PROPOSED CHANGES UNDER THE IRC §414(m) RULES, INCLUDING PERMISSIVE AGGREGATION OF ENTITIES UNDER IRC §414(m)

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Background

The affiliated service group (ASG) rules under Code Section 414(m) attempt to impose what are effectively anti-fraud rules to prevent creative business combinations which may sponsor plans discriminating in favor of the highly compensated. The rules provide that plans of certain related companies that are not otherwise aggregated under Code Sections 414(b) and (c) be treated as if maintained by a single employer.

There are three types of business arrangements that are aggregated under the ASG rules:

1. A service company (a “First Service Organization” or “FSO”) in which another service company (the “A Org”) holds an ownership interest and which provides services to that A org or to the A Orgs customers are aggregated.

2. A company (the “B Org”), a significant portion of its business is in providing employee-like services to the FSO or A Org, is aggregated with them if 10% or more of the B Org is owned by the highly compensated employees of the FSO or A Org;

3. A company whose principal business is providing management services on a “regular and continuing basis” to a related company, which is defined by those with which business losses between them will be denied, will be aggregated.

These rules also apply with multiple ASG arrangements, or those also involving controlled groups. If applied broadly in a service-based economy, these rules can have significant, if unintended, impact. The proposed regulations seek to ameliorate the statute’s impact by requiring that the rules apply if the FSO is also a specified professional service company.

We have two recommendations for Treasury to consider for purposes of its regulatory and guidance plan.

- The first is, as described below, to allow the permissive aggregation of related employers as an ASG, even where the FSO is not a professional service company. This will have two effects: first, it will prevent the periodic whipsaw effect under which periodic changes in ownership structures or service levels may cause employers to fall out of or back into ASG status. This potential for changing ASG status makes it virtually impossible to maintain single plan status on a continual basis.

This also would permit organizations that are closely related but do not fall within controlled group status or ASG status, to combine their resources for more favorable retirement arrangements.
• The second recommendation is to recognize that the ASG rules can have an impact on related laws, and, as described below, coordinate the ASG rules with ERISA and the DOL.

Permissive Aggregation

• The nature, size, and functioning of service industries have incredibly changed since the passage of the ASG rules and the issuance of the proposed regulations. Business combinations now form and reform with a great deal of non-traditional flexibility, with a variety of different tools used to parse out the exercise of control between business partners. Much of this has simply been enabled by business technology which did not exist at the time the proposed regs were written. This is particularly true in smaller, flexible technology and other expert organizations. It is not uncommon for related groups of companies to exist within certain groups of expert industries under virtual common control, without actually falling within the definition of a controlled group-or within the same ASG, as described in the existing scheme of proposed regulations.

• The ASG proposed regulations themselves were written to prevent abusive business combinations that can have the effect of undermining the application of important non-discrimination and coverage rules. They also attempt to strike a balance between overbroad application to avoid mandating ASG status where the circumstances are unlikely to result in abuse. Much of the commentary in the past has argued for limiting the application of these rules, to permit related companies to be treated on a disaggregated basis.

• Not all small businesses seek to abuse the IRS compliance rules. There are a number of business combinations that regularly perform services for each other or which are regularly associated each other in performing services for third persons that do not qualify as ASGs under the proposed regulations yet would benefit from the ability to combine for retirement plan purposes without raising the additional burden of multiple employer plan (“MEP”) status. There has been a growing recognition of this need in the marketplace, as evidenced by both the movements by the states to establish broad state-based programs; the bi-partisan support for MEPs; the exploding marketplace to consolidate services to unrelated plans; and the proposed expansion of association health plans to otherwise unrelated employers. Aggregating services to plans extends to employers (particularly smaller employers) the buying power and access to expertise; institutional level investment pricing; a wider variety of investments; and cost-effective services that may otherwise be unavailable to them at any price. This could be an especially useful tool in providing cost effective plans to the growing contingent workforce.

• Permitting certain related business to permissively aggregate as ASGs would support the public policy of encouraging cost-effective plan coverage, especially for smaller employers, and would recognize the changing nature of the manner in which business services are being delivered. Simple modifications to the current structure of the A Org rules could accommodate non-abusive combinations, without needing to change the B Org or the 414(m)(5) management group rules:
Code Section 414(m) does not require the FSO to be a professional service organization; this requirement is a feature of the proposed regulations. Though that rule does serve to usefully limit the scope of the rules to the most potentially abusive circumstances, it also limits the ability of related service organizations to avail themselves of the benefits of being treated as ASGs. Allowing the FSO to elect to be treated in the same manner as a professional service corporation, while retaining the same requirements that the employers be regularly associated with each other or regularly provide services to third parties along with the A Org would make ASG status available to employers for which it is important to do so. Note that it would not be useful to use the Code Section 144(a)(3) definition of related organization under 414(m)(5)(B), as this requires that losses be disallowable between the employers in order to qualify as “related,” which would undermine the entire purposes of providing broad coverage and flexibility of business combinations.

Define shareholder and partner interests between the FSO and the A Org expansively, to encompass business combinations with similar ownership interests to include other business entities such as limited liability companies, sole proprietorships and joint venture arrangements with joint ownership features. This recognizes the reality that there are a wide variety of non-traditional arrangements under which related organizations operate.

Application to the ACA and ERISA

Under current law, the compliance by ASGs, regardless of whether due to mandatory or the previously proposed permissive aggregation, with the Patient Protection and Affordable Care Act (ACA”) employer mandate will result in such ASGs, which are treated as a single employer under the Code, being subject to multiple employer welfare arrangement (“MEWA”) status under ERISA.

- Code Section 4980H(a) imposes a penalty on any applicable large employer that fails to offer to its full-time employees (and their dependents) the opportunity to enroll in minimum essential coverage under an eligible employer-sponsored plan for any month if at least one full-time employee of the applicable large employer has been certified to the employer under the ACA as having enrolled for such month in a qualified health plan with respect to which an applicable premium tax credit or cost-sharing reduction is allowed or paid with respect to the employee. The resulting assessable payment is equal to the product of the applicable payment amount and the number of individuals employed by the employer as full-time employees during such month.

  - The term applicable large employer means, with respect to a calendar year, an employer that employed an average of at least 50 full-time employees (including full-time equivalent employees) on business days during the preceding calendar year.

  - For purposes of determining whether an employer is an applicable large employer, all persons treated as a single employer under section 414(b), (c), (m),
or (o) are treated as a single employer. Thus, all employees of a controlled group of entities under section 414(b) or (c), an ASG under section 414(m), or an entity in an arrangement described under section 414(o), are taken into account in determining whether the members of the controlled group or ASG together are an applicable large employer.

- The term “multiple employer welfare arrangement” means an employee welfare benefit plan, or any other arrangement (other than an employee welfare benefit plan), which is established or maintained for the purpose of offering or providing a health and welfare benefit to the employees of two or more employers (including one or more self-employed individuals), or to their beneficiaries.

  o For purposes of this definition:

    - two or more trades or businesses, whether or not incorporated, shall be deemed a single employer if such trades or businesses are within the same control group;
    - the term “control group” means a group of trades or businesses under common control;
    - the determination of whether a trade or business is under “common control” with another trade or business shall be determined under regulations of the Secretary applying principles similar to the principles applied in determining whether employees of two or more trades or businesses are treated as employed by a single employer under section 4001(b), except that, for purposes of this paragraph, common control shall not be based on an interest of less than 25 percent.

Although the DOL has the rule-making authority to lower the threshold above which related entities will be treated as single employers under ERISA, no such rules have been put in place since the MEWA rules were adopted. Therefore, although consolidated as a single employer under the Code and ACA, trades or businesses combined as ASGs under Code Section 414(m) will be treated as single employers under ERISA and ACA-mandated health and welfare plans provided to employees of these otherwise aggregated employers will be subject to the ERISA reporting and state insurance law obligations applicable to MEWAs.

We recommend that Treasury work with the DOL to use the existing rulemaking authority under ERISA Section 3(40) to provide that trades or businesses that are consolidated as single employers under Code Sections 414(b), (c), (m), or (o) be treated as single employers under the MEWA rules. Such a change would alleviate the compliance issues faced by ASG members that are mandated by the ACA to provide minimum essential and affordable coverage to employees and the potential additional costs associated with securing separate plans or policies in order to address MEWA status. The change, however, would not risk the rise of abusive practices by otherwise unrelated employers offering illusory or thinly capitalized coverage since the consolidated employers would still have to satisfy the ERISA definition of “employer” under Section 3(5) in order for coverage to be treated as single-employer coverage under ERISA.