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An Early Warning System for Controlled Group Retirement Plans

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Where the sponsor of a qualified retirement plan is part of a controlled group, IRC Sec. 414(b) requires the sponsor to take into account all the members of the controlled group for purposes of--

Sec. 401-basic qualification rules, Sec. 410-minimum coverage standards, Sec. 411-minimum vesting standards, Sec. 415-maximum benefits and contributions, and Sec. 416-top-heavy rules.

In addition, the controlled group members may become liable to the Pension Benefit Guaranty Corporation (PBGC) for the funding deficiencies of the defined benefit plans of other group members or have to file notices and financial information with the PBGC after certain reportable events have taken place.

Given this mandated interdependence, a pressing need arises for a controlled group to establish an early warning system for monitoring and evaluating significant changes to plans, employees, or compensation practices. Problems that may affect plan qualification can thus be nipped in the bud.

What Is a Controlled Group?

A parent/subsidiary controlled group takes into account ownership of one entity (corporations, partnerships, and sole proprietorships) by another. Basically, if one entity owns at least 80% of the outstanding voting stock of the other, they form a parent/subsidiary controlled group. If an owner or officer of the parent entity owns at least 5% of the subsidiary, such stock is ignored in determining the percentage. Therefore, if partnership A owns 70% of the stock of company B, but one or more of the partners (or spouses) own 15% of B, then the ownership of B by A is considered to be 82% (70% divided by 85%), and a controlled group exists.

A brother/sister controlled group involves ownership of two or more corporations, partnerships, or sole proprietorships by five or less individuals, trusts, or estates who (i) have ownership interests in each entity, (ii) the total of such ownership in each entity is at least 80%, and (iii) when the lowest ownership of each individual in the entities is taken into consideration, the total for the individuals is at least 50%. Although the family attribution rules normally only require the ownership of a minor child to be considered as owned by the parents, if the parent owns at least 50%, then ownership by any child is attributed to the parent. There are instances in which spousal attribution is not required so that a husband's 80% owned company and the sole proprietorship of the wife may not be a "brother/sister" controlled group if certain conditions are met.

A combination controlled group consists of a parent/subsidiary group and a brother/sister group. It is also possible for an entity to be part of more than one brother/sister group! The factors for determining if an employer is a member of a controlled group are complex and include deciding which stock is included in the determination, the application of the family attribution rules, and foreign ownership of employers.

Effect of Common Control

A qualified plan must pass IRS's minimum coverage and participation rules after taking into account all employees of the controlled group. Failure may require the plan to expand coverage or to be "aggregated"

with another for testing purposes, provided the combined plan can be shown to be nondiscriminatory. If the controlled group can be broken down into qualified separate lines of business (QSLOBs), then some simplification in testing may be possible. Until recently, there were only general guidelines regarding when a controlled group can be operated as consisting of one or more QSLOBs. Employers frequently assumed they would qualify and operated without collecting the required information about the number of employees of other members to do testing. However, under IRS's final regulations, Sec. 1.414(r), the determination of whether a controlled group can operate as QSLOBs now requires accumulation of data from all members of the controlled group making QSLOB status not as widely available as originally thought.

Minimum Coverage. To satisfy the minimum coverage requirements, the ratio of the percentage of nonhighly compensated employees (NHCEs) who benefit under the plan relative to the percentage of highly compensated employees (HCEs) who benefit must be at least 70%. The percentages take into account all employees of the controlled group not otherwise excludable by the plan. (Plans can exclude employees with less than one year of service, under age 21, or subject to collective bargaining.) It may be possible to use a ratio less than 70%, so long as the plan also satisfies an "average benefits test," wherein the average benefits or contributions provided to all NHCEs of the controlled group is at least 70% of the average provided to all HCEs; nonexcludable employees who do not benefit under any plan are still counted in the average. If the employer is a QSLOB, it may be possible to perform the average benefits test relative to the QSLOB's employees only. In any event, a good deal of data must be collected from other members of the controlled group with respect to their employees and plans.

Example. Employer A's plan benefits 100% of its nonexcludable employees: 100 NHCEs and 10 HCEs. After taking into account employees who can be excluded (e.g., union employees and employees who have not satisfied the age or service requirements of the plan), there are 1,000 NHCEs and 50 HCEs in the controlled group. The coverage ratio is therefore only 0.50 (100/1,000 divided by 10/50), and the plan does not satisfy the minimum coverage test. However, based on there being a 95% concentration of NHCEs in the group (1,000/1,050), IRS regulations require that the ratio need only exceed 0.2375 provided the average benefits test can be passed on a controlled groupwide basis. IRS allows plans to rely on the results of coverage and nondiscrimination testing for up to three years provided there have not been any significant changes in the population. Changes to any member of the controlled group can require retesting before the three year period is up or, if QSLOBs are being used, changes can require redesignation of the separate lines of business. Minimum participation. The number of participants in a plan must at least be equal to the lesser of 50 or 40% of the total number of nonexcludable employees of the controlled group. An employer with less than 50 employees will therefore only be able to sponsor its own plan if the controlled group is a small one.

Other Rules to Be Observed

In addition to the minimum coverage and participation rules, all controlled groups are subject to the following:

Maximum Benefits. Amounts credited an employee under all plans count toward the maximum benefit or contribution that can be provided under IRC Sec. 415; e.g., there is only one \$30,000 maximum contribution per year for an employee under all defined contribution plans of the controlled group. Note that if two employers are not considered a "parent/subsidiary" controlled group because the ownership falls short of 80%, but would be such a group using 50%, then the combined maximum benefit/contribution limits apply even though there is no controlled group.

Top-Heavy Testing. For top-heavy testing, all plans must be combined if a key employee (five percent owner, officer, one percent owner making over \$150,000) is a participant. Therefore, if the value of the accrued benefits and account balances of all key employees in such combined plans divided by that for all participants exceeds 60%, each plan is top-heavy, even if on its own the plan would not be.

Prior Employment. An employee's years of service with another member of the controlled group counts in determining eligibility to participate with investing. An employee who transfers may thus be immediately eligible for the new employer's plan and 100% vesting. If the new employer does not act accordingly, the plan could be disqualified.

Setting Up an Early Warning System

Let us assume a controlled group has been identified, a decision on whether to use the QSLOB exceptions has been made, and all testing has been done. A procedure then needs to be established to monitor and evaluate significant changes to the controlled group that can affect the testing of any plan. It also becomes necessary to designate those who will be responsible for operating the program. These will normally include management executives from the parent company and actuarial, accounting, and legal professionals. A coordinator needs to be designated to whom the employers that make up the controlled group can report. The coordinator's function is to expedite the professional evaluations required to determine, preferably in advance, whether additional materials are required, if testing needs to be redone, or what notifications need to be made.

The following is a list of the primary events that should be reported to the coordinator and routinely reviewed. [DBP = defined benefit plan and DCP = defined contribution plan including 401(k)]:

Plan Events

- Establishment of a plan (DBP, DCP)
- Amendment of plan (DBP, DCP)
- Sponsorship of acquired plan not previously reported, or change in sponsorship of a plan (DBP, DCP)
- Plan termination or partial termination, including 20% or more reduction in plan participation (DBP, DCP)
- Freezing of a plan (DBP, DCP)
- Disqualification of a plan (DBP, DCP)
- Required contributions have not been paid on time (DBP)
- Notice of reportable event filed with PBGC (DBP)

Corporate Events

- Acquisition of a company or division
- Spinoff, sale, liquidation, shutdown, or bankruptcy of a company or division
- Change in ownership of a controlled group member
- Significant change in a company's workforce
- Significant change in a company's compensation practice

Other Controlled Group Defined Benefit Plan Checkpoints

Where there are defined benefit plans in the controlled group, a regular check must be made by the coordinator to see if any of the following events has occurred that would trigger reporting requirements or liens on controlled group members:

- A plan has missed making minimum required contributions totalling \$1 million or more. (Liens can be imposed on all members of the controlled group; PBGC may also request plan and corporate information.)
- Total underfunding of all the controlled group's underfunded plans exceeds \$50 million and total assets are under 90% of total vested liabilities. (Each sponsor of a defined benefit plan must notify PBGC 30 days in advance if any member of the controlled group leaves the group or undergoes liquidation and provide plan and corporate financial information.)
- A plan has unfunded vested liabilities of \$1 million or more. (The sponsor must notify PBGC within 30 days of leaving or entering the controlled group due to a change in ownership.)
- A reduction in workforce causes more than a 20% drop in participants and there are unfunded vested liabilities of \$250,000 or more. (The plan sponsor must notify PBGC of the reduction within 30 days; however, the notice is waived if there is no such decrease in the total number of participants in all of controlled group's defined benefit plans.)
- A plan undergoes a distress termination. (All members of the group can be held liable for the plan's underfunding to a certain degree.)

It is advisable that, rather than waiting for employers to report changes, the coordinator sends regular

requests to controlled group members asking if any of the above events have occurred and follows up with periodic phone calls to establish rapport with the contact at each employer. A Required Database. To enable the establishment of a database for the coordinator, members should provide the following for each qualified defined benefit plan and defined contribution plan:

- Plan document and the summary plan description
- Form 5500 or Form 5500-C and schedules for the last one or two plan years
- Defined benefit plan: the latest actuarial valuation report
- Defined contribution plan: the latest financial statement
- Summary of plan changes since the last summary plan description

In addition to avoiding potential problems with the Federal regulators, the benefit of the early warning system includes the advantages of keeping in close touch with all of the plans sponsored by the employers in the controlled group.

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