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Qualified Plan Controlled Group Rules

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302 Harper Drive, Suite 103
Moorestown, NJ 08057

856-866-0028 Phone
856-234-4975 Fax

PRosengard@R4RWS.com
www.R4RWS.com

I. Introduction

Employer-sponsored qualified retirement plans, along with Social Security income and personal savings, are a vital part of the retirement income plans of many people.¹ The importance of qualified plans stems in large measure from the tax benefits provided under the Internal Revenue Code.² While each type of plan has different features, many provide the sponsoring employer current tax deductions for employer contributions while providing tax-deferral and tax-deferred growth for the participating employee.

Congress intended that qualified plans be an incentive to save not only for highly compensated employees but also for the rank and file. To curb potential abuse, the Code provides threshold requirements related to participation, contributions, and benefits, for example.³ It disqualifies plans that do not comply with these standards – plans deemed to benefit too disproportionately key employees and owners, relative to other workers.

The controlled group rules (and related rules for leased employees and affiliated service groups) deter the use of multiple entities to circumvent the Code's requirements. In short, the rules assume employees of all entities found to be in a controlled group are employees of a single employer for many qualified plan purposes. For example, if one employer in a controlled group establishes a qualified plan, the employees of all employers in the controlled group will be included for purposes of coverage and nondiscrimination testing. Without these rules, owners could establish separate entities to employ different groups of employees. For instance, key employees and owner-employees could work for one employer entity (with a qualified plan) while rank and file employees worked for another entity (without a qualified plan).

Employers who currently sponsor or who may sponsor a qualified plan should be familiar with these common control rules. While the rules largely involve straightforward numerical tests, they can be a trap for the unwary. Determining whether a controlled group exists could make the difference between a particular plans qualification or failure. This Legal and Tax Trends will cover controlled groups, affiliated service groups, and leased employees – what the rules are, how they apply, and provide examples to illustrate the rules in action.

II. Definitions and General Rules

The “controlled group” rules (loosely defined) comprise four distinct sets of rules under the Code, each of which targets a specific type of business structure or employment arrangement.

Section 414(b) covers employees of a **controlled group of corporations (CGC)**. It provides that for many qualified plan purposes, all employees of all corporations which are members of a CGC shall be treated as employed by a single employer. The affected Code sections include the qualification requirements of §401, the minimum coverage standards of §410, the vesting requirements of §411, the contribution and benefit limitations of §415, and the top-heavy rules of §416.⁴ Under §414(b), an employer in a CGC who establishes a qualified plan may not have to actually include all of the

¹ As of 2007, more than 60% of all private sector employees have access to an employer-sponsored retirement plan. Congressional Research Service study, “401(k) Plans and Retirement Savings: Issues for Congress” July 14, 2009.

² All Code section (§) references are to the Internal Revenue Code (IRC) or Treasury Regulations, unless otherwise noted. The term “corporation” includes C corporations and S corporations; “partnership” includes all forms of partnership and LLCs taxed as partnerships, unless otherwise noted.

³ In the words of a U.S. General Accounting Office letter to a Senate Committee in 2000, the Code provides two sets of generally applicable rules that together “promote equity and inclusiveness” in the plans of private employers. <http://www.gao.gov/archive/2000/he00141.pdf>

⁴ The CGC rules apply also to Simplified Employee Pensions (SEPs) of §408(k) and SIMPLE plans of §408(p). The IRS publishes a short guide to each of these provisions. See, “A guide to qualified plan requirements” at <http://www.irs.gov/retirement/article/0,,id=112858,00.html#9>

employees of all controlled group employers, but will have to consider all such employees when applying discrimination tests, for example.⁵

Section 414(c) addresses employees of partnerships, sole proprietorships, LLCs, and any other non-corporate form of **businesses under common control** (BCC). As with the corporate rule, it states that all employees of all businesses under common control will be treated as employed by a single employer. The affected Code sections are the same as those for CGCs, above. The Code expressly provides that the principles underpinning the regulations applicable to corporations also guide the common control rules for non-corporate employers. Unless otherwise noted, the term “**controlled group**” in this article will apply to both corporations and unincorporated businesses.

Section 414(m) prescribes similar rules for employees in an **affiliated service group** (ASG). As with the controlled group provisions, the ASG rules will treat all employees of all ASG employers as employees of a single employer. The ASG rules support the controlled group provisions by covering arrangements involving certain service-providing entities. In general, these arrangements do not meet the technical ownership definitions of a controlled group and so fall outside the scope of the controlled group rules. The ASG rules ensure that all employees of the affiliated group will be counted, even though the employers are not a controlled group. The affected portions of the Code are the same as those listed for controlled groups, above, except that only certain parts of §401 are included.⁶

Section 414(n) outlines rules relating to **leased employees**. It will include in the definition of “employee” some people who perform services for a business but who are not employed directly by that business. While the leasing rules target a slightly different abuse than those described above, they nevertheless similarly help to ensure that any qualified plan benefits accrue to a broad portion of an employer’s workforce. The leasing rules affect the same portions of the Code as those listed for ASGs, above.

For business owners who participate in more than one qualified plan, §415 complicates the plan testing process. A **special rule for related businesses** holds that for purposes of calculating an owner’s annual addition limit to the qualified plans, all the plans in a controlled group or ASG will be treated as a single plan. For these purposes, controlled group testing is done with lower ownership thresholds (50% instead of 80%).

⁵ Treas. Reg. §1.410(a)(4)-1(b)(3) requires that all benefits, rights, and features provided under a qualified plan must be made available in a plan in a nondiscriminatory manner. Often, to satisfy this requirement, either a single plan will include all of the employees of all members of the controlled group, or all member employers will implement identical plans.

⁶ Treas. Reg. §414(m)(4)(A) provides that the employee benefit requirements of §401 affected by the ASG rules are paragraphs 3,4,7,16,17, and 26 of §401(a). These include requirements relating to minimum participation, vesting, benefit limits, contribution limits, and nondiscrimination.

III. Controlled Group of Corporations

To determine whether a group of employers is a controlled group for qualified plan purposes, §414 refers to the corporate controlled group rules, §1563(a), and expands them to include unincorporated entities, such as partnerships, trusts, estates, or proprietorships. Under §1563 and the regulations under §414, there are three types of controlled groups:

1. Parent-subsidiary groups;
2. Brother-sister groups; and
3. Combined groups.

If any of these three classifications applies, the group is considered a controlled group. In more complex cases, an employer may be a part of more than one controlled group. Keep in mind that, as explained in more detail below, ownership for these purposes excludes some interests and includes other interests. Further, in addition to interests owned directly, a person or entity may own interests indirectly through constructive ownership rules and attribution rules.

Parent-Subsidiary Groups

A parent-subsidiary controlled group refers to ownership of one entity by another (as opposed to ownership by individuals). The general rule states that a parent-subsidiary controlled group exists when one entity (the parent) has a “controlling interest” in another entity (the subsidiary).⁷ Controlling interest of a corporation means ownership either of at least 80% of all voting stock, or of at least 80% of the total value of all stock outstanding.⁸ Controlling interest of a partnership means ownership either of at least 80% of the capital or profits interests.⁹ Thus, the simplified rule in the corporate context finds a controlled group when one corporation owns at least 80% of the stock (by value or by voting) of another corporation.

Example 1. Pere Partnership owns 80% of the voting shares of Filiale Corporation, which has both voting and non-voting stock. Pere is the parent of a parent-subsidiary controlled group of businesses consisting of the Pere Partnership and Filiale Corporation. This controlled group depends on Pere’s ownership of at least 80% of the outstanding voting shares of Filiale. If either Pere or Filiale adopt a qualified plan, the employees of both entities must be considered when applying the requisite qualification provisions.

⁷ Treas. Reg. §1.414(c)-2(b)(1).

⁸ Treas. Reg. §1.414(c)-3(a) explains that the term “stock” does not include treasury stock or preferred dividend nonvoting stock.

⁹ Treas. Reg. §1.414(c)-2(b)(2) indicates that for a trust or estate the beneficiary must have at least an 80% interest in the trust, actuarially determined.

Example 2: Pater Partnership owns 70% of the voting shares (class A) and 100% of the nonvoting shares (class B) of Filius Corporation. Filius Corporation has only two classes of stock, A and B, which are of equal value. Pater is the parent of a parent-subsidary controlled group of businesses consisting of the Pater Partnership and Filius Corporation. This controlled group depends on the total value of Filius owned by Pater. Although Pater only owns 70% of the voting shares, it owns 85% of Filius by total value (50% from class B + 35% from class A).

A parent-subsidary group can involve either a chain of entities or a group of multiple entities owned by a common parent.

Example 3. Parental Partnership owns 80% of the voting shares of Subsidiary Corporation, which has both voting and non-voting stock. Parental owns 80% of the profits interest of Daughter Partnership. Parental is the parent of a parent-subsidary controlled group consisting of Parental Partnership, Subsidiary Corp., and Daughter Partnership.

For purposes of determining whether an entity has a controlling (e.g., 80% of voting stock) interest, certain holdings are excluded from the calculation. That is, whenever the parent entity owns at least 50% of the subsidiary, some interests in the subsidiary owned by others are treated as not existing when calculating the parent's amount of control. This exclusion rule, for example, omits from the calculation interests owned by the principal owner, officer, partner, or fiduciary of the parent company.¹⁰ It also excludes stock held in trust for employees under a qualified or nonqualified deferred compensation plan.

Example 4. Pearl Corp owns a 50% interest in capital and profits of Scallop Partnership. Four officers of Pearl (the President, two Vice-Presidents, and the CEO) each own 10% of Scallop (capital and profits). An unrelated person owns the remaining 10% interest in Scallop. For purposes of determining the extent of Pearl's interest in Scallop, the 40% owned by Pearl's officers is ignored. As a result, Pearl is assumed to own 50/60 or 83.3% of Scallop. Since this is more than 80%, Pearl is the parent of a parent-subsidary controlled group consisting of Pearl and Scallop.

The stock owned directly or constructively by these individuals must be excluded, as must certain other subsidiary stock, as detailed in the Treasury Regulations.¹¹ Note

¹⁰ A principal owner means a person who owns (directly or constructively) 5% or more of a corporation, partnership, or trust (as applicable). An officer includes the president, vice-president, secretary, treasurer, general manager, and comptroller, or anyone performing the duties normally performed by persons occupying those positions. Treas. Reg. §1.414(c)-3(d).

¹¹ Other stock may also be excluded. See Treas. Reg. §1.414(c)-3(b)(3) through (b)(6) for other kinds of stock to be excluded.

that this exclusion rule can create a controlled group where it is not obvious at first blush that the parent has an 80% controlling interest in the subsidiary.

Example 5. ABC Partnership owns 75% of the only class of stock of both X and Y Corporations. X owns the remaining 25% of Y stock. Y owns the remaining 25% of X stock. Since inter-organization ownership is excluded (i.e., such shares are treated as not outstanding or not existing) for purposes of determining whether ABC owns an 80% controlling interest of the other entities, the shares of X owned by Y and the shares of Y owned by X are ignored. As a result, ABC owns 100% of both X and Y for purposes of determining controlling (80%) interest. Thus, ABC is the common parent of a parent-subsidiary controlled group consisting of ABC, X, and Y.

Without such rules, owners might have been able to avoid a controlled group by manipulating legal ownership while maintaining substantial ownership in practice.

Brother-Sister Groups

A brother-sister controlled group refers to ownership of two entities by a common owner or group of common owners who are individuals, estates, or trusts. The general rule states that a brother-sister controlled group exists when two conditions are met:

1. five or fewer common owners own a “controlling interest” (i.e., 80% or more) of each entity; and
2. taking into account each person’s ownership only to the extent such ownership is identical with respect to both entities, the same common owners are in “effective control” (i.e., more than 50%) of both entities.¹²

As above, the 80% and “more than 50%” thresholds in the corporate context refer to either voting stock or total value of all stock of a corporation. For partnerships the thresholds apply to either capital or profits interests, while for trusts the threshold applies to the beneficiary’s aggregate actuarial interest in the trust.

Example 6. Unrelated individuals Mike, Nancy, Owen, and Paul each own 25% of the single class of stock of both Red Corporation and Blue Corporation. In this case, four owners own 100% of each entity, satisfying the 80% controlling interest condition. The same four owners own 100% of each entity taking into account only each shareholder’s identical ownership, satisfying the “more than 50%” effective control condition. As a result, Red and Blue constitute a brother-sister controlled group under the common control of the four individuals.

¹² Treas. Reg. §1.414(c)-2(c).

Example 7. The stock of corporations U and V, which each have only one class outstanding, is owned by eight unrelated individuals in the amounts listed in the following table.

Individuals	U Corp	V Corp	
A	12	12	
B	12	12	
C	12	12	
D	12	12	} 64%
E	13	13	
F	13	13	
G	13	13	
H	13	13	
	100%	100%	

Any group of five shareholders will own more than 50% of the stock of both companies, taking into account only each shareholder's identical ownership in both U and V. However, no group of five collectively owns more than 80% of each company. The greatest percentage in this respect is the group of D, E, F, G, and H, who together own only 64% of either U or V. Thus while there are several groups of five that may satisfy the "more than 50%" effective (identical interest) control condition, no group of five can satisfy the 80% controlling interest condition. Consequently, U and V are not members of a brother-sister (or parent subsidiary) controlled group.

Not only must the same people – the same common owners – be used when analyzing both the controlling interest (1) and effective control (2) conditions, but each of the people must own interests in both entities.

Example 8. The stock of T Corporation and V Corporation, which each have only one class of stock, is owned by three unrelated individuals in the amounts listed in the following table.

Individuals	T Corp	V Corp	T + V identical %
A	50	-	-
B	40	-	-
C	10	100	10
	100%	100%	

T Corp and V Corp are not in a brother-sister controlled group. In determining whether a brother-sister controlled group exists, A and B may not be counted in the owner group as neither owns any shares in V Corp. As a result, only C's interests may be counted towards the two requirements. Stated another way, the "group of five or fewer owners" includes only C. In this case, neither ownership condition is met for a V Corp brother-sister controlled group with T Corp. Individual C only owns 10% of T, less than the required 80%. Individual C

has identical ownership of only 10% in the two companies, less than the required “more than 50%.”

In many cases, the question of whether a brother-sister group exists will depend on the second factor, effective control, which itself hinges on the concept of **identical ownership**. The owners’ identical ownership in a particular entity refers to the ownership percentage corresponding to the common owner with the smallest interest in that entity.

Example 9. The stock of P Corp, Q Corp, and R Corp, which each have only one class of stock, are owned by unrelated individuals E, F, and G in the amounts indicated below.

Individuals	P Corp	Q Corp	R Corp	P+Q	P+R	R+Q
				identical %	identical %	identical %
E	40	10	75	10	40	10
F	50	10	5	10	5	5
G	10	80	20	10	10	20
	100%	100%	100%	30	55	35

In determining whether a brother-sister controlled group exists between any two or all of the three corporations, the possible “five or fewer” ownership group may include E, F, and G or any combination thereof since each person is a shareholder in each corporation. The possible controlled groups are P+Q, P+R, R+Q, and P+Q+R.

Here a number of potential controlled groups meet the 80% controlling interest standard. For example, E, F, and G collectively own 100% of each corporation, so P+Q+R is a potential group. Even without individual G, individuals E and F collectively own 90% of P Corp and 80% of R Corp, so a P+R group is also a potential group. However, only the pairing of P and R corporations will satisfy the “more than 50%” identical ownership test, with an identical ownership of 55% amongst all three individuals. P+Q has identical ownership of only 30%, while R+Q has identical ownership of only 35%. Therefore, only P and R Corps are members of a controlled group.

As with parent-subsidiary groups, certain holdings must be excluded from the calculation when determining if the common owners have a controlling interest or have effective control. The exclusions occur if the same common owners own 50% or more of the subject entity.¹³ For both determinations, treasury stock and nonvoting

¹³ See notes 9 and 10, supra. Notice that the exclusion rule uses the standard “50% or more” while the brother-sister general rule uses the standard “more than 50%.”

preferred stock are excluded. Also excluded are interests owned by certain qualified plan trusts, officers, partners, and fiduciaries.¹⁴

Example 10. Individuals A and B own shares of Red Corp and Blue Corp as indicated in the table below. An ESOP qualified plan owns 40 of the Red Corp shares. A and B are unrelated. Each corporation has only one class of stock.

Without the exclusion rule, Red and Blue would not be members of a controlled group.

<i>(including the 40 ESOP shares)</i>			Red+Blue
Individuals	Red Corp	Blue Corp	identical %
A	45	30	30%
B	15	70	15%
ESOP	40	-	-
	100%	100%	45%

While common owners A and B own 100% of Blue, they would only own 60% of Red, less than the necessary 80%. This group would also fail the identical interest test as A and B only own 45% when taking into account their identical interest.

However, because of the exclusion of ESOP stock for purposes of both the controlling interest and exclusive (identical) control tests, Red and Blue are members of a brother-sister controlled group. A and B own 50% or more of Red (60 shares out of 100) and Blue (100 shares out of 100), so any shares owned by a qualified plan sponsored by Red or Blue must be excluded.

<i>(excluding the 40 ESOP shares)</i>			Red+Blue
Individuals	Red Corp	Blue Corp	identical %
A	75%	30%	30%
B	25%	70%	25%
ESOP	0%	-	-
	100%	100%	55%

Excluding the ESOP's shares, A and B collectively own 100% of Red (60 out of 60 shares) and 100% of Blue (100 out of 100). This satisfies the first requirement of at least 80% common ownership. Regarding the identical ownership test, A is considered to own 75% of Red (45 out of 60 shares) and 30% of Blue (30 out of 100). B is considered to own 25% of Red (15 out of 60) and 70% of Blue. The identical ownership of A and B in both companies is 55%, satisfying the "more

¹⁴ Treas. Reg. §1.414(c)-3(c) contains the section related to excluded stock and other interests. The rules for brother-sister exclusions are slightly different than those for parent-subsidiary. For example, with respect to stock held in a trust for an employee, only stock held in a qualified trust is excluded.

than 50%” threshold. Red and Blue are members of a brother-sister controlled group.

As with parent-subsidiary groups, constructive ownership and attribution rules apply to infer ownership for these calculations.

Combined Groups

A combination controlled group (or combined controlled group) means any group of three or more organizations, if:

1. each such organization is a member of either a parent-subsidiary group under common control or a brother-sister group under common control; and
2. at least one such organization is the common parent in the parent-subsidiary group as well as a member of the brother-sister controlled group.¹⁵

In practice, the flow of attribution ensures that the combined controlled group will always involve a situation in which individuals (including estates or trusts) own at least two entities that are members of a brother-sister group, and that at least one of the entities will be the parent of the parent-subsidiary group.

Example 11. A, an individual, owns a controlling interest in both ABC partnership and DEF partnership. Recall that a controlling interest of a corporation means ownership either of at least 80% of all voting stock, or of at least 80% of the total value of all stock outstanding. ABC, in turn, owns a controlling interest in X Corporation. ABC is the parent in a parent-subsidiary controlled group consisting of ABC and X Corp. ABC and DEF are members of a brother-sister controlled group under the common control of A. As a result, ABC, DEF, and X Corp are members of the same combined controlled group.

Combination groups multiply the number of possible controlled groups significantly. As a result, groups of employers may be tied together such that the whole constellation must be treated as a single employer for qualified plan purposes.

Since a combined controlled group is at heart a combination of each of the other types of controlled groups, the rules applicable to those other types (e.g., the exclusion rules) are incorporated as appropriate when evaluating a particular situation.

¹⁵ Treas. Reg. §1.414(c)-2(d).

Ownership Rules, Constructive Ownership, and Attribution

For purposes of determining whether a controlled group exists, several considerations shade the definition of ownership. As mentioned above, where there are multiple classes of ownership the controlled group rules look at the highest ownership percentage by class. For corporations this means either (a) the combined voting power, or (b) the total value of all shares of all classes, excepting unissued treasury stock or nonvoting preferred stock. For partnerships, this means either (a) profits interests, or (b) capital interest.¹⁶

Options to buy an interest must be treated as ownership of the interest itself. For this purpose, even an option to acquire an option will be construed as ownership of the underlying interest.

Attribution also complicates questions of ownership, by attributing ownership to a person or entity even where the person does not directly or actually hold such an interest. The rules relating to attribution depend on the relationship of the actual owner to the indirect or deemed owner. While the attribution rules related to controlled groups are similar to the Code's general controlled group provisions, there are important differences that should be kept in mind.

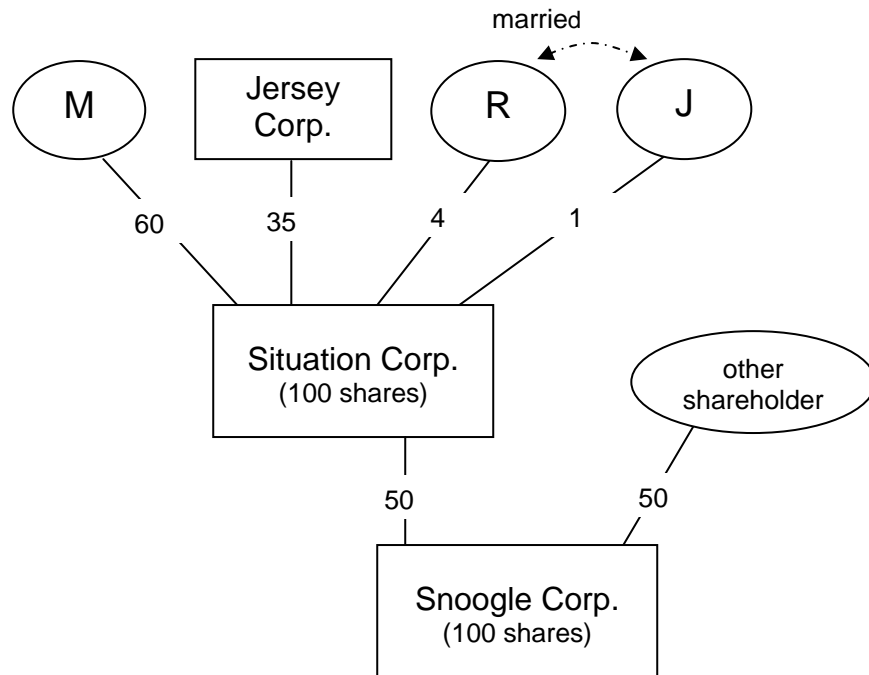
Attribution from spouse. In general, an individual will be considered to own any interest owned directly or indirectly by his or her spouse, unless legally separated or divorced.¹⁷ There is an exception where certain conditions can be met. Four conditions must be satisfied to avoid attribution of a spouse's interest in an entity to an individual: (1) the individual may not directly own an interest in the entity; (2) the individual may not participate in the entity as director, officer, employee, etc.; (3) the entity may not derive more than 50% of its income passively (e.g., rents, dividends, interest, etc.); and (4) the interests of the spouse must not be restricted in such a way as to favor the individual or the individual's children under age 21.¹⁸

Example 12. The 100 outstanding shares of Situation Corp are owned by Michael (60 shares), Ronald (4 shares), Jennifer (1 share), and Jersey Corp. (35 shares). Ronald and Jennifer are married. Neither are related to Michael. Situation Corp owns, directly and indirectly, 50 shares of Snoogle. The ownership is outlined in the figure below.

¹⁶ Interestingly the partnership profits-capital distinction allows for the possibility of ownership of more than 100% of an entity. For example, Carlos and Pedro could have a partnership in which capital is divided 60/40 and profits 30/70. For controlled group purposes, Carlos owns 60% of the partnership (based on his capital interest) and Pedro owns 70% (based on his profits interest). The fact that together they theoretically own 130% of the partnership does not impair the resulting assumption.

¹⁷ Federal law does not recognize same-sex marriage, so same-sex couples are considered unrelated for these purposes.

¹⁸ Treas. Reg. §1.414(c)-4(b)(5)(ii).



As a result of attribution, Michael is considered to own 30 shares of Snoogle (60% x 50 shares). Jersey Corp is considered to own 18 shares of Snoogle (35% x 50 shares). Ronald and Jennifer each are considered to own 2.5 shares of Snoogle (5% x 50 shares). However, absent spousal attribution, neither Ronald nor Jennifer would be considered to own any of Snoogle Corp, as neither would own enough (5% or more) of the Situation to have its holdings attributed to them.

Attribution to and from minor children. An individual will be considered to own an interest owned directly or indirectly by his or her children under age 21. Children under age 21 are considered to own interests owned directly or indirectly by their parents.

Example 13. Individual F directly owns 40% of the profits interest of GHI Partnership. His son, M (age 20), directly owns 30% of GHI. The remaining 30% profits interest and 100% of the capital interest in GHI is owned by an unrelated individual. F owns 40% of the profits interest directly, and is considered to own the 30% profits interest owned directly by M.

Attribution to and from adult children, and grandparents. If an individual has “effective control” of an entity, taking into account the other rules of attribution, then the individual will be considered to also own any interests owned by his or her parents,

grandparents, grandchildren, and adult children.¹⁹ There is no direct attribution between siblings.

Example 14. Individual F directly owns 40% of the profits interest of DEF Partnership. His minor son, M (age 20), directly owns 30% of DEF, and his adult daughter, A (age 30), directly owns 20% of DEF. The remaining 10% profits interest and 100% of the capital interest in DEF is owned by an unrelated individual.

In this case, F owns 40% of DEF directly and is considered to own the 30% profits interest owned directly by M. Further, because F is in effective control (i.e., more than 50%) of DEF with 70% of the profits interest, F is also considered to own the 20% profits interest owned by A. In sum, F is treated as owning a total of 90% of the profits interest of DEF.

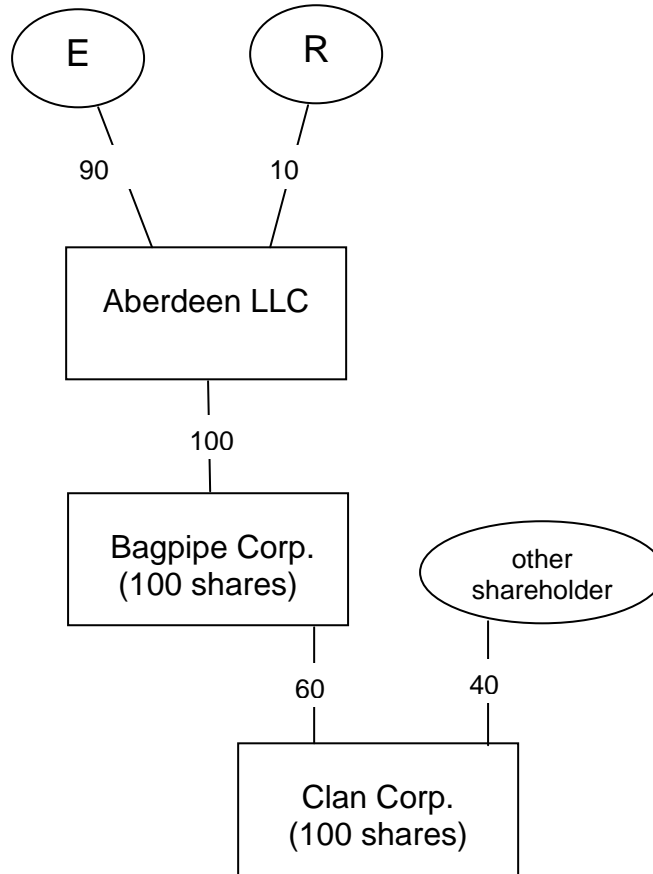
In this case, M owns 30% of DEF directly and is considered to own the 40% profits interest owned directly by his father. As there is no attribution between siblings, M is not considered to own the 20% interest of his sister, A, through direct attribution. Nor is M considered to own his sister's 20% owned constructively by his father, because shares constructively owned by F because of family attribution are not considered as owned for purposes of further family attribution. Accordingly, M is considered to own 70% of the profits interest of DEF.

In this case, A owns 20% of the profits interest directly. Since for purposes of determining effective control only A's actual ownership may be counted, A does not have effective control. As a result, F's shares are not constructively owned by A. In sum, A is considered to own only the 20% of DEF that she actually owns.

Attribution from corporations, partnerships, estates and trusts. A pro rata portion of any interests owned directly or indirectly by an organization will be attributed to each of the organization's 5% (or greater) owners.

¹⁹ For example, more than 50% as applicable of voting, value, capital, profits, or actuarial interest.

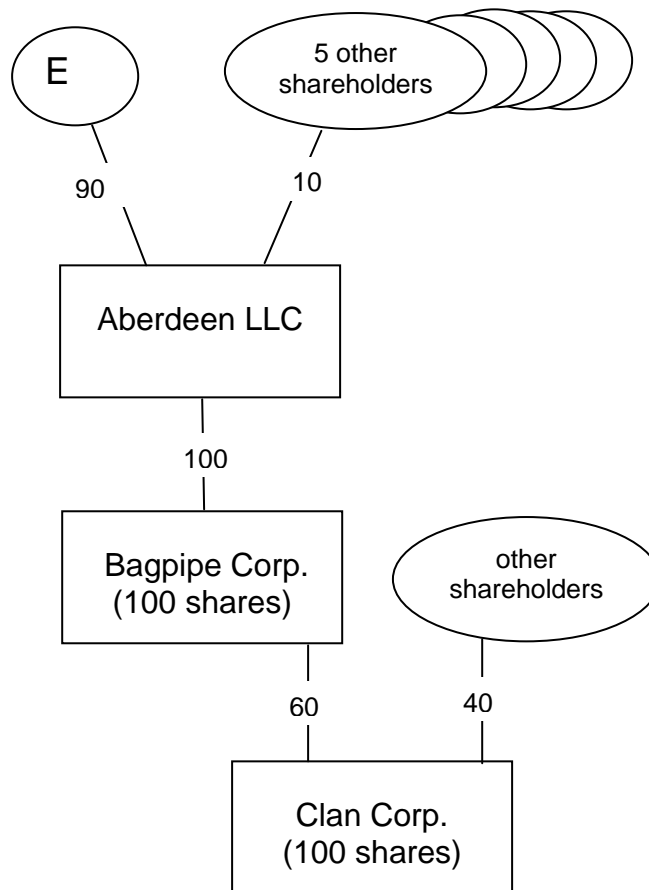
Example 15A. Ewan has a 90% interest in the capital and profits of Aberdeen LLC. Robby, unrelated to Ewan, has a 10% interest in Aberdeen LLC. Aberdeen LLC owns all 100 shares of Bagpipe Corporation, which in turn owns 60 shares (out of 100 outstanding) of Clan Corporation.



The 100 shares of Bagpipe actually owned by Aberdeen are attributed to Ewan (90 shares) and Robby (10 shares). The 60 shares of Clan constructively owned by Aberdeen through entity attribution are treated as actually owned by Aberdeen for purposes of further attributing ownership to Ewan and Robby. As a result, Ewan is considered as owning 54 shares of Clan (90% of 60 shares), Robby 6 shares (10% of 60 shares).

Notice that if there are owners whose stake is less than 5%, then not all of the organization's shares will be attributed.

Example 15B. Ewan has a 90% interest in the capital and profits of Aberdeen LLC. Five other unrelated individuals equally own the remaining 10% of Aberdeen LLC. Aberdeen LLC owns all 100 shares of Bagpipe Corporation, which in turn owns 60 shares (out of 100 outstanding) of Clan Corporation.

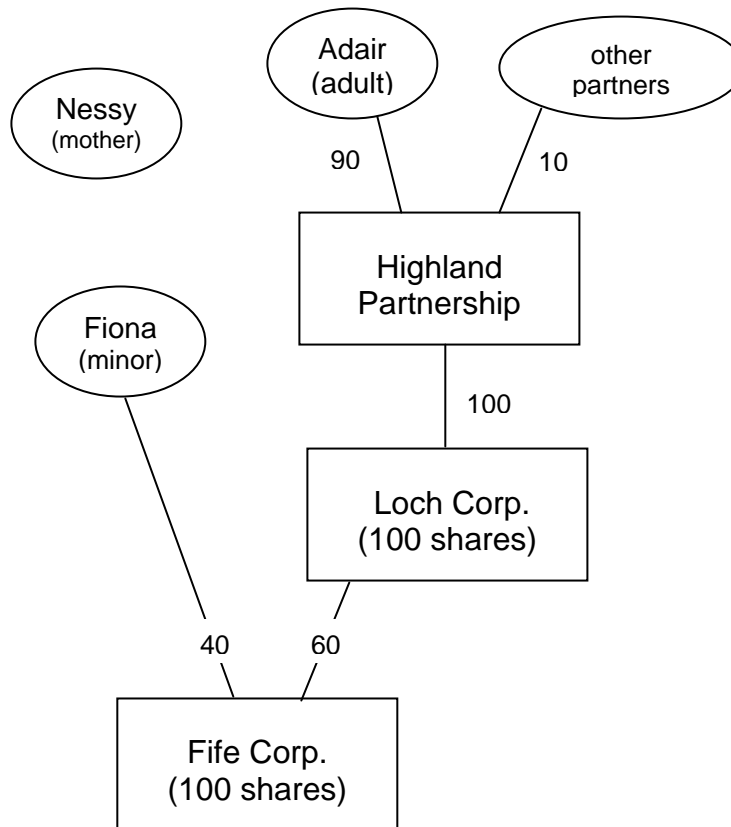


The 100 shares of Bagpipe actually owned by Aberdeen are attributed to Ewan (90 shares) and the other five individuals (2 shares each). The 60 shares of Clan constructively owned by Aberdeen through entity attribution are treated as actually owned by Aberdeen for purposes of attributing ownership to Ewan and the other individuals. However, only Ewan owns enough of Aberdeen to be attributed any downstream stock. As a result, Ewan is considered as owning 54 shares of Clan (90% of 60 shares). The other five Aberdeen members are not considered as owning any shares of Clan.

In applying the attribution rules, only one level of family attribution applies at a given time. In other words the interest held constructively by an individual because of family

attribution is not owned by that individual for purposes of again applying the attribution rules to another – i.e., there is no “double” family attribution.²⁰

Example 16. Adair (age 30) owns 90% of Highland Partnership. Other unrelated investors own the remaining 10%. Highland owns 100% of Loch Corporation, which in turn owns 60 shares of Fife Corporation (out of 100). Fiona (age 20), Adair’s sister, owns the other 40 shares of Fife. Their mother Nussy actually owns no shares or interests in any of these entities.

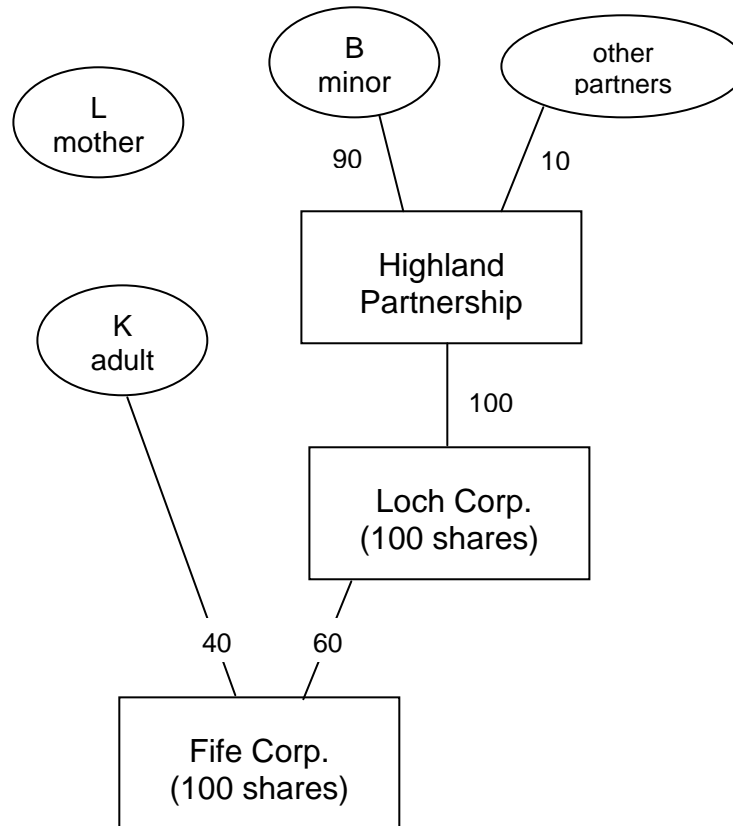


By reason of family attribution, Nussy constructively owns her minor daughter Fiona’s 40 shares of Fife. However, these 40 shares are not then re-attributed to Adair. Adair owns 54 shares of Fife through entity attribution.

In applying the attribution rules, family and entity attribution may both apply. Further, interests held constructively by an individual because of entity attribution may be attributed from the individual to another person by reason of family attribution, or vice versa. That is, a chain of attribution of the same interests is possible using both entity attribution and family attribution.

²⁰ Treas. Reg. §1.414(c)-4(c).

Example 17. Minor child Bonnie (age 19) owns 90% of Highland Partnership. Other unrelated investors own the remaining 10%. Highland owns 100% of Loch Corporation, which in turn owns 60 shares of Fife Corporation (out of 100). Kara (age 25), Bonnie’s sister, owns the other 40 shares of Fife. Their mother Lorna actually owns no shares or interests in any of these entities.



Bonnie constructively owns 54 shares of Fife through entity attribution. By reason of family attribution – minor child to parent – Lorna constructively owns these 54 Fife shares. Further, because Lorna is in “effective control” of Fife, she also constructively owns Kara’s 40 shares of Fife, even though in this example Kara is over age 21. In total, Lorna is considered to own 94 shares of Fife.

The attribution rules greatly complicate determinations of ownership and hence controlled group analysis. Each case should be examined carefully.

Example 18. Dave’s wholly owned corporation owns a number of beachside bars. The business has a SIMPLE plan. His fiancée, Janelle, owns all of a corporation operating several beach spas. Her business sponsors a profit-sharing plan. Because there is no attribution between unmarried co-habitants, there is no controlled group. As a result, Dave’s SIMPLE plan and Janelle’s profit sharing plan remain separate for testing purposes.

After Dave and Janelle are married their plans remain separate. Although married, their respective interests are not attributed to each other so long as neither directly owns an interest in the other's business, holds no officer/employee position, and the businesses earn income from activity, not passively (as discussed in footnote 18, above).

Assume that Dave and Janelle adopt a daughter. As a result of family attribution, their daughter is considered to own 100% of her father's corporation and 100% of her mother's corporation. Consequently, the two corporations are in a controlled group. Under the controlled group rules, employees of both corporations will be treated as employed by a single employer for purposes of §401 (regarding plan qualification), §415 (regarding contribution limits), and the other previously enumerated Code provisions.²¹

IV. Affiliated Service Groups (ASGs)

In response to evasion of controlled group status by professionals (doctors, attorneys, accountants, architects, etc.), and other service organizations, through the use of service companies or management companies, these rules treat the employees of each ASG organization as if they were employees of a single employer for many qualified plan purposes. The affiliated service group rules supplement the controlled group rules outlined above. As with controlled groups, attribution of ownership rules apply, although the affiliated service group attribution rules are based on §318(a), which are more inclusive than the rules under §414.

The following is a common example of the situation addressed by the ASG rules.

Example 19. Dr. A owns 100% of A's medical practice. Dr. B owns 100% of B's medical practice. Dr. C owns 100% of C's medical practice. Each practice employs nurses and administrative staff. Each doctor wants a qualified plan but does not want to pay for (i.e., contribute on behalf of) the employees. So, the doctors formed a new LLC (each with 1/3 ownership) with only themselves as employees. It was intended that the LLC establish a qualified plan to cover Drs. A, B & C. However, for reasons explained below, the LLC is an affiliated service group with each doctor's medical practice. Therefore, if the LLC establishes a qualified plan it must include all eligible employees from Dr. A's, Dr. B's and Dr. C's medical practices.

²¹ See also footnote 5, regarding the requirement under §401 that the available rights and features of "a plan" be offered in a nondiscriminatory manner. Where there are two different kinds of plans, satisfaction of this provision becomes more difficult. The finding of a controlled group in this example is further complicated by the SIMPLE plan, which by its terms requires that it be the exclusive (i.e., only) plan to which the employer makes contributions.

The ASG rules have been provided by the Treasury Department in the form of Proposed Regulations, on which taxpayers may rely.²² Under the Proposed Regulations, an ASG consists of a service organization referred to as the “First Service Organization” (FSO) and one or more other organizations: A-Organizations, B Organizations, or both A and B Organizations. In all three types, services will flow from the A or B Organizations to the FSO or to third persons. An ASG can exist also where a management organization’s principal business is the providing of management services to a single organization (or related group of organizations).

An **A-Organization** (A-Org) is one that both (1) owns a portion of the FSO as either shareholder or partner, and (2) either regularly performs services for the FSO or is regularly associated with the FSO in providing services to third parties.²³

Example 20. Attorney N is incorporated, and the corporation is a partner in a law firm. Attorney N and his corporation are regularly associated with the law firm in performing services for third parties. Considering the law firm as an FSO, the corporation is an A-Org because it is a partner in the law firm and it is regularly associated with the firm in providing services to others. Accordingly, the corporation and the firm are an ASG.

Under an A-Org arrangement, a corporation cannot be an FSO unless it is a professional corporation.

Example 21. Corporation F is a service organization that is a shareholder in Corporation G, another service organization but not a professional corporation. F regularly provides services to G. In this case, G cannot be an A-Org because it is not a shareholder or partner in F, nor can G be an FSO because G is a corporation which is not a professional service corporation. Note that while there is no ASG based on the A-Org requirements, F and G may be an ASG under the B-Org rules.

Determination of whether a potential A-Org “regularly performs services for” or is “regularly associated with” the FSO must be made on the basis of facts and circumstances of each case. The Proposed Regulations explain that one relevant factor is the amount of income derived from work done for the FSO or with the FSO for third parties. Keep in mind that the association element does not necessarily depend on a particular amount of work, as illustrated in the following example.

Example 22. Lawfirm is a law partnership with offices in several cities. The office in Dallas is incorporated and is a partner in Lawfirm. All of the employees of the corporation work directly for the corporation, and none of them work

²² Prop. Treas. Reg. §1.414(m)-1.

²³ Prop. Treas. Reg. §1.414(m)-2(b).

directly for any of Lawfirm’s other offices. Considering Lawfirm as an FSO, the corporation is an A-Org because it is a partner in Lawfirm and is regularly associated with Lawfirm in providing services to third persons. Lawfirm and the corporation are an ASG.

A B-Organization (B-Org) is one that meets three criteria:

1. a “significant portion” of its business involves providing services to the FSO, to a related A-Org, or both;²⁴
2. the services provided by B-Org are of a type historically performed by employees in the service field (e.g., medicine, insurance, etc.) of the FSO or A-Org; and
3. at least 10% of B-Org is owned by persons who are “designated group” members of either the FSO or A-Org. This includes, generally, officers, highly compensated employees, and common owners of the FSO (or A-Org) and the potential B-Org.

For these purposes, taking into account attribution rules, a common owner must own at least 3% of the FSO or A-Org and be an owner (in any amount) of the possible B-Org.

Example 23. R is a medical service partnership that has 11 partners. Each partner of R owns one percent of D Corporation. D Corp provides secretarial services to R. A significant portion of D’s business consists of providing such services to R. Considering R as the FSO, corporation D is a B-Org because (1) a significant portion of its business is the performance of services for the partnership (of a type historically performed by employees in the medical field), and (2) more than ten percent of D is held by “designated group” members – i.e., the 11 common owners. Partnership R and D Corp are members of an ASG.

A Management organization ASG classification creates an ASG in some cases that involve businesses unrelated to professional trades, i.e., unrelated to medicine, architecture, law, accountancy, etc.²⁵ The law provides that an ASG also exists where there is a group consisting of at least two entities:

- (1) a management organization, the principal business of which is performing management functions for one or more related recipient entities, and
 - (2) a recipient organization for which management services are performed.²⁶
- In contrast to other controlled groups, the management ASG grouping does not require any common ownership.

²⁴ Interestingly, an organization may be classified as a B-Org even though it does not itself qualify as a service organization. See Prop. Treas. Reg. §1.414(m)-2(c)(7) and -(2)(f). For more detail about what constitutes a “significant portion,” see Example 6 at Prop. Reg. §1.414(m)-2(c)(8).

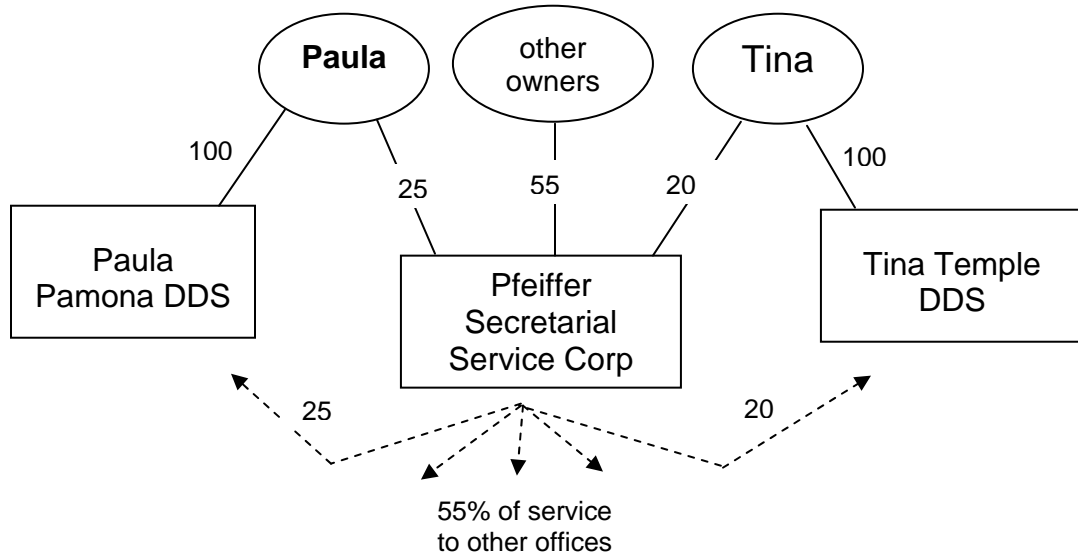
²⁵ The specific fields and other information may be found at Treas. Reg. §1.414(m)-2(f).

²⁶ Neither the Code nor the Regulations define “management functions” for purposes of §414. Former Proposed Regulations, now withdrawn, at 1.414(m)-5(c) included supervising, planning, personnel and other functions in the definition.

Example 24. Laura is the sole owner and employee of the LMC Management Company. Ravi is the sole owner and sole employee of RavMed, a professional corporation. Laura was formerly an employee of Ravi, but has since established LMC, which handles the daily business operations of RavMed. Because handling daily business activities is a type of management service historically performed by employees in the health field, and since all of LMC’s services are performed solely for RavMed, LMC and RavMed constitute an affiliated service group.

If an organization is an FSO with respect to two or more A-Orgs or two or more B-Orgs, or both, all of the organizations will be considered as a single ASG. However, there are limits to the chain of aggregation where multiple ASGs exist. That is, two or more affiliated groups will not necessarily be aggregated simply because an entity is an A-Org or a B-Org with respect to each ASG. The example that follows illustrates how a single entity may be in two ASGs, but the ASGs are not collapsed into a single group because the common entity is a B-Org with respect to both, not an FSO with respect to both.

Example 25. Pfeiffer Corporation provides secretarial service to numerous dentists in a medical building, each of whom maintains a separate unincorporated practice. Tina Temple, D.D.S., owns 20% of the secretarial corporation and accounts for 20% of its gross receipts. Paula Pomona, D.D.S., owns 25% of the corporation and accounts for 25% of its gross receipts.



Since the secretarial corporation, Pfeiffer Corporation, is a B-Org with respect to both dentists, there are two separate affiliated service groups as follows:

1. Tina Temple, D.D.S. is an FSO and Pfeiffer Corporation is a B-Org.
2. Paula Pomona, D.D.S., is an FSO and Pfeiffer Corporation is a B-Org.

Pfeiffer Corporation is a B-Org for each FSO because:

1. A significant portion of its business is the performance of services for each FSO (20% of gross receipts from Tina and 25% from Paula); and
2. The services are of a type historically performed by employees in the service field of the FSO, and
3. Ten percent or more of the interests in Pfeiffer Corporation are held, in the aggregate, by persons who are highly-compensated employees of the FSO.

V. Special Rule for Related Businesses

For employees who participate in more than one qualified plan, §415(g) and §415(h) complicate the controlled group and ASG analysis. These sections hold that for the purpose of calculating the amount of contribution or benefit allocated to the participant owner, the controlled group and ASG testing is done with lower ownership thresholds (50% instead of 80%). In practical terms, this means that two different controlled group examinations must be undertaken when there are two related employers who each have a plan.

Solely for the purpose of calculating each participant's maximum annual contribution (or benefit) under §415, certain groups of employers more often will be classified as a controlled group under this more inclusive lower threshold. It is possible that a controlled group may exist for the special purpose of determining the owner's maximum contribution but not for other purposes. For example, in the brother-sister controlled group context, the 80% "controlling interest" factor is changed to a "50% controlling interest" factor. As a result, if five or fewer owners (i) own 50% or more of two or more businesses and (ii) own more than 50% of the same businesses taking into account only identical interests, then there will be a controlled group for these contribution limit purposes.²⁷

Example 26. Sandra owns 49% of Garage Corporation and 60% of Parking Corporation. Jesse owns 5% of Garage and 5% of Parking. Unrelated shareholders own the remaining shares of Garage and Parking. Each corporation sponsors a profit sharing plan. Sandra is a participant in both plans.

Under the general controlled group rules Garage and Parking are not a controlled group. Sandra and Jesse do not have the requisite 80% controlling interest, falling short with only 54% of Garage and 65% of Parking. Thus even though Sandra and Jesse have effective control of both corporations, with 54% identical interest, there is not a controlled group for most purposes.

²⁷ Notice that the controlling interest threshold is "50% or more" while the effective control (identical interest) threshold is "greater than 50%."

For purposes of determining how much may be contributed to Sandra's profit sharing accounts, the ownership of the two corporations must be examined again using the lower 50% threshold. Under this lower standard, Garage and Parking are members in a brother-sister controlled group. Sandra and Jesse have (i) a controlling interest of "50% or more" in both corporations and also have (ii) effective control of both, with a 54% identical interest. As a result, \$49,000 (for 2010) is the total aggregate contribution between the two plans that may be contributed on Sandra's behalf to a defined contribution plan (not counting "catch-up" contributions for persons 50 and older).

VI. Leased Employees

The employee leasing rules of §414(n) represent yet another attempt to curb circumvention of the anti-discrimination rules by some employers. These provisions include in the definition of "employee" some people who perform services for a business but who are employed directly by another (i.e., by a leasing organization).²⁸ The leasing rules help indirectly to ensure that any qualified plan benefits extend to workers who might otherwise be omitted from participation, even after application of the controlled group and ASG rules.

In basic form, the leased employee problem arises when an employer implements a qualified plan for its own actual employees, but excludes those who similarly provide services to the employer but who are employees of a leasing company. To combat this situation, under the general rule, the term "**leased employee**" means any person providing services to a recipient if :

1. the person is not an employee of the recipient;
2. such services are provided pursuant to an agreement between the recipient and the leasing organization;
3. the person has performed such services for the recipient (or a related person or entity) on a substantially full time basis for at least one year; and
4. such services are performed under the "primary direction or control" of the recipient.

Any "leased employee" meeting these terms must be counted for qualified plan purposes as if employed directly by the employer.

Example 27. Arlene, age 30, is employed by Jack's Leasing Corporation (JLC). Through JLC, Arlene provides services as a leased employee to MEM Corp,

²⁸ The definitions and requirements of §414(n) do not depend on definitions of common law. That is, a person may at the same time be an employee under §414 standards but not an employee under common law. Alternatively, a leased employee may be a common law employee, in which case the leasing rules would not apply. See the Committee Report on the treatment of leased employees, Small Business Job Protection Act (SBJPA) of 1996, PL 104-188.

working at least 1,000 hours of service each year under the direction of MEM Corp employees. MEM Corp maintains a profit sharing plan with a single eligibility restriction: that participants attain age 21. For the plan testing purposes described earlier, Arlene must be considered an employee of MEM Corp.

Note that the exclusion of leased employees from plan participation may not be a problem for the employer if the leased employees are all highly compensated employees, because qualified plans may discriminate against highly compensated employees. The inclusion of leased employees may not necessarily cause a plan to fail.

Example 28. Arlene is employed by Jack’s Leasing Corporation (JLC). Through JLC, Arlene provides services as a leased employee to MEM Corp, working at least 1,000 hours of service each year under the direction of MEM Corp employees. MEM Corp maintains a profit-sharing plan in which all ten of its employees participate. Three of the ten employees are highly compensated. Arlene, who is not highly compensated, is MEM’s only leased employee.

For the plan testing purposes described earlier, Arlene must be considered an employee of MEM Corp. However, even if the plan terms prevent Arlene’s participation, the plan may still pass the various discrimination tests. Under the ratio-percentage test for example, a plan must cover a percentage of rank and file employees that is at least 70% of the percentage of highly compensated employees covered. MEM’s plan, not counting Arlene, covers 100% of the highly compensated, and 100% (7 out of 7) of rank and file employees. Including Arlene for testing purposes, MEM’s plan covers 87.5% (7 out of 8) of the rank and file. Since this 87.5% is more than 70% of the percentage of highly compensated employees (i.e., more than 70% of 100%), the MEM profit sharing plan still passes this particular test.

The question of whether the services are performed under the “primary direction and control” of the service recipient is one of facts and circumstances, but ultimately hinges on whether the service recipient exercises a “majority of direction and control” over the individual. Relevant factors include:

- whether the individual is required to comply with instructions of the service recipient about when, where, and how he or she is to perform the services,
- whether the services must be performed by a particular person,
- whether the individual is subject to the supervision of the service recipient, and
- whether the individual must perform services in the order or sequence set by the service recipient.²⁹

²⁹ Committee Report, SBJPA of 1996. Whether the recipient has a right to hire or fire the individual is not a relevant factor.

For example, temporary assistants, receptionists, and similar office personnel subject to the same day-to-day control of the service recipient employer as a common law employee will be treated as “leased employees” under §414(n) once they reach the one-year service threshold. Thus a person may be subject to the “primary direction or control” of the service recipient even if the leasing company hires, trains, and pays the individual, and even if the leasing company retains the ultimate right to control and exclusive right to fire the individual.³⁰ For example, nurses provided to a doctor’s office by a leasing organization generally would be considered to be subject to primary direction or control of the service recipient doctor’s office, and so would be treated as “leased employees.”

In contrast, a person is not automatically treated as a leased employee merely because he or she performs some services on the premises of the service recipient, even if the individual is under the nominal supervision of the service recipient while on the premises. For example, consider a repair crew that will install, repair, or modify equipment at a business. The crew includes a foreman and other employees of the equipment manufacturer. The crew works at the business where the equipment is located, with employees of the business, and follows safety standards enforced by a supervising employee of the business. However, the foreman (representing the equipment manufacturer) has the authority to direct and control the crew and must follow the direction (e.g., procedures) outlined by the manufacturer. Neither the foreman nor the other crew members would be considered leased employees of the business.

The general rule that an employer must include “leased employees” for plan testing has been modified to lessen its scope in several ways. First, §414(n)(5) provides a **safe harbor** for plan sponsoring employers, allowing them to exclude any leased employees if (a) such employees are covered by a money purchase pension plan (MPPP) maintained by the leasing organization, and (b) such leased employees do not constitute more than 20% of the employer’s non-highly compensated work force.³¹ In determining the percentage of non-highly compensated employees, the employer must exclude highly compensated employees and must include employees with at least 1000 hours of service (who have been employed for at least a year) and leased employees.

Second, benefits and contributions provided by the leasing organization to its own employees are treated as provided to them by the lessee for some purposes. That is, if the employer receiving services (i.e., the lessee) must include the leased employees in the testing calculations, it will also get credit for contributions made on behalf of the employees in question by the leasing organization to the leasing organization’s qualified

³⁰ Id.

³¹ Code §414(n)(5)(B) specifies that the MPPP must have an employer contribution rate of at least 10%, must have 100% immediate and full vesting for participants, and must grant eligibility to each employee who earns at least \$1000 per year.

plan.³² Importantly, the lessee employer does not get to treat these “deemed contributions” as its own plan contributions for deduction purposes. Thus, for example, while a payment to the leasing organization may be deductible as an ordinary and necessary business expense, the portion of the payment attributable to qualified plan contributions for the leased employee will not be deductible (again) by the service recipient employer as a qualified plan contribution.

An employer interested in a formal determination of the status of their particular plan vis-à-vis leased employees may obtain a determination letter from the IRS. The IRS has also issued Revenue Procedures that provide guidance to leasing organizations (defined as “professional employer organizations”) in determining under the facts and circumstances test whether a particular worker is an employee of the leasing organization, the lessee service recipient, or both.³³

VII. Expanded ASG and Leased Employee Rules

In addition to the ASG classifications and leased employee rules of subsections (m) and (n), §414(o) widens the net by granting to the Treasury Department the authority to issue regulations that include additional rules necessary to prevent the avoidance of employee benefit requirements through the use of separate organizations, employee leasing, or other arrangements. Thus, Treasury has been given latitude to further develop standards by which employees and plans must be aggregated.

VIII. Qualified Separate Lines of Business (QSLOB)

The Code’s minimum coverage tests take into account all employees of an employer, including those treated as employees under the controlled group, affiliated service group, or leased employee rules.³⁴ However, for specified purposes, the employer may be allowed to apply the test separately to different groups within the company instead of on a company-wide basis.

Where an employer operates two or more **qualified separate lines of business** (QSLOB), the minimum coverage tests can be applied to each QSLOB independently.

³² Code §414(n)(1)(B). In Proposed Regulations that were withdrawn, the Treasury department had provided an example of how this might work. The contributions made by the leasing company to the leasing company plan for a worker were credited to the service recipient towards its plan in proportion to the amount of the leased employee’s time was spent working for the lessee.

³³ See Revenue Procedure 2002-21, 2002-1 C.B. 911, and Rev. Proc. 2003-86, 2003-2 C.B. 1211.

³⁴ See Treas. Reg. §1.414(r)(1)(a). The QSLOB allowance pertains only to: the minimum coverage tests of §410(b) which includes the ratio percentage test and the average benefit test; the nondiscrimination test of §401(a)(4); the minimum participation requirements of §401(a)(26); and the 55% average benefits test of §129(d)(8).

Importantly, the QSLOB exception does not apply to affiliated service group situations. However, it may be used in controlled group situations.

The QSLOB definition requires the following:³⁵

- the employer maintain the separate lines of business for bona fide business reasons;
- that each line of business be identified by property and or services provided to customers;
- that each line of business actually be organized and run separately;
- that each QSLOB have at least 50 employees;
- that each employee be assigned to one of the employer's QSLOBs

Numerous criteria further refine the use of QSLOBs. Employers who intend to use a QSLOB exception to meet the discrimination and other qualified plan rules must notify the IRS with the appropriate form. Further, an employer must either (a) meet a statutory safe harbor regarding the ratio of HCEs to rank and file employees in each QSLOB, or (b) must request an receive an individual determination letter from the IRS that each QSLOB satisfies an administrative scrutiny test.

IX. Conclusion

The rules for controlled group, entities under common control, affiliated service groups, and leased employees each play an important part in guaranteeing that qualified plans broadly include employees in the member employers. These rules prevent tax benefits for plans that do not meet plan criteria when counting all employees of the group as “eligible employees.”

Employers who currently sponsor or who may sponsor a qualified plan should be familiar with these common control rules, which can disqualify plans that otherwise appear to meet the Code's standards. Determining whether a controlled group exists could make the difference between a particular plan's qualification or failure.

³⁵ A full discussion of QSLOB rules is beyond the scope of this document. More information about QSLOBs may be found at Treas. Reg. §1.414(r)-1 and following. See also IRS Form 5310-A and IRS Publication 6393.

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