

Audit Technique Guide – Multiple Parent Title Holding Companies, IRC Section 501(c)(25)

Introduction

These examination guidelines provide technical information and examination techniques useful in identifying and developing issues commonly encountered during an IRC Section 501(c)(25) organization.

These guidelines aren't all inclusive and don't intend to restrict identifying issues or using audit techniques not included here.

Exemption Requirements

IRC Section 501(c)(25) was enacted under the Tax Reform Act of 1986 (Public Law 99-514), effective for taxable years beginning after December 31, 1986. The code section was specifically designed to provide exemption for title holding organizations with up to 35 shareholders or beneficiaries. Holdings are limited to interests in real property.

IRC Section 501(c)(25) requires that an organization must have the following attributes to qualify for exemption.

- Be organized for the exclusive purposes of acquiring real property and holding title to, and collecting income from that property and remitting the entire amount of income from such property (less expenses) to its shareholders, or beneficiaries described below.
- Be a corporation with no more than 35 shareholders or a trust with no more than 35 beneficiaries.
- Each shareholder or beneficiary may have only one class of stock or beneficial interest.
- The organization may be organized as a non-stock corporation if its articles of incorporation or bylaws provide members with the same rights as required by Notice 87-18 (Notice 88-121).
- A corporation or trust must permit its shareholders or beneficiaries to dismiss the corporation's or trust's investment adviser, upon the shareholders or beneficiaries majority vote.

Each shareholder or beneficiary must be one of these:

- A qualified pension, profit sharing, or stock bonus plan that meets the requirements of IRC Section 401(a)
- A governmental plan (within the meaning of IRC Section 414(d))
- The United States, any State or political subdivision thereof, or any agency or instrumentality or any of the foregoing
- Any organization described in IRC Section 501(c)(3)

A corporation or trust must permit its shareholders or beneficiaries to terminate their interest in the corporation or trust by either, or both, of the following, as the corporation or trust determines:

- By selling or exchanging their stock in the corporation or interest in the trust (subject to any federal or state securities law) to any organization described above so long as the sale or exchange doesn't increase the number of shareholders or beneficiaries in that corporation or trust above 35, or
- By having their stock or interest redeemed by the corporation or trust after the shareholder or beneficiary has provided 90 days notice to the corporation or trust.

A corporation or trust must not derive more than 15 percent of the total rent for the taxable year from rent from personal property leased under or connected to a lease of real property.

A corporation or trust must not derive more than 10 percent of its gross income from otherwise disqualifying income which is incidentally derived from holding real property. Examples of this type of income include revenues from vending machines and parking lots.

The organization must remit the entire amount of income from this property (less expenses) to one or more organizations which are shareholders of the corporation or beneficiaries of the trust (IRC Section 501(c)(25)(A)(iii)(II)). The organization must remit at least once a year, in the same way as required for IRC Section 501(c)(2) organizations.

An IRC Section 501(c)(25) applicant's articles of incorporation or trust instrument must include provisions that clearly demonstrate that the organization meets the above requirements (Notice 87-18, 1987-1 C.B. 455).

If state law prevents a corporation from including the provisions required by Notice 87-18 in its articles of incorporation, these provisions must instead be included in the corporation's bylaws (Notice 88-121, 1988-2 C.B. 457, modifies Notice 87-18).

An organization seeking exemption under IRC 501(c)(25) should submit a completed Form 1024, Application for Recognition of Exemption under Section 501(a), to Cincinnati.

The application should include all information required by [Form 1024, Schedule A](#). For Schedule A, Question 4, the organization should outline how each shareholder or beneficiary meets the requirements of IRC Section 501(c)(25)(C). Organizations formed before 1969 and churches aren't subject to the IRC Section 508 application requirements and may not have ever applied for and received a determination letter.

Qualified Subsidiaries

IRC Section 501(c)(25)(E) was enacted in Public Law 100-647 to permit IRC Section 501(c)(25) organizations to have fully-owned subsidiary corporations, called "qualified

subsidiaries,” that could hold some or all of the assets of the IRC Section 501(c)(25) organization.

- A qualified subsidiary isn’t treated as a separate corporation for tax purposes and, accordingly, the IRS doesn’t issue a letter to the subsidiary recognizing it as exempt.
- All assets, liabilities, and items of income of qualified subsidiaries are considered assets, liabilities, and items of income of the IRC Section 501(c)(25) organization, and must be included in the its annual returns.

A qualified subsidiary doesn’t file a separate [Form 990](#), Return of Organization Exempt From Income Tax, or other federal tax information return.

The IRS doesn’t issue a ruling to a qualified subsidiary recognizing it as such. However, to meet some state tax authorities requirements that a qualified subsidiary have its own exemption letter to qualify for exemption from state tax, the IRS will issue a ruling to the IRC Section 501(C)(25) parent that its subsidiaries are qualified subsidiaries under IRC Section 501(c)(25)(E).

“Qualified subsidiary” means, under IRC Section 501(c)(25)(E)(ii), any corporation if, at all times it existed, the IRC Section 501(c)(25) parent held 100 percent of its stock. So, an IRC Section 501(c)(25) parent can’t acquire a pre-existing corporation from the pre-existing corporation’s shareholder, unless that shareholder is also an IRC Section 501(c)(25) organization. A qualified subsidiary must be a subsidiary of an IRC Section 501(c)(25) organization, not a direct subsidiary of a pension plan or other permissible IRC Section 501(c)(25) shareholder.

An IRC Section 501(c)(25) parent may have more than one qualified subsidiary. The statute doesn’t limit the number of qualified subsidiaries a parent may own directly.

A qualified subsidiary must comply with all rules of IRC Section 501(c)(25) for the parent to retain exemption. The qualified subsidiary’s activities are considered along with the other activities of the parent (and any other qualified subsidiaries).

Example: If a qualified subsidiary received unrelated business taxable income from parking, and this income was incidentally derived from its holding of real property, but didn’t exceed 10 percent of the combined gross income of the parent and all qualified subsidiaries, then the parent would retain its exemption along with its qualified subsidiaries.

If the parent transfers any qualified subsidiary stock to another person, the subsidiary is disqualified. If the parent transferred less than all the stock it held in the qualified subsidiary, the parent would then be holding an impermissible interest in personal property and would no longer meet the requirements for exemption under IRC Section 501(c)(25).

If a qualified subsidiary issued stock to anyone other than its parent, the qualified subsidiary would be disqualified. This would also result in the parent’s loss of

exemption, as the parent would own stock, an impermissible holding for an IRC Section 501(c)(25) title holding company.

If a qualified subsidiary conducted an unrelated trade or business, not incidental to its holding real property, the activity wouldn't result in its disqualification, but would cause the parent's loss of exemption, as well as the loss of exemption of all the parent's other qualified subsidiaries (unless the requirements of IRC Section 501(c)(25)(G)(ii) were satisfied).

If a corporation which was a "qualified subsidiary" ceases to meet the requirements of IRC Section 501(c)(25)(E)(ii), it's treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) from its IRC Section 501(c)(25) parent immediately before the date it ceased to be a "qualified subsidiary" in exchange for its stock (IRC Section 501(c)(25)(E)(iii)). When a qualified subsidiary becomes disqualified, consider the rules in IRC Section 337(d) and the rules governing corporate reorganizations in IRC Section 351.

Assets

IRC Section 501(c)(25) title holding companies generally may not own stock, because stock is not real property. The only exception to this rule is IRC Section 501(c)(25)(E), which permits a title holding company to own 100 percent of the stock in a qualified subsidiary.

An IRC Section 501(c)(25) organization may acquire and hold options to purchase real property if the options are purchased according to a plan to purchase the particular real estate involved and not for options trading. See Notice 88-121, 1988-2 C.B. 457.

An organization may hold reasonable cash reserves sufficient to meet its operational requirements.

- The reserves must be held in cash, or in short term investments such as certificates of deposit, banker's acceptances, interest-bearing savings accounts, commercial paper, government obligations, and shares in money market funds.
- Investments aren't considered short term if the period to maturity exceeds 91 days.

Unrelated Business Income

An IRC Section 501(c)(25) organization may not engage in unrelated business activities. In general, an IRC Section 501(c)(25) organization's receipt of unrelated business income subjects it to loss of exempt status. The following are exceptions:

- A limited amount of personal property leased with the real property is treated as real property (IRC Section 501(c)(25)(F)). This applies only if the rental income attributable to the personal property doesn't exceed 15 percent of the total rental income.

- Acquisition indebtedness per IRC Section 514(c)(9), doesn't include indebtedness a "qualified organization" incurs when it acquires or improves certain real property.
- The organization isn't considered to have acquisition indebtedness and income from the property not taxable if shareholders of an IRC Section 501(c)(25) organizations are "qualified organizations" per IRC Section 514(c)(9)(C). "Qualified organizations" are schools described in IRC Section 170(b)(1)(A)(ii), their affiliated IRC Section 509(a)(3) supporting organizations, and qualified trusts under IRC Section 401.

A "disqualified holder" of an interest in an IRC Section 501(c)(25) organization takes into account as gross income from an unrelated trade or business, its pro rata share of income that would be treated as unrelated debt-financed income but for IRC Section 514(c)(9) (IRC Section 514(c)(9)(F) as amended).

- Disqualified holders are shareholders or beneficiaries of an IRC Section 501(c)(25) organization that are not schools described in IRC Section 170(b)(1)(A)(ii), their affiliated IRC Section 509(a)(3) supporting organizations, and qualified trusts under IRC Section 401.
- For interests acquired after June 10, 1987, shareholders and beneficiaries are put in the same position for holdings of an IRC Section 501(c)(25) organization that they would be in if they held the property directly.

IRC Section 501(c)(25) organizations may receive unrelated business income of up to 10 percent of their gross income, if the unrelated business income is incidentally derived from holding real property (IRC Section 501(c)(25)(G)).

- Examples of this type of income: revenue from vending machines and parking lots.
- Exempt status isn't affected by the organization's receipt of debt-financed income treated as unrelated business taxable income solely because of IRC Section 514.

Income an organization derives from a business operation or the business of acquiring, improving, and selling real property or trading options, is income from unrelated trade or business and will result in the loss of exempt status.

Pre-Audit Examination Procedures

Before you initially contact the organization, check IDRS to see if the organization filed and application; if so, request the determination file from Cincinnati using Form, "Request for EP or EO Determinations Administrative File." Submit the form by fax or an email attachment:

- Fax #: (513) 263-3780
- Email: *TEGE DETERMINATIONS PROCESSING

See below for a completed copy of "Request for EP or EO Determinations Administrative File":

Request for EP or EO Determinations Administrative File	
To: EO Determinations Records Unit Fax: 513-263-3780	E-mail: *TEGE DETERMINATIONS PROCESSING
<small>*email is for use with unsecured messages only, when fax is not available</small>	
From: Revenue Agent Name/Emp ID # Business Unit or Group #: EG:79XX	Date: February 13, 2017 Phone Number: (XXX) XXX-XXXX
<div style="display: flex; justify-content: space-between;"> <div style="width: 45%;"> Check One: <input checked="" type="checkbox"/> EO <input type="checkbox"/> EP </div> <div style="width: 50%;"> Attach one of the following: <input type="checkbox"/> EDS print <input checked="" type="checkbox"/> BMFOLO or INOLES (only if EDS is not available) <input checked="" type="checkbox"/> Name / EIN <small>ABC Organization / XX-XXXXXX</small> </div> </div>	
Comments / Delivery Instructions (i.e. return address) :	
EP/EO DETERMINATIONS PROCESSING USE ONLY	
Received Date:	Preliminary Research: Closed Date: _____ Type of Request: _____ <input type="checkbox"/> Closed Date Prior to July 2004 (DVD or microfiche) <input type="checkbox"/> DVD Database Research Completed. DVD # _____ <input type="checkbox"/> No DVD Found - search microfiche <input type="checkbox"/> Closed Date After July 2004 (TEDS case or hard-copy case) Batch #: _____ Comments: _____ Date Completed: _____ Completed By: _____
Actions Taken:	
Closed Date Prior to July 2004	
<input type="checkbox"/> Researched DVD Database <input type="checkbox"/> Copied administrative file from master DVD <input type="checkbox"/> Record not found on DVD	Date Completed: _____ Completed By: _____
<input type="checkbox"/> Researched microfiche <input type="checkbox"/> Copied administrative file from master microfiche <input type="checkbox"/> Record not found on microfiche	Date Completed: _____ Completed By: _____
Closed Date After July 2004	
<input type="checkbox"/> Researched TEDS repository <input type="checkbox"/> Copied administrative file from TEDS repository <input type="checkbox"/> Record not found in TEDS repository	Date Completed: _____ Completed By: _____
<input type="checkbox"/> Researched EOCC Database and/or EOCC Transmittals <input type="checkbox"/> Pulled case from EOCC boxes <input type="checkbox"/> Record not found on EOCC database	Date Completed: _____ Completed By: _____
<input type="checkbox"/> Researched closed cases boxes (FTEs, ready for doc prep, ready to be scanned) <input type="checkbox"/> Pulled case from closed case boxes <input type="checkbox"/> Record not found in closed case boxes	Date Completed: _____ Completed By: _____

Determine whether the organization has filed a determination application on [Form 1024](#). For organizations that have no determination application, ask in the initial document request (IDR) for the organizing documents. When you receive the determination file, determine if the organization has included all the required language in its organizing documents as specified in Notice 87-18, 1987-1 C.B. 455 and Notice 88-121, 1988-2 C.B. 457.

- Review the organizing documents to determine whether the organization is organized for the exclusive purpose of acquiring and holding title to real property, and collecting income from that property and distributing the income to its shareholders/beneficiaries.

Note: If state law prevents a corporation from including the required language in its articles of incorporation, the organization must include such language in its bylaws.

- Review articles of incorporation and other corporate documents to ensure the organization has no more than 35 shareholders or beneficiaries and only one class of stock or beneficial interest.

Research IDRS to verify that the organization's shareholders or beneficiaries are described in IRC Section 501(c)(25)(C). If you're unable to determine which entities are the shareholder(s), request documentation, such as determination letters in your initial IDR.

If the determination application describes the real property to be held, search the internet to:

- Determine whether the property still exists.
- View aerial images of property, to estimate whether the applicant's description of any property is still accurate.
- See if there is a property management company operating the facility.
- Retrieve any current and/or revised corporate information from the appropriate state regulatory agency.

Obtain any prior or subsequent years [Forms 990](#) and [990-T, Exempt Organization Business Income Tax Return](#) via Online SEIN.

- Review the Forms 990-T to determine the sources of income reported.
- Using the Forms 990-T as a guide, add to the initial IDR any items on the Form 990-T that merit review, including items such as property records.
- Review the Forms 990 to identify the list of shareholders, if provided.
- Match the income and expenses reported on the Form 990 to the Form 990-T. Note any differences, and whether there may be allocation issues.
- Perform the standard risk analysis, identifying the large, unusual and questionable items for inclusion on the initial IDR.

Using these records, revise your initial interview accordingly. Interview the officers and/or managers who run the title holding corporation. At a minimum, ask the following questions:

- Who are the shareholders of the organization?
- Are the shareholders all exempt under IRC Section 501(c)(3), or do they include governmental units or pension plans?
- What is the foundation status of each shareholder, if exempt under IRC Section 501(c)(3)?
- What kind of property does the organization hold?
- Does the organization use a property management company?
- Who among the shareholders has the right to terminate the management company, or is it a group decision?
- Does the organization collect any form of income other than rent?
- How many tenants does each property held by the organization have?
- If there are subsidiaries, who owns the stock of the subsidiaries?
- Do the subsidiaries (if any) generate any income of their own?
- Are there any mortgages against any of the properties owned by the organization (and any subsidiaries)?

Field Examination Procedures

Determine whether the shareholders or beneficiaries control the title holding corporation, as specified in IRC Section 501(c)(25)(D) by:

- Reviewing the organizing documents
- Reviewing the minutes
- Reviewing the contracts and agreements
- Interviewing the officials

Obtain any revised organizing documents not already included in the determination file, even if previously attached to [Forms 990](#).

Identify any changes to the number of shareholders, classes of stock, or other structural elements in the articles of incorporation and/or bylaws.

Inspect all sources of income, such as cash receipts journal, bank statements, to determine if the organization receives income from unrelated business activities. If so, verify the amount of this income:

- Is incidental to the holding of real property
- Doesn't exceed 10 percent of the organization's gross income
- Matches the amount reported on [Form 990-T](#).

Review lease agreements to identify rental of personal property. Determine whether the rental of real property includes personal property. If rental of real property includes personal property, determine whether the amount attributable to personal property exceeds the 15 percent of total rental income.

Determine whether the organization is receiving income from the business of acquiring, improving, and selling real property or trading options. This income is unrelated trade or business income and results in the loss of exempt status.

Analyze the organization's balance sheet to identify all assets.

Analyze financial records and interview officials to determine if the organization owns options and if the purpose of owning the options is to purchase real estate.

Review minutes, correspondences, files and agreements to determine if the organization owns one or more qualified subsidiaries and has not transferred stock to any person.

Determine if the organization is improperly accumulating income.

Concluding the Examination

Determine if the organization continues to qualify for exemption under IRC Section 501(c)(25). Prepare a report of examination revoking the organization if:

- The organization has any shareholders who are neither a qualified pension, profit sharing, or stock bonus plan that meets the requirements of IRC Section 401(a); a governmental plan (per IRC Section 414(d); the United States, any State or political subdivision thereof; or any agency or instrumentality of any of the foregoing; nor any organization described in IRC Section 501(c)(3).
- It is no longer organized for the exclusive purposes of acquiring real property and holding title to, and collecting income from, this property, and remitting the entire amount of income from such property (less expenses) to its shareholders or beneficiaries described above.
- It is a corporation with more than 35 shareholders or a trust with more than 35 beneficiaries.
- Any shareholder or beneficiary has more than one class of stock or beneficial interest.
- The corporation or trust cannot permit its shareholders or beneficiaries to dismiss the corporation's or trust's investment adviser, via the shareholders or beneficiaries majority vote.
- The shareholders or beneficiaries are unable to terminate their interest in the corporation or trust by selling or exchanging their stock in the corporation or interest in the trust to any organization described above so long as the sale or

exchange does not increase the number of shareholders or beneficiaries in that corporation or trust above 35.

- The shareholders or beneficiaries are unable to terminate their interest in the corporation or trust by having their stock or interest redeemed by the corporation or trust after the shareholder or beneficiary has provided 90 days notice to such corporation or trust.
- Any shareholder or beneficiary has terminated their interest in the organization by selling or exchanging their stock with an organization not described above.
- The organization derived more than 15 percent of the total rent for the taxable year from rent attributable to personal property which is leased under or in connection with a lease of real property.
- The organization derived more than 10 percent of its gross income from otherwise disqualifying income which is incidentally derived from the holding of real property.
- The organization fails to remit the entire amount of income from such property (less expenses) to one or more organizations which are shareholders of such corporation or beneficiaries of such trust at least annually.
- Any qualified subsidiaries cause the organization to lose exemption through actions of their own.

For an agreed revocation:

- Discuss the issue with the taxpayer fully to verify that they will agree.
- Issue the final report using Letter 3610, Forms 886-A, 4621-A, and 6018-A. Allow the taxpayer 30 days to respond.
- Prepare Form 2363-A for revocation to eliminate the exempt status and to change the filing requirement to Form 1120, U.S. Corporation Income Tax Return.
- Prepare the Form 1120 Conversion Package as outlined in [IRM 4.75.31.4](#).
- Close the case to Mandatory Review.

For an unagreed revocation:

- If not otherwise excluded from Fast Track Settlement, issue a report of preliminary findings (draft Revenue Agent Report (RAR)), with a drafter cover letter, Forms 886-A, 6018-A, and 14017. Issue with [Publication 4539](#), Fast Track Settlement. Allow 30 days for a response.
- For cases not entered into the Fast Track Settlement process, issue the final report using Letter 3610, Forms 886-A, 4621-A, and 6018-A. Allow the taxpayer 30 days to respond.
- Prepare Form 2363-A for revocation to eliminate the exempt status and to change the filing requirement to [Form 1120](#).

- Prepare the Form 1120 Conversion Package as outlined in [IRM 4.75.31.4](#).
- Close case to Mandatory Review.

Note: Prepare an administrative file in all unagreed cases in case the organization files a declaratory judgment action under IRC Section 7248.

If not revoking, identify any adjustments to be made to [Form 990-T](#).

- Discuss the adjustment fully with the taxpayer to determine whether they will agree to the adjustment.
- If agreed, prepare a report of examination, issued via Letter 3621, Forms 886-A and 4549.
- For agreed cases, collect payment at the time of agreement. If taxpayer indicates an inability to pay the tax due at closing, discuss alternative payment methods. Offer an installment agreement if the taxpayer meets the requirements. Use [Form 9465](#), Installment Agreement Request, to solicit a payment agreement. See IRM 4.10.7.5.8, Payment Expectations and IRM 4.75.16.5.7, Installment Agreements.
- When closing agreed cases, prepare Letter 3607, with a copy of the Form 886-A and Form 4549. Close the case to EO Closing Unit.
- For unagreed cases, if not otherwise excluded from Fast Track Settlement, issue a report of preliminary findings (draft RAR), with a drafted cover letter, Forms 886-A, 4549 and 14017. Issue with [Publication 4539](#). Allow 30 days for a response.
- For cases not entered into the Fast Track Settlement process, issue the final report using Letter 3621, Forms 886-A, and 4549-A. Allow the taxpayer 30 days to respond.
- Close unagreed cases to Mandatory Review at the end of the 30 day period. For short statute cases, you may need to follow statutory notice procedures.

If you close the case as a no change, prepare Letter 3594. Follow the closing case procedures outlined in [IRM 4.75.16](#).