

Chapter ____
Controlled Groups
and
Affiliated Service Groups

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§ 1.01 Introduction

This section describes the origin and purpose of the controlled group and affiliated service group rules. Historically, employers sponsoring qualified retirement plans have attempted to circumvent the nondiscrimination and similar qualification requirements by subdividing their businesses. To avoid this circumvention, the Internal Revenue Code requires employers to take into account the controlled groups and affiliated service group rules in applying the nondiscrimination and similar requirements. This section includes examples illustrating the impact of the controlled group and affiliated service group rules on the application of those qualification requirements.

[1] Controlled Groups

Because qualified retirement plans enable plan sponsors and participants to receive favorable income tax treatment, the Internal Revenue Code ("IRC") has prohibited these plans from discriminating in favor of the highly compensated employees. Before ERISA, however, an employer could discriminate in favor of its highly compensated employees by establishing a separate corporation to employ its nonhighly compensated employees. The employer would provide a generous qualified retirement plan for its highly compensated employees. The new corporation would either not sponsor a qualified retirement plan or, if did, would provide a significantly less generous plan for nonhighly compensated employees. This separate-and-avoid technique was successful before ERISA because the nondiscrimination rules applied separately to each employer.¹

To combat the separate-and-avoid technique of circumventing the nondiscrimination rules,

ERISA amended the IRC to require a qualified retirement plan maintained by an employer within a group of employers that are under common control to meet the nondiscrimination requirements as if a single employer employed all employees of the group. One of the Senate committee reports accompanying ERISA explained: "The Committee, by this provision, intends to make it clear that the coverage and nondiscrimination provisions cannot be avoided by operating through separate corporations instead of separate branches of one corporation."² One of the House committee reports was more expansive in its explanation:

The committee bill also provides that in applying the coverage test, as well as the antidiscrimination rules, the vesting requirements, and the limitations on benefits, employees of all corporations who are members of a "controlled group of corporations" (within the meaning of sec. 1563(a)) are to be treated as if they were employees of the same corporation. Thus, if two or more corporations were members of a parent-subsidiary, brother-sister, or combined controlled group, all of the employees of all of these corporations would have to be taken into account in applying these tests. A comparable rule is provided in the case of partnerships and proprietorships which are under common control (as determined under regulations), and all employees of such organizations are to be treated for purposes of these rules as though they were employed by a single person. The committee, by this provision, intends to make it clear that the coverage and antidiscrimination provisions cannot be avoided by operating through separate corporations instead of separate branches of one corporation. For example, if managerial functions were performed through one corporation employing highly compensated personnel, which has a generous pension plan, and assembly-line functions were performed through one or more other corporations employing lower-paid employees, which have less generous plans or no plans at all, this would generally constitute an impermissible

¹ See *Packard v. Commissioner*, 63 T.C. 621 (1975) (Tax Court rejects IRS attempt to disqualify qualified retirement plan adopted by a dental partnership after it transferred its common law employees to corporation owned by the three partners).

discrimination.³

To accomplish this objective, ERISA added IRC sections 414(b) and (c). As discussed in more detail below, the controlled group definitions in IRC sections 414(b) and (c) are based on whether the employers within the group satisfy certain ownership thresholds (e.g., if a parent owns 80% or more of a subsidiary's shares, the parent and subsidiary are within the same controlled group).

[2] Affiliated Groups

After ERISA, some employers employed the separate-and-avoid technique again. This time, however, they reduced the ownership interests in their businesses below the thresholds that created a controlled group. For example in the *Kiddie*⁴ and *Garland*⁵ decisions, a doctor incorporated his medical practice and his professional medical corporation then formed a partnership with another doctor.⁶ The partnership employed the supporting personnel (secretaries, paraprofessionals, etc.). The professional medical corporation in question adopted a qualified retirement plan. The partnership did not provide comparable retirement benefits to its employees. However, the IRS could not apply the nondiscrimination rules on a controlled group basis to disqualify the qualified retirement plan of the professional medical corporation because its ownership interest in the partnership was insufficient to establish a controlled group under IRC 414(c).⁷

In response to the *Kiddie* and *Garland* separate-and-avoid technique, IRC section 414(m) was

² S. Report No. 93-383 (8/21/73) reprinted at 1974 U.S. Code Congressional and Administrative News 4890, 4929.

³ H. R. Report 93-807 (2/21/74) reprinted at 1974 U.S. Code Congressional and Administrative News 4670, 4716.

⁴ *Kiddie v. Commissioner*, 69 TC 1055 (1978).

⁵ *Garland v. Commissioner*, 73 TC 5 (1979).

⁶ In *Kiddie*, the other doctor also incorporated his medical practice and his professional medical corporation formed the partnership with the other professional medical corporation in question.

⁷ In both *Kiddie* and *Garland*, the Tax Court also ruled that employees of the partnership could not be attributed to the professional medical corporation in question under partnership taxation rules in Subchapter K of the IRC because it did not own more than 50% of the partnership.

added to address affiliated service groups. Similar to IRC sections 414(b) and (c), IRC section 414(m) provides that all employees of the members of an affiliated service group shall be treated as if they were employed by a single employer when applying the nondiscrimination rules.

[3] Impact on Qualified Retirement Plans

Although the history of the controlled and affiliated service group rules is rooted in efforts to prevent employers from circumventing the nondiscrimination rules, the controlled and affiliated service group rules also apply to a wide variety of other qualification requirements:

- minimum participation requirements;⁸
- nondiscrimination rules;⁹
- minimum vesting standards;¹⁰
- limitations on benefits and contributions;¹¹
- compensation limits;¹²
- top-heavy rules;¹³ and
- simplified employee pension and simple retirement accounts rules.¹⁴

In addition, if two or more members of a controlled group¹⁵ adopt a single plan, then the members are treated as a single employer¹⁶ for purposes of the following requirements:

⁸ IRC § 401(a)(3), 401(a)(26), and 410.

⁹ IRC § 401(a)(4).

¹⁰ IRC § 401(a)(7) and 411.

¹¹ IRC § 401(a)(16) and 415.

¹² IRC § 401(a)(17).

¹³ IRC § 416.

¹⁴ IRC § 408(k) (simplified employee pension) and 408(p) (simple retirement accounts).

¹⁵ Treas. Reg. § 1.414(b)-1(b).

¹⁶ Treasury has not yet proposed a similar rule for members of an affiliated service group maintaining the same plan.

- minimum funding standards;¹⁷
- taxes on failure to meet the minimum funding standard;¹⁸ and
- contribution deduction limitations.¹⁹

IRS Examples: In training²⁰ its personnel, IRS uses the following examples to explain some of the impact of applying the controlled and affiliated service group rules to these requirements.

Minimum Participation Requirements. Creek Manufacturing, Inc. and Dunn, Inc. are members of a controlled group of corporations. Creek maintains a qualified plan for its employees only; Dunn employees are not eligible to participate in the plan. The Creek plan has a one-year service requirement. Mary had completed three years of service with Dunn prior to her transfer to Creek. The plan administrator cannot require Mary to complete a year of service with Creek before including her in the plan. Rather, the plan administrator must recognize service with all employers in the controlled group. Thus, Mary must become a participant in the plan as soon as she started to work for Creek because she had already completed her year of service with Dunn. Failure to have Mary participate immediately in the plan means the plan violates minimum participation requirement of IRC sections 401(a)(3) and 410(a)(1)(A).

Nondiscrimination Rules. Tabor Equipment Co, Inc. and Wells Supplies, Inc. are members of a controlled group of corporations. Wanda is a participant in the Tabor Equipment Co, Inc. Profit Sharing Plan. Wanda's compensation is \$55,000 from Tabor and \$65,000 from

¹⁷ IRC § 412.

¹⁸ IRC § 4971.

¹⁹ IRC § 404(a).

²⁰ Employee Plans Continuing Professional Education Technical Instruction Program, Chapter 7: Controlled and Affiliated Service Groups (September 2004).

Wells. Wanda would not be deemed a highly compensated employee based upon her compensation from Tabor alone. However, she would be a highly compensation employee under the controlled group rules because all of her compensation from both employers would be aggregated.

Minimum Vesting Standards. Teton corporation maintains a profit sharing plan with a 5-year cliff vesting schedule. The plan only covers Teton employees. Teton is the parent company of subsidiary L. Carmen commenced employment on January 1, 2005, with subsidiary L. On January 1, 2008, Carmen transfers to Teton corporation. In determining Carmen's vesting percentage under Teton's plan, Carmen's service with subsidiary L must be counted because IRC Sections 414(b) and (c) require her to be treated as if employed by one employer. Therefore, Carmen has three years of service for vesting purposes under Teton's plan upon transferring from subsidiary L to Teton's plan.

Limitations on benefits and contributions. Starr, Inc. and Upson Ltd. are a controlled group. Each maintains an identical money purchase plan with calendar plan years. For 2008, the IRC section 415(c)(1)(A) limitation is the lesser of 100% of compensation or \$46,000. During the 2008 plan year, Sue earns \$100,000 from each employer and is a participant in each plan. She receives an allocation of \$25,000 in each. Her allocations under each plan are aggregated to \$50,000 because the employers are members of a controlled group. The allocations in this instance result in a disqualification of either one or the other of the plans due to a violation of IRC section 415(c)(1)(A). The actual plan to be disqualified is determined pursuant to Treas. Regulation 26 CFR 1.415-9(b)(3)(iii).

Compensation Limits. Gordon, Inc. and Bacon, Inc. are unrelated employers who have two separate money purchase pension plans. Both plans have a 10 percent of compensation

contribution formula. Bob is an employee of both employers and earns \$150,000 from each of them. In 2007, he received an allocation of \$15,000 under each plan. In 2008, Gordon, Inc. and Bacon, Inc. became members of a controlled group. For subsequent allocation purposes, Bob's compensation is limited to \$225,000 (not the \$300,000 if counted separately) because he is treated as if one employer pays his entire compensation amount. Therefore, the amount that may be allocated to his account under both plans is limited to \$22,500 (not the \$30,000 he was entitled to previously). Failure to limit Bob's compensation will result in a violation of section 401(a)(17).

Other Examples: The following two simple examples are intended to illustrate more common problems created by the controlled group rules:

Coverage. Plump Corporation is the parent corporation of a multi-state retail business with a separate wholly owned subsidiary in each state in which it operates. Plump Corporation sponsors a qualified retirement plan for its employees. Employees of Plump Corporation's subsidiaries are not eligible to participate in Plump Corporation's qualified retirement plan. In addition, none of the subsidiaries maintain a qualified retirement plan for its employees.

Because Plump Corporation's ownership interest in each subsidiary is at least 80% (i.e., 100%), Plump Corporation and its subsidiaries are members of the same controlled group. As a result, in determining whether Plump Corporation's qualified retirement plan meets the coverage portion of nondiscrimination requirements under IRC section 410(b), the employees of Plump Corporation's subsidiaries must be treated as if they were Plump Corporation employees.²¹

If the percentage of Plump Corporation's highly compensated employees participating in the plan is significantly higher (e.g., 43% higher) than the percentage of its nonhighly compensated employees participating in the plan, then the plan is unlikely to pass the coverage test. In calculating these percentages, Plump Corporation must count the total number of highly compensated employees in the controlled group and the total number of nonhighly compensated employees in the controlled group.

Benefits. Plump Corporation is the parent corporation of a multi-state retail business with a separate wholly owned subsidiary in each state in which it operates. Plump Corporation sponsors a qualified retirement plan for its employees. Employees of Plump Corporation's subsidiaries are eligible to participate in Plump Corporation's qualified retirement plan. However, the value of the benefits for the employees of subsidiaries is significantly less (e.g., 43% less valuable) than the value of the benefits for employees of Plump Corporation.

Because Plump Corporation's ownership interest in each subsidiary is at least 80% (i.e., 100%), Plump Corporation and its subsidiaries are members of the same controlled group. As a result, in determining whether Plump Corporation's qualified retirement plan meets the coverage portion of nondiscrimination requirements under IRC section 410(b), the employees of Plump Corporation's subsidiaries must be treated as if they were Plump Corporation employees. In addition, the employees of Plump Corporation's subsidiaries must be treated as if they were Plump Corporation employees for purposes of applying the benefit portion of the nondiscrimination requirements under IRC section 401(a)(4).

In this example, the Plump Corporation's qualified retirement plan will satisfy the coverage

²¹ In this example, the benefits portion of the nondiscrimination requirements under IRC 401(a)(4) is irrelevant because

requirement under IRC section 410(b) because all employees within the controlled group are eligible to participate. However, the plan is likely to fail the benefits requirement under IRC section 401(a)(4) because of the disparity in the value of the benefits provided under the plan if the percentage of Plumb Corporation's highly compensated employees receiving the more valuable benefits is significantly greater than the percentage of its nonhighly compensated employees receiving those more valuable benefits.

[4] Softening the Impact

To soften the impact of the controlled group, the Internal Revenue Code has provisions

addressing:

- Qualified separate lines of business,
- Mergers and acquisitions, and
- Nondiscrimination testing based on average benefits.²²

[a] Qualified Separate Lines of Business

Under the controlled group rules, all employees within the group are treated as if employed by a single employer. Thus, a qualified retirement plan must be tested for nondiscrimination on an employer-wide basis, even though benefit levels could legitimately vary among the employer's businesses for competitive market reasons.

To pass the nondiscrimination tests, the controlled group rules would have forced some employers to change their benefits to more uniform levels above or below the levels offered by

the benefits under all the qualified retirement plans in the controlled group are identical.)

competitors. Either way, these employers would have operated at a competitive disadvantage.

To address this problem, Internal Revenue Code section 414(r) allows employers to test qualified separate lines of business ("QSLOB") separately. In other words, an employer may test its plans for nondiscrimination on a QSLOB basis rather than on an employer-wide basis. This enables the employer to vary benefits among its different business without failing the nondiscrimination tests.²³

[b] Mergers and Acquisitions

To provide temporary relief from the controlled group rules following a merger or acquisition, Internal Revenue Code section 410(b)(6)(C) provides a transition period that begins when the controlled group changes (i.e., because a member joins the controlled group or leaves the controlled group) and ends on the last day of the first plan year beginning after the change in the controlled group. During the transition period, a qualified retirement plan within the controlled group is treated as satisfying the nondiscrimination requirements if these requirements were met before the change in the controlled group and there is no significant change in the plan's coverage during the transition period.

[c] Nondiscrimination Testing Based on Average Benefits

Different qualified retirement plans with a controlled group are likely to have different benefit formulas and the coverage provided by those benefit formulas are likely to fail the coverage test (i.e., the percentage of nonhighly compensated employees is less 70% of the percentage of the highly compensated employees). To provide relief for potential relief for this situation, Internal Revenue Code section 410(b)(2) allows plans to be aggregated and tested for nondiscrimination on an average

²² This entire subsection technically could apply to affiliated service groups. In practice, an affiliated service group would take advantage of only average benefits testing.

benefits basis. To pass the average benefits test, average value of benefits for the nonhighly compensated employees must be at least 70% of the average values of the benefits for highly compensated employees. While not providing as much relief as the QSLOB rules, average benefits testing allows a controlled group to maintain qualified retirement plans with different benefit formulas to satisfy the nondiscrimination requirements, even if the plans are tested on an employer-wide basis.

§ 1.02 Controlled Groups

This section describes the controlled group rules for incorporated and unincorporated businesses. It also explains and illustrates the three types of controlled groups.

[1] Incorporated v. Unincorporated Businesses

The controlled group rules apply to incorporated and unincorporated businesses.²⁴ For incorporated businesses (i.e., corporations), the controlled group rules under IRC section 414(b) and its regulations²⁵ incorporate by reference IRC section 1563(a) and its regulation for controlled groups of corporations that existed before ERISA for other purposes.²⁶ For unincorporated businesses (e.g., sole proprietorships, partnerships or other trades and businesses), IRS had to create a new set of controlled group regulations²⁷ after ERISA under IRC section 414(c). However, because of the substantial similarity of the controlled group rules for incorporated and unincorporated business,²⁸ this

²³ See Chapter ___ for an in-depth discussion of the IRC section 414(r)'s rules for qualified separate lines of business.

²⁴ IRC § 414(b) as to corporations; IRC § 414(c) as to partnerships, proprietorships, and other non-corporate forms.

²⁵ Treas. Reg. § 1.414(b)-1.

²⁶ Enacted by the Revenue Act of 1964 [Pub. L. No. 88-272 (2/26/64)] with IRC section 1561, IRC section 1563(a) discourages medium and large businesses from fragmenting into multiple corporations to take advantage of lower tax rates that apply to small businesses.

²⁷ Treas. Reg. § 1.414(c)-1, -2, -3, -4, and -5.

²⁸ For example, Treas. Reg. section 1.414(c)-2(a) defines "two or more trades or businesses under common control" to mean any group of trades or businesses which is either a "parent-subsidary group of trades or businesses under common control," a "brother-sister group of trades or businesses under common control," or a "combined group of trades or businesses under common control."

chapter integrates the discussion of both sets of controlled group rules and uses the term organization²⁹ to mean a sole proprietorship, a partnership,³⁰ a trust, an estate, or a corporation.

[2] Three Types of Controlled Groups

There are three types of controlled groups:

- parent-subsidiary controlled group,
- brother-sister controlled group, or
- combined controlled group.

[a] Parent-Subsidiary Controlled Group

The “parent-subsidiary” controlled group³¹ is a group of organizations where one or more of the organizations owns at least an 80% interest in the other organizations within the group. Alternatively, the controlled group can consist of several layers where one organization owns at least 80% of another organization, which in turn owns at least 80% of a third organization.

Example 1: Organization A owns at least 80% of Organization B, Organization C, and Organization D. Organizations A, B, C, and D are members of a parent-subsidiary controlled group.

Example 2: Organization A owns at least 80% of Organization B, which owns at least 80% of Organization C, which owns at least 80% of Organization D. Organizations A, B, C, and D are members of a parent-subsidiary controlled group.

²⁹ Treas. Reg. § 1.414(c)-2(a).

³⁰ Partnership in this chapter has the same meaning as partnership as defined in IRC section 7701(a)(2).

³¹ IRC § 1563(a)(1); Treas. Reg. § 1.414(c)-2(b) and 1.1563-1(a)(2).

The 80% ownership interest is called a “controlling interest” in the regulations³² and is more precisely defined as follows:

- Corporation: ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote of such corporation or at least 80 percent of the total value of shares of all classes of stock of such corporation;
- Trust or estate: ownership of an actuarial interest of at least 80% of such trust or estate;
- Partnership: ownership of at least 80 percent of the profits interest or capital interest of such partnership; and
- Sole proprietorship: ownership of such sole proprietorship.

[b] Brother-Sister Controlled Group

A brother-sister controlled group is a bit more complex. In a brother-sister controlled group,³³ the same five or fewer persons³⁴ own³⁵ 50% or more of each organization in the group with the ownership of each person taken into account only to the extent it is identical with respect to each organization in the group and these persons together own at least 80% (i.e., a controlling interest³⁶) of each organization in a group of organizations. In addition, only persons with an ownership interest in each organization are taken into account.³⁷

The 50% ownership interest is called “effective control” in the regulations³⁸ and is defined the same way as “controlling interest” except “50% or more” is substituted for “at least 80%.”

³² Treas. Reg. § 1.414(c)-2(b)(2).

³³ IRC § 1563(a)(2); Treas. Reg. § 1.414(c)-2(c) and 1.1563-1(a)(3).

³⁴ Persons include individuals, estates, or trusts.

³⁵ The ownership can be direct or indirectly by attribution as discussed below.

³⁶ The controlling interest under the brother-sister controlled group rules has the same definition as under the parent-subsidiary controlled group rules.

³⁷ United States v. Vogel Fertilizer Co., 455 U.S. 16 (1982).

Example 1: The following table shows the ownership interests of three individuals in three organizations:

Owners	Org. X	Org. Y	Org. Z	Identical Interest
Mr. Smith	33 1/3%	50%	45%	33 1/3%
Mr. Brown	33 1/3%	25%	10%	10%
Mr. Jones	<u>33 1/3%</u>	<u>25%</u>	<u>45%</u>	<u>25%</u>
	100%	100%	100%	68 1/3%

Messrs. Smith, Brown, and Jones own 50% or more (i.e., 68 1/3%) of Organizations X, Y, and Z, when only their identical ownership in each organization is taken into account. Together, they also own at least 80% (i.e., 100%) of these organizations. Therefore, Organizations X, Y, and Z are a brother-sister controlled group.

Example 2: If the ownership interests in the above example changes slightly as shown below, Organizations A, B, C would not be a brother-sister controlled group:

Owners	Org. X	Org. Y	Org. Z	Identical Interest
Mr. Smith	33 1/3%	50%	50%	33 1/3%
Mr. Brown	33 1/3%	25%	50%	25%
Mr. Jones	<u>33 1/3%</u>	<u>25%</u>	<u>0%</u>	<u>0%</u>
	100%	100%	100%	58 1/3%

In this example, Mr. Jones' ownership interest in Organization X and Y are ignored

³⁸ Treas. Reg. § 1.414(c)-2(b)(2).

because Mr. Jones does not have an ownership interest in Organization Z. As result, the ownership table now looks as follows:

Owners	Org. X	Org. Y	Org. Z	Identical Interest
Mr. Smith	33 1/3%	50%	50%	33 1/3%
Mr. Brown	<u>33 1/3%</u>	<u>25%</u>	<u>50%</u>	<u>25%</u>
	66 2/3%	75%	100%	58 1/3%

Mr. Smith and Mr. Brown still own 50% or more (i.e., 58 1/3%) of Organizations X, Y, and Z, when only their identical ownership in each organization is taken into account. In addition, they still own at least 80% (i.e., 100%) of Organization Z. However, they no longer own at least 80% of Organizations X and Y (i.e., they own only 66 2/3% of Organization X and only 75% of Organization Y). Thus, Organizations X, Y, and Z are no longer members of a brother-sister controlled group.

However, Organizations X and Y are still members of a brother-sister controlled group based on the following ownership table:

Owners	Org. X	Org. Y	Identical Interest
Mr. Smith	33 1/3%	50%	33 1/3%
Mr. Brown	33 1/3%	25%	25%
Mr. Jones	<u>33 1/3%</u>	<u>25%</u>	<u>25%</u>
	100%	100%	83 1/3%

Messrs. Smith, Brown, and Jones own 50% or more (i.e., 83 1/3%) of Organizations X and Y, when only their identical ownership in each organization is taken into account. Together,

they also own at least 80% (i.e., 100%) of these organizations. Therefore, Organizations X and Y are a brother-sister controlled group.

[c] Combined Controlled Group

A combined controlled group is a combination of a brother-sister controlled group and a parent-subsidiary group. Technically, the controlled group³⁹ regulations define a combined group as any group of three or more organizations if:

- at least one of the organizations is the common parent organization of a parent-subsidiary group of trades or businesses under common control and a brother-sister group of trades or businesses under common control; and
- each organization in the group is a member of either a parent-subsidiary or brother-sister group of trades or businesses under common control.

Example: If Organization X in Example 2 of a brother-sister controlled group in the immediate prior subsection owned 100% of Organization A in the Example 1 of a parent-subsidiary controlled group, then Organizations X, Y, A, B, C, and D would be members of the same combined controlled group.

§ 1.03 Attributions Rules

This section describes the attribution rules that apply in determining whether a controlled group exists. It illustrates the impact of the attribution rules on the controlled group determination. The attribution rules generally increase the likelihood that a controlled group exists.

In determining ownership interests, the controlled group rules apply a set of attribution rules.⁴⁰ These rules attribute actual ownership from one person (e.g., wife) to another person (e.g., husband) who is deemed to have constructive ownership. In determining whether the ownership thresholds (e.g., 80%) under the controlled group rules are met, constructive ownership is treated the same as direct ownership. This next example illustrates the effect of the attribution rules. After the example, the attribution rules are described in more detail.

³⁹ IRC § 1563(a)(3); Treas. Reg. § 1.1563-1(a)(4).

⁴⁰ IRC § 1563(d) and (e); Treas. Reg. § 1.414(c)-4 and 1.1563-3.

Example: The following table shows the actual ownership interests of four individuals in three organizations:

Owners	Org. X	Org. Y	Org. Z	Identical Interest
Mr. Smith	33 1/3%	50%	45%	33 1/3%
Mr. Brown	33 1/3%	25%	45%	25%
Mr. Jones	33 1/3%	25%	0%	0%
Mrs. Jones	0%	0%	10%	0%
	100%	100%	100%	68 1/3%

If the brother-sister controlled rules were applied based on direct ownership interests, the ownership table would be revised as follows in determining whether Organizations X, Y, and Z are members of brother-sister controlled group:

Owners	Org. X	Org. Y	Org. Z	Identical Interest
Mr. Smith	33 1/3%	50%	45%	33 1/3%
Mr. Brown	<u>33 1/3%</u>	<u>25%</u>	<u>45%</u>	<u>25%</u>
	66 2/3%	75%	90%	58 1/3%

Mr. Smith and Mr. Brown still own 50% or more (i.e., 58 1/3%) of Organizations X, Y, and Z, when only their identical ownership in each organization is taken into account. In addition, they still own at least 80% (i.e., 90%) of Organization Z. However, they no longer own at least 80% of Organizations X and Y (i.e., they own only 66 2/3% of Organization X and only 75% of Organization Y). Thus, Organization A, B, and C are no longer members of a brother-sister controlled group.

Under the attribution rules, however, Mrs. Jones' 10% ownership interest in Organization Z is attributed to Mr. Jones. Mr. Jones' 10% constructive ownership is treated as a direct ownership interest under the controlled group rules. Thus, the ownership table is revised as follows:

Owners	Org. X	Org. Y	Org. Z	Identical Interest
Mr. Smith	33 1/3%	50%	45%	33 1/3%
Mr. Brown	33 1/3%	25%	45%	25%
Mr. Jones	<u>33 1/3%</u>	<u>25%</u>	<u>10%</u>	<u>10%</u>
	100%	100%	100%	78 1/3%

Based on this ownership table, Messrs. Smith, Brown, and Jones now own 50% or more (i.e., 78 1/3%) of Organizations X, Y, and Z, when only their identical ownership in each organization is taken into account. Together, they also own at least 80% (i.e., 100%) of these organizations. Therefore, Organizations X, Y, and Z are a brother-sister controlled group.

[1] Options

If a person has an option to acquire any outstanding interest in an organization, that interest is considered as owned by the person (including options to acquire options).

[2] Partnerships

An interest owned, directly or indirectly by attribution, by or for a partnership is considered as owned by any partner having an interest of 5 percent or more in either the profits or capital of the partnership in proportion to such partner's interest in the profits or capital, whichever such proportion is greater. For example, if A has a 25% profits interest in partnership ABC, and ABC owns 80% of the

stock of corporation Y, then A will, by attribution, be deemed to have a 20% interest in corporation Y (25% x 80%).

[3] Estates and Trusts

An interest in an organization owned, directly or indirectly by attribution, by or for an estate or trust is considered as owned by any beneficiary of the estate or trust who has an actuarial interest of 5 percent or more in such estate or trust, to the extent of such actuarial interest. The actuarial interest of each beneficiary is determined by assuming the maximum exercise of discretion in favor of a beneficiary and the maximum use of the organization interest to satisfy the beneficiary's rights. An interest owned, directly or indirectly, by or for any portion of a trust of which a person is considered the owner (a "grantor trust") is considered as owned by such person.

[4] Corporations

An interest owned, directly or indirectly by attribution, by or for a corporation is considered as owned by any person who owns 5 percent or more in value of the stock in the same proportion that the value of that person's stock in the corporation bears to the total value of all the stock in such corporation. For example, if corporation X has one class of stock and B owns 25% of such stock, and corporation X owns 80% of corporation Y's only outstanding class of stock, then B will, by attribution, be deemed to own 20% of corporation Y (25% x 80%).

[5] Spouse

An individual is considered to own an interest owned, directly or indirectly by attribution, by or for his or her spouse, other than a spouse who is legally separated from the individual under a decree

of divorce or a decree of separate maintenance, unless all of the following conditions are satisfied:

- The individual does not, at any time during such taxable year, own directly any interest in such organization;
- The individual is not a member of the board of directors, a fiduciary, or an employee of such organization and does not participate in the management of such organization at any time during such taxable year;
- Not more than 50 percent of the organization's gross income for the taxable year was derived from royalties, rents, dividends, interest, and annuities; and
- The interest in the organization is not, at any time during the taxable year, subject to conditions which substantially restrict or limit the spouse's right to dispose of such interest and which run in favor of the individual or the individual's children who have not attained the age of 21 years.

[6] Children, Grandchildren, Parents, And Grandparents

An individual is considered to own an interest owned, directly or indirectly by attribution, by or for the individual's children who have not attained 21 years of age, and if the individual has not attained 21 years of age, an interest owned, directly or indirectly, by or for the individual's parents. If an individual is in effective control (i.e., 50% or more ownership interest), directly or indirectly, of an organization, then the individual is considered to own the interest in such organization owned, directly or indirectly, by or for the individual's parents, grandparents, grandchildren, and children who have attained the age of 21 years.

[7] Special Attribution Rules

[a] Option attribution prevails over other forms of attribution

If an interest may be considered as owned under both option attribution and any other attribution rule, then such interest is considered as owned by such person through option attribution.⁴¹

[b] Constructive ownership through family attribution does not pass through

An interest indirectly owned by an individual through attribution from the spouse or child/parent/grandchild/grandparent rules is not treated as owned by that individual to make another the constructive owner of such interest.⁴²

[c] Constructive ownership results in membership in one controlled group

If an interest is owned by two or more persons (e.g., one by direct ownership and another by constructive ownership through attribution), the interest is considered as owned by the person whose ownership of the interest results in the organization being a component member of a controlled group. If this rule would cause an organization to become a component member of two controlled groups, it is treated as a component member of one controlled group.⁴³ The determination as to which controlled group exists is made as follows:⁴⁴

⁴¹ IRC § 1563(f)(3)(A); Treas. Reg. § 1.414(c)-4(c)(3) and 1.1563-3(c)(3).

⁴² Treas. Reg. § 1.414(c)-4(c) and 1.1563-3(c)(2).

⁴³ IRC § 1563(f)(3)(B); Treas. Reg. § 1.1563-3(d).

⁴⁴ Treas. Reg. § 1.1563-3(d)(2).

[i] Direct prevails over indirect constructive ownership

If an organization would be a member of one controlled group by treating each interest as owned only by the person who owns the interest directly, then the interest will be treated as owned by the person who owns the interest directly.

[ii] Greatest ownership interest prevails over lesser interest

If applying [i] does not result in the organization being treated as a member of only one controlled group, then the interest will be treated as owned by the person who owns the greatest percentage interest directly and indirectly by attribution of options, partnerships, estates and trusts, and corporations.

**[iii] Organization or IRS will make decision if applying other rules is
inconclusive**

If applying (i) or (ii) does not result in the organization being treated as a member of only one controlled group, then the organization may file an election or, in the absence of such an election, the district director with audit jurisdiction will decide.

**[iv] Constructively owned stock cannot be treated as excluded stock in
certain situations**

If stock is indirectly owned by a person through attribution and that constructive ownership results in the corporation being a component member of a controlled group, the stock is not treated as

excluded stock if the result of treating the stock as excluded stock would prevent that corporation from being a component member of a controlled group.⁴⁵

§ 1.04 Excluded Stock Rules

This section explains the excluded stock rules that apply in determining whether a controlled group exists. Generally, the excluded stock rules decrease the likelihood that a controlled group exists.

An interest in stock is treated as not outstanding stock for purposes of determining control⁴⁶ if the stock is:

- nonvoting stock that is limited and preferred as to dividends;
- treasury stock (stock that is authorized but has not been issued); and
- “excluded stock”.

The definition of “excluded stock” varies slightly depending upon whether the determination involves a parent-subsiary, brother-sister controlled group, or combined group.

[1] Excluded Stock For Parent-Subsidiary Controlled Group⁴⁷

If an organization directly owns, or indirectly owns through attribution, interests in the following entities:

- Corporation: 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 shares of all classes of

⁴⁵ IRC § 1563(f)(3)(C).

⁴⁶ IRC § 1563(c); also see Treas. Reg. § 1.414(c)-3 and 1.1563-2(a) and (b).

stock of such corporation;

- Trust or estate: an actuarial interest of 50% or more of such trust or estate;
- Partnership: 50 percent or more of the profits interest or capital interest of such partnership;

then for purposes of determining whether the parent organization and/or subsidiary organization are members of a parent-subsidary group of trades or businesses under common control, the following interests in the subsidiary organizations are excluded (treated as not outstanding):

- Plan of deferred compensation: an interest in or stock of the subsidiary organization held by a trust which is part of a plan of deferred compensation (whether or not described in IRC section 401(a) or 403(a)⁴⁸) for the benefit of the employees of the parent organization or the subsidiary organization.
- Principal owners, officers, etc.: an interest which is an interest in or stock of the subsidiary organization owned by an individual who is a principal owner, officer, partner, or fiduciary of the parent organization. A "principal owner" means a 5% or more owner.
- Employees: an interest which is an interest in or stock of the subsidiary organization owned by an employee of the subsidiary organization if such interest or such stock is subject to conditions which substantially restrict or limit the employee's right (or if the employee constructively owns such interest or such stock, the direct or record owner's right) to dispose of such interest or such stock and which run in favor of the parent or subsidiary organization.
- Controlled exempt organization: an interest which is an interest in or stock of the subsidiary organization if owned by an organization (other than the parent organization):
 - To which IRC section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies, and

⁴⁷ IRC § 1563(c)(2)(A); Treas. Reg. § 1.414(c)-3(b) and 1.1563-2(b)(1) and (2).

- Which is controlled directly or indirectly by the parent organization or subsidiary organization, by an individual, estate, or trust that is a principal owner of the parent organization, by an officer, partner, or fiduciary of the parent organization, or by any combination thereof.

[2] Excluded Stock For Brother-Sister Controlled Group⁴⁹

If five or fewer persons who are individuals, estates, or trusts directly owns, or constructively owns through attribution, interests in the following entities:

- Corporation: 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 shares of all classes of stock of such corporation;
- Trust or estate: an actuarial interest of 50% or more of such trust or estate;
- Partnership: 50 percent or more of the profits interest or capital interest of such partnership;

then for purposes of determining whether such organization is a member of a brother-sister group of trades or businesses under common control, the following interests in such organization are excluded (treated as not outstanding):

- Exempt employees' trust: an interest in or stock of such organization held by an employees' trust described in IRC section 401(a) which is exempt from tax under IRC section 501(a) if such trust is for the benefit of the employees of such organization.
- Employees: an interest which is an interest in or stock of such organization owned by an employee of such organization if such interest or such stock is

⁴⁸ Treas. Reg. § 1.414(c)-3(b)(3) and 1.1563-2(b)(2)(i).

subject to conditions which substantially restrict or limit the employee's right (or if the employee constructively owns such interest or such stock, the direct or record owner's right) to dispose of such interest or such stock and which run in favor of such organization.

- Controlled exempt organization: an interest which is an interest in or stock of such organization if owned by an organization:
 - To which IRC section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies, and
 - Which is controlled directly or indirectly by such organization, by an individual, estate, or trust that is a principal owner of such organization, by an officer, partner, or fiduciary of such organization, or by any combination thereof.

[3] Excluded Stock For Combined Group⁵⁰

The rules that apply to parent-subsidiary and brother-sister controlled groups apply equally to combined groups.

§ 1.05 Tax-Exempt Organizations

This section explains how the controlled group rules apply to tax-exempt organizations that have no ownership interests. In lieu of ownership interests, these rules focus on the power to replace directors on the tax-exempt organization's board of directors.

Although tax-exempt organizations generally have no ownership interests, the controlled group

⁴⁹ IRC § 1563(c)(2)(B); Treas. Reg. § 1.414(c)-3(c) and 1.1563-2(c)(3) and (4).

rules apply to IRC section 501(c)(3) charitable organizations and other tax-exempt organizations under IRC section 501(a),⁵¹ including civic and business leagues, social clubs, fraternal societies, and credit unions.⁵² The controlled group regulations for tax-exempt organizations have four main parts:

- General rule: mandatory aggregation
- Permissive aggregation:
- Permissive disaggregation
- Anti-abuse rule

[1] General Rule: Mandatory Aggregation⁵³

In the case of a tax-exempt organization whose employees participate in a plan, the employer with respect to that plan includes the tax-exempt organization and any other organization that is under common control. Common control exists between two tax-exempt organizations if at least 80% of the directors or trustees of one of the tax-exempt organizations are either representatives of, or are controlled directly or indirectly by, the other tax-exempt organization. A trustee or director of a tax-exempt organization is a representative of another organization if the director is a trustee, director, agent or employee of the other organization. A trustee or director of a tax-exempt organization is controlled by another organization if the other organization has the power to remove that director and designate another trustee or director. Other facts and circumstances might indicate control.

⁵⁰ Treas. Reg. § 1.1563-2(b)(5).

⁵¹ As explained in more detail below, however, these regulations do not apply to certain church entities or to government organizations (including public schools).

⁵² Treas. Reg. § 1.414(c)-5. These relatively recent final regulations were published at 72 Federal Register 41128, 41158 (July 26, 2007). The regulations are generally effective for taxable years beginning after December 31, 2008. Note that former Treas. Reg. § 1.414(c)-5 was redesignated as Treas. Reg. § 1.414(c)-6.

⁵³ Treas. Reg. § 1.414(c)-5(b). This incorporates the guidance provided in General Council Memorandum 39616 in which the IRS indicated that for nonstock tax-exempt entities a controlling interest in such an entity will exist if at least 80% of the directors or trustees of such organization are either representatives of or directly controlled by another entity.

[2] Permissive Aggregation

Tax-exempt organizations that maintain a single plan covering one or more employees from each organization may treat themselves as under common control if each of the organizations regularly coordinates their day-by-day exempt activities. For example, a hospital that is a tax-exempt organization and another tax-exempt organization with which it coordinates medical services may treat themselves as under common control if there is a single plan covering employees of the hospital and employees of the other tax-exempt organization and the coordination is a regular part of their day-to-day exempt activities.

[3] Permissive Aggregation

A church plan (defined in IRC section 414(e)) to which contributions are made by more than one common law entity may apply the mandatory and permissive aggregation provisions to those entities that are not a church separately from those entities that are churches.

[4] "Anti-Abuse Rule"

The IRS may treat two entities (at least one of which is tax-exempt) as being under common control if the structure of those entities is designed to avoid or evade common control treatment.

[5] Church and Governmental Organizations

[a] Exclusion from Controlled Group Regulations

The above controlled group rules for tax-exempt organization generally do not apply to certain church entities or government organizations. They may continue to rely on IRS Notice 89-23 for determining controlled group status.⁵⁴

[b] IRS Notice 89-23

IRS Notice 89-23 states that for purposes of the nondiscrimination rules applicable to tax sheltered annuities under Section 403(b), the controlled group of a not-for-profit entity includes each entity of which at least 80% of the directors, trustees or other individual members of the entity's governing body are either representatives of or directly or indirectly control, or are controlled by, the contributing employer. In addition, an entity is included in a controlled group if such entity provides directly or indirectly at least 80% of the contributing employer's operating funds and there is a degree of common management or supervision between the entities. A degree of common management or supervision exists if the entity providing the funds has the power to appoint or nominate officers, senior management or members of the board of directors (or other governing board) of the entity receiving the funds. A degree of common management or supervision also exists if the entity providing the funds is involved in the day-to-day operations of the entity.

⁵⁴ Preamble to Treas. Reg. §1.414(c)-5 at 72 Federal Register 41128, 41138 (July 26, 2007).

§ 1.06 Definitions

This section defines the key terms used in the controlled group rules: employee, principal owner, officer, substantial conditions, and component member.

The terms used in the prior sections have the following meanings:

[1] Employee

“Employee” means any officer of a corporation or any common law employee (for purposes of the Federal Unemployment Tax Act).⁵⁵

[2] Principal owner

“Principal owner” means a person who owns directly or indirectly:

- Corporation: 5 percent or more of the total combined voting power of all classes of stock entitled to vote in such corporation or 5 percent or more of the total value of shares of all classes of stock of such corporation;
- Trust or estate: an actuarial interest of 5 percent or more of such trust or estate;
or
- Partnership: 5 percent or more of the profits or capital interest of such partnership.⁵⁶

⁵⁵ IRC § 1563(f)(1); Treas. Reg. § 1.414(c)-3(d)(1) and 1.1563-2(c)(6).

⁵⁶ Treas. Reg. § 1.414(c)-3(d)(2).

[3] Officer

“Officer” includes the president, vice-president(s), general manager, treasurer, secretary, and comptroller of a corporation, and any other person who performs duties corresponding to those normally performed by persons occupying such positions.⁵⁷

[4] Substantial Conditions

Any legally enforceable condition which prohibits the direct or record owner from disposing of his or her interest or stock without the consent of another person, such as a right of first refusal, will be considered to be a substantial limitation running in favor of such person. It is not necessary that such person be extended a discriminatory concession with respect to price.

With respect to a brother-sister group, if a condition which restricts or limits an employee's right (or direct or record owner's right) to dispose of his or her interest or stock also applies to the interest or stock in such organization held by a common owner pursuant to a bona fide reciprocal purchase arrangement, such condition is not treated as a substantial limitation or restriction. Example: an agreement whereby a common owner and the employee are given a right of first refusal with respect to stock of the employer corporation owned by the other party.

[5] Component Member

An organization is a component member⁵⁸ of a controlled group on December 31⁵⁹ (and with respect to the taxable year which includes such December 31) if such organization:

⁵⁷ Treas. Reg. § 1.414(c)-3(d)(2).

⁵⁸ IRC § 1563(b); Treas. Reg. § 1.1563-1(b).

⁵⁹ IRC § 1563(b)(1); Treas. Reg. § 1.1563-1(b)(1).

- Is a member of such controlled group on such December 31 and is not an “excluded member”, or
- Is not a member of such controlled group on such December 31 but is treated as an “additional member”.

[a] Excluded Member

An organization that is a member of a controlled group on December 31 of any taxable year will be an “excluded member”⁶⁰ of such group for such taxable year if the organization:

- was a member of such group for less than one-half of the number of days in the taxable year that precedes such December 31;
- is exempt from taxation under IRC section 501(a) (except a corporation which is subject to tax on its unrelated business taxable income under IRC section 511) for such taxable year;
- is a foreign corporation subject to tax under IRC section 881 for the taxable year;
- is a franchised corporation (see section 3.a below); or
- is an insurance company subject to taxation under IRC section 802 (other than an insurance company which is a member of a controlled group – see section 3.b below).

[b] Excluded Franchised Corporation

A franchised corporation⁶¹ is an excluded member of a controlled group for a taxable year if:

- a parent organization or a common owner of an organization which is a member of a controlled group is under a duty to sell stock of such corporation which is franchised to

⁶⁰ IRC § 1563(b)(2); Treas. Reg. § 1.1563-1(b)(2).

⁶¹ IRC § 1563(f)(4); Treas. Reg. § 1.1563-4.

- sell the products of another member, or the common owner, of such controlled group;
- such stock is to be sold to an employee (or employees) of such franchised corporation pursuant to a bona fide plan designed to eliminate the stock ownership of the parent organization or of the common owner in the franchised corporation;
 - such plan—
 - provides a reasonable selling price for such stock, and
 - requires that a portion of the employee's share of the profits of such corporation be applied to the purchase of such stock or against other indebtedness;
 - the employee (or employees) owns directly more than 20 percent of the total value of shares of all classes of stock in such franchised corporation;
 - more than 50 percent of the inventory of such franchised corporation is acquired from members of the controlled group, the common owner, or both; and
 - all of the previously listed conditions have been met for one-half (or more) of the number of days preceding the December 31 included within the taxable year of the franchised corporation.

[c] Excluded Insurance Controlled Group

Special rules apply to insurance companies subject to taxation under section 802. If two or more insurance companies are each members of a controlled group, they will be treated as excluded⁶² members for purposes of that controlled group and will be members of their own controlled group, separate from any other organizations, with the common parent referred to as the common parent of the insurance group.⁶³

⁶² IRC § 1563(a)(4); Treas. Reg. § 1.1563-1(a)(5).

⁶³ Treas. Reg. § 1.1563-2(b)(5).

[d] Additional Member

Unless an organization is an excluded member, an organization which is not a member of a controlled group on the December 31 included within its taxable year but which was a member of such group for one-half (or more) of the number of days in the taxable year which precedes such December 31 is an "additional member"⁶⁴ of such group on such December 31.

[e] Day by Day Determination

These component member rules are applied on a day by day basis.⁶⁵ This means that for purposes of determining whether an excluded member was a member of such group for less than one-half the number of days in the taxable year that precedes December 31 and whether an additional member is a member of such group for one-half (or more) of the number of days in the taxable year which precedes such December 31, actual dates should be used.

[f] Overlapping Group

An organization may be a member of only one controlled group⁶⁶ for a taxable year. The general guidelines to determine which controlled group are as follows:

- Parent-subsidiary controlled group. If a corporation is a component member of a controlled group by reason of ownership of stock possessing at least 80 percent of the total value of shares of all classes of stock of the corporation, and if such corporation is also a component member of another controlled group of corporations by reason of

⁶⁴ IRC § 1563(b)(3); Treas. Reg. § 1.1563-1(b)(3).

⁶⁵ Treas. Reg. § 1.1563-1(b)(5).

⁶⁶ IRC § 1563(b)(4); Treas. Reg. § 1.1563-1(c).

ownership of other stock (that is, stock not used to satisfy the at-least-80-percent total value test) possessing at least 80 percent of the total combined voting power of all classes of stock of the corporation entitled to vote, then such corporation shall be treated as a component member only of the controlled group of which it is a component member by reason of the ownership of at least 80 percent of the total value of its shares.

- Brother-sister controlled groups. An organization that would be a component member of more than one brother-sister controlled group may designate which group in which it is to be included by filing a statement with the Internal Revenue Service. Once filed, the election is irrevocable and effective until a change in the ownership of the organization results in termination of membership in the controlled group in which such organization has been included. If no election is filed, then the district director with audit jurisdiction of such organization's return for the taxable year will determine the group in which such corporation is to be included, and such determination shall be binding for all subsequent years unless the corporation filed a valid election with respect to any such subsequent year.

§ 1.07 Affiliated Service Groups

This section explains the affiliated service group rules. It also defines the key terms used in the affiliated service group rules: affiliated service group, organization, service organizations, A organization, B organization, multiple affiliated service groups, and management affiliated service group.

[1] General Rule

Members of an affiliated service group are treated as a single employer for purposes of applying certain employee benefit requirements.⁶⁷ The applicable requirements include.⁶⁸

- minimum participation requirements;⁶⁹
- nondiscrimination rules;⁷⁰
- minimum vesting standards;⁷¹
- limitations on benefits and contributions;⁷²
- compensation limits;⁷³
- top-heavy rules;⁷⁴ and
- simplified employee pension and simple retirement accounts rules.⁷⁵

As explained in greater detail below, there are two forms of an affiliated service group. Both

⁶⁷ IRC § 414(m).

⁶⁸ IRC § 414(m)(4); Prop. Reg. § 1.414(m)-3(a). Note that only proposed regulations have been issued under IRC § 414(m). The preamble to the Proposed Regulations, published on February 15, 1983, states that the Proposed Regulations may be relied upon by taxpayers pending adoption of final regulations, and that any provisions of final regulations that are less favorable to taxpayers will not be applied retroactively. No final regulations have been issued.

⁶⁹ IRC § 401(a)(3), 401(a)(26), and 410.

⁷⁰ IRC § 401(a)(4).

⁷¹ IRC § 401(a)(7) and 411.

⁷² IRC § 401(a)(16) and 415.

⁷³ IRC § 401(a)(17).

⁷⁴ IRC § 416.

forms are built around a so-called "First Service Organization" (e.g., medical clinic) that has primary responsibility for dealing with the clients of the affiliated service group.

In the first form, the professional works for a so-called "A-Organization" and the nonprofessionals work for the First Service Organization. For example, a doctor is regularly associated with a medical clinic in performing services for its clients or performs services for the medical clinic. The A Organization employing the doctor must have an ownership interest in the medical clinic. However, there is no minimum ownership interest requirement.

In the second form, the professional works for the First Service Organization and the nonprofessionals work for a so-called "B Organization." For example, nonprofessionals perform a significant portion of their services for a medical clinic but are employed directly by a separate B Organization. These nonprofessional services are of a type typically performed by employees working directly for a medical clinic. The medical clinic employing the doctor must have a 10% or more ownership interest in the B Organization employing the nonprofessionals.

[2] Special Rules

[a] Discrimination

In testing for discrimination under IRC section 401(a)(4) (requiring that contributions or benefits do not discriminate in favor of employees who are officers, shareholders, or highly compensated), all of the compensation paid to an employee must be considered in determining the contributions or benefits under a plan maintained by a member of an affiliated service group, without regard to the percentage of the organization employing the individual owned by the member maintaining the plan.

⁷⁵ IRC § 408(k) (simplified employee pension) and 408(p) (simple retirement accounts).

[b] Self-Employed Individuals⁷⁶

If a plan maintained by a member of an affiliated service group covers self-employed individual (under IRC section 401(c)(1)), an owner-employee (under IRC section 401(c)(3)), or a shareholder-employee (under IRC section 1379(d)), the plan must also satisfy the following requirements to the extent they apply even though that individual is not employed by the member of the affiliated service group maintaining the plan:

- Section 401(a)(9) (relating to distribution requirements for plans benefiting self-employed individuals);
- Section 401(a)(10) (relating to contribution limitations for plans benefiting owner-employees); and
- Section 401(a)(17) (relating to a limitation on the compensation base of plans benefiting self-employed individuals or shareholder-employees).

These requirements apply only if the earned income of the self-employed individual or owner-employee or the compensation received as a shareholder-employee is taken into account in computing contributions or benefits under the plan.

[c] Multiple Employer Plan⁷⁷

If a plan maintained by a member of an affiliated service group covers an individual who is not an employee of that member, but who is an employee of another member of that affiliated service group, the plan will be considered to be maintained by the member that does employ that individual. A member of an affiliated service group may deduct contributions on behalf of individuals who are not

⁷⁶ Prop. Reg. § 1.414(m)-3(b).

employees of that member, if the individuals are employed by another member of that affiliated service group. This rule does not apply as to a controlled group of corporations (under IRC section 414(b)) or a group of trades or businesses under common control (under IRC section 414(c)).

[3] Definitions

[a] Affiliated Service Group

An “affiliated service group”⁷⁸ is a group consisting of a service organization (referred to as a “First Service Organization”) and:

- one or more “A Organizations” (described below), or
- one or more “B Organizations” (described below), or
- one or more A Organizations and B Organizations.

[b] Organization

The term “organization”⁷⁹ includes a corporation, partnership, sole proprietorship, or any other type of entity regardless of its ownership format. Note that businesses with a bona fide expense-sharing arrangement in which the parties involved share the cost of office overhead but are not working in unison for common business purposes would not be considered an organization. Such costs include rent, supplies, maintenance, and salaries.

⁷⁷ Prop. Reg. § 1.414(m)-3(c).

⁷⁸ IRC § 414(m)(2); Prop. Reg. § 1.414(m)-2(a).

⁷⁹ IRC § 414(m)(6)(A); Prop. Reg. § 1.414(m)-2(e).

[c] Service Organization

An organization is a service organization⁸⁰ if the principal business of such organization is the performance of services.

[i] Non-capital intensive organizations⁸¹

The principal business of an organization will be considered the performance of services if capital is not a material income-producing factor for the organization. The following general guidelines apply:

- Determined based on facts and circumstances.
- 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 (substantial investment in inventories, plant, machinery, or other equipment).
- 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.
- Capital is a material income-producing factor for banks and similar institutions (specific rule).

⁸⁰ IRC § 414(m)(3); Prop. Reg. § 1.414(m)-2(f).

⁸¹ Prop. Reg. § 1.414(m)-2(f)(1).

[ii] Specific Fields⁸²

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.

An organization will not be considered to be performing services merely because it is engaged in the manufacture or sale of equipment or supplies used in the above fields, or merely because it is engaged in performing research or publishing in the above fields.

An organization will not be considered to be a service organization merely because an employee provides one of the enumerated services to the organization or to other employees of the organization unless the organization is also engaged in the performance of the same services for third parties.

⁸² Prop. Reg. § 1.414(m)-2(f)(2); also see Prop. Reg. § 1.414(m)-1(c).

[iii] Other Organizations

Organizations engaged in performing services not described in a. and b. above are not considered service organizations.

[iv] Professional Service Organizations

A professional service corporation is the only form of corporation that will be treated as a First Service Organization for purposes of the A-Organization test.⁸³ A "professional service corporation" is a corporation that is organized under state law for the principal purpose of providing professional services and has at least one shareholder who is licensed or otherwise legally authorized to render the type of services for which the corporation is organized. "Professional services" means the services performed by certified or other public accountants, actuaries, architects, attorneys, chiropractors, chiropractors, medical doctors, dentists, professional engineers, optometrists, osteopaths, podiatrists, psychologists, and veterinarians.

[v] Exempt Organizations

The Commissioner may determine that certain organizations, or types of organizations, should not be subject to IRC section 414(m), even though the organizations would otherwise meet the above requirements.

⁸³ Prop. Reg. § 1.414(m)-1(b).

[d] A Organizations⁸⁴

An organization is an A Organization if it:

- is a service organization, and
- is a shareholder or partner in the First Service Organization (regardless of the percentage interest it owns in the First Service Organization but determined with regard to the constructive ownership rules) (the “ownership test”), and
- regularly performs services for the First Service Organization or is regularly associated with the First Service Organization in performing services for third persons (the “working relationship test”).

It is not necessary that any of the employees of the organization directly perform services for the First Service Organization; it is sufficient that the organization is regularly associated with the First Service Organization in performing services for third persons. A facts and circumstances test applies to the determination of whether a service organization regularly performs services for the First Service Organization or is regularly associated with the First Service Organization in performing services for third persons.

[e] B Organizations⁸⁵

Unlike an A Organization, a B Organization need not be a service organization. An organization is a B Organization if:

- A significant portion of the business of the organization is the performance of services for the First Service Organization, for one or more A Organizations determined with

⁸⁴ Prop. Reg. § 1.414(m)-2(b).

respect to the First Service Organization, or for both.

- Those services are of a type historically performed by employees in the service field of the First Service Organization or the A Organizations, and
- Ten percent or more of the interests in the organization is held, in the aggregate, by persons who are designated group members of the First Service Organization or of the A Organizations, determined using constructive ownership rules.

[i] Significant Portion

Certain tests apply for determining whether providing services for the First Service Organization, for one or more A Organizations, or for both, is a significant portion of the business of an organization. "One or more A organizations" means one or more A organizations determined with respect to the First Service Organization.⁸⁶

- General Rule: A facts and circumstances test applies for determining whether providing services for the First Service Organization, for one or more A Organizations, or for both, is a significant portion of the business of an organization.
- Service Receipts safe harbor. The performance of services for the First Service Organizations, for one or more A Organizations, or for both, will not be considered a significant portion of the business of an organization if the Service Receipts Percentage is less than five percent.

The Service Receipts Percentage is the ratio of the gross receipts of the organization derived from performing services for the First Service Organization, for one or more A Organizations, or for both, to the total gross receipts of the organization derived from performing services. This ratio is the greater of the ratio for the year for which the

⁸⁵ Prop. Reg. § 1.414(m)-2(c).

determination is being made or for the three year period including that year and the two preceding years (or the period of the organization's existence, if less).

- Total Receipts threshold test. The performance of services for the First Service Organization, for one or more A Organizations, or for both, will be considered a significant portion of the business of an organization if the Total Receipts Percentage is ten percent or more.

The Total Receipts Percentage is calculated in the same manner as the Service Receipts Percentage, except that gross receipts in the denominator are determined without regard to whether they were derived from performing services.

[ii] Historically Performed

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, 1980⁸⁷.

[iii] Designated Group

“Designated group” members are the officers, the highly compensated employees, and the common owners of an organization. A person who is an owner of a First Service Organization or of an A Organization is a “common owner” if at least three percent of the interests in the organization is, in the aggregate, held by persons who are owners of the potential B organization (determined using the

⁸⁶ Prop. Reg. § 1.414(m)-2(c)(i).

⁸⁷ Note that the proposed regulations were issued in 1983, and what was considered “historically performed” at that time might not be the same as now.

constructive ownership rules). The term "owner" includes a corporation, partnership, sole proprietorship, or any other type of entity regardless of its ownership format.

Even though a person is not a common owner, the interests the person holds in the potential B Organization will be taken into account if the person is an officer or a highly compensated employee of the First Service Organization or of an A Organization.

[iv] Aggregation of Ownership Interests

It is not necessary that a single designated group member of the First Service Organization or of an A Organization own ten percent or more of the interests, determined using the constructive ownership rules described below, in the organization for the organization to be a B Organization. It is sufficient that the sum of the interests, determined using the constructive ownership rules, held by all of the designated group members of the First Service Organization, and the designated group members of the A Organizations, is ten percent or more of the interests in the organizations.

[f] Multiple Affiliated Service Group⁸⁸

[i] Multiple First Service Organization

An organization that is an A Organization or a B Organization with respect to multiple First Service Organizations will be part of an affiliated service group with respect to each First Service Organization, but each such affiliated service group does not have to be aggregated into a single affiliated service group.

⁸⁸ Prop. Reg. § 1.414(m)-2(g).

Example: Corporation S provides secretarial services to five lawyers, each of whom has a 20% interest in Corporation S and each of whom accounts for 20% of its gross receipts. Each lawyer is a First Service Organization with respect to corporation S, which is a B Organization with respect to each lawyer because 20 percent of the gross receipts of the corporation are derived from performing services for each lawyer of a type historically performed by employees of lawyers, and each lawyer owns 20 percent of the interests in the corporation. Each lawyer and the corporation constitutes a separate affiliated service group, however each such group stands alone and does not have to include the other lawyers.

[ii] Multiple A or B Organizations

If an organization is a First Service Organization with respect to two or more A Organizations or two or more B Organizations, or both, then all of the organizations constitute a single affiliated service group.

Example: Corporation S provides secretarial services to a lawyer who has a 20% interest in Corporation S and who accounts for 20% of its gross receipts. Corporation R provides transcription services to a lawyer who has a 20% interest in Corporation R and who accounts for 20% of its gross receipts. The lawyer is a First Service Organization with respect to each corporation, and each corporation is a B Organization with respect to the lawyer because 20 percent of the gross receipts of each corporation are derived from performing services for the lawyer of a type historically performed by employees of lawyers, and the lawyer owns 20 percent of the interests in each corporation. The lawyer and both corporations constitute a single affiliated service group.

[g] Ownership.⁸⁹

[i] Qualified Plans

An individual's interest under a plan that qualifies under IRC section 401(a) will be taken into account.

[ii] Constructive Ownership

Stock or partnership interests constructively owned by a person are treated as actually owned by such person, but stock or partnership interests constructively owned by an individual are not to be treated as owned by him for the purpose of making another the constructive owner of such stock or partnership interests. The principles of constructive ownership that apply to stock and partnership interests are as follows:⁹⁰

- Members of family. An individual shall be considered as owning the stock or partnership interests owned, directly or indirectly, by or for his spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance), and his children, grandchildren, and parents.

Note: There is no attribution between siblings or from grandparent to grandchild.

- Partnerships and estates.
 - Stock or partnership interests owned, directly or indirectly, by or for a partnership or estate are considered owned proportionately by its partners or beneficiaries.
 - Stock owned, directly or indirectly, by or for a partner or a beneficiary of an estate

⁸⁹ IRC § 414(m)(6)(B); Prop. Reg. § 1.414(m)-2(d).

⁹⁰ IRC § 318(a); see also Prop. Reg. § 1.414(m)-2(d)(3) (before the reference in IRC § 414(m)(6)(B) was changed from IRC § 267(c) to IRC § 318(a)).

shall be considered as owned by the partnership or estate.

- Trusts.

- Stock or partnership interests owned, directly or indirectly, by or for a trust (other than an employees' trust described in section 401(a) which is exempt from tax under section 501(a)) are considered owned by its beneficiaries in proportion to the actuarial interest of such persons in such trust. Stock or partnership interests owned directly or indirectly by or for any portion of a trust of which any person is considered the owner (i.e., the trust's grantor) shall be considered constructively owned by such person).
- Stock or partnership interests owned directly or indirectly, by or for a beneficiary of a trust (other than an employees' trust described in section 401(a) which is exempt from tax under section 501(a)) are considered owned by the trust, unless such beneficiary's or grantor's interest in the trust is a remote contingent interest (i.e., an actuarial interest of 5 percent or less of the value of the trust property). Stock or partnership interests owned, directly or indirectly, by or for the owner of any portion of a trust are considered owned by the trust.

- Corporations.

- If 50 percent or more in value of the stock in a corporation⁹¹ is owned, directly or indirectly, by or for any person, such person shall be considered as owning the stock owned, directly or indirectly, by or for such corporation, in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation.
- If 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person.

⁹¹ An S Corporation is treated as a partnership.

- Options. If any person has an option to acquire stock, such stock shall be considered as owned by such person. For purposes of this paragraph, an option to acquire such an option, and each one of a series of such options, shall be considered as an option to acquire such stock.

[h] Management Affiliated Service Group⁹²

The term “affiliated service group” also includes a “Management Affiliated Service Group” consisting of:

- an organization the principal business of which is performing, on a regular and continuing basis, management functions for one organization (or for one organization and other organizations related to such one organization), and
- the organization (and related organizations) for which such functions are so performed by such organization.

[i] Related Organizations

“Related organizations” has the same meaning as the term “related persons” when used in IRC section 144(a)(3), which includes the attribution rules of IRC sections 267 and 1563(a).

[ii] Special Attribution Rules

The attribution rules that apply to Management Affiliated Service Groups are somewhat different than the rules that apply to A- and B-Organization Affiliated Service Groups. These attribution

⁹² IRC § 414(m)(5). Note that the only regulations issued with respect to Management Affiliated Service Groups were withdrawn. Under such withdrawn proposed regulations, “management functions” include determining, implementing,

rules apply to:⁹³

- An individual is considered as owning the stock or partnership interests owned, directly or indirectly, by or for his spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance), and his brothers and sisters (whether by the whole or half blood), ancestors, lineal descendants;
- Stock or partnership interests owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries;
- An individual owning any stock in a corporation or interest in a partnership shall be considered as owning the stock or partnership interests owned, directly or indirectly, by or for his partner; and
- Stock or partnership interests constructively owned by a person are treated as actually owned by such person, but stock or partnership interests constructively owned by an individual are not to be treated as owned by him for the purpose of making another the constructive owner of such stock or partnership interests.

or supervising daily business operations, long-term planning, personnel matters or employee benefit functions.

Moreover, any professional service, such as medical service, may be treated as a management activity.

⁹³ IRC § 318(a); see also Prop. Reg. § 1.414(m)-2(d)(3) (before the reference in IRC § 414(m)(6)(B) was changed from IRC § 267(c) to IRC § 318(a)).

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