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A Shield Against Liability: Title Holding Corporations and Real Estate Investments of Pension Plans

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Pension plans that have real estate investments as part of their asset allocation model must consider how to hold title to their properties as part of their overall real estate investment policy. Ownership structure issues typically arise in the creation of a real estate separate account where there is direct investment in the real estate assets. However, these issues should be considered with respect to all real estate investments by a pension plan or any other tax-exempt entity.

The ownership of real estate can, in limited circumstances, create exposure to unanticipated, uninsured liabilities. Real estate investment managers and trustees oftentimes expend a great deal of effort evaluating property level insurance requirements, e.g., what coverages, what amounts, what deductibles, and what form of endorsements, etc., as part of the investment policy and real estate guidelines. However, the importance of the ownership structure of their real estate investments is often overlooked. Needless to say this discussion does not apply to pension funds that invest indirectly in real estate through the acquisition of an interest in a commingled fund, REIT stocks, or the stock of other real estate operating companies.

The proper ownership structure of a pension plan's direct separate account real estate investment portfolio will insulate the pension plan and their trustees from unanticipated and uninsured liabilities that may result from the operation and ownership of their real estate investments. Additionally, the proper ownership vehicle can maximize the tax-exempt benefits enjoyed by pension plan investors, and protect the privacy of the pension plan by avoiding public disclosure of their ownership interest. When evaluating ownership alternatives for a real estate investment, trustees of pension plans and investment managers must consider all aspects of the investment to determine the optimal ownership structure to limit the pension plan's exposure to uninsured liabilities, while maximizing the tax exempt benefits afforded to pension plans and providing for the efficient operation of the asset.

There are several alternative ownership structures available to pension plans that invest in real estate. These include the direct ownership of the real estate, or the indirect ownership of the real estate through a corporation, title holding corporation, limited liability corporation, partnership and/or group trust. In each of the indirect ownership structures, the entity owns the real estate and the pension plan owns an interest in the entity. The following issues must be considered by the investment manager, trustees, and plan counsel when determining the optimal ownership structure for real estate investments by pension plans:

- If the pension plan elects to hold title to real property investments in its own name, the pension plan will be directly responsible for any liabilities which arise through the ownership and operation of that property. If there is a loss that is not covered by insurance or a loss that is in excess of the insured limits, the pension plan is financially responsible for that obligation.

- If the pension plan owns real property in its own name, the public can access that information and utilize that information in any manner they see fit.

- If the pension plan owns real property indirectly through any of the structures outlined above, the pension plan will not normally be held liable for financial losses at the entity level if the entity is properly formed and operated.

- If the pension plan owns the property in a group trust, most states provide only limited legal protection to insulate the pension plan from liability for the obligations of the group trust if the group trust does not have sufficient assets to pay for its obligations. Thus, the group trust does not absolutely "shield" the pension plan investor from liability.

- Ownership of real property in a general partnership and/or joint venture also may not "shield" the pension plan's assets from uninsured liabilities arising from the ownership and operation of real property. General partners, joint venture partners, and even limited partners that exercise active management roles can be held liable for the acts of the partnership or joint venture entity.

- The federal, state, and local taxation of the ownership entity must also be considered. For example, some states impose a franchise tax on title holding corporations that are exempt from federal taxation. Therefore, to minimize or eliminate the impact of taxes on the investment, careful consideration must be given to the state and local tax regulations of the state where the ownership entity is formed, and the state and city where the investment is located.

- Finally, the structure of the investment itself, e.g., number of investors, type of investment, use of leverage, etc., must be considered to determine the appropriate ownership vehicle.

General Use of Corporations or Limited Liability Entities

The formation of a corporation or limited liability company ("LLC"), if properly created and properly maintained, provides a "shield" from liability for the shareholders or members of that entity. Additionally, corporate or LLC ownership creates a wall of privacy that can limit public disclosure of the pension funds' ownership interest in the underlying real property. Finally, a properly formed and maintained corporation or LLC ownership entity can eliminate or minimize the amount of income and/or franchise taxes imposed on the income, value and/or long-term gain of the pension plan's real estate investments.

Obtaining appropriate property and casualty insurance, liability insurance and other insurance to limit the exposure of the pension plan's assets to liabilities associated with real estate ownership is critically important, but it is not the purpose of this article to discuss the proper implementation and utilization of a real property insurance program. Nor is this article intended to be an exhaustive discussion of all of the alternative ownership entities available to pension plans for holding title to real estate investments.

The following discussion is intended to discuss the benefits of using Internal Revenue Code ("IRC") §501(c)(2) and §501(c)(25) title holding corporations to hold title to real estate investments of pension funds, and other similarly qualified tax exempt groups. IRC §501(c)(2) and §501(c)(25) title holding corporations have been the ownership vehicles of choice for the majority of direct real estate investments by pension plans. They continue to be an excellent ownership vehicle for most real estate investments by pension plans.

Trustees of pension funds will no doubt want to evaluate the cost of separate corporate ownership for their real estate investments when including this requirement as part of their investment policy. While the potential for most catastrophic losses is remote, the low cost of corporate formation and maintenance is usually easy to justify because of the protection that is afforded to the remainder of the pension plan's assets.

Incorporating Real Estate Investments

The primary purpose of incorporating the ownership of real property investments is to protect a pension plan's assets from those unique instances where there is a catastrophic loss resulting from the ownership of that property which is not covered by insurance. These catastrophic losses can arise from natural disasters, (e.g., earthquake, tornado, flood) or man-made disasters (e.g., environmental contamination, civil disturbance, terrorist attack). It is important for trustees of pension plans to understand that insurance only protects against certain losses and only for the maximum amount of loss specified in the policy. However, there may be potential losses for which insurance cannot be obtained, or for which the insurance is prohibitively expensive.

By holding title to their real estate investments in a title holding corporation a pension plan can minimize the uninsured risks associated with the ownership of those real estate assets. To better understand the benefit of corporate ownership, let us consider a pension plan that makes an investment in the common stock of General Motors, IBM or other public entity. If for example, General Motors contaminates the soil at one of its production facilities, the corporation will be responsible for the cost to remediate that contamination. If the costs associated with the remediation are catastrophic and the corporation does not have sufficient insurance and other assets to satisfy that obligation, the corporation may be forced to declare bankruptcy, but the shareholders would not be held liable for those obligations (absent some limited circumstances discussed later where the shareholder and the corporation are treated as one). Real estate investments should be viewed in the same context.

A tax-exempt pension plan should not, in most circumstances, own real estate through a traditional "C" corporation. Even though dividends of "C" corporations distributed to pension plan shareholders are exempt from federal income tax at the pension plan level, there is a tax at the corporate level on net income derived from the operation of the property. Thus, to allow the income from investments of a pension plan to be subject to tax defeats the opportunity afforded by our tax laws for pension plans to accumulate tax-free gains and income from most investments.

It is important to note that properly formed and maintained corporations under IRC §501(c)(2) and IRC §(c)(25) are exempt from federal income tax and, in most cases, state income tax. It should be noted, however, that some states impose a franchise tax on title holding corporations even though they are exempt from federal income taxes. In these instances, the investment manager and the trustees should work closely with plan counsel to evaluate alternative ownership structures that can eliminate or minimize these state tax obligations, while providing the desired limited liability protection to the pension plan. This area of inquiry is complex, state specific, and requires the careful guidance of an investment manager and tax counsel familiar with these issues.

Pension Plan Tax Exemption For Income and Gain

A pension plan that satisfies the requirements contained in IRC §401(a) is exempt from federal taxation under IRC §501(a), provided that the pension plan is not carrying on a trade or business for profit. If a pension plan carries on a trade or business for profit, the income is not exempt from taxation even if all of its profits are payable to one or more tax-exempt organizations. Most investments in real estate are not considered an active trade or business by the Internal Revenue Service ("IRS"), and income and gain generated from real estate investments will not be taxed, as the income is considered to be passive by the IRS. This issue of active or passive income will be discussed in greater depth later in this article. There are differences and similarities between an IRC §501(c)(2) and §501(c)(25) title holding corporations that must, however, be considered.

IRC §501(c)(2) Title Holding Corporations

IRC §501(c)(2) allows a pension plan exempt from tax under IRC §501(a), to form corporations which are tax-exempt: (i) for the exclusive purpose of holding title to property; as well as, (ii) collecting the rental income from the properties and turning over the entire amount of such income, less the operating expenses, to the pension plan as dividends. An IRC §501(c)(2) title holding corporation can hold a variety of interests in property including partnership interests, interests as a tenant in common, mortgages or deeds of trust. The IRS has taken the position, however, that an IRC §501(c)(2) title holding corporation may not be owned by more than one shareholder. (See G.C.M 39341.) However, the IRS counts a group plan as a single shareholder for these purposes. (See G.C.M 38253.) Thus, a properly formed IRC §501(c)(2) title holding corporation is not subject to tax at the federal level.

A title holding corporation must be organized for certain specified purposes, and their operations are limited as specified in IRC §501(c). A corporation that owns office, industrial, retail and multi-family property investments can receive the income from such assets and not pay tax on that income. It is important to note that the tax exemption is not available to a title holding corporation organized to acquire real and personal property with broad operating powers and purposes beyond that required for passive investment. Thus, the tax-exemption only extends to corporations not carrying on a trade or business. Operating a hotel, nursing home, senior care facility, or other operating businesses are considered to be a trade or business and creates potential traps for those pension plans that acquire these types of assets. If a company engages in business activities other than those that are customary and incidental to the maintenance of the real estate investments that it holds, it will not satisfy the "exclusive purpose" requirement. For those pension plans that do acquire assets that are deemed to be a trade or business, careful planning must be undertaken to ensure that they are structured effectively in order to mitigate any tax obligations.

IRC §501(c)(2) also provides that the §501(c)(2) title holding corporation cannot accumulate income at the corporate level and retain its tax-exemption. Therefore, all of the rental income that is received from the operations of the property falls within this category. An IRC §501(c)(2) title holding corporation must distribute all of its income (e.g., rental income), after expenses, as dividends to the shareholder. Proper planning for the payment of property level capital costs, as well as the regular distribution of dividends to the shareholder, must be carefully considered. This trap for the unwary can occur when the title holding corporation retains rental income at the corporate level without making timely distributions to the shareholders.

Further IRC §501(c)(2) dictates that the shareholder must be a tax-exempt entity under IRC §501(a). A taxable entity such as a "C" corporation, or an individual, cannot be the shareholder of a tax-exempt title holding corporation under IRC §501(c)(2), otherwise the title holding corporation cannot obtain a tax exemption.

Trustees need to understand that a pension plan will be taxed on income generated by its investments which are considered to be Unrelated Business Taxable Income ("UBTI") under IRC §512, irrespective of the ownership structure of the investment. UBTI is income derived from any "unrelated trade or business" by a tax exempt entity such as a pension plan. An unrelated trade or business is any business that is not substantially related to the tax exempt entity's tax exempt purpose. Generally, these are businesses that require active management. The IRC excludes most income generated from industrial, office, multi-family and retail real estate investments from the UBTI rules, even though they are actively managed. The UBTI rules are generally designed to inhibit pension plans from acquiring active businesses and competing with taxable investors. In addition to most rental income from industrial, office, multi-family and retail real estate investments, certain interest payments, dividends, annuities, and gains on the sale of investment assets are also excluded from UBTI. Again, it is the general rule that a pension plan must have passive, rather than active, income in order to avoid taxation.

Income derived from the following services involved in the operation of a real estate investment portfolio may constitute UBTI, if the investment is not properly structured:

- Income from laundry facilities in an apartment building
- Concierge service at an office building
- Parking income at office, industrial, retail or other facilities
- Telephone service income
- Maid and janitorial services income
- Security service income
- Recreational facility income
- Advertising income
- Vending machine income

Many pension plans use borrowed funds to acquire real estate assets particularly when market conditions dictate that a positive arbitrage can be created from the leverage. The use of leverage by an IRC §501(c)(2) title holding corporation to acquire a real estate asset will generate UBTI because an IRC §501(c)(2) title holding corporation is not eligible for the exclusion from the debt-financed income rules provided to certain qualified organizations in IRC §514(c)(9).

If UBTI is generated, the pension plan will pay tax on that portion of the income that is considered UBTI. It is important to note that an IRC §501(c)(2) title holding corporation may lose its tax-exempt status completely from the receipt of certain types of UBTI. If an IRC §501(c)(2) entity conducts a trade or business, or receives income from the sale or disposition of property held primarily for sale to customers in the ordinary course business ("Dealer Property"), then the exemption can be lost. The IRS regulations allow a title holding corporation to receive otherwise disqualifying UBTI of up to 10% of its gross income for the tax year without losing its exemption. However, under this "de minimus" rule, such otherwise disqualifying income must be incidentally derived from holding real property.

The tax exempt status of the title holding corporation will not be affected by (i) income that is generated from rent payments on personal property, leased with real property, that is more than ten percent of the total rent for the property, or (ii) income that is generated from a property which uses acquisition indebtedness. However, this income will still be taxable to the §501(c)(2) title holding corporation as UBTI even though there may not be a loss of the tax exemption.

The above discussion provides only a limited overview of UBTI. The UBTI rules are complex and a more detailed discussion is beyond the scope of this article. However, it is important for pension plan trustees and their advisors to carefully review each real estate investment against the backdrop of the UBTI rules.

IRC §501(c)(25) Title Holding Corporations

The IRC §501(c)(25) title holding corporation is different in some respects from the IRC §501(c)(2) title holding corporation. A corporation formed under IRC §501(c)(25) must be organized: (i) for the exclusive purpose of acquiring and holding title to real property; (ii) collecting income from the real property; and, (iii) remitting the entire amount of income from the property (less expenses) to one or more qualified shareholders (which include qualified pension plans). Unlike an IRC §501(c)(2) title holding corporation, a §501(c)(25) title holding corporation may have up to 35 qualified shareholders, but may only hold title to real property. "Real property" includes personal property leased with the real property so long as the rent attributable to such personal property does not exceed 15% of the total rent for the tax year (IRC §501(c)(25)(F)). An IRC §501(c)(25) must hold title to real property directly and may not hold indirect interests such as a mortgage, partnership interest, or an interest as a tenant in common.

To qualify for exemption under IRC §501(c)(25), a title holding corporation must permit its shareholders:

- To dismiss, after reasonable notice, the company’s investment adviser by majority vote of the shareholders; and

- To terminate the shareholders interest by either (or both) selling or exchanging their stock to another qualified organization, so long as the sale or exchange does not increase the number of shareholders above 35, or redeeming their stock with the corporation after the shareholder has provided 90 days notice to the corporation.

An IRC §501(c)(25) title holding corporation is allowed to own the stock of another §501(c)(25) title holding corporation, so long as the parent at all times holds 100% of the outstanding stock of the "qualified subsidiary". This structure can be particularly helpful in limiting the liability of multi-shareholder title holding corporations who desire to acquire and hold multiple real property investments.

A significant advantage to the §501(c)(25) corporation over the §501(c)(2) corporation is the UBTI safe harbor that is provided by IRC §514(c)(9) regarding acquisition indebtedness. This safe harbor exemption allows §501(c)(25) title holding corporations to use leverage when acquiring real estate investments, with some limitations, without generating UBTI. Thus, if leverage is going to be used to acquire an asset, the §501(c)(25) entity is the only appropriate entity to utilize to acquire the asset.

A §501(c)(25) title holding corporation may hold options to purchase real estate provided the options are purchased under a plan to buy the particular property and not for the purpose of option trading. Additionally, a §501(c)(25) title holding corporation can hold reasonable cash reserves sufficient to meet its operating requirements, and initial cash contributions before investing in real estate if these contributions are held for less than a year.

As with the IRC §501(c)(2) title holding corporation, an IRC §501(c)(25) title holding corporation will lose its tax-exempt status if the corporation generates certain types of UBTI. The same de minimus rule and safe harbors discussed previously also apply to protect the tax-exempt status of the §501(c)(25) title holding corporation.

"C" corporations, §501(c)(2) corporations and §501(c)(25) corporations are compared in the following table.

	"C" Corporation	**501(c)(2) Corporation**	**501(c)(25) Corporation**
Number of Shareholder	Unlimited	One	Up to 35
Tax Exempt Status of Shareholder	May mix taxable and tax exempt shareholder	Shareholder must be tax exempt under IRC §501	Shareholder must be tax exempt under IRC §501
Federal Tax on Income of Corporation	Yes	No, if properly formed	No, if properly formed
Dividend Distributions	Can accumulated income	Must distribute income as distributions to tax exempt shareholders	Must distribute income as distributions to tax exempt shareholders
Unrelated Business Taxable Income UBTI	Allowed, no additional tax	Not allowed - taxed	Generally, not allowed. Exception for certain debt

			financed income
Debt	Allowed	Not allowed - UBTI	Allowed under defined circumstances

Formation of a Title Holding Corporation

The cost to form and maintain a §501(c)(2) and/or IRC §501(c)(25) title holding corporation is minimal relative to the overall benefits to be derived from the use of the title holding corporation. However, to ensure the tax benefits and limited liability benefits of a title holding corporation, it is important that the trustees of pension plans work with investment managers who are adept at forming and operating title holding corporations. To form the title holding corporation the investment manager, on behalf of the pension plan, will perform the following tasks:

- Prepare and file Articles of Incorporation in the appropriate state of incorporation;
- Obtain all necessary certificates and other corporate documentation from the state of incorporation;
- File appropriate documents to qualify the corporation to do business in other states where the corporation is doing business, e.g., state in which property is located;
- Prepare all appropriate corporate documents and resolutions electing directors, officers, etc.;
- File appropriate federal and state securities filings, if applicable, as well as IRS and other government filings; and
- Open corporate bank accounts.

In addition to the above, a title holding corporation must submit a completed Form 1024, Application for Recognition of Exemption under IRC §501(a) ("Exemption Application") to the IRS. When the IRS has finalized its review of the Exemption Application, it will provide the corporation with a Determination Letter confirming the tax-exempt status of the corporation. Many states use a similar or abbreviated procedure to obtain the corporation's exemption from state taxes.

Each of these procedures may seem simple, which they are, but there is a great deal of diligence that is required to ensure proper compliance with the corporate format. A good real estate investment manager will work with the legal counsel for the pension plan to properly oversee this on behalf of the pension plan.

Operations of Title Holding Corporations

The operation of a title holding corporation by a pension plan is relatively easy. Every corporation requires officers and directors and must be operated independently from the pension plan that will be the shareholder of the corporation. Generally, trustees or staff members of the pension plan should not serve as directors and officers of the corporation as they will expand their co-fiduciary liability if they do so. Most pension plans hire real estate investment managers to implement their real estate investment strategy. Thus, it is customary for officers and employees of the real estate investment manager to serve as officers and directors of the title holding corporation. As the shareholder of the corporation, the pension plan retains ultimate control of the corporation and the ability to replace the directors and officers of the corporation at any time it sees fit.

Other procedural issues which must be considered include audits of the corporation's financial records, filing of tax returns, preparing financial statements, and the preparation of minutes or written consents for annual shareholders and directors meetings, as well as the ongoing maintenance of the corporate records of the entity. Clearly, each of these matters must be carefully completed to ensure the proper administration of the corporation. Further, title holding corporations should open and maintain separate corporate bank accounts into which all of the income from the real estate is deposited, and from which all of the expenses and distributions are paid. Designated officers of the corporation will have the authority to sign and make all payments from these accounts on behalf of the corporation. All of the net income from the operation of the real estate investments will be distributed as dividends to the pension plan shareholder.

Piercing The Corporate Veil: The Corporate Alter-Ego Doctrine

Generally a corporation is considered to be a separate legal entity, distinct from its individual shareholders, and courts will not hold those stockholders personally liable for the corporation's debts and obligations. It is important to note that while this issue rarely arises trustees, consultant and investment managers must be mindful of the consequences for failing to comply with the corporate formalities.

In certain circumstances, however, a legal rule known as the "Alter-Ego Doctrine" may be applied, whereby the "fiction" of the corporation's "separateness" from its individual shareholders is disregarded, and creditors are permitted to "pierce the corporate veil" to enforce a corporation's debts directly against those individuals. However, this is considered to be a drastic remedy and is seldom granted because the law specifically allows parties to incorporate their business for the purpose of insulating them from the liabilities of their business. Pension plans that form title holding corporations need to be mindful of the ability of creditors to pierce the corporate veil.

The burden of proving and establishing alter-ego liability is on the creditor. The requirements for application of the Alter-Ego Doctrine are two-fold: (1) a "unity of interest" must exist between the corporation and the shareholder such that their separate "personalities" no longer exist; and (2) an "inequitable result" will occur if the corporate "shield" is upheld to protect the shareholder from the corporate liability.

The conditions under which the Alter-Ego Doctrine will be applied vary according to the circumstances of each case, since the doctrine is essentially an equitable one. As to the first requirement, the "unity of interest" between the corporation and the shareholder, a variety of factors is considered to determine whether a separate identity has been established for the corporation. Some or all of the following factors could lead a court to conclude that no separate personality exists between the corporation and its shareholder:

- Commingling of corporate and shareholder funds and other assets;
- Unauthorized diversion of corporate funds or assets to other than corporate uses;
- Failure to obtain authority to issue stock or failure to actually issue stock;
- Failure to maintain minutes or adequate corporate records;
- The disregard of corporate formalities;
- Failure to adequately capitalize a corporation.

In cases where the Alter-Ego Doctrine has been applied, several of the above factors are usually found to exist. Under-capitalization, while an important factor (and in certain cases the most important element) is still merely "a factor to be considered", together with the other criteria.

As to the second requirement, the "inequitable result," something more than the mere existence of an unsatisfied creditor must usually be shown. While the doctrine does not depend on the presence of actual fraud, it is designed to prevent what would constitute a fraud or injustice, if accomplished. Accordingly, bad faith in one form or another is a major underlying consideration. The purpose of the doctrine is not to protect every unsatisfied creditor, but rather to afford that creditor protection where some conduct amounting to bad faith makes it inequitable for the owner of a corporation to hide behind its corporate veil.

Compliance with the corporate formalities is necessary to protect a shareholder from an attack against the corporate veil. The following are the minimum compliance requirements to follow in order to maximize shareholder protection:

- Observe all post-formation corporate formalities, including but not limited to; holding annual shareholders and directors meetings, keeping minutes of such meetings and clear records of all corporate activities, maintaining up-to-date corporate documents at the corporate executive offices, maintaining separateness and arms-length protocols in all corporate dealings, and requiring full disclosure of any conflicting interests and assuring impartial approval of any conflicting transactions either by the directors or the shareholders as appropriate.

- The officers and other authorized persons of the corporation should execute all contracts or other corporate documents, in their corporate capacity, in the corporation's name, rather than in any individual capacity.

- A signature block should be utilized on all corporate documents as follows:

  ABC, Inc.
  By: ___________________________
  John Smith, President

- Corporate funds should never be co-mingled with the funds of the individual shareholders or any other entity involved with the corporation.

- The corporation should maintain separate operations and records from any subsidiaries and its shareholders.

- Obtain insurance, where appropriate, to protect the corporation from typical corporate risks. Insurance should include, at a minimum, general liability insurance, fire and casualty insurance, and insurance to protect the corporation from losses created by certain natural disasters, e.g., earthquake, flood.

- Any required tax payments should be promptly made when due.

Compliance with these rules will protect the pension plan from liability in the event that there are insufficient assets at the corporate level to satisfy the requirements of any uninsured claim.

Conclusion

The use of title holding corporations to hold title to real estate investments of a pension plan is a simple, inexpensive, and prudent method to shield the pension plan from liability. Trustees should be mindful, however, that while it is easy for experienced investment managers and/or legal counsel to form and maintain these entities, the complexity of the IRS regulations could create a trap for the inexperienced. Careful consideration of the issues discussed in this article will assist with the proper implementation of the pension plan's real estate investment strategy.

All trustees of pension plans, and their real estate investment managers, must be mindful that proper ownership structuring of real estate investments is required to maximize investment returns and fully protect pension plan assets from uninsured liability that can arise from the ownership and operation of real estate. The effective use of title holding corporations is one way to shield pension plan assets from these unusual, but catastrophic losses. While it is extremely remote that any liability will arise, it is just prudent, good common sense, and sound planning for pension plans to consider the use of title holding corporations and other limited liability entities when developing their real estate investment strategy.

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