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Determining Common Ownership: It's All Relative

By Rich Glass, JD

Have you ever attended a wedding and tried to figure out who was related to whom? In this day and age, that can sometimes be a difficult task. A similar challenge confronts the benefits professional trying to determine which companies are related for COBRA application.

In a multiple entity setting — especially one where some of the companies have only a handful of employees — the determination becomes critical because of COBRA's small employer exception. Sifting through the true relatives and the wedding crashers involves a three-step analysis, reviewing one regulation and two sections of the Internal Revenue Code.

Step One: the Treasury Regulations

The start of this journey begins with what constitutes a small employer. It is simply an employer that employed fewer than 20 employees during the prior calendar year on at least 50 percent of its typical business days during that year.

The regulations also define an employer as any "member of a group described in section 414(b), (c), (m), or (o)" of the Internal Revenue Code. Thus, you may have to combine the employee counts of several entities, which might otherwise qualify for the exception. This takes us to Step Two.

Step Two: Controlled Groups

These portions of Code Section 414 refer to three primary types of business structures: partnerships/proprietorships, affiliated service groups and controlled groups. The rule for partnerships/proprietorships is that you combine all businesses under common control as a single employer. The rule for affiliated service groups is that you count all employees within the group as having a single employer. An affiliated service

group essentially is a group of service organizations that perform services for one another.

The rule for controlled groups is not as easy because this portion of Code Section 414 refers to another section in the Code — 1563(a). This takes us to Step Three.

Step Three: Three Relationships

This section of the Code examines three types of corporate relationships: a parent-subsidary relationship (where one entity owns a portion of another), a brother-sister relationship (where two or more entities have a common owner or owners) and a combined group (a combination of parent-subsidary and brother-sister).

- 1) *Parent-Subsidiary.* In this arrangement, at least 80 percent of each entity's stock is owned by one or more of the member corporations, either directly or indirectly. (See the sidebar for some examples.)

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Examples of Parent-Subsidiary Arrangement

- Company A owns 100 percent of Companies B and C.
A, B and C are one employer.
- Company D owns 80 percent of Partnership E and 95 percent of Sole Proprietorship F.
D, E and F are one employer.
- Company G owns 80 percent of Company H, which owns 85 percent of Company I.
G, H and I are one employer.
- Company J owns 90 percent of Companies K and L, each of which own 40 percent of Company M.
J, K, L and M are one employer.

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- 2) *Brother-Sister*. In this arrangement, five or fewer individuals own at least: (i) 80 percent or more of the stock of each corporation; and (ii) more than 50 percent of the stock of each corporation, to the extent that each person's ownership level is identical for each corporation. (See the sidebar for some examples.)
- 3) *Combined Group*. This arrangement occurs where each corporation is part of a parent-subsidary

relationship or brother-sister relationship, and at least one corporation is both a common parent and a member of the brother-sister relationship.

As ownership shares change, the result may change as well for the calendar year after the year in which the change occurs. Special rules exist when two or more companies are part of a merger or acquisition involving an asset or stock sale. For more information on those rules, please see the April 2006 newsletter for the article entitled "Come Together Right Now." 

Examples of Brother-Sister Arrangement

In the first scenario, there are five shareholders (A, B, C, D and E), who hold interests in two companies (W and X):

Shareholder	Interest in W	Interest in X	Identical Ownership
A	15%	10%	10%
B	25%	5%	5%
C	10%	30%	10%
D	30%	25%	25%
E	20%	30%	20%
Totals	100%	100%	70%

The first requirement for brother-sister arrangements is met because the five people own 100 percent of each company, more than the 80 percent that is needed. The second requirement is also met because identical ownership is 70 percent, more than the 50 percent that is needed. Therefore, Companies W and X are one employer.

The next scenario gets a little more complicated, with seven shareholders (A, B, C, D, E, F and G) and two companies (Y and Z):

Shareholder	Interest in Y	Interest in Z	Identical Ownership
A	5%	40%	5%
B	10%	15%	10%
C	10%	10%	10%
D	10%	10%	10%
E	10%	10%	10%
F	15%	10%	10%
G	40%	5%	5%
Totals	100%	100%	60%

The first requirement for brother-sister arrangements is met. If you include A, B, F and G and one other owner, five people own 80 percent of each corporation. However, by meeting the first requirement, the second requirement is not met. Identical ownership among A, B, F and G is only 30 percent, and no other owner has more than 10-percent identical ownership. Therefore, companies Y and Z are not one employer.

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