Identifying the "Employer" Through Ownership and Control

How to address common ownership among multiple companies under the new Health Care Reform Regulations:

One of the cornerstones of the Affordable Care Act is the requirement for employers with more than 50 full time employees to provide health insurance that is both "affordable" and meets certain minimum essential requirements. However a common question asked by business owners is;

How does common ownership structure across different business entities, who may individually employee less than 50 full time employees but combined would have more than 50 full time employees, affect their obligation of providing health insurance to their employees?

The answer becomes one of *"controlled group" provisions, focusing on who controls the company -- not necessarily what they do*. Therefore any potential penalty an employer may face only looks at who owns part or all of the company.

Close examination reveals that the term "controlled group" is a bit of a misnomer: the emphasis is on direct ownership or overlapping (i.e., "common") ownership rather than on actual, hands-on control. The primary controlled group rules, set forth under Internal Revenue Code (the "Code") Sections 414(b) and 414(c), generally provide that "all employees of all corporations which are members of a controlled group of corporations" and "all employees of trade[s] or business[es] (whether or not incorporated) which are under common control" are to be treated as employed by a single employer. That means that organizations related in a parent-subsidiary relationship (a controlled group of corporations) are to be treated as a single employer under PPACA. That also means that trades or businesses (whether or not corporations, limited liability companies, partnerships or otherwise) which meet a defined level of common ownership (found in the Treasury regulations) also are to be treated as a single "employer" under PPACA -- even if the trades or businesses are not linked to each other by direct ownership. (Because this latter rule relies on the presence of common owners rather than a direct ownership link, it also is known as the "brother-sister" rule.)

A few common examples of a controlled group are as follows:

1) A "parent-subsidiary" controlled group exists wherever a parent organization owns 80% or more of the equity in a subsidiary organization. (For corporations, the 80% + test is based on attaining that level of voting power or total value based on all classes of stock; for partnerships, the 80% + test is based on attaining that level of profits interest or capital interest; for trusts and estates, actuarial interests are used.)

2) A "brother-sister"/common control group exists wherever the same five or fewer persons (counting individuals, estates and trusts as "persons") (i) collectively own 80% or more of the equity in two separate trades or businesses, and (ii) taking into account the level of ownership each of those five persons holds in each of the two organizations (using a lowest common denominator approach) collectively own more than 50% of the equity in both of the trades or businesses.

3) An "affiliated service group" exists wherever several organizations regularly collaborate in the services they

provide to the public (typically, integrated services), and the several organizations are linked by a material level of cross-ownership.

The primary key to determining the organizations that must be included within the controlled group -- and thus, be considered part of the same "employer" -- accordingly is ownership. And except for the affiliated service group rule, organizations within a controlled group do not need to have the same management, or even operate in the same industry or in the same state.

The classic example of a controlled group is a parent-subsidiary controlled group, such as a diversified conglomerate where a "parent" company holds a dominant ownership interest in several subsidiary corporations which operate in various industries. However, a controlled group also can take the form of several different trades or businesses, if those trades or businesses have a small number of common owners and thus operate like a close-knit "family" of companies (which explains the use of the term "brother-sister" to describe the relationship). For example, a small medical supply company owned by the company president and an investor group consisting of four doctors could be part of a controlled group which includes the medical practice those same four doctors co-own, even if the supply company markets and sells its products to hospitals (and not the doctors' medical practice). How could this occur? Through overlapping ownership. If the company president owns 20 percent or less of the medical supply company, leaving the four doctors to collectively own 100 percent of their medical practice and also 80 percent of the medical supply company, the requisite level of overlapping ownership has been reached.

The controlled group rules are made more difficult to avoid by special operating rules, which are designed to prevent owners of closely-held companies from easily avoiding the controlled group rules. Under those operating rules, an individual's interest ownership must be attributed to certain family members, which can cause unrelated businesses held by family members or trusts to be caught up under the rules. Similarly, an ownership interest in a corporation or a trade or business which has been transferred to a trusted employee is required to be ignored (for purposes of identifying the common owners) if that employee is required to forfeit that interest, or sell it for a nominal amount, upon termination of employment.

Take, for example, a simple situation that could easily be overlooked as a controlled group: a small manufacturing company which is owned by a single individual, and a lawn care company which is owned and operated by the 18-year-old son of the manufacturing company's owner. Under the controlled group operating rules, the son's ownership interest in the lawn care company is attributed to the manufacturing company owner because the son is under the age of 21. However, once the son reaches age 21 the ownership of the lawn care company no longer is attributed to the manufacturing company owner, and the two entities will cease to be treated as a controlled group -- and as a single "employer" for PPACA purposes.

How Controlled Group Rules Can Make a Difference: An Illustration

A restaurant chain, currently operating 100 restaurants, is operated by a corporate "parent" entity which employs 100 full-time employees (executives, finance and accounting employees, marketing employees, commissary employees, etc.). To function properly, each restaurant unit needs a staff of 12 full-time employees (managers, a head chef, supervisors, etc.) and 50 part-time employees (shift cooks, waiters, etc.). If ownership of the restaurant chain is structured so that the corporate parent franchises each of the restaurants to separate, independent franchisees, the corporate parent and each restaurant unit is treated as a

separate "employer" for PPACA purposes. This may enable many or all of the restaurants to avoid the employer mandate (assuming that most could avoid regularly employing 50 or more full-time employees or full-time equivalent employees by monitoring their part-time employees' hours), even if the corporate parent on January 1, 2014 must offer affordable health care coverage providing minimum essential health benefits to its 100 full-time employees and their dependents. Each restaurant unit also may be able to purchase its own community-rated health insurance on one of PPACA's new health insurance exchanges. Depending on staffing and income levels, it might even be possible for some of the units to qualify for the tax credit available to truly small employers.

Conversely, if the corporate parent owns, outright, 99 of the restaurant units, and the one remaining unit is 45% owned by the corporate parent, 45% owned by a local investor and 10% owned by the on-site general manager, the 99 restaurants (but not the independently-owned unit) would be considered to comprise a controlled group along with the corporate parent -- and the choice gets much more costly and difficult. Under that scenario, on January 1, 2014, that restaurant chain must choose between offering affordable health care coverage providing minimum essential health benefits to all full-time employees of the 99 restaurants and the corporate parent and their respective dependents, or not offer coverage and pay an annual non-deductible penalty.

Lastly, this regulation could even affect married couples. Tax law generally assumes a person owns interest in their spouse's business. That means small business owners who are married to each other should take steps to ensure the Internal Revenue Service, which will enforce the mandate, won't combine their staff.

Summary:

It's still unclear how the IRS will enforce the rules, however, it does seem very likely that many “controlled groups” or “common ownership” structures where the member companies combined have more than 50 full time employees, will be subject to the employer mandate.