

Background

To qualify for tax deductions, retirement plans must meet the requirements of the Internal Revenue Code. The IRC rules emphasize that plans need to provide lower-paid employees with retirement benefits and not favor higher-paid employees and business owners.

To prevent employers from circumventing these rules, Congress created laws that treat certain groups of entities as a single company for retirement plan coverage purposes. These laws establish what are commonly known as “controlled groups” CG and “affiliated service groups” ASG. All employees of a combined group of entities must be considered when determining whether or not a plan passes the IRS coverage and non-discrimination tests.

Why does it matter?

Failure to identify a CG/ASG can cause the plan to lose its tax qualification. This occurs when a plan omits coverage of a CG/ASG member. A plan may also get in trouble when it is improperly assumed that the employer is part of a CG/ASG and it actually is not.



What is a controlled group?

Briefly, if there is 80% or more overlapping ownership among entities, they are generally a controlled group. This can be a parent-subsidary relationship or just common ownership of at least 80% among five or fewer individuals (brother-sister controlled group).

Determining if a controlled group exists

Usually, the most complicated aspect of controlled group analysis is determining each company’s applicable ownership. Some rules attribute ownership to and from certain family members, ownership to individuals from stock held in trusts, and ownership of non-corporate entities. A person cannot reduce his ownership share by giving ownership to a spouse, child, parent, etc. Also, stock or other ownership options are frequently considered when determining ownership for controlled group purposes.

Due to SECURE 2.0 provisions (effective for plan years beginning on January 1, 2024 or later), an exception to apply spousal attribution for separate and unrelated businesses for controlled group purposes will be available to spouses who live in a community property state and for parents who share a minor child.

For example, if a husband and wife each own their own separate, unrelated business, and neither provides services for the other's business, and there is no direct ownership by the spouses in each other's businesses, the businesses do not need to be treated as a controlled group due to spousal attribution. Previously, this exception did not apply if the couple resided in a community property state or shared a minor child.



Controlled group examples

Acme Corporation is owned 80% by John and 20% by Tom (John and Tom are not related.) In addition, John operates a frozen yogurt shop as a sole proprietor. John owns 80% of Acme and 100% of the yogurt shop. Since there is at least 80% overlapping ownership, Acme and the yogurt shop are a controlled group.

Any retirement plan that Acme sets up will have to consider the eligible employees of the yogurt shop when passing its coverage tests. Acme may have to cover those employees (i.e., include as benefiting participants) in the plan to pass the coverage test, depending on the company's size.

Now let us change the example slightly. Suppose John sells 5% of Acme to Tom. There is now just 75% overlapping ownership. The two are no longer a controlled group.



What is an affiliated service group?

An affiliated service group determination is more subjective than a controlled group. Two or more **service** companies with some shared ownership, no matter how small, provide significant services to each other or are associated with providing services to others form an ASG. Furthermore, if a significant portion of a company's business offers management services to another company (even if not a service company), they are also an affiliated service group.



Determining if affiliated group exists

If capital is not a material income-producing factor, it is likely a service company. For example, professional services medical, dental, law, engineering, accounting, etc.) are service companies. A trucking company would not be, even though it provides transportation services, because capital (trucks) is required to generate income.



Affiliated group examples

The most easily identified ASG is a professional law, medical, or accounting practice organized as a professional corporation partnership. Each professional may be separately incorporated, but the corporations are all partners, and income flows from the firm to the individual corporations. The corporations' employees provide professional services to the firm's clients on behalf of the firm. In such a case, any retirement plan will have to consider the entire firm's employees for passing coverage tests.

As another example, a business owner cannot escape the retirement plan coverage rules by setting up a separate company for himself and then have the primary business pay his company a management fee. Even if he structures the ownership to avoid a controlled group, this would still be considered an affiliated service group.

Conclusion

In some straightforward cases, determining the existence of a CG or ASG is relatively simple. However, the Internal Revenue Code is complicated, and various tax court cases add additional nuances. This brief overview is not meant to provide comprehensive guidelines for analysis, but rather to make our clients aware of the issues involved.

If you're unsure if you're part of a CG or ASG, contact us for further consultation and analysis. It is sometimes necessary to seek legal advice in complex situations, and failure to properly identify a controlled group or affiliated service group can result in severe tax consequences.