

## **Chapter 7**

# **Controlled and Affiliated Service Groups**

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## **Overview**

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### **Introduction**

The Internal Revenue Code established its Controlled Groups Provisions as part of the Revenue Act of 1964. They were initially issued as part of a tax reform package intended to encourage small businesses, which operated in the corporate form. Over time some medium and large businesses began taking advantage of the lower tax rates afforded small businesses by organizing their structure into multiple corporate forms.

The Employee Retirement Income Security Act of 1974 (ERISA) added sections 414(b) and (c). These sections required that all employees of commonly controlled corporations, trades or businesses be treated as employees of a single corporation, trade or business. These Code provisions used the statutory definition of controlled groups found in section 1563(a) of the Code.

Section 1563(a) provides mechanical ownership tests, which are used in determining if a controlled group situation exists.

Sections 414 (b) and (c) did not cover many of the arrangements devised by employers who attempted to avoid coverage of employees. Congress enacted section 414(m) pursuant to section 201 of the Miscellaneous Revenue Act of 1980. Section 414 (m) addresses employees of an affiliated service group, which will be discussed later in this chapter.

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## Overview, Continued

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### Objectives

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

- Define a controlled group and identify the three forms of controlled groups.
  - Apply section 1563(a) in conjunction with section 414(b) and (c) to determine if a controlled group is in existence.
  - Identify the effect of the attribution rules on controlled groups.
  - Determine the impact of sections 414(b) and (c) on the determination letter process and qualified plans.
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## **Definition: Controlled Group**

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**Section 414(b) and (c)** The controlled group definition is found in section 414(b) & (c). Section 414(b) covers controlled group consisting of corporations and defines a controlled group as a combination of two or more corporations that are under common control within the meaning of section 1563(a).

All employees of companies in the controlled group must be considered to determine if a plan maintained by a controlled group member meets the requirements of sections 401, 408(k), 408(p), 410, 411, 415, and 416.

Section 414(c) applies to controlled group of trades or businesses (whether or not incorporated), such as partnerships and proprietorships. Since section 1563 was written only for corporations, Treasury Regulations 1.414(c)-1 through 1.414(c)-5 mirror the section 1563 controlled group principles.

The definitions and examples used in this chapter refer to both section 414(b) and 414(c) controlled groups.

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**Three Types of Controlled Groups** A control group relationship exists if the businesses have one of the following relationships:

- Parent-subsidiary,
  - Brother-sister, and
  - Combination of the above
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**Definition: Controlled Group, Continued**

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**Parent-  
subsidiary  
Group**

A parent-subsidiary controlled group exists when one or more chains of corporations are connected through stock ownership with a common parent corporation; and

- 80 percent of the stock of each corporation, (except the common parent) is owned by one or more corporations in the group; and
- Parent Corporation must own 80 percent of at least one other corporation.

Sections 1563(a) and 414(b) and (c).

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**Sections  
1563(a) and  
414(b) and (c)-  
Example 1**

The following examples illustrate the parent-subsidiary rules:

**Example 1**

Redwood Corporation owns:

- 90% of the stock of Bond Corporation,
- 80% of the stock of Greene Corporation, and
- 65% of the stock of Teller Corporation.

Unrelated persons own the percentage of stock not owned by Redwood Corporation.

Redwood Corporation owns 80% or more of the stock of the Bond and Greene Corporations. Therefore, Redwood Corporation is the common parent of a parent-subsidiary group consisting of Redwood, Bond, and Greene. Teller Corporation is not a member of the group because Redwood Corporation's ownership is less than 80%.

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**Definition: Controlled Group, Continued**

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**Sections  
1563(a) and  
414(b) and (c)-  
Example 1  
(continued)-  
Example 2**

**Example 2**

Assume the same facts as in the previous example and assume further that Greene Corporation owns 80% of the profits interest in XYZ Partnership.

Redwood Corporation is the common parent of a parent-subsiary group consisting of Redwood, Bond, Greene and XYZ. The results would be same if Redwood Corporation, rather than Greene Corporation owned the 80% interest in XYZ.

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**Brother- Sister  
Group**

A brother-sister controlled group is a group of two or more corporations, in which five or fewer common owners (a common owner must be an individual, a trust, or an estate) own directly or indirectly a controlling interest of each group and have “effective control”.

- Controlling interest - 1.414(c)-2(b)(2) – generally means 80 percent or more of the stock of each corporation (but only if such common owner own stock in each corporation); and
  - Effective control – 1.414(c)-2(c)(2) – generally more than 50 percent of the stock of each corporation, but only to the extent such stock ownership is identical with respect to such corporation.
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**Definition: Controlled Group, Continued**

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**Example-  
Brother-Sister  
Ownership Test**

Adams Corp and Bell Corp are owned by four shareholders, in the following percentages:

Percentage of Ownership

Shareholder	Adams Corp	Bell Corp
A	80%	20%
B	10	50
C	5	15
D	5	15
TOTAL	100%	100%

To meet the first part of the test in section 1563(a)(2)(A), the same five or fewer common owners must own more than 80% of stock or some interest in all members of the controlled group.

In this example, the four shareholders together own 80% or more of the stock of each corporation, the first test is met, since the shareholders own 100% percent of the stock.

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**Definition: Controlled Group, Continued**

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**50 Percent  
Test-Example**

Shareholder	Identical Ownership Percentage in both Corps.
A	20%
B	10
C	5
D	5
TOTAL	40%

To meet the second part of the test in Section 1563(a)(2)(B), the same five or fewer common owners must own more than 50% of each corporation, taking into account the stock ownership of each person only to the extent such stock ownership is identical with respect to each such corporation.

In this example, although the four shareholders together own 80% or more of the stock of each corporation, they do not own more than 50% of the stock of each corporation, taking into account only the identical ownership in each corporation as demonstrated above.

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**Definition: Controlled Group, Continued**

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**Example-  
Brother-Sister  
Group not  
established**

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

<b>Individual Corp</b>	<b>Percentage of Tate Corp</b>	<b>Percentage of Ward Corp</b>
A	12	12
B	12	12
C	12	12
D	12	12
E	13	13
F	13	13
G	13	13
H	13	13

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

But, Tate and Ward are not members of a brother-sister group because, the same five or fewer individuals do not own at least 80% of each corporation's stock.

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**Definition: Controlled Group, Continued**

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**Combined Group**

A combined group consists of three or more organizations that are organized as follows:

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

**Combined Group-Example**

A is an individual owning:

- 80% in York Partnership; and
- 90% in Sharp Corporation

York Partnership owns 85% of Tripp Corporation

York Partnership, Sharp Corporation and Tripp Corporation are each members of the same combined group of trades or businesses under common control because

- York Partnership, Sharp Corporation, and Tripp Corporation are each members of either a parent-subsidary or a brother–sister group, and
  - York is:
    - the common parent of the parent-subsidary group consisting of York and Tripp; and
    - A member of a brother-sister group consisting of York and Sharp.
-

## Attribution Rules

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**Introduction** Attribution is the concept of treating a person as owning an interest in a business that is not actually owned by that person. Attribution may result from family or business relationships. Section 1563 attribution is used in determining a controlled group of businesses, under section 414(b) and (c).

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**Important Note** Although the following attribution rules are written in terms of stock ownership, the same principles are applied for organizations that are not incorporated.

In the case of a:	Ownership relates to the:
Trust or estate	Actual interest
Partnership	Capital or profits
Sole proprietorship	Sole proprietorship

When calculating ownership interests, use the greater of:

- Corporate ownership – voting stock or value of stock
  - Partnership ownership – capital or profits
- 

**Section 1563 Attribution** Section 1563 contains the rules of attribution used to determine “control” for the following:

- Controlled groups of corporations (section 414 (b)); and
- Trades or businesses, whether or not incorporation, which are under common control (section 414 (c)).

Also see Treas. Reg. § 1.414(c)-4.

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**Attribution Rules, Continued**

**General Rules  
for Family  
Attribution**

The following table is a general description of how the family attribution rules are applied to controlled groups.

**Note: the following family attribution rules only apply to a brother-sister controlled group and do not apply to a parent-subsidary controlled group.**

THE OWNERSHIP INTERESTS OF:	Are attributed to:	
Spouse	Spouse	EXCEPTION: No attribution between spouses if there is no: <ul style="list-style-type: none"> <li>• direct ownership,</li> <li>• participation in company, and</li> <li>• no more than 50% of business gross income is passive investments. See 1.414(c)-4(b)(5)(ii).</li> </ul>
Minor child (under age 21)	Parent	
Parent	Minor child (under age 21)	
Parent	Adult child (age 21 or older)	ONLY IF: Adult child owns greater than 50% of that business.
Adult child	Parent	ONLY IF: Parent owns greater than 50% of that business.
Grandparent	Minor or Adult child	ONLY IF: Minor/Adult child owns greater than 50% of that business.
Minor or Adult child	Grandparent	ONLY IF: Grandparent owns greater than 50% of that business.
Sibling	None	None

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## **Attribution Rules, Continued**

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### **Examples- family attribution**

The following examples illustrate the family attribution rules:

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#### **Example 1- family attribution**

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

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

Ada does not directly own an interest or participate in Barton's practice and less than 50% of the gross income from Barton's practice is from passive investments.

- Barton is attributed the 50% interest that Ada owns in her practice (due to his participation in Ada's practice).
  - Ada is not attributed any ownership interest in Barton's practice.
- 

#### **Example 2**

Clare, age 25 is the daughter of Dana. Dana owns 75% of XYZ Corporation and Clare own the remaining 25%.

Since Dana owns more than 50% of XYZ, her ownership is attributed to Clare.

Since Clare does not own more than 50% of XYZ, her ownership is not attributed to Dana.

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## Attribution Rules, Continued

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**General Rules for Organizational Attribution**

The following table is a general description of how the attribution rules for organizations are applied to controlled groups.

<b>The ownership interest:</b>	<b>Are attributed to:</b>
From a corporation to its shareholder  • Applicable to brother-sister controlled group only.	Corporate ownership interests attributed, proportionately *, <u>to shareholders (owning at least 5% of corporate stock).</u>
From a partnership to its partners  • Applicable to brother-sister controlled group only.	Partnership ownership interests attributed, proportionately *, <u>to partners having at least 5% or more capital or profits interest.</u>
From a trust to its beneficiaries  • Applicable to brother-sister and parent-subsidiary controlled groups.	Trust ownership interests attributed, proportionately *, <u>to beneficiaries having 5% or more actuarial interest.</u>
To an organization	None

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**General Rules – Organizational Attribution**

\* The interest owned is proportionate to the individual’s share of the organization’s value.

For example, a shareholder’s interest in a corporation is proportionate share of the total stock value of the corporation.

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## Attribution Rules, Continued

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### Organizational Attribution Rules

The following examples illustrate the organizational attribution rules:

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#### Example 1

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

The Hale stock is attributed to Elliott and Grant in proportion to their ownership interests in the Fairfield Corporation as follows:

Elliott is treated as a 21% owner of Hale Corporation.

- $70\%$  (interest in Fairfield)  $\times$   $30\%$  (Fairfield's interest in Hale)

Grant is treated as a .06 % owner of Hale Corporation.

- $20\%$  (interest in Fairfield)  $\times$   $30\%$  (Fairfield's interest in Hale)

Since each of the four remaining shareholders of Fairfield Corporation own less than 5%, they are not treated as owning any interest in Hale Corporation.

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#### Example 2

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

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

Jay is treated as a 35% owner of Lake Corporation ( $70\% \times 50\%$ ).

Kendall is treated as a 15% owner of Lake Corporation ( $30\% \times 50\%$ ).

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## Attribution Rules, Continued

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### Other Rules under Section 1563

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

However:

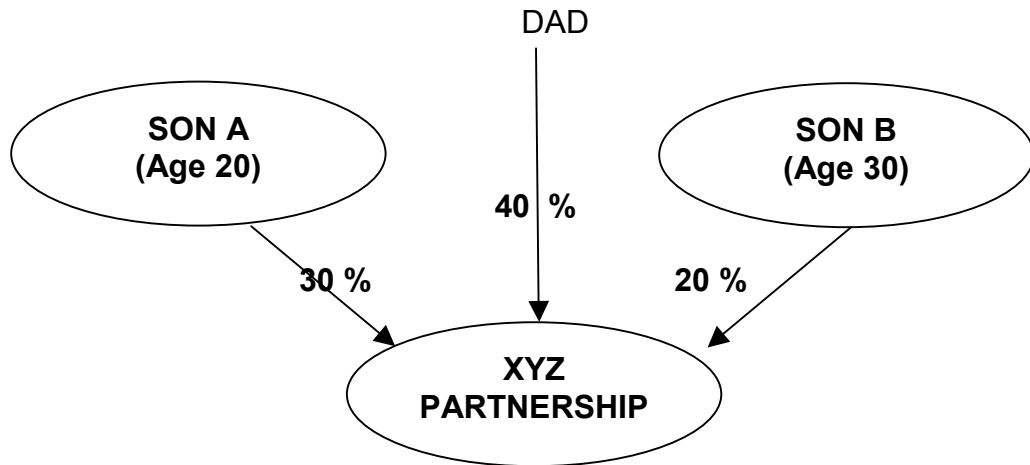
1. The ownership interests of an individual may be attributed *to more than one family member.*
2. After an individual is attributed the ownership of a corporation, partnership or trust, the interest may then be taken into account under other attribution rules.

Options to acquire stock are, generally, treated as stock ownership under IRC section 1563. Refer to Rev. Rul. 68-601 and *North American Industries, Inc. v. Commissioner*, 33 TCM 1275 (1974) for further information.

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### Example- Attribution to More than One Family Member-facts

The following example illustrate attribution to more than one family member



An unrelated person owns the remaining interest in XYZ.

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## **Attribution Rules, Continued**

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**Dad-Ownership percentage** Dad is considered to own a total of 90% of the profits interest in XYZ Partnership as follows:

- He directly owns 40% of XYZ Partnership,
  - He is considered as owning the 30% interest owned by minor Son A, and
  - He is also considered as owning the 20% interest of XYZ that is owned by his adult son. Note that generally, the stock ownership of family members who are 21 or older are not attributed to an individual. However, such attribution is required if the individual has effective control. Dad has more than a 50% ownership of XYZ. See 1.414(b)-4(b)(6).
- 

**Son A** Son A is considered to own a total of 70% of the profits interest in XYZ:

- He directly owns 30%, and
- He is considered to own the 40% profits interest owned directly by Dad.

Son A is not, however, considered to own the 20% owned directly by Son B (and attributed to Dad).

---

**Son B** – Son B is considered to own a total of 20% of the profits interest in XYZ:

- He directly owns 20%, and
  - He is not considered to own the 40% interest of XYZ that is owned by his father. This is because Son B owns only 20% and he would have to own more than 50% in order for his father's interest to be attributed to him.
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## Attribution Rules, Continued

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**Other Rules for  
Spousal  
Attribution  
under Section  
1563**

The following examples illustrate other spousal attribution rules

**Example 1**

Marian and Mitchell are the parents of Norton, age 25, and Oliver, age 20. Mitchell has a 45% interest in the Pitkin Corporation and his son, Norton, has a 55% interest.

**ATTRIBUTION BETWEEN SPOUSES:**

Marian is treated as owning Mitchell's 45% interest in Pitkin, assuming the spousal exception described above is not applicable.

**FAMILY ATTRIBUTION IS NOT FURTHER ATTRIBUTED TO ANOTHER FAMILY MEMBER:**

The 45% interest attributed to Marian is not further attributed to Oliver.

This rule would not prevent Mitchell's interest from being attributed to Oliver (see below).

---

**Example 2**

**FAMILY ATTRIBUTION RULES MAY BE APPLIED TO MORE THAN ONE FAMILY MEMBER:**

In addition to attributing Mitchell's 45% interest in Pitkin to his wife, Marian, using the rule for attribution between spouses, Mitchell's 45% interest is also attributed to Norton. Since Norton is over age 21 and owns more than 50% of Pitkin, Mitchell's ownership is attributed again to Norton under the family attribution rule for parents and adult children.

Since Oliver is under age 21, Mitchell's 45% interest may be attributed again to Oliver under the family attribution rule for parents and minor children.

**NO ATTRIBUTION BETWEEN SIBLINGS:**

The 55% interest owned by Norton is not treated as owned by Oliver.

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## **Attribution Rules, Continued**

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**Example -  
Other Rules for  
Organizational  
Attribution  
under Section  
1563**

Assume the same facts as in Example 2. In addition, the Pitkin Corporation has a 50% interest in Rich and Riley, Inc. and Norton is married to Shannon.

**ATTRIBUTION RULES APPLIED AFTER ORGANIZATIONAL  
ATTRIBUTION:**

Norton is considered to own a 50% (100% x 50%) interest in Rich and Riley, Inc.

- Norton is treated as owning 100% of Pitkin (55% directly and 45% attributed from his father).
  - Shannon is attributed the 50% interest in Rich and Riley, Inc.
-

## **Determination Letter Program: Controlled Group Plans**

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**Background** The Employee Plans (EP) Determination Letter Program provides a means whereby plan sponsors may submit their plans to the Service for review. The Service reviews the form of the plan and, if the plan sponsor elects, reviews certain operational features as well. If the plan meets the qualification requirements under 401(a) of the Internal Revenue Code (Code), a favorable determination letter is issued to the plan sponsor. The letter gives the employer reliance on the form of plan.

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**Controlled Group Pension Plans** When the sponsor of a qualified retirement plan is part of a controlled group, all employers of the group must be treated as a single employer to determine if a plan meets the requirements of sections 401, 408(k), 408(p), 410, 411, 415, 416, and 417.

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**Rev. Proc 2004-6 : Required Information** When a plan sponsor submits a determination letter application (Forms 5300, 5307, 5310 and 6406), question 6 on the applications, asks if the employer is a member of a controlled group or affiliated service group.

If question 6 is answered “Yes”, Rev. Proc. 2004-6 provides certain information about the controlled group. The EP Specialist should secure for review the following information (if not present with the application):

1. All members of the group;
  2. Their relationship to the plan employer;
  3. The type(s) of plan(s) each member has; and
  4. Plans common to all members.
- 

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## Determination Letter Program: Controlled Group Plans, Continued

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**Example-  
Determination  
Letter  
Application for  
a Controlled  
Group Plan-  
Facts**

Corporation A submits a Form 5307 Prototype Application for a Determination Letter for a Profit Sharing Plan, which indicates that Corporation A is a member of a controlled group. Along with the application, the plan sponsor provides a controlled group statement with the following information.

---

**Example-  
Controlled  
group  
statement**

Corp A owns:

- 90% of Corp B,
- 85% of Corp C, and
- 50% of Corp X.

There is only one plan, sponsored by Corp A and members will adopt the sponsor's plan.

Plan effective date 1-1-1997

Corp A has 56 employees, Corp B has 20 employees, Corp C has 30 employees and Corp X has 90 employees.

Plan sponsor paid **no** user fee per EGTRRA section 620, which exempts small plans from user fees on determination letter requests.

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## **Determination Letter Program: Controlled Group Plans,** Continued

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**Application and  
controlled  
group  
statement  
review**

Since the Service doesn't rule on the controlled group status of qualified plans, the analysis performed by the EP Specialist, regarding the controlled group status of an employer, must include the following:

- Review the controlled group information to determine if the employer's status meets the requirements of a controlled group, under sections 1563(a) and 414(b) & (c). If the requirements are met, the employer has declared that are a member of a controlled group.
- If the requirements of sections 1563(a) and 414(b) & (c) are not met, the EP Specialist should notify the employer or their representative that based on sections 1563(a) and 414(b) & (c), the employer status is not a controlled group member.

The specialist should secure a revised application (with question 6, answered "No") or notate the case file with the correct employer status.

---

**Application and  
Controlled  
Group  
Statement  
Analysis**

Based on the information provided, a controlled group exists between Corporation A, Corporation B and Corporation C. This is a parent-subsidary group, due to the 80% rule. Corporation X is excluded as a member (less than 80%).

In this example, once the controlled group status is determined, the EP Specialist should secure the appropriate user fee for a Form 5307 Application.

Since all employees of a controlled are treated as employed by a single employer, the number of employees exceeds 100 (total # of employees for Corporations A, B, and C equals 106).

The application is not eligible for user fee exclusion, under EGTRRA section 620.

Once the user fee is received, the application should be reviewed for general qualification requirements, which are discussed later in this chapter.

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## **Determination Letter Program: Controlled Group Plans,** Continued

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**Specific  
Instructions  
Form 5310  
Application for  
Controlled  
Group Plans**

Form 5310, Application or Determination for Terminating Plans, is used by any plan sponsor or administrator of the pension plan to request a determination letter on the plan's qualified status at the time it terminates.

Rev. Proc. 2004-6 states that an application for a determination letter involving plan termination must also include any supplemental information or schedules required by the forms or form instructions. For example, the application must include copies of all records of actions taken to terminate the plan (such as a board of directors resolution) and a schedule providing certain information regarding employees who separated from vesting service with less than 100% vesting.

The Form 5310 application is the last opportunity for the Service to review the qualified status of the plan before termination. When a Form 5310 is filed for a plan sponsor who is a member of a controlled group.

The EP specialist should ensure that the controlled group members are treated as a single employer when applying certain employee plan benefits requirements.

Also when analyzing the application for employees separated without 100% vesting, reversion issues, spin-off termination/change in funding and any other issues addressed in (IRM) 7.12.1, Plan Terminations.

---

**Example-  
Termination  
Application for  
a Controlled  
Group Plan-**

Assume the same facts in previous example except the application submitted is a Form 5310 and the application indicated that the termination date is 12-31-2003. In addition the application states that in 2001, 6 participants were separated without 100% vesting

The plan document has a 3-year cliff vesting schedule and immediate participation upon employment.

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**Determination Letter Program: Controlled Group Plans,**  
Continued

**Example-  
coverage  
information**

Also the following coverage information was provided:

	<b>A</b>	<b>B</b>	<b>C</b>	<b>Total</b>
Total Employees	56	20	30	106
Highly Comp. Employees	4	2	5	11
Highly Comp. Employees Benefiting	4	1	5	10
Ineligible Employees	9	0	1	10
Total	43	18	24	85
Other NHCEs not benefiting	10	2	4	16
NHCEs Benefiting	33	16	20	69

**Application  
review for  
Form 5310**

In addition to the determination made in the previous example (Corporations. A, B and C are members of a controlled group), the EP Specialist should secure (if not provided) the following information:

A schedule with the following information for each participant who has separated from vesting service with less than 100% vesting:

1. Name of participant,
2. Date of hire,
3. Date of termination,
4. Years of participation,
5. Vesting percentage,
6. Account balance/account benefit at the time of separation from service,
7. Amount of distribution,
8. Date of distribution, and
9. Reason for termination.

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## **Determination Letter Program: Controlled Group Plans,** Continued

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### **Analysis of Form 5310 Application for a Controlled Group Plan**

The analysis should review the information to ensure that the participants, who separated without 100% vesting, were cashed out properly. Also investigate if there was any previous service with other members of the controlled group, and

Consider whether the form requirements of the plan are met and coverage is adequate. If the facts have materially changed or new legislation has affected the entity, sufficient information should be requested from the employer to determine whether all eligible employees are considered for purposes of coverage.

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### **Results of Performing Coverage Testing for a Controlled Group**

The coverage information was included to illustrate controlled group coverage testing under section 410(b).

Results:

The percentage of HCEs benefiting is 91% (HCEs benefiting/total HCEs).

The NHCEs benefiting is 81% (total NHCEs benefiting/total NHCEs)

The final step in the coverage test is to calculate the coverage percentage, which is 89% (percentage of NHCEs benefiting/Percentage of HCEs benefiting, which passes coverage).

The application should be reviewed for general qualification requirements, which are discussed later in this chapter.

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## **Impact of Section 414(b) and (c) on Qualified Plans**

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**Code Sections  
Effected by  
Controlled  
Group Plans**

If two or more corporations, trades or businesses are part of a controlled group of businesses, the controlled group members are treated as a single employer when applying certain employee plan benefits requirements.

These requirements are:

- 1 – Nondiscrimination, IRC 401(a)(4),
  - 2 – Compensation dollar limit under IRC 401(a)(17),
  - 3 – Minimum participation test under IRC 401(a)(26),
  - 4 – Eligibility, IRC 401(a)(3) and 410(a),
  - 5 – Coverage, IRC 410(b),
  - 6 – Vesting, IRC 401(a)(7) and IRC 411,
  - 7 – Section 415 limits,
  - 8 – Top heavy rules IRC 416, and
  - 9 – SEP’s under 408(k) and SIMPLE-IRA plans under IRC 408(p).
- 

**Section  
401(a)(4)**

Section 401(a)(4) requires that contributions under the plan may not discriminate in favor of those who are highly compensated (as defined in section 414(q)).

An employee is a highly compensated employee if the employee meets one of two tests:

- the five-percent owner test ,or
- the compensation test. Section §414(q)(1)

Since all employees of a controlled group are treated as employed by a single employer, any employee of the related business, who is (or was) a five percent owner, will be a highly compensated employee.

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## Determination Letter Program: Controlled Group Plans, Continued

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**Nondiscrimination** The following examples illustrate the impact of section 401(a)(4) on qualified plans:

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**Example 1** Tucker Computing, Inc., Smith Mainframe, Inc. and Yuma Software, Inc. are a controlled group of corporations.

Jack is a participant in the Tucker Computing, Inc. Profit Sharing Plan. Jack has never had any ownership in Tucker Computing, Inc. and is not a highly compensated employee.

Prior to the buy out of Smith Mainframe, Inc. by Tucker Computing, Inc., Jack was a 30% owner in Smith Mainframe.

Solely as a result of the controlled group relationship, Jack would be deemed to be a highly compensated employee in the Tucker Computing plan.

Similar issues may result in determining if an employee is highly compensated under IRC sections 414(q)(1)(B), (C), and (D). See next Example.

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**Example 2** 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 from Travis is \$45,000 and from Wells is \$35,000.

Wanda would not be deemed a highly compensated employee based upon her compensation from Tabor Equipment Co, Inc alone.

However, because all of her compensation from both employers would be aggregated to determine the "Top Paid Group", she would be a highly compensation employee.

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*Continued on next page*

## Determination Letter Program: Controlled Group Plans, Continued

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**Section 401(a)(17)** Section 401(a)(17) limits the amount of compensation that may be considered under a qualified plan to \$200,000

All of the employees in the controlled group must be considered as if there were one employer.

---

**Compensation Limits- Example** 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 2000, he received an allocation of \$15,000 under each plan.

In 2001, Gordon, Inc. and Bacon, Inc. became members of a controlled group.

For subsequent allocation purposes, Bob's compensation is limited to \$200,000 (not the \$300,000 if counted separately), because one employer pays his entire compensation. Therefore, the amount that may be allocated to his account under both plans is limited to \$20,000 (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).

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**Section 401(a)(26)** Section 401(a)(26) requires that a plan must benefit the lesser of 50 employees or 40 percent or more of all employees.

In testing a plan for section 401(a)(26), all employers required to be aggregated under sections 414(b) and (c), must be treated as a single employer.

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*Continued on next page*

## **Determination Letter Program: Controlled Group Plans,** Continued

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### **Additional Participation Requirements- Example**

Alma and her husband, Clay jointly own 100% of the Caldwell Corporation. Alma also owns 100% of the capital and 50% of the profits of A & B Partnership. Clay owns the other 50% profit interest in A & B. Alma is the only employee in the Caldwell Corporation and there are no common law employees in A & B Partnership. Alma wants to set up a defined benefit plan for Caldwell. A & B does not maintain a retirement plan. There are only two employees, Alma and Clay, in the controlled group.

Caldwell Corporation and A & B Partnership are a controlled group of businesses under section 414(c) because Alma owns:

- 100% of A & B (the greater of her ownership in the capital or profits), and
- 100% of Caldwell (due to attribution from Clay).

Alma could not set up a defined benefit plan for only the Caldwell Corporation.

Since both businesses must be treated as a single employer and section 401(a)(26) applies, she would have to cover both employees of the controlled group in order to have 40% or more employee participation.

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### **Section 401(a)(3)**

Section 401(a)(3) requires that a qualified plan satisfy section 410, coverage and eligibility.

In general, all years of service with an employer must be counted.

Sections 414(b) and (c) require the consolidation of all employees in the group as if employed by one employer.

Therefore years of service with the following entities must be counted:

- Any member of a controlled group of corporations, or
  - A commonly controlled entity, whether or not incorporated.
- 

*Continued on next page*

## **Determination Letter Program: Controlled Group Plans,** Continued

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### **Coverage**

Creek Manufacturing, Inc. and Dunn, Inc. are members of a controlled group.

Creek maintains a qualified plan in which only their employees may participate. Dunn employees are not eligible to participate in the plan. The Creek plan has a one-year service requirement. It must recognize service with all employers in the controlled group and otherwise meet the coverage requirements of section 410(b) with reference to the entire group.

You determine that one employee, Mary, had completed three years of service with Dunn prior to her transfer to Creek. The plan administrator required Mary to complete a year of service with Creek before including her in the plan.

In this instance, Mary should have become a participant in the plan as soon as she started to work for Creek, because she had already completed her year of service under Dunn.

Failure to have Mary participate immediately in the plan means the plan violates sections 401(a)(3) and 410(a)(1)(A).

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### **Section 401(a)(7) & Section 411**

Section 401(a)(7) requires that a qualified plan satisfies section 411, vesting.

In general, all years of service with an employer must be counted.

Sections 414(b) and (c) require the consolidation of all employees in the group as if employed by one employer.

Therefore years of service with the following entities must be counted:

- Any member of a controlled group of corporations, or
  - A commonly controlled entity, whether or not incorporated.
- 

*Continued on next page*

**Determination Letter Program: Controlled Group Plans,**  
Continued

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**Vesting-  
example**

Teton corporation is the parent company of subsidiary L. Carmen works for subsidiary L and commenced employment on September 1, 2000. Teton corporation maintains a profit sharing plan. The plan only covers employees of Teton.

On May 1, 2004, Carmen transfers to Teton corporation. In determining Carmen's vesting percentage under Tech's plan, Carmen's service with subsidiary L must be counted.

Teton's plan prescribes a 5-year cliff vesting schedule. Therefore, as of the vesting period in which Carmen transferred, she already has three years of service for vesting purposes under L's plan (although no accrued benefit to vest in).

Sections 414(b) and (c) require the consolidation of all employees in the group as if employed by one employer.

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**Section 415**

Section 401(a)(16) requires that a qualified plan must meet the requirements of Section 415.

Sections 414(b) and (c) require the consolidation of all employees in the group as if employed by one employer.

Benefits and contributions under all plans maintained by employers in the group must be aggregated to determine the maximum amount allowed by section 415.

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*Continued on next page*

## **Determination Letter Program: Controlled Group Plans,** Continued

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**Section 415  
Limits-  
Example**

Starr, Inc. and Upson Ltd. are a controlled group. Each maintains an identical money purchase plan.

During the 2003 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.

Since the employers are members of a controlled group, the limitation of section 415(c)(1)(A) should have been applied by **aggregating** the allocations under both plans. This would have limited the total allocations to the lesser of 25% of compensation or \$40,000.

The allocations in this instance result in a disqualification of either one or the other of the plans due to a violation of sections 401(a)(16) and 415(c)(1)(A). The actual plan to be disqualified is determined pursuant to Treas. Regulation section 1.415-9(b)(3)(iii).

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**Section 416**

Section 416, special rules for top-heavy plans

Aggregate all years of service and compensation earned by organizations within a controlled group for purposes of:

- Minimum contributions and benefits,
  - Minimum vesting,
  - Determining if a plan is top-heavy.
- 

*Continued on next page*



**Determination Letter Program: Controlled Group Plans,**  
Continued

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**SEPs &  
SIMPLE-IRA**

Section 408(k) establishes the rules for simplified employer plans (SEPs). In many ways, the rules for SEPs mirror those for qualified plans.

Sections 414(b), (c) and (m) require the consolidation of all employees in the group as if employed by one employer for the purposes of section 408(k).

Such items as the minimum service requirement of subsection (2)(B) and the non-discrimination requirements of subsection (3) would have to be applied as if all the employers in the group constituted a single employer.

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## **Controlled Group: Exercises**

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**Exercise 1**

A Corp owns:

- 90% of the stock of B Corp,
- 80% of the stock of C Corp, and
- 50% of the stock of D Corp.

Unrelated persons own the percentage of stock not owned by A Corp.

C Corp. owns 80% of the profits interest in the XYZ Partnership.

Which of the following constitutes the controlled group and what type of group?

- a. B Corp, C Corp and XYZ Partnership
- b. A Corp, B Corp and C Corp
- c. A Corp, B Corp, C Corp and XYZ Partnership
- d. A Corp, B Corp, C Corp, D Corp and XYZ Partnership
- e. B Corp and C Corp

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*Continued on next page*

## Controlled Group: Exercises, Continued

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**Exercise 2** Assume the same facts as in exercise 1, except C Corp and D Corp are owned by three unrelated shareholders in the following percentages:

Shareholder	Percentage of Ownership	
	C Corp	D Corp
A	80 %	20 %
B	10	50
C	10	30
TOTAL	100 %	100 %

C Corp and D Corp not considered to be a controlled group, Why?

- a. To be a controlled group, each of the three shareholders would have to own 80% or more of the stock of each corporation.
- b. Although the three shareholders together own 80% or more of the stock of each corporation, they do not own more than 50% of the stock of each corporation taking into account only the identical ownership.
- c. To be a controlled group, each of the three shareholders would have to own 50% or more of the stock of each corporation.
- d. In order to satisfy the requirements of section 414(c), there must be a chain of corporations, connected through stock ownership with a common parent that owns 80% or more of at least one other organization.
- e. C Corp and D Corp constitute an affiliated service group.

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*Continued on next page*

## Controlled Group: Exercises, Continued

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**Exercise 3** X Corp and Y Corp are owned by five unrelated shareholders in the following percentages:

Shareholder	Percent of Ownership	
	X Corp	Y Corp
A	40%	30%
B	20	40
C	35	15
D	5	0
E	0	15
Total	100%	100%

Do X Corp and Y Corp constitute a controlled group of corporations? Why?

- Yes. All shareholders, together, own at least 80% of each corporation and no individual shareholder owns more than 50% of either corporation.
- No. Neither corporation owns at least 80% of the other.
- No. No individual shareholder owns more than 50% of either corporation.
- No. Since D and E do not have ownership in both X Corp and Y Corp, there cannot be any combined identical ownership.
- Yes. A, B and C, together, own more than 80% of X Corp and more than 80% of Y Corp and their combined identical ownership is more than 50%.

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## **Controlled Group: Exercises, Continued**

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**Exercise 4**      What are the three types of controlled groups?

- a. Parent-subsiary, Brother-brother and Combined group.
  - b. Brother-sister, Combined and Parent-child group.
  - c. Parent-subsiary, Brother-sister and Combined groups.
  - d. Husband -wife, Brother-sister and Combined groups.
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## **Summary**

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**Summary**      IRC sections 414(b) & (c) were added to the Code because, in the words of the Senate Committee Report on ERISA: “ 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.”

A plan that is maintained by an employer, within a group of employers that are under common control, must meet the requirements of IRC section 401(a) as if a single employer employed all employees of the group.

This chapter explains how to recognize a controlled group and the impact on qualified plans and the Determination Letter process.

In the next section of this chapter, we will discuss Affiliated Service Groups.

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## **Overview: Affiliated Service Group**

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### **Introduction**

As you have learned, section 414(b) and (c) require that all employees of commonly controlled corporations or trades or businesses be treated as employees of a single corporation or trade or business.

By arranging the ownership of related business entities in an artificial manner, the definition of "control" under section 414(b) and (c) and the aggregation rules established by ERISA could be circumvented. In addition, the basic rule that employee plans provide an exclusive benefit for employees or their beneficiaries could be violated.

Section 414(m) was enacted to prevent such circumvention by expanding the idea of control to separate, but affiliated, entities. Proposed Treas. Reg. § 1.414(m) provides that all employees of the members of an affiliated service group shall be treated as if a single employer employed them.

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### **Objectives**

At the end of this section, you will be able to identify situations where the plan sponsor is a member of an affiliated service group and recognize the impact on qualified plans. Therefore, you will be able to:

1. Describe the relationship between employers and determine if an affiliated service group exists.
2. Describe the relationship between a first service organization and an A-Organization and determine whether an affiliated service group exists.
3. Describe the relationship between a first service organization and a B-Organization and determine whether an affiliated service group exists.
4. Describe a management organization situation and determine whether an affiliated service group exists.
5. Determine how these relationships affect the status of qualified plans.
6. Describe the procedure for processing a affiliated service group determination letter request.

Describe other employer/employee relationships, such as leased employees, impendent contractors, professional employee organization and management organization



## Affiliated Service Group

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### History

The *Kiddie v. Commissioner* 69 T.C. 1055 (1978)) and *Garland v. Commissioner* 73 T.C. 5 (1979)) cases addressed the issue of control. The Tax Court held that where a controlled group situation did not exist, it would not be necessary to aggregate employees for purposes of testing for coverage and discrimination.

IRC § 414(m) was enacted to expand the idea of control to separate, but affiliated, entities. Proposed Treas. Reg. § 1.414(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.

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### Definition

An affiliated service group is one type of group of related employers and refers to two or more organizations that have a service relationship and, in some cases, an ownership relationship, described in IRC section 414(m). An affiliated service group can fall into one of three categories:

1. A-Organization groups (referred to as “A-Org”), consists of an organization designated as a First Service Organization (FSO) and at least one “A organization”,
  2. B-Organization groups (referred to as “B-Org”), consists of a FSO and at least one “B organization”, or
  3. Management groups.
- 

### First Service Organization

An FSO must be a "service organization":

- Performance of services is the principal business of the organization as defined in section 414(m)(3), and Proposed Treas. Reg. § 1.414(m)-2(f) .
  - “Organization” refers to a corporation, partnership, or other organization.
- 

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## **Affiliated Service Group, Continued**

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### **A-Org**

To be an A-Org, an organization must satisfy a two-part test:

– Ownership Test

The organization is a partner or shareholder in the FSO (regardless of the percentage interest it owns in the FSO) determined by applying the constructive ownership rules as specified in section 318(a), and

– Working Relationship Test

- The organization "regularly performs services for the FSO," or
- Is "regularly associated with the FSO in performing services for third parties.

Facts and circumstances are used to determine if a working relationship exists. See Proposed Treas. Reg. § 1.414(m)-2(b).

See section 414(m)(2)(A).

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## **Affiliated Service Group, Continued**

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### **B-Org**

To be a B-Org, the organization must meet the following requirements:

- A significant portion of its business must be the performance of services for a FSO, for one or more A-Org's determined with respect to the FSO, or for both,
- The services must be of a type historically performed by employees in the service field of the FSO or the A-Org's, and
- Ten percent or more of the interests in the organization must be held, in the aggregate, by persons who are highly-compensated employees (pursuant to IRC § 414(q)) of the FSO or A-Org.

A B-Org **need not** be a service organization.

See IRC § 414(m)(2)(B).

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### **Performance of Services**

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, even though the organization is not engaged in a field listed in Proposed Treas. Reg. § 1.414-(m)-2(f)(2) .

Whether capital is a material income-producing factor must be determined by reference to all the facts and circumstances of each case. In general, capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business as reflected, for example, by a substantial investment in inventories, plant, machinery or other equipment.

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

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

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## **Affiliated Service Group, Continued**

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**Specific fields**      Regardless of whether the above subparagraph applies, 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.

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**An organization will not be considered as performing services**

An organization will not be considered as performing services merely because:

- It is engaged in the manufacture or sale of equipment or supplies used in the above fields,
  - It is engaged in performing research or publishing in the above fields, or
  - An employee provides one of the enumerated services to the organization or other employees of the organization, unless the organization is also engaged in the performance of the same services for third parties.
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## **Affiliated Service Group, Continued**

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**Commissioner may determine other specific fields**      The Commissioner may determine that a specific business field, not enumerated in the proposed regulations, is engaged in performing services. In this case, the above list will be expanded, but only prospectively.

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**“Organization” defined**      The term "organization" includes a sole proprietorship, partnership, corporation or any other type of entity, regardless of its ownership format.

A bona fide expense-sharing arrangement, in which the parties involved share the cost of the office overhead but are not working in unison for common business purposes, would not be considered an organization. These costs would include rent, supplies, maintenance and employees' salaries.

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**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, 1980.

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**Professional Service Corporations**      All the employees of professional service corporations that are members of an affiliated services group shall be aggregated together and treated as if they were employed by a single employer for purposes of the employee benefit requirements.

A professional service corporation:

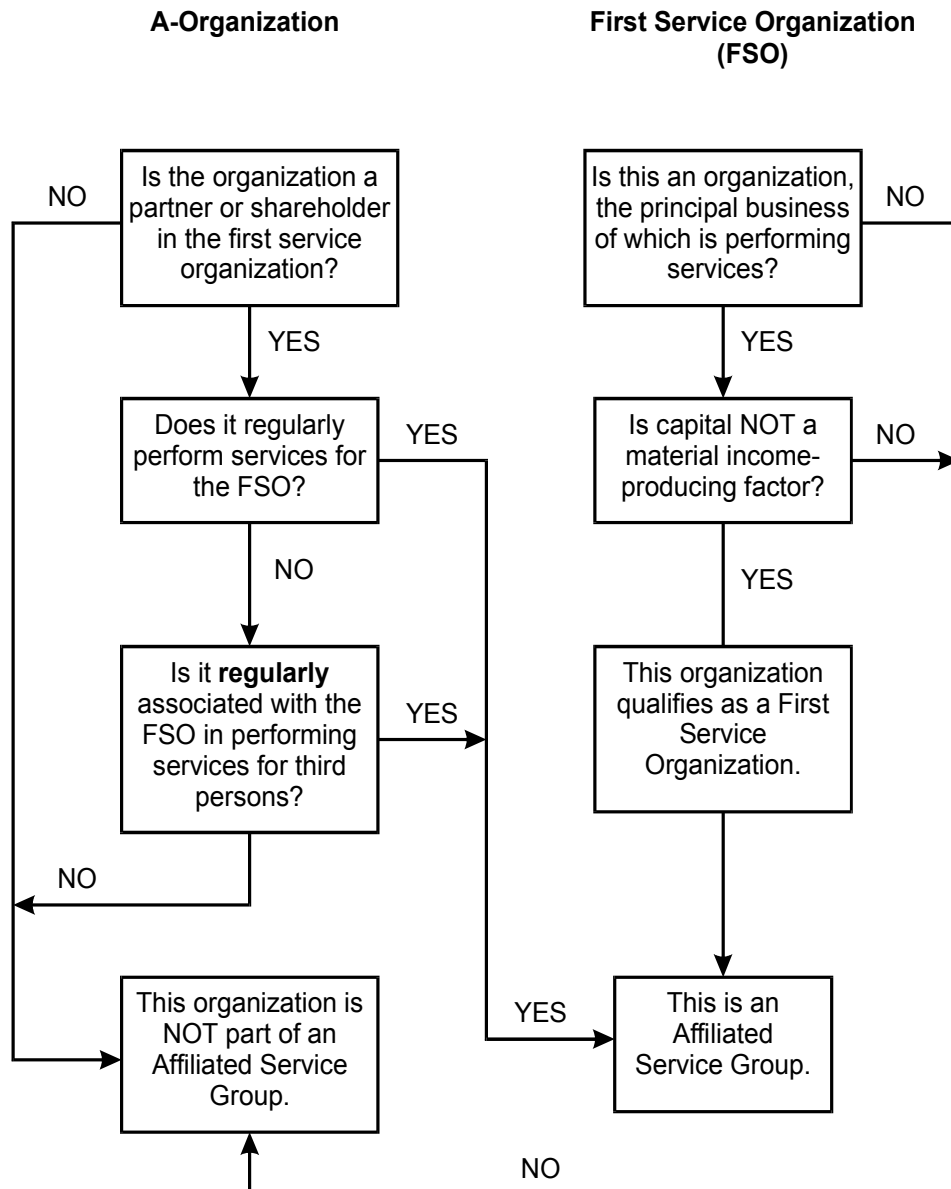
- Is a corporation that is organized under state law for the principal purpose of providing professional services,
  - Has at least one shareholder who is licensed or otherwise legally authorized to render the type of services for which the corporation is organized, and
  - Provides the services performed by certified or other public accountants, actuaries, architects, attorneys, chiroprodists, chiropractors, medical doctors, dentists, professional engineers, optometrists, osteopaths, podiatrists, psychologists and veterinarians. The Commissioner may expand the list of services.
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## Affiliated Service Group, Continued

Flowchart

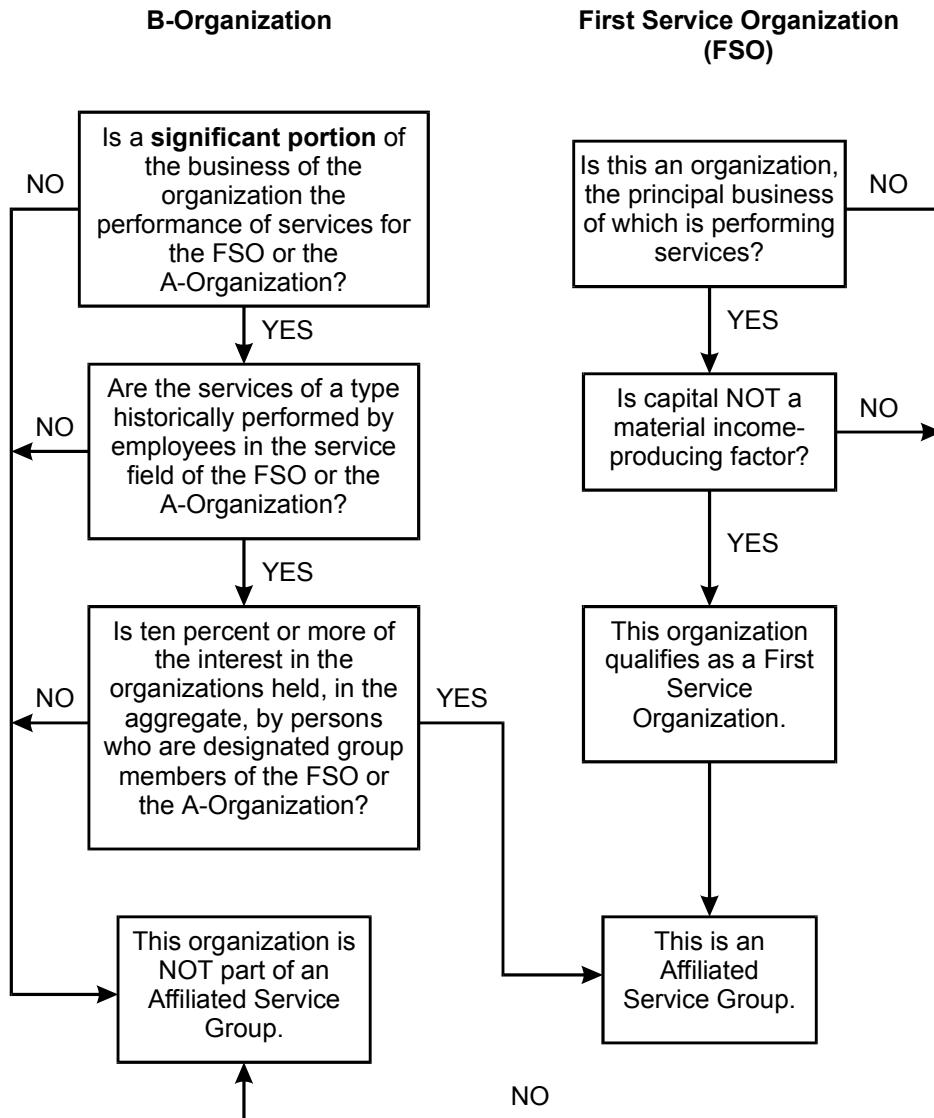
### Affiliated Service Group



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Flowchart

Affiliated Service Group



## **Affiliated Service Group, Continued**

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**Section 414(m)-  
Example**

Allen Averett, a doctor, is incorporated as Allen Averett, P.C. and this professional corporation is a partner in the Butler Surgical Group. Allen Averett and Allen Averett, P.C., are regularly associated with the Butler Surgical Group in performing services for third parties.

The Butler Surgical Group is an FSO. Allen Averett, P.C. is an A-Org because it is a partner in the medical group and is regularly associated with the Butler Surgical Group to perform services for third parties.

Accordingly, Allen Averett, P.C. and the Butler Surgical Group would constitute an affiliated service group.

As a result, the employees of Allen Averett, P.C. and the Butler Surgical Group must be aggregated and treated as if they were employed by a single employer per section 414(m).

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**First Service  
Organization  
and an A-Org-  
Example**

The Everett, Furman and Guilford Partnership is a law partnership with offices in numerous cities. EFG of Capital City, P.C., is a corporation in Capital City that is a partner in the law firm. EFG of Capital City, P.C. provides paralegal and administrative services for the attorneys in the law firm. All of the employees of the corporation work directly for the corporation, and none of them work directly for any of the other offices of the law firm.

The law firm is an FSO. The corporation is an A-Org because it is a partner in the FSO and is regularly associated with the law firm in performing services for third parties.

The corporation and the partnership would together constitute an affiliated service group. Therefore, the employees of EFG of Capital City, P.C. and the employees of The Everett, Furman and Guilford Partnership must be aggregated and treated as if they were employed as a single employer per section 414(m).

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## **Affiliated Service Group, Continued**

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**First Service Organization and a B-Org-Example**

Reinhardt & Associates is a financial services organization that has 11 partners. Each partner of Reinhardt owns one percent of the stock in Asbury Corporation. Asbury provides services to the partnership of a type historically performed by employees in the financial services field. A significant portion of the business of Asbury consists of providing services to Reinhardt.

Considering Reinhardt & Associates as an FSO, the Asbury Corporation is a B-Org because:

1. A significant portion of its business is in the performance of services for the partnership of a type historically performed by employees in the financial services field. And,
2. More than 10% of the interests in the Asbury Corporation is held, in the aggregate, by the highly-compensated employees of the FSO (consisting of the 11 common owners of Reinhardt and Associates).

Accordingly, the Asbury Corporation & Reinhardt and Associates constitute an affiliated service group. Therefore, the employees of the Asbury Corporations and Reinhardt and Associates must be aggregated and treated as if they were employed by a single employer per section 414(m).

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**Non Service Organization-Example**

Dade Properties, Inc. sells land that it has purchased and developed. Craig is a 25% shareholder of Dade and a 50% shareholder of Craig and Son Construction Company, Inc. Dade Properties regularly engages the services of Craig and Son. Although it appears that Dade Properties could be an FSO, the affiliated service group rules do not apply because Dade Properties is not a service organization.

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## **Affiliated Service Group: Performance of Service**

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**Significant Portion**

Proposed Treas. Reg. § 1.414(m)-2(c)(2) specifies that whether providing services (for the FSO, for one or more A-Org's or for both,) is a "significant portion" of the business of an organization will be based on the facts and circumstances.

The following tests may be used to substantiate the facts and circumstances:

- Service Receipts Safe Harbor Test, and
- Total Receipts Threshold Test.

For additional information, see Proposed Treas. Reg. § 1.414(m)-(2)(c)(2).

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**Service Receipts Safe Harbor**

The performance of services for the FSO, for one or more A-Org's, 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:
    1. Gross receipts of the organization derived from performing services for the FSO, for one or more A-Org's, or for both, to
    2. Total gross receipts of the organization derived from performing services.
  - This ratio is the greater of:
    1. the ratio for the year for which the determination is being made, or
    2. the ratio for the three-year period including that year and the two preceding years (or the period of the organization's existence, if less).
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**Affiliated Service Group: Performance of Service**, Continued

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**Total Receipts  
Threshold Test**      The performance of services for the FSO, for one or more 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.

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## Affiliated Service Group: Performance of Service, Continued

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**Service receipts- Example**

The income of Cascade Corporation is derived from performing both services and other business activities. The amount of its total receipts and its receipts derived from performing services and its total receipts from Starr Corporation and from all customers is provided below:

	Origin of Income	All Customers	Starr Corp.
<b>Year 1</b>	Services	\$ 100	\$ 4
	Total	\$120	
<b>Year 2</b>	Services	150	9
	Total	180	
<b>Year 3</b>	Services	200	42
	Total	240	

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**Service Receipts Percentage**

In **Year 2**, the services receipts percentage is the greater of:

1. The ratio for that year ( $\$9/\$150$ , or 6%), or
  2. For Years 1 and 2 combined ( $\$13/\$250$ , or 5.2 %).
- = 6%

The total receipts percentage is the greater of:

1. The ratio for that year ( $\$9/\$180$ , or 5%), or
  2. For Years 1 and 2 combined ( $\$13/\$300$ , or 4.3%).
- = 5%

The services receipts percentage is greater than 5% and, therefore, the Service Receipts safe harbor is not met.

The total receipts percentage is less than 10% and, therefore, the Total Receipts threshold test is not met.

As a result, for Year 2, facts and circumstances is used to determine whether performing services for Starr Corporation constitutes a significant portion of the business of Cascade Corporation.



**Affiliated Service Group: Performance of Service**, Continued

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**Total Receipts Percentage**

In Year 3, the services receipts percentage is the greater of:

1. the ratio for that year ( $\$42/\$200$ , or 21%), or
  2. for Years 1, 2, and 3 combined ( $\$55/\$450$ , or 12.2%).
- = 21%.

The total receipts percentage is the greater of:

1. the ratio for that year ( $\$42/\$240$ , or 17.5%), or
  2. for Years 1, 2, and 3 combined ( $\$55/\$540$ , or 10.2%).
- = 17.5%

Because the total receipts percentage is greater than 10% and the services receipts percentage is not less than 5%, a significant portion of the business of Cascade Corporation is considered to be the performances of services for Starr Corporation.

For Year 3, therefore, the Cascade Corporation and the Starr Corporation are part of an affiliated service group within the meaning of section 414(m), and the employees of both corporations must be aggregated and treated as if they were employed by a single employer.

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## **Affiliated Service Group: Performance of Service, Continued**

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**Example-Total  
Receipts,  
Percentage Test**

Marsha Mesa owns one-third of an employee benefits consulting firm, Benefits by Marsha. Marsha also owns one-third of an insurance agency, Mesa, Long and Toole Insurance Agency. A significant portion of the business of Benefits by Marsha consists of assisting the Mesa, Long and Toole Insurance Agency in developing employee benefit packages for sale to third persons and providing services to the insurance company in connection with employee benefit programs sold to other clients of the Mesa, Long and Toole Insurance Agency.

Additionally, Benefits by Marsha frequently provides services to clients who have purchased insurance arrangements from the Mesa, Long and Toole Insurance Agency for the employee benefit plans they maintain. Mesa, Long and Toole Insurance Agency frequently refer clients to Benefits by Marsha to assist them in the design of their employee benefit plans. Twenty percent of the total gross receipts of Benefits by Marsha represent gross receipts from the performance of these services for the Mesa, Long and Toole Insurance Agency.

Considering Mesa, Long and Toole Insurance Agency as a FSO, Benefits by Marsha is a B-Org because:

- A significant portion of the business of Benefits by Marsha (as determined under the total receipts percentage test) is the performance of services for Mesa, Long and Toole Insurance Agency of a type historically performed by employees in the service field of insurance, and
- More than 10% of the interests in Benefits by Marsha is held by owners of the Mesa, Long and Toole Insurance Agency.

Thus, Mesa, Long and Toole Insurance Agency and Benefits by Marsha constitute an affiliated service group, and the employees of both companies must be aggregated and treated as if they were employed by a single employer.

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## **Affiliated Service Group: Performance of Service, Continued**

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**Example-Gross Receipts Derived from Performing Services**

Calvin Cameron is a 60% partner in Decatur, a service organization, and regularly performs services for Decatur. Cameron is also an 80% partner in Fleming Brothers. A significant portion of the gross receipts of Fleming Brothers is derived from providing services to Decatur of a type historically performed by employees in the service field of Decatur.

If Decatur is an FSO, then Fleming Brothers would be a B-Org because:

- A significant portion of gross receipts of Fleming Brothers is derived from performing services for Decatur of a type historically performed by employees in that service field, and
- More than 10% of the interests in Fleming Brothers is held by a highly-compensated employee, Calvin Cameron (who is a common owner of Decatur).

Accordingly, Decatur and Fleming Brothers constitute an affiliated service group. Additionally, the employees of Decatur and Fleming Brothers are aggregated under the rules of section 414(c). Thus, any plan maintained by a member of the affiliated service group must satisfy the aggregation rules of section 414 (c) and 414 (m).

The aggregation rules of section 414(c) and 414(m) require all employees of the “employer” to be aggregated and treated as if they were employed by a single employer. The “employer” is Decatur and Fleming Brothers.

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## **Affiliated Service Group: Performance of Service, Continued**

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**Example-FSO  
with an A-Org  
and a B-Org**

- Karen King, incorporated as Karen King Corporation, is a partner in the management consulting firm of King & Ferris and she regularly performs services for King & Ferris.
- Morehead Corporation provides secretarial services for King & Ferris. This constitutes a significant portion of Morehead's business. Karen King owns all of the stock of the Morehead Corporation.
- King & Ferris, is an FSO. Karen King Corporation is an A-Org because it is a partner in King & Ferris and regularly performs services for the firm or is regularly associated with the firm in performing services for third persons.
- Under the attribution rules of section § 318(a) (attribution rules are discussed in the next section), Karen King owns the partnership interest in the consulting firm, King & Ferris, which is held by Karen King Corporation. Thus, Karen King is an owner of the consulting firm.
- King & Ferris is an FSO. The secretarial corporation, Morehead Corporation, is a B-Org because:
  - a. a significant portion of its business consists of performing services for the consulting firm, King & Ferris, or for the Karen King Corporation, of a type historically performed by employees in the service field of management consulting, and
  - b. at least 10% of the interests in Morehead Corporation is held by Karen King, an owner of the consulting firm.

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*Continued on next page*



## **Affiliated Service Group: Performance of Service, Continued**

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**Example-FSO  
and a B-Org**

Jasper Jay is the office manager and a highly compensated employee of an accounting partnership, Hickory & Holmes. Woodruff Corporation provides the secretarial services for the partnership. Jasper Jay owns 50% of the stock of the secretarial corporation. A significant portion of the business of the secretarial corporation consists of providing services to the partnership.

Considering the partnership as a FSO, Woodruff Corporation is a B-Org because:

- A significant portion of the business of the secretarial corporation is the performance of services for the partnership, Hickory & Holmes, of a type historically performed by employees of accounting firms, and
- More than 10% of the interests in the corporation is held by a highly-compensated employee of the partnership, Hickory & Holmes.

Under the principles of section 318(a), the result would be the same, for example, if the stock were held, instead of by Jasper Jay, by his spouse, children, parents, grandparents or a combination of such relatives.

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## Multiple Affiliated Service Group

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### Introduction FSOs

Two or more affiliated service groups will not be aggregated simply because an organization is an A-Org or a B-Org with respect to each affiliated service group.

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

For additional information, see Proposed Treas. Reg. § 1.414(m)-2(g)

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### Example- Multiple FSOs

Pfeiffer Corporation provides secretarial service to numerous dentists in a medical building, each of whom maintains a separate unincorporated practice. Tina Temple, D.D.S., owns 20% of the secretarial corporation and accounts for 20% of its gross receipts. Paula Pomona, D.D.S., owns 25% of the corporation and accounts for 25% of its gross receipts.

***REMEMBER: Two or more affiliated service groups will not be aggregated simply because an organization is an A-Org or a B-Org with respect to each affiliated service group.***

Since the secretarial corporation, Pfeiffer Corporation, is a B-Org with respect to both dentists, there are two separate affiliated service groups as follows:

1. Tina Temple, D.D.S. is an FSO and Pfeiffer Corporation is a B-Org.
  2. Paula Pomona, D.D.S., is an FSO and Pfeiffer Corporation is a B-Org.
- 

*Continued on next page*

## **Multiple Affiliated Service Group, Continued**

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**Example-  
Multiple FSOs**  
(continued)

Pfeiffer Corporation is a B-Org for each FSO because:

- A significant portion of its business is the performance of services for each FSO,
  - 20% of the gross receipts of the corporation are derived from performing services for Tina Temple, D.D.S., and 25% of the gross receipts of the corporation are derived from performing services for Paula Pomona, D.D.S.
- The services are of a type historically performed by employees in the service field of the FSO, and
- Ten percent or more of the interests in Pfeiffer Corporation are held, in the aggregate, by persons who are highly-compensated employees of the FSO.

Again, using the attribution rules of section 318(a) (discussed in the next section), Tina Temple and Paula Pomona are each considered to own the interests in Pfeiffer that is held by their respective dental practices.

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## Multiple Affiliated Service Group, Continued

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### Multiple B-Org-Example-Facts

The following examples illustrate a multiple B-Org :

Dr. Neil Northland is incorporated as Dr. Northland, M.D., P.C. His secretarial services are provided by Quincy Corporation. Dr. Northland, M.D., P.C., owns 20 percent of the interests in the secretarial corporation and provides 20 percent of its gross receipts.

Redwood Corporation provides nursing services to Dr. Northland, M.D., P.C. Neil Northland, M.D., P.C., owns 25 percent of the interests in the nursing corporation and provides 25 percent of its gross receipts.

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### Example-Analysis-Dr. Northland is an FSO and Quincy is a B org.

Dr. Northland, M.D., P.C. is an FSO. The secretarial corporation, Quincy Corporation, is a B-Org because:

- 20 percent of the gross receipts of the secretarial corporation, Quincy Corporation, are derived from performing services for Neil Northland, M.D., P.C., of a type historically performed by employees of doctors, and
- 20 percent of the secretarial corporation is owned by the owner of Neil Northland, M.D., P.C.

Accordingly, Neil Northland, M.D., P.C., and the secretarial corporation, Quincy Corporation, constitute an affiliated service group.

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### Redwood corp. is a B org.

Considering Neil Northland, M.D., P.C., as a FSO, the nursing corporation, Redwood Corporation, is a B-Org because:

- 25 percent of the gross receipts of the nursing corporation, Redwood Corporation, are derived from performing services for Neil Northland, M.D., P.C., of a type historically performed by employees of doctors, and
- 25 percent of the nursing corporation is owned by the owner of Neil Northland, M.D., P.C.

Accordingly, Neil Northland, M.D., P.C. and the nursing corporation constitute an affiliated service group.

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**Multiple Affiliated Service Group, Continued**

**Redwood corp.  
is a B org.  
(continued)**

REMEMBER: If an organization is an FSO with respect to two or more A-Org's or two or more B-Org's, or both, all of the organizations shall be considered to constitute a single affiliated service group.

For purposes of section 414(m), there will be considered to be one affiliated service group consisting of Neil Northland, M.D., P.C., the secretarial corporation, Quincy Corporation, and the nursing corporation, Redwood Corporation.

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## **Attribution Rules for Affiliated Service Groups**

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**Introduction** You have been introduced to situations in which an individual is treated as owning an interest in a business, even though the individual does not actually own such interest. This concept, known as “attribution”, may result from family or business relationships. In this section, we will discuss attribution as it relates to affiliated service groups.

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**Section 318** Section 318 contains the rules of attribution to determine “control” for affiliated service groups (section 414(m)).

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**Note 1** Affiliated service group proposed regulations were issued in 1983 and, Prop. Treas. Reg. § 1.414(m)-2(d)(1) referred to section 267(c) attribution rules. Section 414(m)(6)(B) was amended in 1984 and refers to section 318 attribution rules. At this time, the proposed regulations have not been updated or finalized.

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**Note 2** Attribution rules for management-type affiliated service groups are determined under IRC §§ 267 and 1563. These rules are discussed later in this chapter.

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**General Rules – Family Attribution** The following table is a general description of how the family attribution rules are applied to affiliated service groups (other than management organizations).

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**Attribution Rules for Affiliated Service Groups, Continued**

**Family Attribution, Section 318**

The ownership interests of:	Are attributed to	
Spouse	Spouse	N/A
Parent	Child	Child's age is irrelevant
Child	Parent	Child's age is irrelevant
Grandchild	Grandparent	Grandparent's interest is not attributed to <u>grandchild</u>
Siblings	None	N/A

**Section 318- Example- Married**

Dana and Drew are married. Dana is a 50% partner in a medical practice. Drew is treated as owning 50% of the medical practice.

**NOTE:** For controlled group purposes, section 1563 provides an exception for spouses under certain conditions. This exception does not apply to affiliated service groups.

**Example- General Rules, Family Attribution**

Hope is the daughter of Howard. Howard owns 75% of H Company, Inc. and Hope owns the remaining 25%. Howard's ownership is attributed to Hope and Hope's ownership is attributed to Howard.

**NOTE:** For controlled group purposes, IRC § 1563 provides that the child's age and the ownership percentages of the parent or child are considered in determining attribution. For affiliated service groups, there are no exceptions for attribution between parent and child.

*Continued on next page*

## Attribution Rules for Affiliated Service Groups, Continued

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**General Rules - Org Attribution** The following table is a general description of how the attribution rules for organizations are applied to affiliated service groups (other than management organizations):

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

\* The interest owned is proportionate to the individual's share of the organization's value. For example, a shareholder's interest in a corporation is his proportionate share of the total stock value of the corporation.

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## **Attribution Rules for Affiliated Service Groups, Continued**

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**Example-Org  
Attribution**

Alvin owns 80% and Alfred owns 20% in the Butler Corporation. Butler Corporation owns a 40% interest in Cornell Corporation. Since Alvin owns at least 50% of Butler, he is considered to own a proportionate share of the Cornell stock owned by Butler. Alvin is attributed 32% (80% and 40%) of Cornell; Alfred is not considered to own an interest in Cornell because he does not own at least 50% of Cornell.

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**Example-Org  
Attribution,  
Partnerships**

If, in the previous example, Butler and Cornell were a partnership, rather than corporations, Alfred would be considered to own a .08% (20% and 40%) interest in Cornell.

For partnerships and trusts, under section 318, the ownership interests are attributed to all partners and beneficiaries. The “at least 50%” rule applies only to corporations under section 318.

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## **Attribution Rules for Affiliated Service Groups, Continued**

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**Example-Org  
Attribution for  
an FSO**

Trimble Corporation is a service organization. The sole function of Worth Corporation is to provide services to Trimble Corporation of a type historically performed by employees in the service field of Trimble Corporation. Wallace Wheeler owns all of the stock of Worth Corporation and 2.5 % of Trimble Corporation. He is not a highly-compensated employee of Trimble Corporation.

---

**If Trimble is  
considered to  
be an FSO**

Worth Corporation is not an A-Org because the corporation does not have an interest in Trimble, and

Worth Corporation is not a B-Org because highly-compensated employees do not own at least 10% of it.

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**If Worth  
Corporation is  
considered to  
be an FSO**

Trimble Corporation is an A-Org because:

- It has an ownership interest in Worth due to attribution from its sole shareholder, and
  - Trimble regularly performs services for the FSO.
- 
- 

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## Attribution Rules for Affiliated Service Groups, Continued

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**Example-Org.  
Attribution for  
an FSO**

Dr. Dawson is the sole shareholder of the Dawson Medical Corporation. She has a 25% interest in Fairfield Diagnostic Imaging, Inc. and regularly refers her patients for services. Dr. Dawson's 25% interest in Fairfield Diagnostic Imaging, Inc. is attributed to Dawson Medical Corporation.

An affiliated service group exists as follows:

- Fairfield is the FSO
- Performance of services is the principal business of the organization

Dawson Medical is the A-Org. The organization is a shareholder in the FSO (determined by applying the attribution rules), and the organization is regularly associated with the FSO in performing services for third parties.

**Note** - Dawson Medical is not a B-Org because it does not perform services *for* an FSO.

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**Dawson  
Example-Could  
be an FSO**

Dawson Medical *could* be a FSO, but Fairfield is not an A-Org.

To be an A-Org, Fairfield must be a shareholder in Dawson Medical.

Dawson Medical *could* be a FSO, but it is not clear as to whether Fairfield is a B-Org.

The facts do not allow a determination as to whether a significant portion of Fairfield's business is the performance of services for Dawson Medical. If there was significant performance of services of a type historically performed by employees in the medical field of the FSO, however, Fairfield *would* be a B-Org because at least 10% of the interest in Fairfield is held by highly-compensated employees of Dawson Medical. Dr. Dawson, through attribution, *is* a highly-compensated employee of Dawson Medical.

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## **Attribution Rules for Affiliated Service Groups, Continued**

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**Other Rules  
under  
Section 318**

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

However:

1. The ownership interests of an individual may be attributed *to more than one family member.*
2. After an individual is attributed the ownership of a corporation, partnership or trust (whether that interest is derived from a family member or an organization), the interest may then be taken into account under other attribution rules.

Options to acquire stock are, generally, treated as stock ownership under section 318. Refer to Rev. Rul. 68-601 and 89-64 for further information.

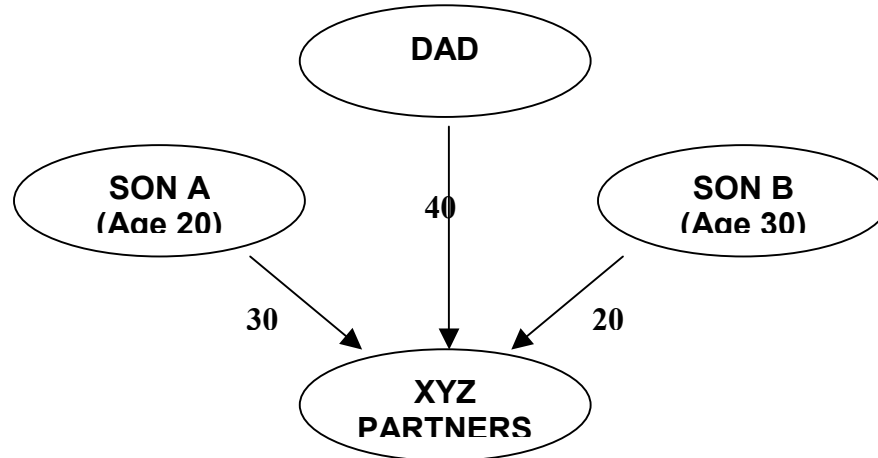
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## Attribution Rules for Affiliated Service Groups, Continued

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**Section 318-  
Example**



An unrelated person owns the remaining interest in XYZ.

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**Analysis-Dad**

Dad is considered to own a total of 90% of the profits interest in XYZ Partnership as follows:

- He directly owns 40% of XYZ Partnership
- He is considered as owning the 30% interest owned by minor Son A.

He is also considered as owning the 20% interest of XYZ that is owned by his adult son. (Remember that, for affiliated service group purposes, the child's age and percentage ownership of parent and child are not relevant.)

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## Attribution Rules for Affiliated Service Groups, Continued

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**Analysis-Son A** Son A is considered to own a total of 70% of the profits interest in XYZ:

- He directly owns 30%, and
- 
- He is considered to own the 40% profits interest owned directly by Dad.

Son A is not, however, considered to own the 20% owned directly by Son B (and attributed to Dad).

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**Analysis-Son B** Son B is considered to own a total of 60% of the profits interest in XYZ:

- He directly owns 20%, and
  - He is also considered to own the 40% interest of XYZ that is owned by his father.
- 

### **Examples- Other Rules for Spousal Attribution**

The following examples illustrate other spousal attribution rules:

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#### **Example 1- Attribution between spouses**

Marian and Mitchell are the parents of Norton and Oliver. Mitchell has a 45% interest in the Pitkin Corporation and his son, Norton, has a 55% interest.

Marian is treated as owning Mitchell's 45% interest in Pitkin.

#### **FAMILY ATTRIBUTION IS NOT ATTRIBUTED AGAIN TO ANOTHER FAMILY MEMBER:**

The 45% interest attributed to Marian is not further attributed to Oliver.

This rule would not prevent Mitchell's interest from being attributed to Oliver (see below)

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*Continued on next page*

## **Attribution Rules for Affiliated Service Groups, Continued**

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**Example 2-  
family  
attribution  
rules may be  
applied to more  
than one family  
member**

In addition to attributing Mitchell's 45% interest in Pitkin to his wife, Marian, using the rule for attribution between spouses, Mitchell's 45% interest is attributed again to both Norton and Oliver under the family attribution rule for parents and children.

### **NO ATTRIBUTION BETWEEN SIBLINGS:**

The 55% interest owned by Norton is not treated as owned by Oliver.

---

**Example 3-  
attribution  
rules applied  
after  
organizational  
attribution**

Assume the same facts as in previous example. In addition, the Pitkin Corporation has a 50% interest in Rich and Riley, Inc. and Norton is married to Shannon.

### **ATTRIBUTION RULES APPLIED AFTER ORGANIZATIONAL ATTRIBUTION:**

- Norton is considered to own a 50% (100% x 50%) interest in Rich and Riley, Inc.
  - Norton is treated as owning 100% of Pitkin (55% directly and 45% attributed from his father).
  - Shannon is attributed the 50% interest in Rich and Riley, Inc.
-

## Management Organizations

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### Introduction

Section 414(b), (c), and (m) were enacted to avoid violating the “exclusive benefit” requirement applicable to qualified plans. Even after rules were created to define controlled groups and affiliated service groups, the definition of “control” was subject to circumvention.

In *Silvano Achiro and Carol Achiro, and Peter Rossi and Gemma Rossi v. Commissioner of Internal Revenue*, 77 T.C. 62 (1981), the Tax Court determined that a company performing management services should be aggregated with the company it was performing management services for as part of a control group relationship under section 414(b). This case was initiated before the addition of section 414(m). The *Achiro and Rossi* case represents the type of maneuver that taxpayers tried to use in order to avoid coverage of certain employees.

In 1982, TEFRA added section 414(m)(5). This section added organizations that perform management services as another type of affiliated service group.

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### Organizations Performing Management Functions

A management-type affiliated service group exists when:

- An organization performs management functions, and
- The management organization's principal business is performing management functions on a regular and continuing basis for a recipient organization.

There does not need to be any common ownership between the management organization and the organization for which it provides service.

Any person related to the organization performing the management function is also to be included in the group that is to be treated as a single employer.

See section 414(m)(5).

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## **Management Organizations, Continued**

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**Recipient Organization**

A recipient organization is:

- An organization for which management services are performed,
- Any organizations aggregated under section 414(b), 414(c), 414(m), and 414(o), and
- All related organizations (for this purpose, related organization has the same meaning as related person within the meaning of section 144(a)(3)).

The recipient need not be a service organization.

---

**Example- Section 414(m)**

Anson and Branch Corporations constitute a controlled group of corporations under section 414(b).

Crockett and Duval Corporations constitute an affiliated service group under section 414(m)(2).

Assume Crockett or Duval (or both) perform management functions and other services for Anson or Branch (or both) and the performance of these management functions or services satisfy the requirements of a principal business on a regular and continuing basis.

Crockett and Duval are treated as a single management organization and Anson and Branch are treated as a single recipient organization for purposes of section 414(m)(5).

Anson, Branch, Crockett and Duval would constitute an affiliated service group under section 414(m)(5).

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## **Management Organizations, Continued**

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**Principal  
Business on  
Regular and  
Continuing  
Basis**

There are several tests used in the determination of principal business on a regular and continuing basis:

- Two-Tax-Year Rolling Percentage
  - Percentage of Gross Receipts
  - Facts and Circumstances
- 

**Two-Tax Year  
Rolling  
Percentage**

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

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

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

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## Management Organizations, Continued

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**Two-Tax Year  
Rolling  
Percentage  
(continued)**

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

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

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**Examples-the  
principal  
business test**

The following examples illustrate the principal business test:

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**Example 1**

The Ramsey Management Company performed services for unrelated entities: Ellsworth, Inc., Forrest, Inc. and Garfield, Inc. The gross receipts for 1999 and 2000 were \$148,000 and \$258,000, respectively. The following are Ramsey Management Company's gross receipts with respect to each company for which Ramsey performed management services.

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**Management Organizations, Continued**

Year	1999		2000		Two-Year Average
	Gross Receipts	Percent of Total	Gross Receipts	Percent of Total	
Ellsworth	\$ 68,000	46%	\$160,000	62%	56.2%
Forrest	50,000	34	58,000	22	26.6
Garfield	30,000	20	40,000	16	17.2
Total	\$148,000	100%	\$258,000	100%	100 %

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**Analysis**

In 2000, Ramsey Management Company and Ellsworth, Inc. satisfy the "principal business on a regular and continuing basis" test because management activities performed by Ramsey Management Company for Ellsworth, Inc., on average, is more than 50 percent of the management organization's business activities during this two-year tax period.

---

**Use of Gross Receipts to Determine Principal Business**

Except for the use of facts and circumstances to determine principal business, the determination of principal business on a regular and continuing basis is made on the basis of the percentage of gross receipts derived from management functions and other services performed for a recipient organization, as compared to the gross receipts derived from all business activities. In determining the two tax year percentage, gross receipts for the combined two tax year period are compared. Thus, it is not permissible to average the percentages determined separately for each tax year.

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

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**Management Organizations, Continued**

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**Use of Facts and Circumstances to Determine Principal Business**

The Commissioner has the discretion to determine that the use of gross receipts is not an appropriate method for determining principal business.

In that event, the determination of principal business shall be made on the basis of all relevant facts and circumstances, such as the amount of time actually spent by individuals in performing management functions and other services for a recipient organization.

The determination that the use of gross receipts is not an appropriate method for determining principal business may not be made by the taxpayer.

---

**Aggregated Organizations with Different Tax Years**

If the gross receipts test is being used and the aggregated organizations have different tax years:

- Any 12 month period used at any time by any such organization may be used for purposes of the determination of principal business
  - Provided that the 12-month period selected is used consistently
- 

**Management Functions**

The term "management functions" includes two concepts:

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

Both must be satisfied to be considered a management function.

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## **Management Organizations, Continued**

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**Definition of Management Functions**

Management functions are:

- Only those management activities and services historically performed by employees.
  
- Management activities and services that include determining, implementing, or supervising (or providing advice or assistance) in accomplishing any of the foregoing:
  1. Daily business operations (such as production, sales, marketing, purchasing, and advertising),
  2. Personnel (such as staffing, training, supervising, hiring and firing.),
  3. Employee compensation and benefits (such as salaries and wages, paid vacations and holidays, life and health insurance, and pensions),
  4. Short-range and long-range business planning (such as product development, budgeting, financing, expansion of operations, and capital investment),
  5. Organizational structure and ownership (such as corporate formation, stock issues, dividends, mergers, and acquisitions), and
  6. Any other management activity or service.

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

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## **Management Organizations, Continued**

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**Historically  
Performed by  
Employees**

Management activities and services are historically performed by employees in a particular business field, (such as the health field):

- If it was not unusual for management activities and services of such type to be performed by employees of organizations in that particular business field, in the United States, on September 3, 1982. To the extent that particular business field did not exist on September 3, 1982, whether management activity or service will be considered historically performed by employees in that a particular business field will be determined by analogy to similar business fields in existence on September 3, 1982.
- In some situations, even if it is unusual for a particular management activity or service to be performed by employees of organizations in a particular business field, the activity or service may be considered “historically performed”.

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

For purposes of this section, the term "employee" also includes a self-employed individual as defined in section 401(c)(1).

Services performed for a person other than as an employee of such person means services performed directly or indirectly for such person.

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## **Management Organizations, Continued**

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**Example-  
Management  
Services  
Performed**

Justin Anderson is the sole owner and employee of the Mankato Management Company. Dr. Jeb Blackburn is the sole owner and sole employee of Jeb Blackburn, M.D., P.C. Justin Anderson was formerly an employee of Dr. Jeb Blackburn, but has since established Mankato Management Company, which handles the daily business operations, of Jeb Blackburn, M.D., P.C. These are the types of management services historically performed by employees in the health field. All of Mankato Management services are performed solely for Jeb Blackburn, M.D., P.C.

Mankato Management Company and Jeb Blackburn, M.D., P.C. constitute an affiliated service group under section 414(m)(5).

---

**Insubstantial  
Management  
Functions**

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

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

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

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**Management Organizations, Continued**

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**Example-No  
Management  
Organization  
Exists**

Stetson and Stevens is a management organization that provides services to a number of recipient organizations, including the Fannin Corporation. The only employee of Stetson and Stevens is Clayton Plumas. Clayton Plumas works 40 hours a week (2080 hours a year) and spends 2 hours a week (104 hours a year) performing services for the Fannin Corporation.

Stetson and Stevens is not a management organization with respect to the Fannin Corporation because Clayton Plumas does not perform a significant amount of management services for the Fannin Corporation. Less than 15 percent of his time ( $104 / 2080 = 5$  percent) is spent performing services for the Fannin Corporation.

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## Attribution Rules for Management Organizations

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**Section 267** Section 267 contains the rules of attribution to determine “control” for management organizations section 414(m)(5)).

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**General Rules – Family Attribution** The family attribution rules are applied to management organizations as follows:

An individual is attributed interests owned by his spouse, siblings, ancestors and lineal descendants.

- Remember that siblings were *not* included in section 1563 and 318.
  - Section 267(c)(3) is not applied to partnerships and trusts.
- 

**Example- General Rules Illustrated**

Marian owns 80% and Milton owns 20% in the Double M Corporation. Double M Corporation owns a 40% interest in Nasson Company, Inc.

- Marian and Milton are considered to own a proportionate share of the Nasson stock owned by Double M Corporation.
  - Marian is attributed 32% (80% and 40%) of Nasson, and
  - Milton is attributed .08% (20% and 40%) of Nasson.
- 

**General Rules Org Attribution** The ownership interests of a corporation, partnership, or trust are attributed, proportionately, to all of its shareholders, partners, or beneficiaries.

- Remember that, for purposes of section 1563 (controlled group attribution) and 318 (affiliated service group attribution, other than management organizations), the shareholders, partners, or beneficiaries must have a minimum ownership percentage before the organization’s interest is attributed to them.
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## **Exercises – Management Organizations**

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### **Exercise 1**

Barry Baylor is the sole owner and employee of the Baylor Medical Services, Co., Inc. Dr. Reed Rockford is the sole owner and sole employee of Reed Rockford, M.D., P.C. Barry Baylor was formerly an employee of Dr. Reed Rockford, but has since established Baylor Medical Services, Co., Inc., which handles the daily business operations of Reed Rockford, M.D., P.C. These are the types of management services historically performed by employees in the health field. All of Baylor Medical Services, Co., Inc. services are performed solely for Reed Rockford, M.D., P.C.

In order to constitute an affiliated service group under IRC § 414(m)(5), which of the following must exist?

- a. Common ownership must exist between Baylor Medical Services, Co., Inc. and Reed Rockford, M.D., P.C.
- b. Baylor Medical Services, Co., Inc., the management organization, must perform management functions to more than one recipient organization in order to satisfy the “principal business” test.
- c. The principal business of Baylor Medical Services, Co., Inc., the management organization, must be the performance of management functions on a regular and continuing basis for Reed Rockford, M.D., P.C., the recipient organization.
- d. Since Barry Baylor was formerly an employee of Reed Rockford, M.D., P.C. and is performing essentially the same functions, as when he was employed, Baylor Medical Services, Co., Inc. is not considered a management organization.

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*Continued on next page*

**Exercises – Management Organizations, Continued**

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**Exercise 2**

Spencer and Todd were formerly employed by Sterling Industries, Inc. After leaving Sterling, they began Spencer and Todd Consulting Partners, L.L.C. Spencer and Todd started their business with four clients, one of which was Sterling Industries, Inc., their former employer. Spencer and Todd, or their business, do not, and have never had a common ownership interest with Sterling. None of the clients are related. Spencer and Todd Consulting Partners, L.L.C. derives about one quarter of its business from each of its clients.

Which of the following is true?

- a. Spencer and Todd Consulting Partners, L.L.C. and Sterling Industries, Inc. constitute an affiliated service group under IRC § 414(m)(5).
- b. In order for an affiliated service group to exist, there would have to be common ownership between Spencer and Todd Consulting Partners, L.L.C. and Sterling Industries, Inc.
- c. In order for an affiliated service group to exist, the highly compensated employees of Sterling Industries, Inc. would have to have an ownership interest in Spencer and Todd Consulting Partners, L.L.C.
- d. An affiliated service group exists with Spencer and Todd Consulting Partners, L.L.C. as the FSO and Sterling Industries, Inc. as the A-Org.
- e. Since Spencer and Todd Consulting Partners, L.L.C. does not derive its principal business from any one client, it is not part of an affiliated service group with Sterling Industries, Inc. or any of the other 3 clients.

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*Continued on next page*

## **Exercises – Management Organizations, Continued**

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### **Exercise 3**

Meredith is 50% owner of the Meredith and Martin Law Firm. The law firm specializes in real estate and their principal client, from whom they derive approximately 90% of their business, is the Lincoln and Langley Real Estate Corporation.

In addition, Meredith has a 100% ownership interest in the M Title Insurance Company, Inc.

Which of the following is *not* true?

- a. A management-type affiliated service group cannot exist once any of the owners have a controlling interest in another company.
  - b. A management-type affiliated service group exists between the Meredith and Martin Law Firm and Lincoln and Langley Real Estate Corporation.
  - c. An affiliated service group exists with M Title Insurance Company, Inc. as the FSO and Meredith and Martin Law Firm as the A-Org.
  - d. Since Martin, Meredith's partner in the law firm, is attributed with her ownership in the M Title Insurance Company, Inc. under section 267, he is also treated as owning a 100% interest.
  - e. A management-type affiliated service group consists of a management organization that derives its principal business from the performance of management functions, on a regular and continuing basis, for a recipient organization.
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## **Determination letter Program: Affiliated Service Groups**

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**Form 5300 for  
Affiliated  
Service Group**

If an employer requests a ruling concerning the effect of section 414(m) on the plan being submitted or because of a change in the affiliated service group membership or if the employer is not certain if they are a member of an affiliated service group, the employer must submit a Form 5300, with question number 3(a), answered with a “3”.

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**Additional  
Information**

In addition to the Form 5300, the application must include the following information: (Rev. Proc 85-43 and Rev. Proc 2004-6).

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**Affiliated  
Service Group  
Statement**

1. A description of the nature of the business of the employer, specifically whether it is a service organization or an organization whose principal business is the performance of management functions for another organization, including the reasons therefore;
  2. The identification of other members (or possible members) of the affiliated service group;
  3. A description of the business of each member (or possible member) of the affiliated service group, describing the type of organization (corporation, partnership, etc.) and indicating whether the member is a service organization or an organization whose principal business is the performance of management functions for the other group member(s);
  4. The ownership interests between the employer and the members (or possible members) of the affiliated service group (including ownership interests as described in section 414(m)(2)(B)(ii) or section 414(m)(6)(B));
  5. A description of services performed for the employer by the members (or possible members) of the affiliated service group, or vice versa (including the percentage of each member’s (or possible member’s) gross receipts and service receipts provided by such services, if available, and data as to whether such services are a significant portion of the member’s business) and whether, as of December 13, 1980, it was not unusual for the services to be performed by employees of organizations in that service field in the United States;
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*Continued on next page*

**Determination letter Program: Affiliated Service Groups,**  
Continued

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**Affiliated  
Service Group  
Statement**  
(continued)

6. (6) A description of how the employer and the members (or possible members) of the affiliated service group associate in performing services for other parties;
7. In the case of a management organization under section 414(m)(5):
  - A description of the management functions, if any, performed by the employer for the member(s) (or possible member(s)) of the affiliated service group, or received by the employer from any other members (or possible members) of the group (including data explaining whether the management functions are performed on a regular and continuous basis), and
  - whether or not it is unusual for such management functions to be performed by employees of organizations in the employer's business field in the United States;
8. A brief description of any other plan(s) maintained by the members (or possible members) of the affiliated service group, if such other plan(s) is designated as a unit for qualification purposes with the plan for which a determination letter has been requested;
9. A description of how the plan(s) satisfies the coverage requirements of § 410(b) if the members (or possible members) of the affiliated service group are considered part of an affiliated service group with the employer;
10. A copy of any ruling issued by the headquarters office on whether the employer is an affiliated service group; a copy of any prior determination letter that considered the effect of § 414(m) on the qualified status of the employer's plan; and, if known, a copy of any such ruling or determination letter issued to any other member (or possible member) of the same affiliated service group, accompanied by a statement as to whether the facts upon which the ruling or determination letter was based have changed.

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*Continued on next page*

## **Determination letter Program: Affiliated Service Groups,** Continued

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**Application  
Review**

Form 8388, Affiliated Service Group (Worksheet Number 10) is a worksheet that should be used in reviewing a request concerning the effect of IRC section 414(m) on the plan submitted or because of a change in the affiliated service group (ASG) membership or if the plan sponsor is not certain if they are a member of an ASG. Note: The worksheet is not designed to address every possible issue, which may arise in reviewing a form 5300 requests for ASG status.

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**Analysis of  
Determination  
Application for  
414(m)  
Qualified Plans**

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

After reviewing the affiliated service group information and testing it against IRC section 414(m), if it is determined that the application meets the requirements of an affiliated service group, then the Determination Letter is caveated with a “21” caveat (Affiliated Service Group request).

If the requirements are not met, the Determination Letter receives a “23” caveat (Does not meet Affiliated Service Group).

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**Additional  
Processing  
Determination  
Letter Request**

Another impact of being an affiliated service group, is when a plan sponsor submits an application for determination (Forms 5300, 5307, 5310 and 6406), question 6(a) on the applications, asked if the employer is a member of a controlled group or affiliated service group.

If the plan employer is a member of a controlled group of corporations, trades or businesses under common control, or an affiliated service group, all employees of the group will be treated as employed by a single employer for purposes of certain qualification requirements.

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*Continued on next page*



**Determination letter Program: Affiliated Service Groups,**  
Continued

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**Additional  
Processing  
Determination  
Letter Request**  
(continued)

If question 6 is answered “Yes”, the EP Specialist should secure and review the following information (if not present with the application):

- All members of the group;
- Their relationship to the plan employer;
- The type(s) of plan(s) each member has, and
- Plans common to all members.

Once the above information is secured, it should be tested, using affiliated service group rules under section 414(m).

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## **The Impact of Section 414(m) on Qualified Plans**

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### **The Effect of Section 414(m) and Section 414(b) and (c) on Qualified Plans**

The impact of section 414(m) on qualified plans is the same as the impact of section 414(b) and (c).

All of the employees in the affiliated service group or controlled group must be considered, as if they were employees of one employer.

Note: See the impact of section 414(b) and (c) on qualified plans, in the control group section for guidance.

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## **Professional Employee Organizations (PEOs)**

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### **Introduction**

A PEO is a complex employer/employee relationship, which the PEO provides workers to its clients. There is no one universally agreed definition of a PEO. Revenue Procedure 2002-21 only describes a typical PEO as an entity that makes an agreement with another employer (called a client organization or a “CO”) whereby Worksite Employees (individuals who perform work at, and under the direction of, a (CO) are placed on the payroll of the PEO, claimed as PEO employees, and claimed to be eligible to participate in PEO sponsored employee benefit plans.

Note: PEOs are also known as “Employee Leasing Organizations”

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### **History**

PEOs evolved from early forms of temporary staffing agencies. These businesses provide employees to employers on a temporary basis.

Over the years the size of this workforce increased and being a contingent workforce, they were subject to lower wages and the first to be laid off during slow periods.

The size of this workforce caused problems for employers in the employee benefits area, because of the non-discrimination rules developed under the Internal Revenue Code. Also there were problems with violations of the exclusive benefit rules under section 401(a)(2).

In May 2002, the IRS issued Rev. Proc. 2002-21, which addresses the steps that may be taken to ensure the qualified status of defined contribution plans maintained by PEOs for the benefit of Worksite employees.

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*Continued on next page*

## **Professional Employee Organizations (PEOs), Continued**

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**PEO  
Retirement  
Plans**

Rev. Proc. 2002-21, section 6.01 defines a PEO retirement plan as defined contribution plan (including a plan that includes a cash or deferred arrangement described in section 401(k) intended to satisfy the requirements of section 401(a) or 403(a).

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**Rev. Proc.  
2002-21 Relief**

Section 4.01 of Rev. Proc 2002-21, states that no disqualification of a PEO retirement plan will occur. If a PEO has a PEO retirement plan in existence on May 13, 2002, that benefits Worksite Employees, section 5 (rev. Proc. 2002-21) provides the PEO the option of either:

- Converting the PEO plan to a multiple employer plan or;
  - Terminating the plan.
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**Determination  
Letter  
Applications**

In order to obtain the relief provided in section 4, the plan sponsor must:

- File a Form 5300 to convert the PEO plan to a multiple employer plan or;
- File a Form 5310 to terminate the plan.

Rev. Proc. 2002-21 provides instruction on how to analyze PEO applications and what information needs to be secured to submit under Rev. Proc. 2002-21. See Rev. Proc. 2002-21.

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**Rev. Proc 2003-  
86**

This revenue procedure amplifies Rev. Proc. 2002-21, relating to relief provided to certain defined contribution plans maintained by PEOs that benefits Worksite Employees who perform services for a client organization. These plans are referred to below as PEO Retirement Plans. The questions and answers contained in this revenue procedure provide guidance on certain transitional issues that were raised by practitioners after the publication of Rev. Proc. 2002-21.

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## Professional Employee Organizations (PEOs), Continued

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**Rev Proc 2003-86 Q & A,** The following questions and answers provide guidance on common inquiries that the Service has received relating to certain transitional issues for a PEO Retirement Plan and a Multiple Employer Retirement Plan.

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**Q-1, successor plans** **Q-1: Successor Plans.** Can a Spin-off Retirement Plan make distributions upon termination of the plan in accordance with section 5.04(2) of Rev. Proc. 2002-21 to Worksite Employees who perform services for a CO, if (following termination of the PEO Retirement Plan or conversion of the PEO Retirement Plan to a Multiple Employer Retirement Plan) the CO maintains a defined contribution plan for its employees (whether or not the plan covers Worksite Employees) or if the PEO maintains another plan that covers the PEO's own employees?

A-1: (a) Section 1.401(k)-1(d)(3) of the Income Tax Regulations provides that a distribution may not be made upon termination of a § 401(k) plan if the employer establishes or maintains a successor plan. A successor plan is defined as any other defined contribution plan maintained by the same employer if the plan exists at any time during the period beginning on the date of plan termination and ending 12 months after distribution of all assets from the terminated plan. The plan is not a successor plan if at all times during the 24-month period beginning 12 months before the termination, fewer than two percent of the employees who were eligible under the terminated plan as of the date of plan termination are eligible under the plan.

(b) Neither a defined contribution plan maintained by the CO for its employees (whether or not the plan covers Worksite Employees) nor a plan maintained by the PEO covering the PEO's own employees will be treated as a successor plan to the Spinoff Retirement Plan for purposes of § 1.401(k)-1(d)(3). Accordingly, the Spinoff Retirement Plan is permitted to make a distribution to Worksite Employees regardless of whether the CO or the PEO maintains a plan described in the preceding sentence.

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## **Professional Employee Organizations (PEOs), Continued**

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**Q-2-top heavy rules**

**Q-2: Top-heavy rules.** After a PEO Retirement Plan converts to a Multiple Employer Retirement Plan, how do the top-heavy rules apply with respect to participants' benefits that accrued in the PEO Retirement Plan by the Compliance Date?

A-2: (a) Q&A G-2 of § 1.416-1 provides that a multiple employer plan is subject to the requirements of § 416, but only with respect to each individual employer. Q&A T-2 of § 1.416-1 provides that, for top-heavy purposes, a multiple employer plan to which an employer makes contributions on behalf of its employees is treated as a plan of that employer to the extent that benefits under the plan are provided to its employees because of service with the employer.

(b) Section 7.01(3) of Rev. Proc. 2002-21 provides that, for purposes of determining whether a Multiple Employer Retirement Plan is top-heavy (as defined in § 416(g)(1)(A)(ii)) in its first plan year, the determination date with respect to the first plan year will be the last day of such plan year.

(c) In general, a CO that is a sponsor of a Multiple Employer Retirement Plan may treat the benefits of Worksite Employees who perform services for the CO that accrued in the PEO Retirement Plan on or before the Compliance Date as attributable to contributions made by the CO when determining whether the plan is top heavy for plan years beginning after the Compliance Date. If a CO chooses this option, in subsequent years the CO must continue to treat the benefits of Worksite Employees who provide services to the CO that accrued in the PEO Retirement Plan on or before the Compliance Date as attributable to contributions made by the CO when determining whether the plan is top-heavy.

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*Continued on next page*

## **Professional Employee Organizations (PEOs),** Continued

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**Q-2-top heavy rules**  
(continued)

(d) However, it is also permissible for a CO that is a sponsor of the Multiple Employer Retirement Plan to treat the benefits of Worksite Employees who perform services for the CO that accrued in the PEO Retirement Plan prior to the plan conversion as attributable to contributions made by the PEO and not the CO. Thus, when testing the Multiple Employer Retirement Plan for top-heaviness, a CO may treat the benefits of Worksite Employees who perform services for the CO that accrued in the PEO Retirement Plan on or before the Compliance Date prior to the plan conversion as being zero. Nevertheless, the Multiple Employer Retirement Plan must include in these Worksite Employees' benefits the amounts that accrued in the PEO Retirement Plan prior to the plan conversion and compute the gains and losses attributable to these benefits in subsequent plan years.

(e) For purposes of this Q&A-2, the following applies:

- (1) The consistency rule of section 4.06 of this revenue procedure is deemed satisfied if each CO is consistent in treating the accrued benefits of all Worksite Employees who perform services for that CO in accordance with either (c) or (d) of this question and answer.
- (2) In determining whether a plan is top-heavy, the aggregation rules under § 414(b), (c), and (m) apply with respect to a CO. See Q&A T-1 of § 1.416-1.
- (3) Regardless of whether the plan uses the option set forth in (c) or (d) of this Q&A-2, the determination date with respect to the first plan year of the Multiple Employer Retirement Plan will be the last day of such plan year.

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## **Professional Employee Organizations (PEOs), Continued**

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**Q-3-ADP and ACP testing**

**Q-3: ADP and ACP Testing.** How do the actual deferral percentage (ADP) and actual contribution percentage (ACP) tests under § 401(k)(3) and (m)(2) apply to a Multiple Employer Retirement Plan in its first plan year?

A-3:

- (a). General rule. A Multiple Employer Retirement Plan must be treated as a new plan for purposes of ADP and ACP testing rules rather than as a successor plan to the PEO Retirement Plan. Thus, for the first plan year beginning after the Compliance Date, a Multiple Employer Retirement Plan can elect to use the prior year testing method for the ADP and/or ACP test without regard to the ADP and ACP testing methods used by the PEO Retirement Plan.
- (b). ADP testing. A Multiple Employer Retirement Plan that uses the prior year testing method for the ADP test is permitted to provide that the ADP for the nonhighly compensated employees for the first plan year beginning after the Compliance Date is 3% or is determined based on the actual deferral percentages of the nonhighly compensated employees for that year.
- (c). ACP testing. A Multiple Employer Retirement Plan that uses the prior year testing method for the ACP test is permitted to provide that the ACP for the nonhighly compensated employees for the first plan year beginning after the Compliance Date is 3% or is determined based on the actual contribution percentages of the nonhighly compensated employees for that year.

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## Professional Employee Organizations (PEOs), Continued

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**Q-4, minimum distribution requirements**

**Q-4: Minimum Distribution Requirements.** For purposes of applying the required minimum distribution rules under § 401(a)(9) with respect to Worksite Employees who have attained age 70 1/2 but have not yet retired, who will be treated as a 5-percent owner of a CO in the first plan year of the Multiple Employer Retirement Plan, what is the first calendar year for which a minimum distribution is required, and how is the required distribution calculated for that calendar year?

A-4:

- (a). General Rule. Section 401(a)(9)(A) provides that a trust will not be a qualified trust unless the plan provides that the entire interest of each employee will be distributed to the employee not later than the required beginning date or, in accordance with the regulations, will be distributed beginning not later than the required beginning date over the life of the employee or the lives of the employee and a designated beneficiary. The required beginning date is defined in § 401(a)(9)(C) as April 1 of the calendar year following the later of the calendar year in which the employee attains age 70 1/2 or the calendar year in which the employee retires. However, § 401(a)(9)(C)(ii) provides that, in the case of an employee who is a 5-percent owner (as defined in § 416(i)(1)(B)(i)), the required beginning date is April 1 of the calendar year following the calendar year in which the employee attains age 70 1/2.
- (b). Options for Determining 5--Percent Ownership Status. Beginning in 2004, a Multiple Employer Retirement Plan may use either of the following two options in determining whether Worksite Employees who have attained age 70 1/2 (but have not yet retired) before the first day of the first plan year of the Multiple Employer Retirement Plan are 5--percent owners of a CO for whom they perform services. Under the first option, a Multiple Employer Retirement Plan may opt to test whether Worksite Employees are 5--percent owners of a CO on the first day of the first plan year of the Multiple Employer Retirement Plan. If a Worksite Employee is a 5--percent owner on that day, the Worksite Employee will be treated as a 5--percent owner of the CO in the plan year ending in the calendar year in which the employee attained age 70 1/2. Under the second option, a Multiple Employer Retirement Plan may opt to test whether Worksite Employees

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**Professional Employee Organizations (PEOs),** Continued

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**Q-3-ADP and  
ACP testing A-  
4(c)-minimum  
distribution  
requirements**

- (c). Minimum Distribution Requirements for Worksite Employees who are 5-Percent Owners. Under either option, a Multiple Employer Retirement Plan will not be required to make minimum distributions under § 401(a)(9) for calendar years before 2004 to Worksite Employees who have attained age 70 1/2 before the first day of the first plan year of the Multiple Employer Retirement Plan and who have not retired (and the employees will not be subject to the excise tax under § 4974 for failure to receive required minimum distributions for those years) even if they are 5-percent owners of a CO for whom they perform services. However, a minimum distribution is required for 2004 and subsequent years for each Worksite Employee who is a 5-percent owner of a CO (determined under paragraph (b) of this Q&A-4) and who attained age 70 1/2 before January 1, 2004, as well as each Worksite Employee who is a 5-percent owner of a CO and who attains age 70 1/2 in 2004. The required beginning date for the 2004 required minimum distribution for those Worksite Employees (those who attained age 70 1/2 in 2004 and in any earlier year) is April 1, 2005. Thus, the required minimum distribution for 2004 for those employees is not required to be made until April 1, 2005, but subsequent required minimum distributions must be made by the end of the calendar year for which they are made, including the required minimum distribution for 2005. For calculating the minimum required distributions for Worksite Employees for each calendar year, see Q&A-4 of § 1.401(a)(9)-5 and the Uniform Lifetime Table in Q&A-2 of § 1.401(a)(9)-9.

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## Professional Employee Organizations (PEOs), Continued

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Q-3-ADP and  
ACP testingQ-  
5-  
determination  
of HCE status

Q-5: **Determination of Highly Compensated Employee (HCE Status).** If an individual was a Worksite Employee in the year preceding the first plan year of the Multiple Employer Retirement Plan, is compensation received by that individual during that year taken into account in determining if the individual is a highly compensated employee, as defined in § 414(q)(1), in the first plan year of the Multiple Employer Retirement Plan?

A-5:

- (a). (a) General Rule. HCE status is generally determined on the basis of the plan year of the plan for which a determination is being made (the determination year) and the preceding 12-month period (the look-back year). Section 414(q)(1) defines a highly compensated employee as any employee who was a 5-percent owner at any time during the determination year or the look-back year and any employee who, for the look-back year, had compensation from the employer in excess of \$ 80,000 (adjusted for inflation) and, if the employer elects, was in the top-paid group of employees for the look-back year.
- (b). Worksite Employees Treated as CO Employees. For purposes of *Rev. Proc. 2002--21*, the HCE status of an individual who was a Worksite Employee in the year preceding the first plan year of the Multiple Employer Retirement Plan (the MERP look--back year) and who performed services for a CO in that year is determined by treating the Worksite Employee as an employee of the CO for the MERP look--back year. Any compensation received by the Worksite Employee from the PEO or the CO in the MERP look--back year for services performed for the CO must be treated as received from the CO. Accordingly, all compensation received by a Worksite Employee from the PEO or the CO for services performed for the CO in the MERP look--back year must be considered in determining whether the Worksite Employee is an HCE of the CO for the first plan year of the Multiple Employer Retirement Plan.

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## **Professional Employee Organizations (PEOs), Continued**

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**Rev Proc 2002-21 Relief-Example**

The following examples illustrate relief under Rev Proc 2001-21

A PEO maintains a PEO Retirement Plan established in 1994, and the PEO uses the calendar year for its plan year. The PEO Retirement Plan treats all Worksite Employees performing services for COs as employees of the PEO. There are 75 COs with Worksite Employees benefiting under the PEO Retirement Plan.

(ii) After reviewing the options set forth in section 5, the PEO decides to convert the PEO Retirement Plan to a Multiple Employer Retirement Plan. In accordance with the requirements of section 5.03, on January 31, 2003, the PEO adopts amendments to the PEO Retirement Plan converting the plan to a Multiple Employer Retirement Plan, effective January 1, 2004. On February 14, 2003, the PEO mails notification to each CO that it has decided to convert the PEO Retirement Plan to a Multiple Employer Retirement Plan and explains the options available to the CO as described in section 5.03(4). In its letter to the COs, the PEO explains that each CO has until August 15, 2003, to notify the PEO, in writing, of its choice. The letter explains that if the CO does not notify the PEO of its selected option on or before August 15, 2003, the PEO will treat the CO as having selected the spin-off and termination option. The letter further explains that if a CO elects to adopt the Multiple Employer Retirement Plan, the Plan must be adopted on or before December 1, 2003.

(iii) By August 15, 2003, fifty of the COs with Worksite Employees benefiting under the PEO Retirement Plan notify the PEO of their decision to adopt and maintain the Multiple Employer Retirement Plan for the Worksite Employees. By December 1, 2003, forty-nine of the fifty COs adopted the Multiple Employer Retirement Plan, effective January 1, 2004. In accordance with section 5.03(4)(a) of this revenue procedure, on December 10, 2003, the PEO spins off the assets and liabilities attributable to the one CO that did not timely adopt the Multiple Employer Retirement Plan to a Spin-off Retirement Plan.

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## **Professional Employee Organizations (PEOs), Continued**

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**Rev Proc 2002-21 Relief-Example**  
(continued)

**Example cont.**

(iv) Ten COs timely elect a transfer, in which the assets and liabilities attributable to each CO's Worksite Employees are transferred to a qualified retirement plan established and maintained by each CO, and that satisfy the requirements described in section 5.04(1). The ten COs timely provide all information required to effect the transfer, including documentation of the plans' qualified status. The transfers to each of the CO plans are completed by December 31, 2003.

(v) Ten COs affirmatively elect the spin-off and termination option. The PEO spins off plan assets and liabilities attributable to the Worksite Employees performing services for those COs to the Spin-off Retirement Plan on December 10, 2003.

(vi) The remaining five COs failed to notify the PEO of their choice by August 15, 2003. Therefore, in accordance with requirements in section 5.03(5), each of those COs is treated as having selected the spin-off and termination option as its choice. The PEO spins off the assets and liabilities of these COs to the Spin-off Retirement Plan on December 10, 2003.

(vii) On December 11, 2003, the PEO terminates the Spin-off Retirement Plan. On February 5, 2004, the PEO submits an application for a determination letter on the termination of the Spin-off Retirement Plan. The PEO receives a favorable determination letter on the termination of the plan. As soon as administratively feasible following the termination, distributions are made to the Worksite Employees performing services for the sixteen COs (the one CO that failed to timely adopt the Multiple Employer Retirement Plan, the ten COs that selected the spin-off and termination option, and the five COs that failed to timely notify the PEO of their choice) with assets in the Spin-off Retirement Plan.

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## Professional Employee Organizations (PEOs), Continued

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**Rev Proc 2002-21 Relief-  
Example  
(continued)**

**Example cont.**

(viii) On February 5, 2004, the PEO submits an application for a determination letter on the qualified status of the Multiple Employer Retirement Plan, and subsequently receives such a determination letter from the Service. Because the PEO took all of the steps required in section 5 of the revenue procedure, the PEO Retirement Plan is entitled to the relief set forth in section 4 of the revenue procedure.

*PEOs not electing to take advantage of relief under this revenue procedure.* If a PEO does not, as of the Compliance Date, either terminate the PEO Retirement Plan it maintains for Worksite Employees performing services for COs (as provided for in section 5.02) or convert the PEO Retirement Plan to a Multiple Employer Retirement Plan (as provided for in section 5.03), the relief in this revenue procedure is not available for any violations of the qualification requirements, including violations of the exclusive benefit rule, by PEO Retirement Plan.

*No Reliance on Determination Letters for PEO Retirement Plans.* After the Compliance Date, a PEO may not rely on a determination letter for a PEO Retirement Plan that benefits Worksite Employees performing services for COs, regardless of when the determination letter was issued.

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## **Leased Employees**

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### **Introduction**

Congress enacted section 414(n) in 1982 as part of TEFRA to prevent employers from providing pension benefits only to the highly compensated employees, by leasing other workers. The TEFRA became effective January 1, 1984.

In 1984, the Service published Notice 84-11, 1984-2 C.B. 469. The Notice provided question and answers relating to the employee leasing provisions of section 414(n). Until applicable regulations are published the guidance provided by these questions and answers may be relied upon to comply with the provisions of section 414(n).

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### **Definition, Section 414(n)**

A leased employees for purposes of section 414(n), is any person who performs services for a recipient if:

1. Such services are provided pursuant to an agreement between the recipient and any other person (“the leasing organization”),
  2. Such person has performed such services on a substantially full-time basis for a period of at least one year, and
  3. Such services are performed under the primary direction or control of the recipient.
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### **Leased Employee, Determination Letter Request**

If an employer requests a ruling concerning the effect of section 414(n) on the plan being submitted, the employer must submit a Form 5300, with question number 3(a), answered with a “4”.

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## **Leased Employees, Continued**

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**Required  
Information for  
a  
Determination  
Letter, Section  
414(n)**

Unless the plan provides that all leased employees within the meaning of section 414(n)(2) are treated as common law employees for all purposes under the plan, a determination letter issued with respect to the plan's qualification under section 401(a), 403(a), or 4975(e)(7) will be a determination as to the effect of section 414(n) upon the plan's qualified status only if the application includes:

- 1) A description of the nature of the business of the recipient organization;
- 2) A copy of the relevant leasing agreement(s);
- 3) A description of the function of all leased employees within the trade or business of the recipient organization (including data as to whether all leased employees are performing services on a substantially full-time basis);
- 4) A description of facts and circumstances relevant to a determination of whether such leased employees' services are performed under primary direction or control by the recipient organization (including whether the leased employees are required to comply with instructions of the recipient about when, where, and how to perform the services, whether the services must be performed by particular persons, whether the leased employees are subject to the supervision of the recipient, and whether the leased employees must perform services in the order or sequence set by the recipient); and
- 5) If the recipient organization is relying on any qualified plan(s) maintained by the employee leasing organization for purposes of qualification of the recipient organization's plan, a description of such plan(s) (including a description of the contributions or benefits provided for all leased employees which are attributable to services performed for the recipient organization, plan eligibility, and vesting).

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**Determination  
Letter**

If the plan meets the requirements of section 414(n), the determination letter should include caveat "22"(Meets section 414(n) status), if not, the letter should include caveat "24" (Does not meet section 414(n)).

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## **Independent Contractors**

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### **Independent Contractor**

The courts have considered many facts in deciding whether a worker is an independent contractor or an employee. The relevant facts fall into three categories:

- Behavioral control
- Financial control, and
- Relationship of the parties

Rev. Rul. 87-21 lays out the “20” factor test for determining independent contractor status. Also, IRS publication 1779 is an excellent source for information about independent contractors.

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## **Exercises – Affiliated Service Groups**

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**Exercise 1** Margaret Jackson, an attorney, is incorporated as Margaret Jackson, P.C., and this professional corporation is a partner in Snead Law Firm. Margaret and her corporation are regularly associated with Snead Law Firm in performing services for third parties.

Which of the following best describes this relationship?

- a. MJ, P.C. and Snead Law constitute an affiliated service group. Snead Law is the First Service Organization because it is a service organization and its principal business is the performance of services. MJ, P.C. is the A-Organization because it is a partner in the FSO and is regularly associated with the FSO in performing services for third parties.
- b. MJ, P.C. and Snead Law constitute an affiliated service group. MJ, P.C. is the FSO because it is a service organization and its principal business is the performance of services. Snead Law is the A-Organization because one of the partners is the FSO and it is regularly associated with the FSO in performing services for third parties.
- c. There is no affiliated service group relationship. A controlled group exists between MJ, PC and the Snead Law Firm because the “regular association” between the organizations constitutes control within the meaning of section 414(c).
- d. There is no affiliated service group because the qualifications for a parent-subsidary group or brother-sister group are not met.
- e. There is no affiliated service group because neither organization qualifies as a B-Organization.

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**Exercises – Affiliated Service Groups, Continued**

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**Exercise 2** Cole Properties, Inc. sells land that it has purchased and developed. Jack is a 25% shareholder of Cole and a 50% shareholder of Jack and Son Construction Company, Inc.

Cole Properties regularly engages the services of Jack and Son. Does a affiliated service group exist?

- a. Yes, Cole Properties, Inc and Jack and Son Construction Co., Inc. are members of a affiliated service group because Jack is a 25% shareholder of Cole Properties..
- b. No, although it appears that Cole Properties could be a First Service Organization, the affiliated service group rules do not apply because Cole is not a service organization.

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## **Exercises – Affiliated Service Groups, Continued**

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**Exercise 3** Boise Properties, Inc. sells land that it has purchased and developed.

Eddy is a 25% shareholder of Boise and a 50% shareholder of Eddy and Son Construction Company, Inc. Boise Properties regularly engages the services of Eddy and Son. Which of the following best describes this situation?

- a. Eddy and Son Construction Company is the FSO and Boise Properties, Inc. is the A-Org.
- b. Eddy and Son Construction Company is the FSO and Boise Properties, Inc. is the B-Org.
- c. Although it appears that Boise Properties, Inc. could be a FSO, the affiliated service group rules do not apply because Boise Properties, Inc. is not a service organization.
- d. Boise Properties, Inc. is the FSO and Eddy and Son Construction Company, Inc. is the B-Org.

Boise Properties, Inc. is the FSO and Eddy and Son Construction Company, Inc. is the A-Org.

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**Exercise 4** Dr. Douglas is the sole shareholder of the Douglas Medical Corporation. She has a 25% interest in Hinsdale Diagnostic Imaging, Inc. and regularly refers her patients for services. Does an affiliated service group exist? Why or why not?

- a. Yes. Hinsdale is the FSO; Douglas Medical is the A-Org
- b. No. Douglas cannot be an A-Org because the ownership test is not satisfied.
- c. Yes. Douglas Medical is the FSO; Hinsdale is the A-Org.
- d. No. A corporation cannot be a FSO.

No. This is a controlled group of corporations.

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## **Affiliated Service Group Summary**

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### **Summary**

The purpose of section 414(m) is to eliminate the practice of excluding non-highly-compensated employees from plan coverage through the creation of artificial business entities.

A plan that is maintained by an employer, within a group of employers that is part of an affiliated service group, must meet the requirements of section 401(a) as if a single employer employed all employees of all employers in the group.

This lesson explains how to identify situations where the plan sponsor is a member of an affiliated service group and how to recognize the impact on qualified plans and the Determination Letter Process.

Also different forms of related employee groups were discussed, including PEOs, Leased employees and Independent Contractors.

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