



## Controlled Groups and Affiliated Service Groups: How They Apply to the ACA

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The Patient Protection and Affordable Care Act (ACA) imposes a penalty on “large” employers that either do not offer “minimum essential” (basic medical) coverage, or who offer coverage that is not affordable (the employee’s cost for single coverage is greater than 9.5 percent of income) or it does not provide minimum value (the plan is not designed to pay at least 60 percent of claims costs). A large employer is one that employed at least 50 full-time or full-time equivalent employees during the prior calendar year. To discourage employers from breaking into small entities to avoid the penalty, the ACA provides that, for purposes of the employee threshold, the controlled group and affiliated service group aggregation rules will apply to health plans. Essentially, this means that the employees of a business with common owners or that perform services for each other may need to be combined when determining if the employer is “large.”

The aggregation rules are very complicated and may require a large amount of information to do an accurate analysis. This article does not address all of the possible considerations or all of the intricacies of the rules, and assumes that the regulations that apply to retirement plans will also apply to health plans. **We strongly encourage clients with complex arrangements to consult with their attorney or accountant.**

### Controlled Group

When one business owns a significant part of another business, there may be a “controlled group.” There are four types of controlled groups – parent-subsidiary, brother-sister, combined, and life insurance.

Ownership includes:

- Stock ownership in a corporation
- Capital interest or profits in a partnership
- Membership interest in an LLC
- A sole proprietorship
- Actuarial interest in a trust or estate
- A controlling interest in a tax-exempt organization (80 percent of the trustees or directors are also trustees, directors, agents or employees of the other organization or the other organization has the power to remove a trustee or director)

- A government entity, including a school, if there is common management or supervision or one entity sets the budget or provides 80 percent of the funding for the other.

### Parent-Subsidiary

A parent-child subsidiary controlled group occurs when one **business** owns 80 percent or more of another business or businesses.

- The parent might own multiple subsidiaries
  - Example 1: P Corp. owns 85 percent of J Co. and 80 percent of K Co. P has 30 full-time employees, J has 15 full-time employees and K has 12 full-time employees. P, J, and K are all part of a parent-sub controlled group with 57 full-time employees, so all three companies must offer affordable, minimum value coverage or pay a penalty.
  - Example 2: N Corp. owns 80 percent of A Co. and 75 percent of B Co. N has 27 full-time employees, A has 23 full-time employees and B has 28 full-time employees. N and A are part of a parent-sub controlled group with 50 full-time employees, so these two companies must offer affordable, minimum value coverage or pay a penalty. B is not part of the group because N owns less than 80 percent of B. Since B has fewer than 50 full-time employees, B does not have to offer coverage.
- The parent might own multiple tiers of subsidiaries
  - Example 3: Z Corp. owns 100 percent of Q Co. Q has a 90 percent interest in R Partnership. Z has 35 full-time employees, R has 18 full-time employees and Q has 10 full-time employees. Z, Q and R are all part of a parent-sub controlled group with 63 full-time employees, so all three companies must offer affordable, minimum value coverage or pay a penalty.

### Brother-Sister Group

A brother-sister controlled group is a group of two or more entities that meet **all** of these requirements:

1. There must be five or fewer common owners.
  - Each owner must be **an individual, a trust or an estate**.
  - Ownership can be direct or by attribution.
    - Interests of spouse are attributed to the owner (with limited exceptions).
    - For children under age 21, the ownership interests of the parent (no matter how large or small) are attributed to the minor child, and the ownership interests of the minor child (no matter how large or small) are attributed to the parent.
    - For children age 21 or older, the ownership interests of the parent or grandparent are attributed to the adult child only if the child owns more than 50 percent of the business, and the ownership interests of the adult child are attributed to the parent or grandparent only if the parent or grandparent owns more than 50 percent of the business.
    - Partnership and corporate ownership interests are attributed proportionately to owners of more than 5 percent of the interest or stock.

Example 4: Mary owns 100 percent of Ajax Corp. and 51 percent of Best Corp. Mary has two children. William is age 28 and he owns 30 percent of Best Corp. Rebecca is age 20 and she owns nothing. Since Mary owns more than 50 percent of Best, Williams's 30 percent is attributed to her. Rebecca will be considered to own 100 percent of Ajax and 51 percent of Best because those are Mary's holdings and Rebecca is a minor.

2. The common owners must own at least 80 percent of each business.
3. The combined identical ownership must be 50 percent or more.

Use the lowest percentage ownership of each person when determining identical ownership

Example 5: Ann, Bill, Carl and Dee own Adams Corp. and Bell Corp. in these percentages:

Shareholder	Adams Corp.	Bell Corp.	Identical Ownership
Ann	80%	20%	20%
Bill	10%	50%	10%
Carl	5%	15%	5%
Dee	5%	15%	5%
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>40%</b>

This group:

- Meets test No. 1 because there are fewer than five common owners
- Meets test No. 2 because the four common owners own 100 percent of the corporations, and 100 percent is at least 80 percent of the stock
- Does not meet test No. 3 because “identical” means lowest interest in the entities, which is:

Ann	20%
Bill	10%
Carl	5%
Dee	5%
<b>Total</b>	<b>40%</b>

Example 6: Jane, Jack and Jim own parts of Wright Co., Hill Corp. and Smith Co. in these percentages:

Shareholder	Wright Co.	Hill Corp.	Smith Co.	Identical Ownership
Jane	100%	15%	15%	15%
Jack	0%	40%	50%	0%
Jim	0%	40%	20%	0%
<b>Total</b>	<b>100%</b>	<b>95%</b>	<b>85%</b>	<b>15%</b>

There is no controlled group among Wright, Hill and Smith because their identical ownership is less than 50 percent.

Example 7: There is a controlled group among Hill and Smith, because Jane, Jack and Jim own more than 80 percent of those two companies and their identical ownership is 75 percent.

Shareholder	Hill Corp.	Smith Co.	Identical Ownership
Jane	15%	15%	15%
Jack	40%	50%	40%
Jim	40%	20%	20%
<b>Total</b>	<b>95%</b>	<b>85%</b>	<b>75%</b>

## Combined Group

A combined group consists of **three or more** entities that meet **all** of these requirements:

1. Each organization is a member of either a parent-subsidary or brother-sister group.
2. At least one corporation is:
  - The common parent of a parent-subsidary and
  - A member of a brother-sister group.

Example 8:

- Mary owns 80 percent of York's stock and 85 percent of Zest Partnership – York and Zest are a brother-sister group
- York owns 90 percent of Sharp Corporation – York and Sharp are a parent-sub group
- York, Zest and Sharp are part of a combined group, with York as the common entity

## Life Insurance Controlled Group

A life insurance controlled group means **two or more** life insurance companies that meet all of these requirements:

1. Each company is a member of a controlled group of corporations described in the statute as a parent-subsidary, brother-sister, or combined.
2. Section 1.1502-47(f)(6) regarding common parent election under section 1504(c)(2) does not apply.

These insurance companies are treated as a controlled group of corporations separate from any other corporations which are members of the controlled groups described in the statute as parent-subsidary, brother-sister, or combined.

Example 9:

Since January 1, 1999, corporation P has owned all the stock of corporations L1 and Y, and L1 has owned all the stock of corporation X. On January 1, 2005, Y acquired all of the stock of corporation L2. Since L1 and L2 are members of a parent-subsidary controlled group of corporations, such companies are treated as members of a life insurance controlled group separate from the parent-subsidary controlled group consisting of P, X and Y. For purposes of this section, P is referred to as the common parent of the life insurance controlled group even though P is not a member of such group.

Example 10:

The facts are the same as in Example 9, except that, beginning with the 2005 tax year, the P affiliated group elected to file a consolidated return and P made a section 1504(c)(2) election. Pursuant to paragraph (a)(5)(i) of this section, L1 and L2 are not members of a separate life insurance controlled group. Instead, P, X, Y, L1 and L2 constitute one controlled group.

## Affiliated Service Groups

If the company regularly performs certain types of **personal services or management functions** with or for related entities, it may be part of an "affiliated service group" even if there is not common ownership.

An affiliated service group is basically a group of businesses working together to provide services to each other or jointly to customers, and can be one of three types:

1. A-Organization (A-Org), which consists of a First Service Organization (FSO) and at least one A-Org
2. B-Organization (B-Org) which consists of an FSO and at least one B-Org
3. Management groups

Only entities that provide personal services are subject to the affiliated service group rules. Attribution rules similar to those that apply to controlled groups apply to affiliated service groups.

To be an FSO, the performance of personal services must be the principal business of the organization (corporation, partnership, sole proprietorship, or not-for-profit). Compensation must be through commissions, fees or similar compensation based upon providing services (as opposed to having profits based at least in part on inventories, equipment, or manufacturing). These services are always considered covered services when deciding if an organization is an FSO:

- Accounting
- Actuarial science
- Architecture
- Consulting
- Engineering
- Health (including chiropractors, chiropractors, dentists, medical doctors, optometrists, osteopaths, podiatrists, psychologists, veterinarians)
- Insurance
- Law
- Performing arts

Professional service corporations are always FSOs.

If the entity is an FSO, you need to determine if there is also an A-Org or a B-Org group that will create an affiliated services group.

### **A-Org**

To be an A-Org group, all of these criteria must be met:

- The FSO must be a professional service corporation (this often means their name includes "P.C."), a sole proprietorship or a partnership
- The other organization must be a service organization, too
- The other organization must have an ownership interest in the FSO
- The other organization must regularly perform services for the FSO, or the other organization and the FSO must work together to perform services for third parties

Example 11: Dr. Johnson owns 100 percent of his medical corporation (James Johnson, MD, PC) and 20 percent of JB Diagnostics, Inc. Dr. Johnson regularly refers patients to JB. There is an affiliated service group; JB is the FSO and James Johnson, MD, PC is the A-Org.

## B-Org

To be a B-Org group, all of these criteria must be met:

- The FSO must be a service organization, but it can be any kind of entity
- The other organization must derive a significant portion of its business (generally 10 percent or more) from the performance of services for the FSO or for an A-Org related to the FSO
- The other organization must perform services that are the type historically performed in the field of the FSO or by employees
- The other organization must be at least 10 percent owned by persons who are highly compensated employees of the FSO or the related A-Org (attribution rules apply)
- The other organization does not need to be a service organization

Example 12: Jordan is a CPA. He is a 15 percent owner in an accounting firm and a 20 percent owner in a secretarial firm. The accounting firm engages the services of the secretarial firm, which derives at least 10 percent of its gross receipts from this relationship. The accounting firm and the secretarial firm are an affiliated service group.

If an organization is an FSO with respect to two or more A-Orgs and/or B-Orgs, all will be combined into an affiliated service group.

## Management Group

To be a Management Group:

- There are no ownership requirements
- One organization must regularly perform management functions for the other
  - Management functions include daily operations, management of personnel, employee compensation and/or benefits, business planning and other standard management activities
- The managing firm generally must receive over half its income from managing the other organization

Example 13: A landscape design and maintenance company splits into two companies. One company, W, was established to employ the workers who perform work in the field, and a second company, M, was established to employ the management and design team. M performs management responsibilities for W, and W is the only client of M. W and M are an affiliated service group.

## When Does a Controlled Group Analysis Apply?

Controlled group rules apply to many types of health and welfare benefits governed under the Internal Revenue Code, such as cafeteria plans, health savings accounts, and self-insured medical reimbursement plans. Examples of the contexts in which controlled group rules apply include:

- COBRA obligations and penalties
- Medicare Secondary Payer
- Nondiscrimination testing for self-insured group health plans
- Cafeteria plan compliance
- Small business health care tax credit

- Employer shared responsibility payment
- Fringe benefits under the Internal Revenue Code

All members of a controlled group are jointly and severally liable for:

- Insurance premiums under ERISA
- Plan termination liability under ERISA
- Liability for a single-employer plan under ERISA
- Plan termination premiums under ERISA
- Penalties for a failure to notify the Pension Benefit Guaranty Corporation of reportable events, as required by ERISA
- Multiemployer plan termination liability under ERISA
- Liability upon a complete or partial withdrawal from a multiemployer plan under ERISA

### In summary

- These rules are complicated, and include additional requirements and exceptions not covered in this piece.
- If a business isn't wholly owned by an individual or other entity, it's important to know who owns the rest of the business and what else the other owners have an interest in.
- It's important to know what an individual owner's family situation is.
- It's important to know if a business owns other businesses.
- The affiliated service group rules apply only if the entity is providing personal services.
- If personal services are the entity's main "product," it's important to know if it provides or receives services to or from other businesses.

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