Benefit Insights

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A non-technical review of qualified retirement plan legislative and administrative issues
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The Hidden Pension Trap—The Aggregation Rules

One of the primary objectives of the qualified plan rules is to make the tax advantages contingent upon covering a significant number of the nonhighly compensated employees. As this goal could be thwarted by creating separate legal entities for the highly compensated and nonhighly compensated employees, a complex set of rules has evolved concerning the aggregation of related employers for purposes of the minimum coverage rules and other qualified plan requirements.

Unnoticed, these aggregation rules can cause serious negative ramifications. Let's look at an example:

Jean the pension consultant goes to visit her client Exterminator, Inc. that sponsors a profit sharing plan. When she arrives, she also sees the name of Bug Analysis, Inc. on the door. Immediately she becomes concerned, since she knows that the plan only covers employees of Exterminator, Inc.

She discovers that both companies are wholly owned by the same two individuals. Since this is a situation in which the employees must be aggregated, the profit sharing plan could be disqualified if it cannot satisfy minimum coverage after counting the excluded employees of Bug, Inc.

As failure to identify required aggregation can result in plan disqualification, employers need a basic understanding of these rules.

The Rules

There are several aggregation rules. The controlled group rules require aggregation of employers that have a sufficient amount of common ownership, and the affiliated service group rules apply to other situations in which related businesses work together to provide goods or services to the public.

When either rule applies, aggregated employers are treated as one entity for most qualified plan rules. Specifically, such organizations must be combined for purposes of the coverage requirements, nondiscrimination provisions, vesting requirements, maximum limitations on benefits and contributions, compensation limitations and top heavy requirements. Both rules apply to corporations and "trades and businesses," including partnerships, proprietorships, estates and trusts.

A third type of affiliation relates to situations in which individuals are "leased" on a long-term, full-time basis.

An individual who meets the definition of "leased employee" is treated as working for the recipient for purposes of the qualified plan requirements. Each of these rules is covered more fully below.

Controlled Group Rules

There are three types of controlled groups: brother-sister, parent-subsidiary and combined groups.

Brother-Sister Controlled Group

A brother-sister controlled group exists whenever the same five (or fewer) owners of two or more entities own 80% or more of each entity, and more than 50% of each entity when counting only identical ownership. Let's look at an example:

Shareholder	Corp. X	Corp. Y	Identical Ownership
Joe	20%	12%	12%
Sally	60%	14%	14%
Ralph	20%	74%	20%
Total	100%	100%	46%

In this case the 80% ownership test has been met, because the three individuals (Joe, Sally and Ralph) who have ownership in each entity own 100% of both businesses. However, the 50% identical ownership interest test has not been satisfied. Identical ownership is determined first by determining the common ownership interest for each individual. For example, Joe's identical interest is 12%. The second step is to add up the identical ownership interests of Joe, Sally and Ralph. Since these only add up to 46%, this group does not constitute a controlled group.

When performing the 80% test, only shareholders owning interests in each potential member of the group are counted—any shareholder who does not own stock in all of the companies being considered is ignored.

Another key consideration is the stock attribution rule that applies to stock owned by certain family members. A spouse is generally deemed to own an interest owned directly or indirectly by or for his or her spouse. However, attribution is not required if the spouses are separated or divorced or in situations in which an individual has no direct ownership interests in the entity owned by his or her spouse and is not an employee, director or otherwise involved in the management of the company.

An individual is considered to own an interest owned by the individual's children who are under age 21. Also, children under age 21 are attributed ownership interests of parents. Because of this attribution rule, if a husband and wife each own 100% of their own businesses and they have a child under age 21, the child is deemed to own both businesses. Therefore, a controlled group will exist even if the spousal exception would otherwise apply.

In addition, when a person owns more than 50% of an entity, he or she is deemed to own any interest owned in that entity by his or her adult children, grandchildren, parents and grandparents.

Parent-Subsidiary Controlled Group

A parent-subsidiary controlled group exists whenever one entity (referred to as the parent company) owns at least 80% (measured by vote or value) of another entity. Additional entities may be brought into the group if a chain of common ownership exists.

Example: Corporation A owns 80% of Corporations B and C, and Corporations B and C each own 40% of Corporation D. Because Corporation D is 80% owned by entities within the group, Corporation D is part of the parent-subsidiary controlled group that includes all four corporations.

Combined Group

The last type of controlled group is the combined group under common control. A combined group exists if an entity is both a common parent in a parent-subsidiary group and a member of a brother-sister group. If this is the case, the two related controlled groups are treated as one controlled group.

Affiliated Service Group Rules

Congress first enacted the affiliated service group rules to address the concern that small corporations had

managed to divide management and the rank-and-file into separate entities and avoid the controlled group rules. The rules have been expanded several times over the years to address new avoidance schemes. Today, the law is quite complex. There are several threshold issues that help to identify when affiliation may exist. Except for management services affiliation (discussed below), affiliated groups exist only when all three of the following elements are present:

- When two or more business entities work together to provide one service or product to the public;
- When at least one of the entities is a service organization; and
- When at least some common ownership exists between the two entities.

A service organization is an organization for which capital is not a material income-producing factor. Generally, capital is to be deemed a material income-producing factor if a substantial portion of gross income is attributable to substantial investments in such things as plant and inventory. Organizations in the fields of health, law, engineering, actuarial science, consulting and insurance are automatically deemed service organizations.

These affiliation rules come into play regularly in the medical world, where there are partnerships between doctors and hospitals that provide services in outpatient clinics, MRI testing centers and other cooperative medical centers. In these cases, there must be careful analysis to see if the MRI testing center, for example, is affiliated with the doctor's medical practice or with the hospital.

Management services affiliation is defined by a much broader rule, which essentially prohibits an executive of any size company from separating himself from the company for the purpose of establishing his or her own retirement plan.

Leasing of Employees

Instead of hiring employees directly, a business may lease employees from a third party for a number of legitimate reasons. Unfortunately, at one time, leasing of employees was also used as a way to circumvent the minimum coverage requirements. The employer would lease rank-and-file employees and then exclude them from plan eligibility. Code Section 414(n) was enacted to eliminate such practices by requiring that individuals leased on a full-time, ongoing basis would be treated as employees for purposes of the coverage requirements.

A leased employee is a person who provides services to the recipient and meets all three of the following requirements:

- The services are provided pursuant to an agreement between the recipient and a leasing organization;
- The services are provided on a substantially full-time basis for a period of at least one year; and
- The individual's services are performed under the primary direction or control of the service recipient.

Even if an individual is a leased employee under the above conditions, he or she will not be treated as an employee of the recipient if leased employees constitute no more than 20% of the recipient's nonhighly compensated workforce and the leasing entity maintains a safe harbor plan.

Note that leased employees do not necessarily have to be covered under the plan, they simply have to be counted for purposes of the coverage test.

Conclusion

The affiliation rules are quite complex. It's helpful to remember that they were, for the most part, enacted to eliminate perceived abuses, and any situation in which employees are artificially separated to avoid coverage is probably prohibited. Unfortunately, the rules can also extend beyond situations that were not originally foreseen. With the potential adverse affects of failing to miss these situations, it's crucial for everyone involved in the plan to keep an eye out for hidden aggregation problems.

IRS and Social Security Annual Limitations

Each year the U.S. government adjusts the limits for qualified plans and social security to reflect cost of living adjustments and changes in the law. Many of these limits are based on the "plan year." The elective deferral and catch-up limits are always based on the calendar year. Here are the 2009 limits as well as the three prior years for comparative purposes:

Limit	2009	2008	2007	2006
Maximum compensation limit	$245,000	$230,000	$225,000	$220,000
Defined contribution plan maximum contribution	$49,000	$46,000	$45,000	$44,000
Defined benefit plan maximum benefit	$195,000	$185,000	$180,000	$175,000
401(k), 403(b) and 457 plan maximum elective deferrals	$16,500	$15,500	$15,500	$15,000
Catch-up contributions*	$5,500	$5,000	$5,000	$5,000
SIMPLE plan maximum elective deferrals	$11,500	$10,500	$10,500	$10,000
Catch-up contributions*	$2,500	$2,500	$2,500	$2,500
IRA maximum contributions	$5,000	$5,000	$4,000	$4,000
Catch-up contributions*	$1,000	$1,000	$1,000	$1,000
Highly compensated employee threshold	$110,000	$105,000	$100,000	$100,000
Key employee (officer) threshold	$160,000	$150,000	$145,000	$140,000
Social security taxable wage base	$106,800	$102,000	$97,500	$94,200

*Available to participants who are or will be age 50 or older by the end of the calendar year.