the employer, specifically whether it is a service organization or an organization whose principal business is the performance of management functions for another organization, including the reasons therefor;

2. Identification of members

The identification of other members (or possible members) of the affiliated service group;

3. Description of the business of each member

A description of the business of each member (or possible member) of the affiliated service group, describing the type of organization (corporation, partnership, etc.) and indicating whether the member is a service organization or an organization whose principal business is the performance of management functions for the other group member(s);

4. Ownership interest between employer and members

The ownership interests between the employer and the members (or possible members) of the affiliated service group (including ownership interests as described in §§ 414(m)(2)(B)(ii) or 414(m)(6)(B));

5. Description of services

A description of services performed for the employer by the members (or possible members) of the affiliated service group, or vice versa (including the percentage of each member's (or possible member's) gross receipts and service receipts provided by such services, if available, and data as to whether such services are a significant portion of the member's business) and whether, as of December 13, 1980, it was not unusual for the services to be performed by employees of organizations in that service field in the United States;

Continued on next page

Required information-A org and B org groups, Continued

6. Association of members

A description of how the employer and the members (or possible members) of the affiliated service group associate in performing services for other parties;

7. A copy of any ruling

A copy of any ruling issued by the headquarters office on whether the employer is an affiliated service group; a copy of any prior determination letter that considered the effect of § 414(m); and, if known, a copy of any such ruling or determination letter issued to any other member (or possible member) of the same affiliated service group, accompanied by a statement as to whether the facts upon which the ruling or determination letter was based have changed.

Continued on next page

Required information-A org and B org groups, Continued

**Required
information –
Management
groups**

As noted above, 1987 regulations that were initially proposed, then withdrawn, would have established tests to determine whether an organization's principal business activity involves the performance of services for another entity. Information was presented above describing these tests and how they work, because aspects of their information requirements were picked up in Section 14 of the determination letter filing requirements for management group affiliated entities.

Accordingly, in the case of a management organization under § 414(m)(5), the following information is also required:

(a) A description of the management functions, if any, performed by the employer for the member(s) (or possible member(s)) of the affiliated service group, or received by the employer from any other members (or possible members) of the group (including data explaining whether the management functions are performed on a regular and continuous basis) and whether or not it is unusual for such management functions to be performed by employees of organizations in the employer's business field in the United States;

(b) If management functions are performed by the employer for the member (or possible members) of the affiliated service group, a description of what part of the employer's business constitutes the performance of management functions for the member (or possible member) of the group (including the percentage of gross receipts derived from management activities as compared to the gross receipts from other activities).

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Required information-A org and B org groups, Continued

Application review

Form 8388, *Affiliated Service Group* (Worksheet Number 10) should be used in reviewing a request concerning the effect of IRC § 414(m) on the plan submitted or because of a change in the affiliated service group membership or if the plan sponsor is not certain if they are a member of such a group. Note: The worksheet is not designed to address every possible issue which may arise in the course of this review.

If the worksheet indicates deficiencies and amendments should be requested, Form 8400, *EP Deficiencies Checksheet*, provides sample language for requesting plan amendments.

After reviewing the affiliated service group information and testing it against IRC § 414(m), if it is determined that the application meets the requirements of an affiliated service group, then any final determination letter receives caveat 21, denoting affiliated service group status to the employer.

If the requirements are not met, the final determination letter receives caveat 23, indicating that the plan is not sponsored by an affiliated service group.

Examining Controlled and Affiliated Service Groups- Audit steps

Introduction This section lists potential audit steps that can be taken to discover the existence of controlled or affiliated service groups. Not every audit step will need to be taken on every case. Agents should use their best judgment when determining how much time should be spent exploring the possibility that a controlled group exists.

Summary of Steps

Step	Action
1	Review the plan document.
2	Research internal systems.
3	Complete the package audit.
4	Review Forms 5500.
5	Conduct public records research.
6	Interview the taxpayer.

Step 1 – Review Plan Document

Introduction

The plan document(s) should be reviewed to determine if the plan covers or considers employees of other related (or potentially related) employers.. Sometimes the plan document will refer to related employers in the definition of “Employer” extant in the document. Occasionally, preamble text indicates that related employers are considered, or the eligibility section may specifically reference employees of other entities. All of this should be scrutinized for the possibility of related employers.

Plan Document Items to Check

Check for the following:

- The signature page of the plan document or amendments may disclose a controlled group if adopting the employers sign the document.
 - The language of the plan may limit participation to a specific company.
 - A former plan name or former employer may be listed.
 - Additional or transitional provisions relating to coverage, benefits, contributions, vesting and other plan rights and features.
 - Mergers, terminations, partial terminations, predecessor employers.
 - The definition of employer, employee, and eligible employee.
-

Step 2 – Research Internal Systems

Introduction	Use of internal systems can help an agent discover related entities. It is helpful to conduct as much research as possible before conducting the on-site visit and interview. In some instances, you may need to conduct additional research after the on-site visit and interview.
INOLEX	This command code may provide a list of Tax Identification Numbers (TINs) related to the plan sponsor.
INOLES	This command code may list the TINs of subsidiary companies.
TRDBV	<p>If the INOLEX or INOLES indicate related entities exist, the TRDBV command code can be reviewed. This command code will allow you to explore the filings of the related entities.</p> <p>The filings should be reviewed to determine if related entities are operating a business that may have employees or if the entities are paying wages. If wages are not reported they may be included in cost of goods sold or the entity may be leasing its employees.</p>
PMFOLS	If the INOLEX or INOLES indicate related entities this command code may be used to determine how many W-2s the entity issued.
IRPTR	You may review the IRPTR for persons for whom the company is named. If it is not clear who the owners are, then it is best to wait until after you inspect the applicable tax returns. Forms W-2, Schedules K-1, and Forms 1099 contain the information that you should focus on. If an owner is receiving any of these documents from an entity other than the plan's sponsor, you must determine his ownership interest in the other company. (You may also consider ordering an IRPTR for all HCEs because an affiliated service group may be discovered.)

Continued on next page

Step 2 – Research Internal Systems, Continued

RTVUE A RTVUE will indicate if the sponsor’s owner is a sole proprietor.

Determination Letter Material As part of your internal systems review, you can check to see if prior determination letter case history exists. Prior determination letter application(s) may reveal:

- more than one name has been used in either the Name of Plan Sponsor or the Name of Plan, or different names in each;
- more than one TIN has been used by the sponsor of this plan;
- use of the separate line of business rules (“QSLOB”) in the coverage data section;
- the exclusion of a group of employees not employed by the plan sponsor in the general eligibility requirements section; or
- extension of the letter to also applies to another employer

In addition, correspondence in the determination letter case file may reflect the existence of an employer other than the plan sponsor, or may contain workpapers which reflect the questions relating to other potentially related employers which were raised, and how they were resolved.

Related Entities Without Employees If a related entity is a controlled group member, but has no employees, then there is no issue affecting the year you are examining. However, you may wish to make the sponsor aware that if the controlled group member ever hires workers, they must be considered as employees of the sponsor for plan qualification purposes.

Continued on next page

Step 2 – Research Internal Systems, Continued

yK1

The yK1 system allows users to identify relationships between taxpayers. The system includes the following returns: 1120, 1120S, 1041, 1065, 1120S K-1s, 1065 K-1s and 1041 K-1s. It also contains high wealth individuals and any individual who has received a K-1.

The graphs generated through the yK1 system allow you to see entities that are related to the plan sponsor or owners of the plan sponsor.

The new Enterprise feature allows users to retrieve the collection of entities controlled by a common taxpayer and the summary data about the complete enterprise structure.

Step 3 – Package Audit

Introduction

The tax returns include essential information beyond the pension deduction, and an agent should insist on receiving all pages that are relevant.

Many entities now electronically file their tax returns. Returns that have been electronically filed can be obtained from the Modernized E-File (MeF) system using the Employee User Portal (EUP). The MeF system allows agents to view the entire return as it was filed.

Form 1120, Schedule E

You will find the officers' ownership percentage, as well as their social security numbers.

Note: Schedule E was removed from Form 1120 starting in 2012.

Form 1120, Schedule K

Lines 3, 4 and 5 reveal ownership information, and line 4 specifically asks if the employer is part of a controlled group or an affiliated group.

Note: The determination of whether or not a controlled group or an affiliated service group exists for completing Form 1120, Schedule K differs slightly than for making the determination for §§ 414(b) and (c).

Form 851

If a corporation files a consolidated return they are required to attach Form 851 to their Form 1120 filing. Form 851 will list the name and TIN of each entity filing as part of the consolidated return.

Form 1120S, Schedule B, Question 3

The 2012 Form 1120S asks if the S-Corporation owned 50% or more of another domestic corporation. If this question was answered "Yes", then a schedule would be attached to the return listing the corporations owned.

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Step 3 – Package Audit, Continued

**Form 1065,
Schedule B,
Questions 3 & 4**

The 2012 Form 1065 asks two questions about the partnership's ownership of other entities. If either of these questions is answered "Yes" than the other entities names and TINs would be included with the filing.

**Forms 1065
and 1120S,
Schedule K-1**

Both partnerships and S-corporations are required to issue Schedule K-1s to owners. A Schedule K-1 will indicate the percentage of the partnership or the S-corporation that each person or entity owns.

**Form 1040,
Schedule C**

A Schedule C will be attached to Form 1040 for each sole proprietorship owned by an individual. If the plan sponsor is a sole proprietorship than the Form 1040 should be reviewed for multiple Schedule C's. The owners' Form 1040 may also be reviewed to determine if they also own a sole proprietorship.

**Form 1040,
Schedule E**

A Schedule E will report all Schedule K-1s received by an individual. This information can be used to determine if an individual has ownership in any partnerships or S-corporations.

**Examination
tip**

For corporate income tax filing purposes, line A3 of Form 1120 indicates whether the filer is a "personal service corporation" as defined in IRC § 269A(b)(1), which is a corporation whose principal activity for the testing period is the performance of personal services. A filer denoting this status is generally taxed at a higher effective tax rate than other corporations, at the rate equivalent to an individual income tax filer. Although "professional service corporation" and "personal service corporation" are not synonymous terms, there exists substantial overlap in their definitions. As a review tip, the existence of this entry on Form 1120 generally, but not always, means the entity will meet the definition of a PSC for affiliated service group purposes.

Step 4 – Prior, Current and Subsequent Form 5500 Filings

Introduction Agents should be aware of any large changes in participation or assets and determine the causes. If the plan had a merger, consolidation or spin-off, a Form 5310-A should have been filed.

Large Increase A large increase in participants or assets may indicate the plan was merged or combined with another plan you are examining.

Large Decrease A large decrease in participants or assets may indicate that part of the plan you are examining was spun-off or merged with another plan. It is possible that the spun-off organization is still a related organization.

Step 5 – Public Records Search

Introduction

Local public records vary greatly. For example, Arizona corporations must disclose all 20% owners. However, Colorado does not require this disclosure. Agents should make themselves acquainted with the records that are available from the:

- Corporation Commission,
 - Secretary of State,
 - County Assessor,
 - County Recorder, and
 - Any other office that may provide public information relevant to the sponsor and the trust.
-

State and County Websites

Some states report their corporation information through the Secretary of State's office. An agent can obtain much information through state and county websites.

Accurint

Accurint is available to EP agents. Accurint is an internet system for accessing public records and financial information. Accurint allows an agent to research business information including business registration, associated entities, associated individuals and company executives.

In addition to running a report for the plan sponsor it may also be helpful to:

- Run a report on the owners of the plan sponsor or entities related the plan sponsor that were discovered during other research.
 - Perform an address search to find other businesses that are located at the same address as the plan sponsor.
-

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Step 5 – Public Records Search, Continued

Internet Searches

The internet is a powerful research tool that can help agents learn useful information. Some internet searches that may help agents locate information include:

- A news search that will show recent news articles published about the taxpayer.
- A map search that will show businesses that are located at the same location.
- A key word search of the company name
- A review of the company's website

The use of quotation marks or Boolean operators can help in reducing the number of pages returned in an internet search and help the agent find the specific information they are looking for.

Great care should be used when performing taxpayer research using the internet. Agents would closely follow the guidance in IRM § 4.71.1.10.5(8-17-12) (or subsequent revision thereof) to ensure there are no disclosure violations.

SEC Searches

With the exception of many small offerings all companies who securities are publically traded in the United States must register with the Securities and Exchange Commission (SEC).

These companies must generally file the following information with the SEC:

- a description of the company's properties and business;
- a description of the security to be offered for sale;
- information about the management of the company; and
- financial statements certified by independent accountants.

Filings with SEC are available through EDGAR (www.sec.gov/edgar.shtml). SEC filings may contain very useful information about a company's related entities.

Step 6 – Initial Interview

Introduction

The interview of the taxpayer is the single most important audit step when determining if affiliated entities group exists. The questions asked of the taxpayer should be concise yet thorough. Any potential related entities discovered during your pre-audit research or your review of the books and records should be asked about during the interview of the taxpayer.

Interview Questions

Some potential interview questions the agent could ask are:

- Does the owner (or sponsor) have an ownership interest in any other business?
 - Who are the owners of the sponsor?
 - Do any of the owner's relatives have an ownership interest in the sponsor or any business named pursuant to the first question?
 - Do any of the companies named pursuant to the first question have an ownership interest in any business?
 - Is the employer's business one that requires another business or function in order to operate? If so, find out who is performing such functions.
 - Does the employer perform routine services to or with another entity ?
-

Workpaper Development

Examination workpapers should contain the:

- Procedures,
 - Source documents,
 - Actions taken,
 - Pre-contact analysis,
 - Interview,
 - Audit steps, and
 - Determination of the facts and conclusions
-

Conclusion and Summary

The rules at IRC § 414(b), (c) and (m) were created to eliminate the practice of excluding employees from plan coverage through the creation of segregated business entities.

A plan that is maintained by one employer within a group of employers comprising either a controlled or affiliated service group must meet the requirements of IRC § 401(a) as if all employees of all employers in the group were employed by a single employer.

This section explained how to identify situations where the plan sponsor is a member of one of five types of groups – parent-subsidary and brother-sister controlled groups and A-Org, B-Org and management group affiliated service groups. It also provided steps to determine the impact this may have on qualified plans maintained by potentially related employers.
