Controlled Group Rules

Under the controlled group rules, related employers are treated as a single employer for plan purposes. This means that employers who are part of a controlled group may (or may not) be able to maintain separate plans because ALL employees of the employer, i.e., the controlled group, must be considered when determining what plan design options are available. In other words, certain plan testing requirements apply to the group of related employers on a combined basis.

What is a controlled group?

Under the controlled group, companies can be related under either the "brother-sister" or "parent-subsidiary" rules. A brother-sister relationship exists between two (or more) companies when five or fewer owners have common ownership of 80% or more and identical ownership of more than 50%. A parent-subsidiary relationship exists when a company owns at least 80% of another company. In either case, the stock attribution rules under IRC section 1563 must be applied when determining who has ownership (direct or indirect) in the companies.

For example, assume Bill owns 100% of ABC Company and 80% of DEF Company. The two companies are related under the brother-sister rules since Bill owns more than 50% of each company and at least 80% of both companies. Alternatively, assume ABC Company owns 80% of DEF Company. In that case, a parent-subsidiary relationship exists since ABC Company owns at least 80% of DEF Company. Under either scenario, the employers form a controlled group and must be treated as a single employer for plan purposes.

What are stock attribution rules?

They are rules that require certain family members (and other entities) be considered when determining whether an individual (or entity) has ownership in a company. Under these rules, ownership is attributed from the actual owner(s) of a business to another party(ies), i.e., the other party is considered to own the same percentage of the company as the business owner for this purpose.

These rules often hit employer from left field because they do not exactly follow common sense. For example, assume an individual owns a construction company and his wife owns a dental practice. Even though the companies are in completely different industries, they would be considered related under the controlled group rules since ownership is generally attributed between spouses, unless a limited exception applies.

Who are related parties under these rules?

In general, certain family members must be considered for this purpose including spouses, children, parents, grandparents, and grandchildren. There are, however, specific rules that apply when determining whether ownership is attributed to a particular family member. There are also attribution rules that apply to corporations, partnerships, estates, and trusts. Lastly, there are attribution rules that apply to stock options.

What are the attribution rules that apply to spouses?

Generally, a spouse's ownership is attributed to the other spouse unless all of the following conditions are satisfied:

- The spouse has no direct ownership interest in the company; and
- The spouse is not an employee or director; and

- The spouse does not participate in the management of the business; and
- No more than 50% of the company's gross income is derived from rents, royalties, dividends, interest, or annuities; and
- The interest in the company is not subject to restrictions that would limit the spouse's ability to dispose of the stock.

Caution: *Even when all of the above conditions are satisfied, if a couple resides in a community property state, that state's laws could result in the spouse having actual ownership in the company. Additionally, if the couple has minor children, ownership is attributed to the children which could result in businesses being related under these rules.*

What attribution rules apply to minor children?

A parent's ownership interest in a company is attributed to his or her minor children (children who have not attained age 21). From a plan perspective, this rule could result in an unexpected "surprise" when a couple has a baby or adopts a child.

For example, if each spouse owns his or her own business and met the exception (described above) prior to the birth of their child, the companies would not have been related under the controlled group rules. After the birth of their child, however, they would be related, i.e., a controlled group, since the child would be considered to own 100% of both companies under these rules (never mind the fact an infant generally couldn't own a business).

What attribution rules apply to other family members?

There are limited attribution rules that apply with respect to parents, grandparents, grandchildren, and adult children. An individual who owns more than 50% of a company is also considered to own any interest owned (directly or indirectly) by his or her parents, grandparents, grandchildren, and any adult children. Otherwise, there is no attribution.

For example, assume Bill owns 51% of XYZ Company and his adult son owns the remaining 49%. In this situation, Bill is considered to own 100% of XYZ Company since he is attributed his son's ownership interest. His son, however, is not attributed his father's ownership interest since he owns less than 50% of the company. This would matter if Bill owned 80% (or more) of another business – in that case, the businesses would form a controlled group.

Note: There are special rules that limit stock attributed to an individual under these rules from being attributed to another family member, i.e., there isn't "double attribution", and similar rules that apply with respect to ownership interests held by other entities.

What rules apply to ownership interests held by other entities?

In general, when another entity has an ownership interest in a business, ownership is attributed to the underlying owners of that entity (or beneficiaries, in the case of a trust or an estate). For example, assume ABC Company (owned 100% by Sally) owns 50% of DEF Company. In that case, Sally is considered to own 50% of DEF Company under these rules.

Are there rules that apply when a person has options to buy an interest in a company?

Yes. When an individual (or entity) has options to purchase an ownership interest in a company, they are generally considered to own that interest under these rules.

Can companies who are members of a controlled group sponsor different 401(k) plans for each company?

It depends. In general, it is permissible for an employer, i.e., controlled group, to sponsor different 401(k) plans covering different groups of employees.

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In that case, if each plan can pass coverage on its own after considering all employees of the employer, i.e., the controlled group, the plans could have different features and would not be aggregated for nondiscrimination testing (including ADP/ACP testing and other required nondiscrimination testing).

Alternatively, if each plan cannot satisfy coverage on its own, the plans could be aggregated, i.e., combined, for coverage and nondiscrimination testing provided they have same plan year and use the same ADP/ACP testing method, e.g., prior year or current year testing method, the same safe harbor formula, etc. Additionally, each of plan would generally need to have the same features to avoid additional testing requirements.

Lastly, when an employer sponsors multiple 401(k) plans, the plans generally must be aggregated for top-heavy purposes. There is a limited to exception to this rule, however, when an employer sponsors a plan that does not cover any key employees if that plan is not aggregated with any other plan for coverage and nondiscrimination testing purposes.

That said, depending on the situation, it may make more sense to cover all companies under a single plan than to maintain separate plans. It really will depend upon the demographics of the employer's workforce, goals of the employer, specific testing requirements, and other factors.

The Bottom Line

Determining whether employers are related under the controlled group rules can be complex, but it is critical in determining what options are available from a retirement plan perspective. **Not getting this right can result in unintended and costly mistakes!**

For example, assume Bill and Sally are married have three minor children. Each of them owns a business, and since they have children, their companies are related under the controlled group rules.

Bill is an IT consultant and self-employed. He does not have any employees. His business sponsors a 401(k) plan. Sally owns an established and successful dental practice that has 10 employees. Her practice sponsors a safe harbor 401(k) plan. When Bill set up his 401(k) plan several years ago, he never mentioned to his advisors that his wife owns a dental practice because he didn't see how that would be relevant.

Bill has been making 401(k) deferrals to his plan and a 25% profit sharing contribution. Sally's practice, however, has not been making profit sharing contributions for the last few years.

So, what is the problem here? Bill cannot operate his plan without taking into consideration the employees in his wife's practice. As a result, there are a number of issues that would require correction in order to preserve the qualified status of Bill's plan, but let's just look at the profit sharing contribution.

Since Bill has been making a 25% profit sharing contribution for the last several years, and none of the wife's employees have received a profit sharing contribution for those same plan years, Bill's plan fails coverage.

Generally, the correction would be to amend his plan to provide for profit sharing contributions for a sufficient number of Sally's employees (at 25% of their compensation) so that coverage is satisfied. To make things worse, the correction would generally have to be made by seeking IRS approval under the applicable IRS plan correction program. **Clearly, this could be a very expensive mistake to fix!**

How can I learn more?

Please contact us to learn more about these rules and how they may impact your plan and plan participants.