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The Need for Employers to Get "Control" of IRS Controlled Group Rules

By Mark E. Bokert and Alan Hahn

Business owners have wide discretion in determining the best corporate structure to use in setting up their businesses. Some use a single entity, while others use multiple entities, which can take the form of corporations, partnerships, and limited liability companies. Regardless of form, however, if a business owner uses multiple entities to structure their business, then the different entities may need to be combined for certain employee benefit purposes under applicable Internal Revenue Service (IRS) and Department of Labor (DOL) rules. Those controlled group rules describe the conditions under which common ownership, or common control, among businesses result in a single "controlled group," under which the entire group would be treated as if it were a single entity or employer. This would be important, for example, if an employer wanted to provide better (discriminatory) employee benefits to its employees at one entity as compared to a related entity. If the entities must be aggregated as a single "controlled group," then providing better benefits to employees at one entity will become much more difficult,

Mark E. Bokert is a partner and co-chairs the Benefits + Compensation Practice Group of Davis+Gilbert LLP. His practice encompasses nearly all aspects of executive compensation and employee benefits, including matters related to equity plans, deferred compensation plans, phantom equity plans, qualified retirement plans, and welfare plans. Mr. Bokert may be contacted at mbokert@dglaw.com. Alan Hahn is a partner and co-chairs the firm's Benefits + Compensation Practice Group. His practice is devoted to advising clients of all sizes, including in the design and implementation of a wide variety of creative, unique, and tax-effective employee benefit plans and programs. Mr. Hahn may be contacted at ahahn@dglaw.com. William Szanzer, a counsel in the firm's Benefits + Compensation Practice Group, assisted in the preparation of this column.

unless that entity can pass applicable discrimination testing measuring benefits at all of the controlled group members.

Determining that a business is a single controlled group can have profound implications for purposes of retirement plans and health and welfare plans and related purposes, even beyond the discrimination testing concerns described above, and can even affect the availability of certain tax credits. For example, the IRS controlled group rules are incorporated under the Affordable Care Act (ACA) regulatory scheme to determine the size of the employer, for purposes of determining whether and how the ACA applies.[1] Additionally, the controlled group rules will have applicability in determining an employer's eligibility under the Employee Retention Credit (ERC) available under the Coronavirus Aid, Relief, and Economic Security Act (CARES Act).[2]

Unfortunately, the IRS and DOL rules relating to controlled group determinations were last issued approximately thirty years ago,[3] including that the last substantive regulatory action taken by the IRS was to rescind certain proposed rules, as described below.[4] Moreover, the published rules leave open questions when it comes to modern-day corporate forms. For example, the IRS controlled group rules generally divide the world into corporations and partnerships and do not mention LLCs at all, and applying the rules to newer types of groups, like joint ventures, private equity or hedge funds can become very tricky, as described further below.

The IRS rules relating to controlled group determinations are found in Section 1563 of the Internal Revenue Code of 1986, as amended (Code) and focus on corporations. When Congress enacted the Employee Retirement Income Security Act of 1974 (ERISA), these rules were incorporated in Code Section 414(b) and replicated for partnerships under Code Section 414(c) to prevent employers from evading certain aspects of the law by establishing different entities.[5]

This column provides an overview of the controlled group rules and certain considerations that taxpayers may want to have in mind when applying these rules to their modern-day corporate structures, including with respect to the ACA and the ERC.

Traditional Controlled Groups

The traditional IRS controlled group rules set forth the guidelines for aggregating entities as a single employer in the following forms:

(i) A parent-subsidiary controlled group;[6]

(ii) A brother-sister controlled group;[7] or

(iii) A combined group of organizations.[8]

A parent-subsidiary controlled group, generally, is one or more chains of organizations where the common parent organizations owns at least 80% of the total combined voting power of all classes of stock entitled to vote, or at least 80% of the value of all classes of stock of each organization.[9] In the case of an organization which is a partnership, ownership of at least 80% of the profits interest or capital interest of such partnership.[10]

A brother-sister controlled group, generally, is two or more organizations where: (1) five or fewer persons who are individuals, estates, or trusts own at least 80% of the total combined voting power of all classes of stock entitled to vote, or the total value of shares of all classes of stock[11] of each organizations, and (2) the same five or fewer persons, taking into account ownership only to the extent that it is identical with respect to each entity, own more than 50% of the total voting power of all classes of stock entitled to vote, or total value of shares of all classes of stock[12] of each organization.[13]

A combined group of organizations is three or more organizations, each of which is a member of either a parent-subsidiary or a brother-sister controlled group, and at least one of which is both the common parent of a parent-subsidiary controlled group and a member of a brother-sister controlled group.[14]

While these categories of controlled groups may seem straight forward, determining each person's ownership percentage in an organization can be complex. Specifically, in calculating the ownership percentage of each person for purposes of a controlled group analysis, certain attribution rules may apply depending on the form of the controlled group. Based on these attribution rules, an individual will be deemed to own indirectly all interests that are attributed to him or her.[15] These attribution rules include:

- A spouse is generally considered to own the organization interests of his/her spouse, although certain exceptions apply.[16]

- A parent is generally considered to own the organization interests of his/her children under the age of 21.[17]

- Generally, individual owners or partners of corporations or partnerships are considered to own the interests held by the corporations or partnerships, provided the owner or partner has at least a 5 percent ownership stake in the corporation or partnership.[18]

- If a person has a unilateral right to acquire any outstanding interest in an organization (e.g., an option), such interest shall be generally considered as owned by such person.[19]

- A grantor of a revocable trust is generally deemed to own the outstanding interests held by such trust.[20]

- If organization interests are held in a trust or an estate, then any beneficiary of such trust or estate who has an actuarial interest of 5% or more in such organization interest is generally deemed to own the outstanding interests held by the trust or estate, to the extent of such actuarial interest.[21]

Further, shares and interests can be attributed using a combination of different attribution rules,[22] so an organization should undertake a careful review of its organizational structure with its legal counsel to get a better understanding of how these attribution rules affect its controlled group.

While the attribution rules will impact the number of shares or interests that an individual is deemed to own either directly or indirectly, not all shares or interests are counted for purposes of calculating an individual's ownership percentage in an organization for controlled group determinations,[23] including:

- Treasury stock;[24]
- Nonvoting preferred stock;[25]
- Certain stock held by officers;[26]
- Certain stock held by employees that are subject to certain restrictions on the owner's right to dispose of the stock or interests.[27]

However, these excluded stock rules can only be applied for purposes of creating additional controlled groups.[28] Meaning, these excluded stock rules cannot be used as a basis for breaking a controlled group that exists without applying these rules.

Affiliated Service Groups

In addition to traditional controlled groups, an "affiliated service group" is treated as a single employer based on rules related to the performance of certain services by one service organization for another or by one service organization in association with another for third parties, even if one entity does not otherwise have sufficient ownership or control of the other entity.[29] Affiliated service group determinations are based more on facts and circumstances than the bright-line rules that apply to traditional controlled groups.

Although there are no final regulations to assist taxpayers in determining if two or more entities form an affiliated service group, the Treasury Department has issued proposed regulations and announced that taxpayers may rely on these proposed regulations until regulations are

finalized.[30] For example, these proposed regulations provide guidance regarding what constitutes a service organization – an organization that engages in specified industries[31] or if capital is not a material income producing factor for the business of the organization.[32]

Finally, Code Section 414(m)(5) provides that a "management controlled group" is considered a subset of an affiliated services group. A management controlled group is established based on rules related to the performance of certain management services by one entity for another, even if the entity does not have any ownership or control of the other entity to form a controlled group.[33] However, while the Treasury Department has issued guidance in the form of proposed regulations regarding other affiliated service groups, there is no formal guidance regarding management controlled groups. In fact, the Treasury Department issued proposed regulations detailing how a management controlled group is established, but these proposed regulations were withdrawn in 1993 and have not been replaced with any new regulations.[34] As a result, taxpayers are left with the plain meaning of the statute and limited case law to navigate the murky waters of what constitutes a management controlled group.

Application of the Controlled Group Rules

All entities in a controlled group or affiliated service group are treated as a single employer for a growing number of purposes under the Code. For instance, for tax-qualified retirement plan purposes, all entities within a controlled group or affiliated service group are aggregated and treated as a single employer when conducting nondiscrimination and coverage testing.[35] Further, all members of a controlled group can be jointly and severally liable if one member of the group were to withdraw from a multiemployer pension plan. Similarly, when determining if a group health plan is maintained by more than one employer and constitutes a multiple employer welfare arrangement, a modified version of the traditional controlled group rules apply (and the affiliated service group rules are not referenced).[36]

The application of the controlled group rules have expanded over time. For example, in determining if an entity is subject to the ACA,[37] an entity's full-time employee equivalent headcount is determined based on the headcount of all members of its controlled group or affiliated service group.[38] Applying the controlled group rules for ACA purposes can come as a surprise to employers that otherwise think they are a "small" employer and exempt from the ACA. This is especially true in the context of a corporate transaction where a small employer is acquired by a large employer and now becomes subject to the ACA because of the transaction.

Most recently under the CARES Act, Congress applied a slightly modified version of the controlled group rules for purposes of calculating the size of an ERC for eligible employers.[39] The ERC calculation is determined based on an eligible employer's average full-time employee headcount in 2019.[40] For this calculation, all entities that are treated as a single

employer under the modified controlled group rules[41] will have their full-time employee headcounts aggregated when calculating their ERC.[42] For example, an eligible employer deemed to be a "small"[43] employer may be eligible to take a credit for wages paid regardless of whether their employees were providing services during the applicable period, while a "large" employer may only be eligible to take a credit for wages paid with respect to which an employee is *not* providing services. The nuances of these controlled group rules can dictate if an eligible employer will be able to collect an ERC, which can be worth millions of dollars depending on if an eligible employer is a small or large employer.

Due to an influx of applicants that were ultimately determined to be ineligible for an ERC, the IRS has paused the program while it reviews and establishes procedures to combat fraud.[44] Further, the IRS has commenced audits of employers claiming an ERC. In reviewing the calculations of an eligible employer's ERC, an IRS auditor may request supporting documentation regarding the eligible employer's full-time employee headcount, which can include a review of the eligible employer's controlled group. Therefore, taxpayers who believe they are eligible for an ERC should document with legal counsel how they determined their controlled group so that they are prepared to respond to an IRS inquiry if they are selected for an ERC audit.

As the controlled group rules applications have broadened over time, taxpayer's corporate structures have gotten more complex. These corporate structures require a careful controlled group review by qualified legal counsel. For instance –

- Private equity firms frequently divide their ownership interests across different funds. Depending on the structure of these funds and the portfolio companies within each fund, certain interests may still be aggregated for purposes of a controlled group analysis.

- Taxpayers who place their ownership interests in trusts for estate planning reasons may still be treated as the owner of these interests under the controlled group rules.

- Employers considering granting key employees equity awards (including profits interest awards) should be aware of how the design of these awards may impact whether these interests can be excluded when reviewing the employer's controlled group.

Conclusion

The IRS and DOL controlled group rules provide the foundation for several key provisions under the Code and ERISA, affecting

determinations made for retirement, health and welfare, and other tax purposes, including the ACA and ERCs under the CARES Act. Controlled group determinations can be complex due to the various attribution and excluded stock rules and modern day corporate forms. Regulatory bodies, insurance carriers, auditors and others can be expected to ask about an employer's controlled group. Therefore, a taxpayer should engage legal counsel to conduct a thorough review of its controlled group and update the analysis from time to time as their corporate structure changes.

Notes

1. 26 CFR §54.4980H-1(a)(16).

2. 26 U.S.C. § 3134(d).

3. T.D. 8179, 53 FR 6606, Mar. 2, 1988, as amended by T.D. 8540, 59 FR 30102, June 10, 1994.

4. 58 Fed. Reg. 25587 (Apr. 27, 1993); IRS Notice 92-12, 1992-16 I.R.B. 35.

5. Section 1011 of ERISA.

6. 26 CFR § 1.414(c)-2(b).

7. 26 CFR § 1.414(c)-2(c).

8. 26 CFR § 1.414(c)-2(d).

9. 26 CFR § 1.414(c)-2(b)(1).

10. 26 CFR § 1.414(c)-2(b)(2)(i)(C).

11. Or in the case or partnerships, profits interest or capital interest of such partnership.

12. Or in the case or partnerships, profits interest or capital interest of such partnership. Id.

13. 26 CFR § 1.414(c)-2(c).

14. 26 CFR § 1.414(c)-2(d).

15. 26 CFR § 1.414(c)-4(a).

16. 26 CFR § 1.414(c)-4(b)(5).

17. 26 CFR § 1.414(c)-4(b)(5)(i). If an individual is in direct or indirect effective control of an organization, then such individual is generally considered to own such individual's parents', grandparents', grandchildren, and adult children's interests in such organization. 26 CFR § 1.414(c)-4(b)(5)(ii).

18. 26 CFR § 1.414(c)-4(b)(2) and (4).

19. 26 CFR § 1.414(c)-4(b)(1).

20. 26 CFR § 1.414(c)-4(b)(3)(iii).

21. For this purpose, the actuarial interest of each beneficiary shall be determined by assuming the maximum exercise of discretion by the fiduciary (i.e., the trustee or

executor) in favor of such beneficiary and the maximum use of the organization interest to satisfy the beneficiary's rights. 26 CFR § 1.414(c)-4(b)(3)(i).

22. 26 CFR § 1.414(c)-4(c).

23. 26 CFR § 1.414(c)-3.

24. 26 CFR § 1.414(c)-3(a).

25. Id.

26. 26 CFR § 1.414(c)-3(b)(4).

27. 26 CFR § 1.414(c)-3(b)(5) and (c)(3).

28. 26 CFR § 1.414(c)-3(f).

29. 26 U.S.C. §§ 414(m)(1) and (2).

30. Prop. Treas. Reg. §1.414(m)-2. Final regulations have not been issued in over 35 years.

31. Health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, and insurance. Prop. Treas. Reg. §1.414(m)-2(f)(2).

32. Facts and circumstances will determine whether capital is a material income producing factor. The proposed regulations provide some guidance in making this determination by providing the following rules: (i) capital is a material income-producing factor for banks and similar institutions, (ii) capital is a material income-producing factor if there is substantial investment in inventories, equipment, plant, and machinery, and (iii) capital is not a material income-producing factor if the income of the business comes primarily from fees or commissions for personal services performed by an individual. Prop. Treas. Reg. §1.414(m)-2(f)(1).

33. 26 U.S.C. § 414(m)(5).

34. 58 Fed. Reg. 25587 (Apr. 27, 1993); IRS Notice 92-12, 1992-16 I.R.B. 35.

35. There are limited exceptions (e.g., the transition rules under 26 U.S.C. § 410(b)(6)(C).

36. ERISA Section 3(40).

37. If the employer has 50 or more full-time equivalent employees.

38. 26 CFR § 54.4980H-1(a)(16).

39. 26 U.S.C. § 3134(d).

40. 26 U.S.C. § 3134(c)(3).

41. For purposes of determining if a parent-subsidiary controlled group exists for ERC purposes, "more than 50%" is substituted for "at least 80%" in the abovementioned parent-subsidiary controlled group test.

42. 26 U.S.C. § 3134(d).

43. For purposes of taking an ERC in 2020, an employer is considered small if it has no more than 100 full-time employees. In 2021, the threshold increased to 500 full-time employees.

44. IR-2023-169, Sept. 14, 2023.

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