



Retirement Planning

Controlled Groups, Affiliated Service Groups and Management Corporations – Potential Traps for the Unwary

Who cares if an employer, considering adopting a qualified retirement plan for a business, is involved with, or has an ownership interest in, another business? The Internal Revenue Service (IRS) does, that's who. A person who owns multiple businesses may not be able to install a plan solely for one business because there are a number of very complicated rules and tests regarding qualified plans and coverage of employees where there is common ownership, or a significant business relationship, among businesses – otherwise known as Controlled Groups, Affiliated Service Groups, or Management Organizations.

Over the years the IRS has encountered businesses that have common ownership or other business relationships where one company may have retirement benefits for employees employed by that company, but the other businesses may not. This results in a form of discrimination by providing qualified retirement plan benefits to select employees (i.e., those of the company with the plan). As a result, the Internal Revenue Code has a number of provisions that employers must comply with to avoid their plans being deemed discriminatory. Sometimes, the rules can lead to absurd results. For example:

Bill is 100% owner of XYZ Corporation in Boise, Idaho, and wants to install a 401(k) plan for his 10 employees. Susan, Bill's ex-wife and custodial parent of their 12-year-old daughter Ann, is a 100% owner of ABC Corporation, in Akron, Ohio, with 50 employees. If Bill wants to begin a 401(k) plan for his 10 employees, he would also need to consider Susan's employees. Why? Because of certain rules that attribute ownership to others. In this situation, although neither parent's ownership is attributable to the other, Ann, because she is a minor, is deemed to own 100% of the shares of

stock of each parent, and therefore the corporations are members of a Controlled Group. A plan put into place by one must cover the employees of both corporations.

Controlled groups

There are two types of controlled groups:

1. Parent/subsidiary – this one is pretty obvious, where corporations are connected through at least 80% stock ownership. For example, XYZ Corporation owns 85% of ABC Corporation – both are considered part of a Controlled Group and a plan for XYZ must cover the employees of ABC. If the ownership were less than 80% - no parent/subsidiary relationship.
2. Brother/sister groups – this one gets pretty tricky. Five (5) or fewer individuals own 80% or more of stock value or controlling interest in each corporation AND the same five or fewer people own more than 50% of the control of each corporation, taking into account only the common percentage identical to each corporation.

This might be easier understood with an example:

	XYZ Corp.	ABC Corp.	Common
X	80%	20%	20%
Y	10%	50%	10%
Z	5%	15%	5%
Q	<u>5%</u>	<u>15%</u>	<u>5%</u>
	100%	100%	40%

In this example, you do NOT have a controlled group although five or fewer people own more than 80% of each corporation. Their identical ownership in each is less than 50%. Had their identical ownership totaled more than 50%, there would have been a brother-sister Controlled Group.



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These rules can get very complicated to apply and almost always need to be diagrammed to see if there is a controlled group or not. The tests get even more complicated with the application of family attribution rules as we saw earlier. If a spouse is a director, employee, or participates in the management of the corporation owned by the other spouse, then ownership is attributed to him or her. And for those of you who live in a community property state? Each spouse is considered to own 50% of any business the other owns, so if H owns 100% of ABC Corporation and W owns 100% of XYZ Corporation, and H implements a retirement plan for ABC, he must also cover the employees of XYZ corporation. The spousal exception rules do not apply – there is attribution *regardless* of the spouse not being an employee, director or participate in the management of the other spouse's business!

The long and short of it? If you're a business owner and you're interested in setting up a qualified retirement plan for your business, but you may have an ownership interest or other relationship (whether as an employee, director, investor, family member of an owner, etc.) with another business, then it is important to determine if the "Controlled Group" rules apply to you.

Affiliated Service Groups (ASG)

So, you've checked the ownership rules and run the controlled group test and passed – home free, right? Not so fast...the IRS has another set of rules, even *more* difficult to apply, that can ensnare you in the trap of unintended consequences - the ASG rules. These rules are so complicated and tough to apply that the American Society of Pension Professionals and Actuaries (ASPPA) has a break out session every year at its annual convention in Washington, D.C., just to review the rules and examples and any recent case law and or developments from the IRS.

Let's look at a common example:

Bob, Ben and Betsy are veterinarians and the sole employees of their own corporations. Their corporations also each own 1/3 of the Woofer Veterinary Clinic which has 18 full time employees ages 25-47 with salaries of from \$30,000 – 70,000. Bob, Ben and Betsy provide veterinarian services through their corporate practices but also through the Clinic. Betsy, age 52, has a salary of \$300,000 from her corporation, and would like to install a Fully Insured Defined Benefit Plan for her corporation to maximize her retirement plan contributions and income tax deductions. Can she? NO – she is a member of an Affiliated Service Group.

How can this be?

There are two types of Affiliated Service Groups, A-Orgs and B-Orgs. An A-Org is a service organization that owns some interest in a First Service Organization (FSO), and performs services for the FSO or is regularly associated with the FSO in providing services to third parties. In our example above, Woofer Veterinary Clinic is the FSO. A service organization is any organization that engages in health, medicine, law, architecture, engineering, accounting, actuarial science, performing arts, consulting or insurance. A B-Org provides services in the field of the FSO; a significant portion of the B-Org business is for the FSO and/or the A-Orgs; and at least 10% of the B-Org is owned by one or more highly compensated employees of the FSO and/or it's A-Org. Confused? Here's a quick recap:





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Woofers Clinic is a First Service Organization (FSO) Company A(A-Org) (i.e., Bob's, Ben's and Betsy's corporations)

- Shareholder or partner of FSO;
- Performs services for FSO; or
- Performs services with FSO for a 3rd party

Company B (B-Org) (i.e., Bob's, Ben's and Betsy's corporations)

- 10% owned by highly compensated employee of FSO or A;
- A significant part of B's work is performing services for A or FSO; or
- The services are those historically done by employees of A or FSO

What does all this boil down to? The IRS is looking for situations where one company is split into two or more companies with the goal of excluding some employees from receiving retirement benefits.

--- Management Organizations

So, you don't have a Controlled Group or Affiliated Service Group as described above. Guess what? There is another trap that you can fall into and that is "the Management Organization."

An organization that performs management functions, and the management organization's "principal business" is performing management functions on a regular and continuing basis for a recipient organization is also designated an Affiliated Service Group. There does not need to be any common ownership between the management organization and the organization for which it provides service.

For example, if Bob, Ben and Betsy were employees of ABC Corp., and the sole function of ABC Corp. is to manage Woofers Veterinary Clinic (even if ABC Corp. does not own any part of Woofers) which employs the other 18 employees, then ABC Corp. would be an Affiliated Service Group.

What does "principal business" mean? Although not defined in the Internal Revenue Code or regulations, the IRS would consider a percentage of revenues that come from managing as a determining factor. Unfortunately, there also is no definition of what constitutes management functions either. The possibilities include daily business operations (sales, marketing, advertising, production, etc.), hiring and firing of personnel, business planning, and the catch all – any other management activity or service.

Qualified retirement plans are excellent employee benefits to help recruit, retain and reward employees. Of course, as business owners, they are also great tools to help you save towards retirement. Just know, however, that the IRS is always on the lookout for business owners who seek to provide these benefits to select employees, rather than providing equal benefits to all employees. As a result, many complicated rules have been put into place.

Before implementing a qualified retirement plan, make sure you consult with your Guardian Financial Representative who can help you wade through the intricacies and complexities of these rules, as well as to ensure that the most appropriate plan is implemented based upon your goals for your business as well as for yourself.





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Please consult with your Guardian Financial Representative if you have any questions concerning this document.

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