Commonly-Owned Entities Can Be Responsible For Each Other's Employee Benefits Liabilities

2.11.2015

Recently, we were retained to represent a non-U.S. parent corporation which had encountered employee benefits difficulties due to its acquisition of two completely unrelated U.S. businesses. The difficulties arose due to a concept known as a "controlled group" – a concept unique to the employee benefits and tax arenas. First, we very briefly discuss the controlled group concept. Then we very briefly list some implications of entities being part of the same controlled group. We conclude by suggesting that when purchasing U.S. businesses, non-U.S. companies should retain employee benefits counsel to advise them on U.S. employee benefits issues.

What is a controlled group?

A controlled group (also known as a group of trades or businesses under common control) is a group of legal entities (such as corporations, partnerships, limited liability companies, sole proprietorships) which are related to each other due to common ownership. There are three different types of controlled groups:

1. Parent-subsidiary: the parent (for example, the non-U.S. parent corporation) owns the U.S. subsidiary. The parent business must own as least 80% of the subsidiary (directly or indirectly). For example, if a parent entity owns at least 80% of two different subsidiaries (directly or indirectly), all three entities comprise the same controlled group.[1]

2. Brother-sister – at least two entities have common ownership owning each entity. The same 5 or fewer common owners (individuals, trust, or estates) own (directly or indirectly) a controlling interest of at least 80% in each business and at least 50% of the ownership is identical.

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3. Combined groups – a mixture of the parent-subsidiary and brother-sister.

Ownership is based on the type of business. For a corporation, ownership is based on the percentage of the corporation's stock owned. The ownership percentage is based on voting power or value of the stock. For a partnership, ownership is based on the capital interest or profits interest in the partnership. For a sole proprietorship, the sole proprietor is treated as the 100% owner. (Note: in some tax contexts, non-U.S. corporations are excluded from the definition of "controlled group"; however for employee benefits purposes foreign corporations are generally included as members of the controlled group.)

A multitude of attribution rules and constructive ownership rules apply in determining whether entities are part of a controlled group. These rules apply to human family members as well as entities. For example, a spouse is generally deemed to own what the other spouse owns in an entity. A partner who owns at least a 5% or more capital or profits interest in a partnership is deemed to own (proportionately) what the partnership owns in an entity. These rules need to be examined in great detail. Ultimately, application of these rules can result in an entity or individual being deemed as owning an interest in another entity pursuant to indirect means.

The type of work performed by the entity or the industry in which the entity operates is not relevant in determining whether a controlled group exists. For example, an automobile supplier and a financial services firm can be members of the same controlled group. (However, please see the below discussion regarding the qualified separate lines of business exception to the controlled group concept.)

Why does controlled group status matter?

Controlled group status matters in a variety of circumstances for tax-qualified retirement plans, welfare plans, and non-qualified deferred compensation plans. As summarized in the examples below, due to application of the controlled group concept, the "employer" is not only the entity which directly employs the employees but also all other entities which are members of the same controlled group with the employing entity.

Tax-qualified retirement plans:

Eligibility: Employment service with any member of the controlled group generally must be counted for purposes of eligibility to participate in the plan.

Vesting: Employment service with any member of the controlled group generally must be counted for purposes of determining a participant's vested interest in the plan.

Coverage: To determine whether a plan satisfies the Internal Revenue Service's minimum coverage rules, all members of the controlled group are taken into account. More specifically, employee census data from all members of the controlled group must be collected and analyzed when performing the coverage test. In our above described scenario -- a non-U.S. parent corporation acquires two different U.S. entities performing work in unrelated industries -- this was the key failure which occurred. Each U.S.

entity sponsored its own profit sharing/section 401(k) plan. One entity's plan provided much more generous benefits than the other entity's plan. When conducting the coverage testing for each plan, employee census data of both entities should have been taken into account -- but was not.

We recommend that following a business merger or acquisition, all service providers for each plan are promptly informed of the business transaction. Service providers (especially the provider conducting the coverage and other testing) should always be provided with all the employee census data they request -- otherwise the testing results may not be accurate. [2][3]

An exception exists for the controlled group concept for both coverage testing and non-discrimination testing (referenced farther below): qualified separate lines of business. Each entity must comprise a separate line of business, and must satisfy a complex number of requirements. Among other requirements, the entities must be organized and operated separately, have separate financial accountability, and have separate workforces and separate management. Significantly, each entity must employ at least 50 employees. (In our above example, one of the U.S. entities employed just slightly less than 50 employees, and so the separate line of business exception was unavailable.)

Annual additions / annual benefits: Internal Revenue Service rules limit how much can be contributed on an employee's behalf during a plan year to a defined contribution plan and how much can be paid on an employee's behalf during a plan year from a defined benefit plan. These limits apply in the aggregate to all defined contribution plans sponsored by all members of the controlled group and all defined benefit pans sponsored by all members of the controlled group. (Remember: for purposes of these limits, the ownership threshold is 50% -- not 80% -- so it is more likely that a controlled group will exist.)

Top heavy: If a plan is considered "top heavy", accelerated vesting and additional benefits may have to be provided to "non-key employees". In determining whether a plan is top heavy, the accrued benefits of “key employees” are compared to those of non-key employees. In determining whether a plan is top heavy, all members of the controlled group are taken into account.

Compensation limit and definition of highly compensated employee: Internal Revenue Service rules limit how much of an employee's compensation can be taken into account for plan purposes (in 2015 this limit is $265,000). In determining whether an individual's compensation exceeds this limit, the individual's compensation from all members of the controlled group is taken into account. In determining whether an individual is a highly compensated employee (for purposes of nondiscrimination testing referenced below), an individual's compensation from all members of the controlled group is taken into account. (If an individual's compensation in 2014 was at least $115,000, then the individual is considered a highly compensated employee for 2015).

Nondiscrimination testing: In the employee benefits arena, concepts such as "discrimination" or "non-discrimination" pertain to an analysis of contributions, benefits, rights, and features available to highly compensated employees under a plan as compared to those available to non-highly compensated employees under the plan. The non-discrimination rules are complex and extensive.

Suffice it to state that controlled group members may be required to be taken into account for these extensive tests.

Separation from service: A "termination of employment" which would enable an employee to receive a distribution from a retirement plan is not considered to have occurred unless the employee has terminated employment with all members of the controlled group. For example, an employee transferring employment from member #1 of the controlled group to member #2 of the controlled group does not constitute a termination of employment entitling the employee to a distribution from the retirement plan sponsored by member #1.

Pension plan contributions: Contribution liability to a defined benefit pension plan is a liability potentially borne by all members of the controlled group.

Withdrawal liability: Withdrawal liability which an entity must pay when withdrawing from a multiemployer pension plan is a liability potentially borne by all members of the controlled group.

Plan termination liability to PBGC: Liability owed to the Pension Benefit Guaranty Corporation ("PBGC") when a defined benefit pension plan terminates in a distress termination or involuntary termination is a liability potentially borne by all members of the controlled group.

Welfare plans

"Play or pay" -- The "play or play provisions" of health care reform (more formally known as the employer shared responsibility provisions under the Patient Protection and Affordable Care Act of 2010, as amended) apply to employers which employed at least 50 full time employees and full time equivalent employees during the previous year. In determining whether this 50 employee threshold is satisfied, employees of all members of the controlled group are included. (Please note that employees who did not work at all in the United States can be excluded in determining whether this threshold is satisfied.)

COBRA - COBRA (the Consolidated Omnibus Budget Reconciliation Act of 1985, as amended) provides for continuation of health care coverage for a period of time if health care coverage is lost due to certain qualifying events (such as termination of employment, divorce, dependent child reaching maximum age for coverage, etc.). COBRA applies to an employer employing at least 20 employees on 50% or more of the typical working days in the previous calendar year. In determining whether this 20 employee threshold is satisfied, employees of all members of the controlled group are included. So, for example, if a non-U.S. parent corporation employs thousands of individuals outside of the U.S., and it owns all of the stock of a U.S. company which employs 15 employees, the U.S. company will be subject to COBRA (even though the U.S. company itself employs fewer than 20 employees).

Nondiscrimination - Self-insured group health plans are subject to non-discrimination rules. These rules pertain to an analysis of eligibility for, and benefits available, to highly compensated individuals under a self-insured group health plan as compared to eligibility for, and benefits available, to non-highly compensated individuals under the plan. The non-discrimination rules are complex and

extensive. Suffice it to state that controlled group members are taken into account in determining who is a highly compensated individual as well as for conducting these extensive tests. (Note: under health care reform, nondiscrimination rules for fully insured plans are forthcoming.)

Cafeteria plans - Cafeteria plans (also known as Internal Revenue Code section 125 plans) are plans which allow employees (and employers) to make contributions on a tax-exempt basis to pay for medical expenses (and certain other welfare benefits) of employees (and spouses and dependents). Eligibility, contribution, and benefit nondiscrimination rules apply to cafeteria plans (comparing highly compensated individuals/highly compensated participants to non-highly compensated individuals/non-highly compensated participants), and in applying these rules controlled group members are taken into account.

Non-qualified deferred compensations plans

Internal Revenue Code section 409A applies a host of contribution and distribution restrictions to a wide range of deferred compensation arrangements created for both employees and certain independent contractors. The definition of "service recipient" (i.e. employer) encompasses the entire controlled group. In determining whether "service providers" (i.e. employees or certain independent contractors) have experienced a separation from service entitling them to a distribution from the deferred compensation plan, service providers must experience a termination of employment with every member of the controlled group. In determining whether legal entities are members of the same controlled group for these section 409A purposes, the 50% common ownership threshold (rather than the 80% common ownership threshold) is utilized (although the governing plan document may be able to expressly provide for a different common ownership threshold).

Section 409A also requires a minimum 6 month delay of payment to "specified employees" following separation from service. In determining who is a specified employee (and more specifically in determining whether the service recipient is a publicly traded company) the controlled group rules apply. In other words, if any member of the controlled group is a publicly traded company, the specified employee rule may apply.

Bottom line: the above discussion is incredibly brief as Internal Revenue Service and U.S. Department of Labor rules describing the above concepts are thousands of pages in length. The key take-away is that for many aspects of employee benefits rules, the "employer" includes not only the legal entity directly employing the relevant employees, but also the entire controlled group of which the employing entity is a member. Butzel Long can assist you in determining whether your family of legal entities constitutes a controlled group (especially following a merger or acquisition) and the implications of controlled group status in your specific situation.

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[1] Please note that the 80% figure becomes 50% in the context of Internal Revenue Service limits on (a) total contributions made on behalf of an employee to defined contribution tax-qualified retirement plans during a year and (b) total benefits paid to an employee by defined benefit tax-qualified retirement plans during a year.

[2] Note: If various requirements are satisfied a transition rule provides some short term timing relief so that following a business acquisition or disposition employee census data reflecting the controlled group change does not have to be taken into account for the plan year of the acquisition/disposition as well as the following year.

[3] Further Note: Internal Revenue Service rules allow plans to exclude certain classifications of employees for coverage testing purposes - such as nonresident aliens - so if the plan document contains this exclusion then census data of employees of non-U.S. entities would not have to be collected and analyzed, provided the employees do not reside and/or work in the United States.