Retirement Plan Correction Solution
Affiliated Service Groups:
No Pill's Gonna Cure Your Ill

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Dr. Day and Dr. Night are both the sole owners (and sole employees) of two separate corporations, Good Day, Inc. and NightNight, Inc., respectively, that they established to provide medical services. After lamenting to each other that they have such difficulty keeping up with the boring office work of scheduling and billing in addition to providing the actual medical services that interest them, the good doctors come up with an ingenious plan: the two corporations will form a partnership. With their combined resources, the partnership will be able to hire someone to oversee scheduling and billing for both doctors. Thus, the doctors form Noon Partners, which is owned 50% each by Good Day, Inc. and NightNight, Inc. As the years pass, the greater efficiency allows the doctors to eventually rent a floor of an office building together, and for Noon Partners to hire nurses and a receptionist, in addition to their now seasoned office manager.

On what appears to be the excellent advice of a third-party administration firm, Fly-by-Night TPAs, Dr. Night establishes a retirement plan, the NightNight Plan. The plan is designed to provide retirement benefits only for the sole employee of NightNight, Inc., i.e., himself. Dr. Day, also interested in planning for retirement, seeks out her own TPA, Joe at Lister Pensions. Both doctors reason that, since all of the other people work for Noon Partners, the plans sponsored by the doctors' corporations do not have to cover them. What a great savings tool!

Unfortunately, like so many brilliant ideas, the IRS thought of this one well before the doctors did. Joe meets Dr. Day at her office and instantly notices the shared workers that Dr. Day believes will not need to be covered by her plan. Luckily, Joe has read S. Derrin Watson's groundbreaking book, *Who's the Employer?*, and knows better. Joe delivers the bad news: As far as the IRS is concerned, Good Day, Inc., NightNight, Inc., and Noon Partners are one employer. The employees of all three must be counted in determining whether any plan the entities sponsor satisfies coverage, minimum participation, and nondiscrimination.

Patient History

The controlled group rules (discussed **here**) require that entities controlled at least 80% by the same owner or owners be treated as one company for plan purposes. Because Dr. Day owns nothing of Dr. Night's company (and vice versa) and neither doctor controls 80% or more of Noon Partners, there is no controlled group. Unfortunately for the doctors, that's not where the inquiry ends.

As employers (particularly professionals, such as doctors and lawyers) attempted to get around the controlled group rules by creating partnerships like Noon Partners, Congress introduced rules to address this structure. Internal Revenue Code (the "Code") Section 414(m) defines what is an "affiliated service group" or "ASG." Proposed Treasury Regulations provide additional guidance and may be relied upon by practitioners until final Regulations are released (an event for which we have been waiting for more than 38 years, at the time of writing). ASGs can be subdivided into two types: traditional ASGs and management function groups.

Traditional Affiliated Services Groups

In a traditional ASG, the group is comprised of two entities, one called the first service organization ("FSO") and one or more so-called A-Orgs or B-Orgs. All of these must be organizations, meaning the doctors' corporations and partnerships are captured by the rules, as would a sole proprietorship.

What is a service organization? Key to the ASG rules is that at least one of the organizations (specifically, the FSO) must be engaged in the business of providing services (as opposed to goods). Under the Code and the Proposed Regulations, a service organization is a business that practices in certain specified fields, or one for which capital is not a material income-producing factor.

A business is deemed to be a service organization if it engages in one of nine specified fields: health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or insurance. There are a few caveats to this rule. An organization is not a service organization just because it manufactures or sells equipment used by these specified fields (e.g., a manufacturer of medical testing equipment is not a service organization by virtue of existing in the health field). Additionally, a business is not a service organization if it has an employee who performs services in one of these nine fields in-house but not for the public (e.g., a company that has in-house legal counsel is not automatically considered to engage in services in the legal field).

Alternatively, an organization is a service organization if capital is not a material income-producing factor. Capital is a material income-producing factor if a business makes substantial investment in inventories, equipment, plants or warehouses, and machinery. Think back to our manufacturer of medical testing equipment. The manufacturer must invest in a plant and machinery to produce the equipment, as well as the needed raw materials. The manufacturer is not a service organization. Capital is not a material income-producing factor if the business's income is primarily from fees or commissions for personal services. A freelance author earns his income by providing writing services to his clients. Capital is not a material income-producing factor for his business. (The Proposed Regulations provide a third example, noting that capital is a material income-producing factor for banks and similar institutions.)

What is an A-Org? An A-Org is an organization that (1) is a service organization; (2) owns, or is deemed to own, some interest (no matter how small) in the FSO; and (3) regularly performs services for the FSO or is regularly associated with the FSO in providing services to third parties. Whether an A-Org regularly performs services or is regularly associated is a facts and circumstances determination.

What is a B-Org? A B-Org is an organization for which (1) a significant portion of the business of the B-Org is performing services for the FSO or related A-Orgs; (2) the services are the type historically performed by employees in the field of the FSO or its A-Orgs; and (3) at least 10% of the B-Org is owned or deemed to be owned by one or more highly compensated employees ("HCEs") of the FSO or its A-Orgs. Importantly, a B-Org does not need to be a service organization. If the B-Org derives at least 10% of its gross receipts from providing employee services to the FSO or its A-Orgs, then it is a "significant portion" for purposes of the first test. It could be significant if those receipts are as low as 5%.

Management Function Groups

A management function group is an ASG made up of a management firm and its client. A management firm is an organization that performs management functions on a regular and continuing basis for one client or organizations related to that client (the related organizations would then also be part of the ASG). There is scant guidance as to what constitutes management functions, so this must also be a facts and circumstances determination based on our reasonable understanding. Typically, a manager might supervise employees, make hiring and firing decisions, determine a company's objectives, delegate responsibilities, and determine compensation for employees. In looking at the Regulations in the nonqualified plan context, it is reasonable to interpret management services as those that involve the actual or de facto direction or control of the financial or operational aspects of a business. [Treas. Reg. Section 1.409A-1(f)(2)(iv).]

A management organization must perform management functions for a single client (or related clients) as its principal business. Here's how the ASG rules apply in this context:

Example:

Ben Pierce has worked as general manager for Hawkeye Fisheries for many years (in short, he runs the place). Pierce is one of the directors, but owns none of the company. Pierce wants a fat pension, but Hawkeye cannot afford to provide that kind of benefit to all its employees. The directors all decide that Pierce should form and own 100% of his own company, Pierce, LLC. Pierce, LLC will then contract with Hawkeye to provide management services to Hawkeye for a fee. Pierce, LLC will establish its own retirement plan to cover Mr. Pierce as the sole employee, providing Pierce with the maximum permissible contributions without concern for nondiscrimination testing. (Pierce's compensation and plan contributions will be paid out of the fee income paid to Pierce, LLC by Hawkeye.)

Because the A-Org and B-Org structure both require some level of cross-ownership between the FSO and the other companies, there's no ASG, right? Wrong.

In this case, Pierce, LLC is providing management services only to Hawkeye, and Mr. Pierce ends up doing the same work he did as an employee of Hawkeye. The ASG rules are designed to avoid this situation. The two organizations would form an ASG and be treated as a single employer for benefit plan purposes.

What's the Diagnosis?

As noted above, neither Dr. Day nor Dr. Night owns more than 50% of Noon Partners, so there is no controlled group among the entities for retirement plan purposes. But, (apparently unknown to Fly-by-Night) our analysis does not stop there. There is still cause for concern, which Joe correctly determined. For our doctors, Noon Partners is the FSO. Dr. Day, through Good Day, Inc., provides medical services to Noon Partners, which in turn provides medical services to the public. The same is true for NightNight, Inc. Both Good Day, Inc. and NightNight, Inc. have an ownership interest in Noon Partners. Both medical corporations are A-Orgs, and the three entities form an ASG.

The effect of this determination is that, for purposes of any retirement plans, all three entities are treated as a single employer. What is true for controlled groups is, in large measure, true for ASGs. All employees of all three entities must be included in coverage and nondiscrimination testing for the NightNight Plan (and any other plan that may be established).

What Treatments Are Available?

Our doctors have a few options:

1. They can see if the existing and proposed plans would satisfy the coverage requirements of Code Section 410(b), even excluding the Noon Partners employees. Here's a hint: unless every employee is highly compensated, this isn't going to work.
2. The doctors can amend the NightNight Plan so that Noon Partners is a participating employer and allow the Noon Partners employees to participate in the NightNight Plan. Because Dr. Day is an HCE, it is fine to exclude her from participation in the NightNight Plan, but this doesn't help Dr. Day save for retirement.
3. Good Day, Inc. could have its own plan (also covering the Noon Partners employees), or it could adopt the NightNight Plan as a participating employer. Because the three entities are considered a single employer, the NightNight Plan would still be a single employer plan.
4. The doctors might be able to have plans that cover just them in their companies, and have a different plan cover the Noon Partners employees.

Whether the various employees are covered under one plan or three, however, the nondiscrimination testing and coverage testing must include everyone. The benefits from all three entities can be combined for testing (called "permissive aggregation") if certain requirements are met. Under that structure, both Fly-By-Night and Lister Pensions would need to make sure that all testing is passed.

One important thing to note: If the doctors are contemplating defined benefit or cash balance plans, rather than defined contribution plans, the separate plan structure is doomed from the start. Code Section 401(a)(26), known as the "minimum participation" rule for defined benefit plans, requires that each such plan cover at least 40% of all employees (or, if there are only two employees, both of the employees). If only the doctors are in the pension plan sponsored by their own companies, that requirement will be failed. So, even if the contributions in the Noon Partners plan are large enough to meet nondiscrimination testing when aggregated with the doctors' pension plans, those plans still must cover the Noon Partners employees for some amount of benefit to satisfy minimum participation requirements.

And Call Me in the Morning

After much cajoling and illustrations on deduction limits, Dr. Day and Joe are able to convince Dr. Night to open the NightNight Plan to Noon Partners and Good Day, Inc. The Noon Partners employees are thrilled! With Joe's help, the doctors are able to provide much-appreciated benefits to the rank-and-file employees, as well as maximize the profit sharing contributions for the doctors' benefit, and Dr. Night is pleased to be splitting plan expenses and responsibilities with Dr. Day. They're even considering adopting a new cash balance plan. In the end, navigating the Code's tricky requirements has given the doctors a greater understanding of their role as employers and plan sponsors, and has helped them to reach the solution that works best to grow their business. A new day is dawning at Noon Partners.

But remember – not every ASG will look like this. If you have questions or need help diagnosing whether an ASG exists in a given situation, call us. *We are your ERISA and ASG solution!*

Additional Guidance:
Watson, S. Derrin. Who's the Employer? 8th ed.
Code Section 414(m)
Proposed Treasury Regulations Section 1.414(m)-1, et seq.
IRS Revenue Rulings 73-447 and 67-101

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