# PART I

# EXEMPT ORGANIZATIONS TECHNICAL TOPICS

## A. TITLE HOLDING COMPANIES

**by**
**Ron Fowler, William W. Miller and Cheryl Chasin**

Introduction

Since 1916 the tax code has provided for exemption of title holding companies. Committee reports reflect that Congress provided for exemption of title holding companies to overcome state law obstacles against the direct holding of title to property by exempt organizations. Title holding companies hold title to property on behalf of other exempt organizations, including pension trusts. One of the major reasons a tax exempt organization forms a title holding company is to protect itself from tort liability.

Currently, title holding companies are recognized as exempt under either IRC 501(c)(2) or under IRC 501(c)(25). IRC 501(c)(2) provides for recognition of exemption of single-parent title holding companies, whereas IRC 501(c)(25) describes multiple-parent title holding companies.

Prior CPE articles on title holding corporations include 1986, Topic C, IRC 501(c)(2) Title holding Corporations; 1989, Topic F, Update on Title holding Organizations; 1995, Topic C, IRC 501(c)(25)(E) – Qualified Subsidiaries; and 1995, Topic D, Update on OBRA '93. The purpose of this article is to update and summarize the information provided in earlier articles, to identify issues arising in current cases, and to compare and contrast the provisions of IRC 501(c)(2) and 501(c)(25).

### Part I - IRC 501(c)(2)

1. Organizational Obligations

IRC 501(c)(2) describes "corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt under this section. Rules similar to the rules of subparagraph (G) of paragraph (25) shall apply for purposes of this paragraph." The first sentence of this paragraph is substantially the same as the initial enactment in the Revenue Act of 1916. The second sentence, which permits receipt of otherwise disqualifying unrelated business income incidentally derived, was added in 1993 by P. L. 103-66.

The regulations under IRC 501(c)(2) deal largely with various issues related to unrelated business income of title holding corporations. Reg. 1.501(c)(2)-1(a) notes that since a corporation described in section 501(c)(2) cannot be exempt if it engages in any business other than that of holding title to property and collecting income therefrom, it cannot have unrelated business taxable income as defined in section 512 other than certain special categories of unrelated business taxable income. The regulations, however, have not been updated to reflect the statutory changes in the second sentence of IRC 501(c)(2). There are, therefore, additional exceptions to the more general prohibition on unrelated business income. These exceptions are discussed in the section of this article dealing with unrelated business income.

Reg. 1.501(c)(2)-1(b) provides that a corporation described in section 501(c)(2) cannot accumulate income and retain its exemption, but it must turn over the entire amount of such income, less expenses, to an organization which is itself exempt from tax under section 501(a).

The statute uses the term "corporation". Under IRC 7701(a)(3), this includes associations. This also includes business or commercial trusts classified as associations. An IRC 501(c)(2) organization cannot be an ordinary trust within the meaning of section 301.7701-4(a).

Organizations seeking exemption under IRC 501(c)(2) must be "organized for the exclusive purpose" of holding title to property and collecting income therefrom. An organization's purposes can be established by reviewing its activities, the actual language in the organizational documents and all events surrounding the incorporation of the organization. Any language in the organizational documents that empowers the organization to engage in any other business would be evidence that the organization was not formed for the "exclusive purpose" required by the statute. In a situation where the organizational documents are outside the purview of the "exclusive purpose" language, but the organization's activities appear to be permissible, the organization will be given an opportunity to amend the language to comply with the statute.

An IRC 501(c)(2) organization does not necessarily have to be a ***nonprofit*** corporation under state law. As long as the organizational documents do not impose any broad powers outside of holding title to property, collecting income, and turning over the income to an organization exempt under section 501(a), the requirements of the section will be satisfied.

Rev. Rul. 58-566, 1958-2 C.B. 261, describes an organization incorporated under state law with authority to acquire real and personal property; to construct, conduct, and operate buildings of all kinds for the accommodation of the public and of individuals, whether or not such buildings were the property of the organization; to conduct a general real estate business; to buy, sell, deal and trade in mortgages on or interest in real estate; and to acquire, deal in, pledge and dispose of shares of the capital stock, other securities, obligations and evidences of indebtedness issued by any corporations, syndicates, associations, firms, trusts or persons, public or private. The ruling concluded that that the corporation was not organized for purposes specified in section 501(c)(2) of the Code since its broad powers and business purposes are far beyond the scope necessary to a holding company.

2. Permitted Parents

The phrase "under this section" in IRC 501(c)(2) refers to organizations exempt under IRC 501(a) and therefore includes pension trusts described in IRC 401(a) and exempted by 501(a). Thus, a pension trust is an acceptable recipient for the income of an IRC 501(c)(2) organization. Also, a 501(c)(2) organization is itself an acceptable parent for another 501(c)(2) organization; see Rev. Rul. 76-335, 1976-2 C. B. 141.

The following GCM illustrates one application of this principle. GCM 38253 (dated January 23, 1980) involved a title holding company whose sole shareholder was an IRC 401(a) group trust recognized as exempt under IRC 501(a). The trust was composed of and controlled by eleven other pension and profit sharing trusts that were all exempt under IRC 401 and IRC 501(a). The title holding company and group trust were both created by a for-profit corporation that provided investment advice, handled the acquisition of real property and provided property management services. An agreement called the Group Trust Agreement existed which stated that the purpose of the Group Trust is to provide the individual investor-trusts with a medium for the pooling of their property in order that these funds may be economically diversified and thereby increase the ability of the individual investor-trusts to carry out their purposes. The GCM concluded that a corporation could be recognized as exempt under IRC 501(c)(2) when a group trust owns the corporation's common stock because the group trust itself constitutes a single tax-exempt parent.

Although it may seem obvious that the parent must maintain its exemption for the title holding corporation to continue to qualify, this specific issue was considered in Rev. Rul. 68-371, 1968-2 C.B. 204. This revenue ruling described a situation in which a title holding corporation was organized and operated for the exclusive purpose of holding title to real property, collecting income therefrom, and turning over the entire amount thereof, less expenses, equally to two organizations that were exempt under IRC 501(a). At the end of the third year of operation of the title holding corporation, one of the organizations to which it was required to make distributions of income ceased to qualify for exemption under IRC 501(a). However, the title holding corporation continued to make distributions of income to both organizations. This ruling concluded that after the third year of operation, the title holding corporation did not comply with the statute because it did not turn over its entire income less expenses to organizations exempt under IRC 501(a), since one of the two organizations to which it distributed its income had ceased to qualify for such exemption. Therefore, the title holding corporation did not continue to qualify for exemption beyond its third year of operation.

In Rev. Rul. 68-371, the title holding corporation had two parents. However, the revenue ruling should not be interpreted as permitting multiple unrelated parents. It is not clear from the facts as stated in the ruling what relationship, if any, existed between the two parents, or whether the two parents occupied the property in question. See the discussion of GCM 37351, below.

What if the parent is a church or a pre-1969 organization excepted from the requirement that it apply for tax exemption? We cannot require an organization to formally apply for exemption if it is otherwise specifically excepted from the requirement. However, we would need to secure sufficient information regarding the parent to determine that it would qualify for exemption if it applied. If the parent is not excepted from the application requirement, or it claims exemption under a Code section other than IRC 501(c)(3), it should be required to demonstrate that it has received a favorable ruling or determination letter.

3. Required Relationship

The statute does not specify the relationship required between a title holding corporation and the exempt organization receiving its income. Traditionally, the relationship is parent and subsidiary, i.e. the exempt organization owns the title holding corporation.

This traditional view was made explicit in Rev. Rul. 71-544, 1971-2 C.B. 227. In that case, a group of philanthropists organized a non-profit corporation to which they transferred income-producing stocks and securities. The purpose of the organization was to hold title to stocks and securities and at the end of each year to turn over its income, less expenses, to an exempt organization selected by its board of directors. The stock of the title holding corporation was owned by the group of philanthropists. The stock conferred no rights on the shareholders to receive dividends or to participate in liquidating distributions. The ruling invoked the Cambridge doctrine to conclude that Congress intended that a relationship similar to that of a parent and subsidiary exist between an exempt organization and its title holding corporation. [Note: The "Cambridge doctrine" is a basic rule of statutory construction, under which Congress is presumed to have employed words according to their legal significance at the time of the enactment of the particular provisions in which they are used. U.S. v. Cambridge Loan and Building Company, 278 U.S. 55 (1928)]

Control by the same individuals who control the exempt parent would also appear to be permissible. In Rev. Rul. 68-222, 1968-1 C.B. 243, a stock corporation was organized and operated for the purpose of holding title to a chapter house of a college fraternity exempt under IRC 501(c)(7). The stock of the corporation was owned by the members of the fraternity, who had no rights to receive profits. The ruling concluded that the ownership of the stock by the fraternity's members did not preclude exemption under IRC 501(c)(2) provided all the income, less expenses, would be paid over to the fraternity.

4. The Multiple Parent Maze

GCM 37351 (dated Dec. 20, 1977), considered the circumstances in which an IRC 501(c)(2) organization could have multiple parents. In this GCM, the title holding corporation was organized and incorporated by employees of a real estate investment fund to operate as a closed end real estate investment trust in which exempt organizations, primarily employee benefit pension trusts under IRC 401(a), would be solicited to engage in investments. The employees of the Fund personally solicited the management of qualified employee pension trusts to purchase or subscribe to the shares of the Fund. Once the required number of shares was issued, the Fund sought to purchase improved real estate property, including office buildings, shopping centers, and light industrial and warehouse properties. Income from the rental of the real property was paid to the Fund's shareholders.

The Service concluded that a corporation whose stock was owned by several unrelated exempt organizations was not a title holding company within the meaning of IRC 501(c)(2) because the multiple parents evidenced pooling of assets for a cooperative venture, which altered the fundamental character of the corporation from mere holding title to property on behalf of a charitable organization to the active conduct of a trade or business. Consequently, the purpose of the organization and the end to which its resources were dedicated was the conduct of investment activities and the maximization of gains and profits for the financial benefit of the investing charities, not as beneficiaries of a charity or charitable trust, but as owners and investors. Therefore, the title holding company was being used for purposes not contemplated by Congress.

This GCM also discussed exceptions to the general rule that an IRC 501(c)(2) organization may have only one parent. Multiple parents may be allowed if related organizations create a title holding company to hold title to a building used at least in part by the organizations themselves. Multiple parents may also be allowed when unrelated organizations that jointly own real property used in part by such organizations transfer their interests in this property to a title holding corporation they create.

GCM 39460 (dated September 12, 1985) described another multiple parent situation. In this case, five hospitals, all exempt under IRC 501(c)(3), created a title holding corporation to hold shares of stock in a company which reinsured various types of insurance. The hospitals were all members of a 501(c)(6) organization. The GCM concluded that this common membership was not a relationship that would bring the title holding corporation within the limited exception discussed in GCM 37351. The second exception, regarding jointly owned real property, likewise did not apply because the property transferred to the title holding corporation was stock, not real property.

5. Permissible Property and Allowable Activities

The statutory language makes clear that IRC 501(c)(2) organizations are strictly limited to holding title to property and collecting the income therefrom. They generally may not, with certain exceptions discussed below, have income from an unrelated trade or business. Investments in stocks, bonds, certain types of oil and mineral interests, and real estate are all traditional and generally permissible sources of income for IRC 501(c)(2) organizations. A title holding corporation may also hold an interest in a limited partnership, but see the discussion of GCM 39597, below.

Permitting title holding corporations to invest in real estate implies that they can earn income by renting this real estate to the general public. Rev. Rul. 69-381, 1969-2 C.B. 113, describes a corporation that holds title to a building containing offices that are rented on annual leases to the general public. It collects the rents, pays the expenses incident to operation and maintenance of the building, and turns over the remainder to its parent, a charitable organization exempt from Federal income tax under section 501(c)(3) of the Code. The title holding company renders no substantial services to the tenants other than normal maintenance of the building and grounds. The tenants are not related in any way to the title holding company or the charitable organization for which it holds title. The revenue ruling concludes that income from renting offices to the general public does not preclude exemption under IRC 501(c)(2). Under the facts stated, this organization qualifies for exemption from Federal income tax under IRC 501(c)(2). Note that the title holding corporation itself collected the rent, paid the expenses, and provided normal maintenance services. There is no requirement that a title holding corporation hire a management company to carry out these activities.

Regarding oil and mineral interests, only non-working interests are permitted. A working interest, in which the holder of the interest is responsible for a portion of the operating costs of oil or mineral production, is not a permissible holding for a 501(c)(2) organization. See Rev. Rul. 66-295, 1966-2 C. B. 209.

Renting personal property independent of real estate has consistently been treated as the conduct of a trade or business. Rev. Rul. 69-278, 1969-1 C. B. 148, describes a title holding corporation renting real estate and trucks under separate, unrelated leases. There was no direct relation between the rental of the building and the rental of the trucks, even though the lessees were the same. The income from truck rentals was a substantial part of the title-holding corporation's net earnings. The title holding corporation did not qualify for exemption because it was engaged in the business of renting personal property.

However, even an otherwise permissible activity such as renting real property to the general public is not allowed if the activity could not be carried on by the title holding corporation's exempt parent. In *U.S. v. Fort Worth Club of Fort Worth, Texas*, 345 F. 2d 52, modified and reaffirmed 348 F. 2d 891 (1965), the 5th Circuit Court of Appeals upheld the revocation of the Club's exemption under IRC 501(c)(7). The Club created a wholly-owned subsidiary to hold title to its building. The Club used seven of the thirteen floors for its social activities. The remaining floors were leased to commercial tenants, from which activity the Club derived a substantial amount of income. The court concluded that the Club was not exempt because it derived "substantial and recurrent profit from a business altogether unrelated to its activities as a social club."

Because its activities must consist solely of holding title to property and collecting income therefrom, a title holding corporation generally cannot have unrelated business taxable income. However, Reg. 1.501(c)(2)-1(a) provides certain exceptions. Further, as noted above, the regulation has not been updated to reflect the liberalization in the rule for otherwise disqualifying unrelated business income, incidentally derived, in the second sentence of IRC 501(c)(2). These provisions, however, refer only to the effect on the title holding corporation's exemption. They do not affect the taxability of the income in question. If a title holding corporation has unrelated business income from sources other those described below, it does not qualify for exemption under IRC 501(c)(2).

The first exception is for income taxable solely because of IRC 512(a)(3)(C). This section describes title holding corporations whose exempt parents are described in IRC 501(c)(7), (c)(9), (c)(17), or (c)(20) and are subject to the special rules of IRC 512(a)(3), which treat all non-member income as taxable. [Note: IRC 501(c)(20) has expired. However, IRC 512(a)(3) has not been amended to remove the reference to IRC 501(c)(20).] Such a title holding corporation is therefore taxable on income (such as investment income) it receives from non-member sources. Absent the exception in Reg. 1.501(c)(2)-1(a), such a title holding corporation could never qualify for exemption. However, if the title holding corporation's gross receipts, combined with a 501(c)(7) parent's other non-member gross receipts, exceed the 35% limit, the parent will no longer qualify for exemption.

The second exception is for debt-financed income taxable solely because of IRC 514. Such income, while still taxable, will not cause the loss of the title holding corporation's exemption. Note that indebtedness owned by the title holding corporation to its exempt parent is not acquisition indebtedness for purposes of IRC 514 (see Rev. Rul. 77-72, 1977-1 C.B. 157). However, the exclusion from acquisition indebtedness set forth in IRC 514(c)(9) does not apply to IRC 501(c)(2) organizations even if the 501(c)(2)'s parent is a qualified organization for purposes of IRC 514(c)(9). See the discussion in the second part of this article with respect to IRC 501(c)(25) for further details.

The third exception is for investment income taxed solely because of IRC 512(b)(3)(B)(ii). This section pertains to income from leases where the amount of the rent depends on the net income or profits from the leased property. Note that a lease based on a fixed percentage of *gross* receipts or sales does not result in taxable income.

The fourth exception is for investment income taxed solely by reason of IRC 512(b)(3). This section pertains to interest, annuities, royalties, and rents received from controlled entities.

The fifth category of exceptions deals with rents received from personal property *leased with* real property. IRC 512(b)(3)(A)(ii) excludes from the definition of unrelated business income rents from personal property leased with real property if the amount of the rent attributable to the personal property is incidental compared to the total rent received. "Incidental" here means 10% or less of the total rent. If the rent allocated to the personal property exceeds 10% of the total, then it is taxable as unrelated business income. A title holding corporation can receive this type of unrelated business income without jeopardizing its exemption.

Similarly, IRC 512(b)(3)(B)(i) provides that if personal property is leased in connection with real property and more than 50% of the rent is attributable to the personal property, *all* the rental income (not just the portion attributable to personal property) is taxable as unrelated business income. A title holding corporation can also receive this type of unrelated business income without jeopardizing its exemption.

A final permissible form of unrelated business income for title holding corporations was established by the amendment of IRC 501(c)(2) in 1993 by the Omnibus Budget Reconciliation Act (OBRA). For tax years beginning on or after January 1, 1994, a title holding corporation may receive up to 10% of its gross income from unrelated business income incidentally derived from the holding of real property without jeopardizing its exempt status. Examples of the type of income referred to include income from vending machines, laundry facilities, and parking facilities. This income *remains taxable*, but will not result in the loss of exemption. See the second sentence of IRC 501(c)(2) and the section to which it refers, IRC 501(c)(25)(G), added by P.L. 103-66, section 13146(b).

The rulings regarding permissible unrelated business income are more complex when a title holding corporation owns an interest in a partnership. In GCM 39597 (June 17, 1986), the Service considered the exempt status of a title holding corporation whose sole property consisted of a limited partnership interest in an investment partnership. In the year under consideration, the investment partnership received approximately 3% of its income from activities other than trading for its own account. The GCM concluded that each of these activities was an unrelated trade or business, under the general definition of the term, with respect to the title holding corporation. None of the income flowing from these activities to the title holding corporation was unrelated business income described in Reg. 1.501(c)(2)-1(a). The GCM declined to allow a *de minimis* exception, and exemption under IRC 501(c)(2) was precluded. This holding would not change as a result of the OBRA amendment of IRC 501(c)(2) because the income in question here is not incidental to the rental of real property.

GCM 39597 goes on to say that absent the prohibited unrelated business income, the title holding corporation would qualify for exemption. Though IRC 512(c) uses the partnership's activity to determine the character of income at the partner level, it does not impute the partnership's activity to the individual partners. In the case of a limited partner who has no management role in the partnership and whose status is solely that of an investor, exempt status under IRC 501(c)(2) is appropriate.

## 6. Distributions Demanded

Reg. 1.501(c) (2)-1(b) states that a corporation described in IRC 501(c)(2) cannot accumulate income and retain exemption, but must turn over its entire income, less expenses, to an organization exempt under section 501(a). The timing of this distribution is not defined in the Code or regulations. As a practical matter, it would seem reasonable to allow the title holding corporation until the end of the succeeding taxable year to make the distribution. Such a rule of thumb would provide ample time for normal accounting and other administrative procedures by the title holding corporation. The form of the distribution is not important, but payment must actually be made, not merely accrued. Allowing the parent rent free use of the facilities is also a permissible form of distribution.

In computing the amount required to be distributed, the title holding corporation may deduct operating expenses that would be deductible by a taxable corporation. This includes a reasonable allowance for depreciation as discussed in Rev. Rul. 66-102, 1966-1 C.B. 133 and payments to retire indebtedness as discussed in Rev. Rul. 67-104, 1967-1 C. B. 120.

7. How Not to Structure a Title Holding Corporation

M Realty Corporation's articles of incorporation stated that the organization was formed to "take, buy, purchase, exchange, hire, lease or otherwise acquire real estate and property, either improved or unimproved, and any interest or right therein, and to own hold, control, maintain, manage and develop the same." The shares of stock in M were held by three organizations: a church, an association and a community center. The community center was organized before 1969. The association was exempt under IRC 501(c)(4). Neither the church nor the community center had applied for or received recognition of exempt status. No information was provided as to any relationships among the three parent organizations.

The property held by M consisted of real property and investments in stocks and bonds. The primary source of income consisted of the rental of real property. The property was 100% occupied and rented by commercial and residential tenants unrelated to M or M's parents.

For the three years for which financial information was provided in M's application for exemption, M had net income of approximately $100,000, $230,000, and $210,000. In each year, M paid approximately $5,000 to each of its parent organizations. These distributions were characterized as charitable contributions. These distributions amounted to 1%, 6% and 7% of M's net income for those years.

First, in analyzing this case, M's articles of incorporation provided, in part, that it will manage and develop property. These purposes are not limited to holding title to property, collecting income therefrom and turning over the net income to a qualified shareholder. M does not meet the organizational requirements of IRC 501(c)(2) because it was incorporated with broad powers and business purposes far beyond the scope necessary to a title holding company. Compare the language to that used in Rev. Rul. 58-566, discussed above.

M failed to turn over its income less expenses to organizations exempt under IRC 501(a). The financial information submitted indicated that M distributed only $5,000 to each shareholder for each year in question. These amounts were not sufficient so as to be classified as income distributions. Moreover, M had substantial accumulated retained earnings of $2,700,000. These accumulated earnings demonstrate the non-distribution of net earnings from operations in prior years.

It appears that the parent organizations in M’s case may be related, although the point is not certain. However, M's real property is not used by the parent organizations in their exempt activities, and M also holds stocks and bonds. Thus, M does not fall within either of the narrow exceptions to the rule against multiple parents discussed in GCM 37351, above.

Finally, two of M's three parents, the church and the pre-1969 community center, do not have favorable ruling or determination letters. While they are excepted from the filing requirements imposed by IRC 508, it would still be necessary for M to provide enough information to establish that they are described in IRC 501(c)(3) before M could receive a favorable ruling under IRC 501(c)(2).

**Part II - IRC 501(c)(25)**

IRC 501(c)(25), subparagraphs (A) through (D), was enacted in the Tax Reform Act of 1986 by P. L. 99-514, section 1603, and was modified by the Technical and Miscellaneous Revenue Act of 1988, P. L. 100-647, section 1016(a), modifying IRC 501(c)(25)(A) and (D) and adding IRC 501(c)(25)(E) and (F). Finally, IRC 501(c)(25) was amended last in 1993 in the Omnibus Budget Reconciliation Act, P. L. 103-66, section 13146, which added IRC 501(c)(25)(G).

In enacting IRC 501(c)(25), Congress allowed certain pension trusts, governmental entities and IRC 501(c)(3) organizations wider latitude to pool their resources in their real property investments than permitted for IRC 501(c)(2) title holding companies. Even though the purpose of IRC 501(c)(25) was to recognize title holding companies with multiple parents as exempt from federal tax, the vast majority of IRC 501(c)(25) applicants have a single parent. Although no regulations have been issued under this Code section, the Service has published Notice 87-18, 1987-1 C.B. 455 and Notice 88-121, 1988-2 C.B. 457 to provide guidance in this area. Notice 87-18 essentially requires that most of the statutory requirements be included in the title holding company's organizing document. Notice 88-121 clarified permissible holdings and unrelated business income issues. The provisions of both Notices will be discussed in detail in the appropriate sections of this article.

1. Organizational Obligations

IRC 501(c)(25)(A) describes multiple-parent title holding companies that are either corporations or trusts (unlike IRC 501(c)(2) title holding companies, which may not be ordinary trusts) that have no more than 35 shareholders or beneficiaries, have only one class of stock or beneficial interest, and are organized for the exclusive purposes of acquiring, holding title to, and collecting income from, real property, and remitting the entire amount of income from such property (less expenses) to one or more organizations described in section 501(c)(25)(C) which are shareholders or beneficiaries of title holding companies. Notice 87-18 requires that language satisfying these requirements be included in the title holding company's organizing document. Although an IRC 501(c)(25) title holding company may be a trust, such entities are rare. In the remainder of this article we will refer to corporations, but keep in mind that trusts are included as well.

Many IRC 501(c)(25) applicants are formed under general corporation laws and are not nonprofit corporations. In fact, given the language in the statute and the two notices dealing with "shareholders," it would seem logical that such organizations would generally be for-profit corporations. However, as long as the organizational requirements are met, it does not matter what type of corporation is used. For non-stock corporations the term "member" is used and is considered synonymous with "shareholder." A section 501(c)(25) organization may be organized as a nonstock corporation if its articles of incorporation or bylaws provide members with the same rights as required by Notice 87-18.

If state law prevents a corporation from including the required language in its articles of incorporation, the corporation must include such language in its by-laws. Such a state law restriction is the only permissible basis for not including the required language in the articles. See Exhibit 1 for sample articles of incorporation that meet the requirements of IRC 501(c)(25).

IRC 501(c)(25)(B) provides that a title holding company need not be organized by one or more organizations described in IRC 501(c)(25)(C). That is, as long as the shareholders are described in IRC 501(c)(25)(C), it does not matter who organized or incorporated the title holding company. In fact, most 501(c)(25) title holding companies are organized by real estate investment management firms as Delaware business corporations.

IRC 501(c)(25)(D) provides that an organization shall not be treated as a title holding company described in IRC 501(c)(25)(A) unless it permits its shareholders or beneficiaries (i) to dismiss its investment adviser, and (ii) to terminate their interest in the organization by selling or exchanging their stock in the title holding company to any organization described in section 501(c)(25)(C) so long as the sale or exchange does not increase the number of shareholders or beneficiaries in such title holding company above 35, or by having their stock or interest redeemed by the title holding company after the shareholder or beneficiary has provided 90 days notice to the title holding company. Again, Notice 87-18 requires that these provisions be included in the title holding company's organizing document.

2. Permitted Parents

Congress capped the number of shareholders or beneficiaries of an IRC 501(c)(25) title holding company at 35. The committee hearings reflect that the reason for the cap was to ensure that the group of owners is sufficiently small to actually control the title holding company rather than allowing the investment advisor to control the title holding company.

IRC 501(c)(25)(C) provides that all shareholders of an exempt title holding company must be (i) a qualified pension, profit sharing, or stock bonus plan that meets the requirements of section 401(a); (ii) a governmental plan (within the meaning of section 414(d); (iii) the United States, any State or political subdivision thereof, or any agency or instrumentality of any of the foregoing; or (iv) any organization described in IRC 501(c)(3). Each of these is described in more detail below. In contrast to IRC 501(c)(2), most types of 501(c) organizations are ***not*** eligible shareholders for a 501(c)(25) organization.

A. Pension Plans

An applicant organization seeking exemption under IRC 501(c)(25) may have as a shareholder a qualified pension, profit sharing, or stock bonus plan within the meaning of IRC 401(a) of the Code and exempt under IRC 501(a). To establish that its shareholder is described in IRC 501(c)(25)(C)(i), the applicant should submit a copy of the shareholder's determination letter. Two types of entities frequently encountered in this area which require some additional explanation are master trusts and group trusts.

A master trust is established for the purpose of investing and administering the assets of its constituent plans, which may be pension plans described in IRC 401(a). A master trust is not itself a pension plan and therefore will not have a determination letter from the Service. Thus, it would appear that a master trust is not a permissible shareholder under IRC 501(c)(25). However, if each of a master trust's constituent plans has a determination letter establishing that it is described in IRC 401(a) we can look through to such letters to establish that the master trust is an entity described in IRC 501(c)(25)(C)(i).

A master trust must be the trust for each constituent plan. There may not be any intervening trusts between the plans and the master trust. We must obtain a copy of the master trust's trust document to establish that the master trust is the trust for each constituent plan. The trust indenture will identify each of the plans covered by the master trust. Also, a copy of the determination letter issued to each of the constituent plans should be submitted. We must also get a statement from the applicant organization that the master trust's constituent plans have no intervening trusts, and do not contain provisions for individual retirement accounts (IRAs). IRAs are exempt pursuant to IRC 408(c), not IRC 401(a), and thus are not permitted parents.

The following language is included in all exemption letters issued to section 501(c)(25) applicant organizations that have master trusts as their sole shareholder:

> *More specifically, this ruling is based on your representation that the constituent Plans are named in the trust indenture establishing the Master Trust, which is your sole shareholder, and that all the constituent Plans are described in section 401(a) of the Internal Revenue Code and are exempt under section 501(a) of the Code. Furthermore, this ruling is based on your representations that the Plans have no intervening trusts, and do not contain provisions for individual retirement accounts. However, this letter should not be construed as a ruling on the status of the Plans and the Master Trust under sections 401(a) and 501(a) of the Code.*

In some cases, an applicant organization may have a group trust, rather than a master trust, as its shareholder. There is a significant difference in the operations of a group trust and a master trust. A master trust is the trust for each of its constituent plans, while there are intervening trusts between the group trust and its constituent plans.

A group trust is specifically described in Rev. Rul. 81-100, 1981-1 CB 326. Because the Employee Plans Division determines whether a trust is a group trust within the meaning of Rev. Rul 81-100, the applicant organization must furnish a letter from the Service verifying that its shareholder is a group trust. If the group trust does not have such a ruling letter, the applicant organization should be afforded sufficient time for the group trust to apply for and receive such a ruling.

B. Governmental Plan

An organization may have an IRC 414(d) governmental plan as its shareholder. An IRC 414(d) governmental plan is a plan established and maintained for its employees by the Government of the United States, by the government of any state or political subdivision thereof, or by an agency or instrumentality of any of the foregoing. The term "governmental plan" also includes any plan to which the Railroad Retirement Act of 1935 or 1937 applies and which is financed from contributions required under the Act, and any plan of an international organization that is exempt from taxation by reason of the International Organizations Immunity Act.

The applicant organization should be requested to furnish a copy of the letter issued to its shareholder recognizing it as a governmental plan within the meaning of IRC 414(d). However, many governmental plans do not request or receive determination letters. These governmental plans are usually created by state or local law. Even though an applicant cannot furnish a determination letter, the applicant may be able to establish that its shareholder is a governmental entity within the meaning of IRC 501(c)(25)(C)(iii) by furnishing a copy of the statute creating the retirement plan as discussed more fully below.

C. Governmental Entities

A governmental entity within the meaning of IRC 501(c)(25)(C)(iii) may be a qualified shareholder of an IRC 501(c)(25) title holding company. The term governmental entity includes the United States, any State or political subdivision thereof, or any agency or instrumentality of any of the foregoing. The term also includes a corporation organized under an Act of Congress and exempt under IRC 501(c)(1) and entities that have a ruling recognizing them as governmental entities within the meaning of IRC 115. Hospital boards, boards of regents, and retirement plans of states, cities, towns, and counties may be more difficult to verify as being agencies and instrumentalities of governmental entities. In such cases, we request copies of the statute creating the entity to see if the statute establishes it as a governmental agency or entity.

D. IRC 501(c)(3) Organizations

An organization seeking exemption under IRC 501(c)(25) may have as its shareholder an organization described in IRC 501(c)(3). Note that unlike IRC 501(c)(2), no other type of 501(c) organization is a permissible parent. A copy of the determination letter issued to the applicant's shareholder must be submitted, or the shareholder sufficiently identified so the Service can determine its exempt status under IRC 501(c)(3).

Organizations formed before 1969 and churches are not subject to the application requirements of IRC 508 and may not have ever applied for and received a determination letter. As discussed above in connection with IRC 501(c)(2) applications, sufficient information must be obtained to establish that the shareholders would qualify for exemption if they applied.

However, if an organization is currently seeking exemption under IRC 501(c)(3), and is simultaneously creating an IRC 501(c)(25) title holding company, there may be operational problems with respect to both organizations. Careful consideration should be given to exemption applications covering this type of situation. See Exhibit 2.

3. Required Relationship

As discussed in the first half of this article, IRC 501(c)(2) does not explicitly state the relationship required between a title holding company and its parent, although Service position has long been that some element of control of the title holding company by its parent is necessary. In contrast, IRC 501(c)(25) explicitly requires control by the organizations to which income is turned over.

4. Permissible Property and Allowable Activities

With a few exceptions, discussed below, IRC 501(c)(25) organizations may own only real property. Congress also narrowed the definition of "real property" for IRC 501(c)(25) purposes by excluding any interest as a tenant in common (or similar interest), or any indirect interest. Thus, an IRC 501(c)(25) title holding company must own its real property solely and directly, and not through an interest in a partnership, trust, or corporation. Except as discussed below in connection with qualified subsidiaries, it may not own stock in other corporations.

Nothing in the statute or either of the Notices requires a title holding company to use a property management firm to manage its real estate holdings, although it is permissible to do so. By analogy to Rev. Rul. 69-381, discussed in the first half of this article, the use of the language in the statute regarding collecting income and turning over income, less expenses, implies that it is permissible for the title holding company itself to collect the income and pay the expenses, including those expenses for normal maintenance of the building and grounds.

IRC 501(c)(25)(F) provides that for purposes of subparagraph (A), the term "real property" includes any personal property which is leased under, or in connection with, a lease of real property, but only if the rent attributable to such personal property (determined under the rules of section 856(d)(1)) for the taxable year does not exceed 15 percent of the total rent for the taxable year attributable to both the real and personal property leased under, or in connection with, such leased property. This provision permits, for example, the lease of office furniture as part of a lease for office space.

Notice 88-121 clarifies that an IRC 501(c)(25) organization may not be organized for the purpose of holding interests in partnerships or real estate investment trusts or for the purpose of making mortgage loans. However, an IRC 501(c)(25) organization may acquire options to purchase real estate, provided the options are purchased with the intent to purchase particular real estate and not for the purpose of option trading.

Notice 88-121 also provides that an IRC 501(c)(25) organization may hold reasonable cash reserves sufficient to meet its operational needs. Reserves are considered reasonable if initial subscriptions are held for less than one year before investment in real estate. The reserves must be held in cash, or in short term investments such as certificates of deposit, bankers' acceptances, interest-bearing savings accounts, commercial paper, government obligations, and shares in money market funds. Investments will not be considered short term if the period to maturity exceeds 91 days.

A. Qualified Subsidiaries

As noted above, 501(c)(25) title holding companies generally may not own stock, as stock is not real property. The sole exception to this rule is IRC 501(c)(25)(E), which permits a title holding company to own stock in a qualified subsidiary. As originally enacted, IRC 501(c)(25) included 501(c)(25) title holding companies in the category of permissible parents for other 501(c)(25) organizations. The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) eliminated this provision and replaced it with that permitting qualified subsidiaries.

IRC 501(c)(25)(E)(i) provides that a corporation that is a qualified subsidiary is not treated as a separate corporation for tax purposes. All assets, liabilities, and items of income, deduction, and credit of a qualified subsidiary are treated as assets, liabilities, etc., of the IRC 501(c)(25) parent. As a qualified subsidiary is not treated as a separate entity for federal tax purposes, it does not have its own employer identification number. A qualified subsidiary does not file a separate Form 990 or other federal tax or information return. Because a qualified subsidiary is not treated as a separate entity for tax purposes, the Service does not issue a ruling to a qualified subsidiary recognizing it as such. However, to meet the requirements of some state tax authorities that a qualified subsidiary have its own exemption letter to qualify for exemption from state tax, the Service will issue a ruling to the IRC 501(c)(25) parent that its subsidiaries are qualified subsidiaries under IRC 501(c)(25)(E). See Exhibit 3.

IRC 501(c)(25)(E)(ii) provides that the term "qualified subsidiary" means any corporation if, at all times during the period of its existence, the IRC 501(c)(25) parent held 100 percent of its stock. Thus, an IRC 501(c)(25) parent cannot acquire a pre-existing corporation from the pre-existing corporation's shareholder, unless that shareholder is also an IRC 501(c)(25) organization. A qualified subsidiary must be a subsidiary of a

501(c)(25) organization, not a direct subsidiary of a pension plan or other permissible 501(c)(25) shareholder.

An IRC 501(c)(25) parent may have more than one qualified subsidiary. The statute contains no express limit on the number of qualified subsidiaries a parent may own directly.

A qualified subsidiary must comply with all rules of IRC 501(c)(25) for the parent to retain exemption. The activities of the qualified subsidiary are considered along with the other activities of the parent (and any other qualified subsidiaries). If, for example, a qualified subsidiary received unrelated business taxable income from parking, and such income was incidentally derived from its holding of real property, but did not exceed 10% 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 501(c)(25). Also, 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 a 501(c)(25) title holding company.

If a qualified subsidiary conducted an unrelated trade or business, that was not incidental to its holding of real property, the activity would not 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 501(c)(25)(G)(ii) were satisfied).

IRC 501(c)(25)(E)(iii) provides that if a corporation which was a "qualified subsidiary" ceases to meet the requirements of IRC 501(c)(25)(E)(ii), it is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) from its IRC 501(c)(25) parent immediately before the date it ceased to be a "qualified subsidiary" in exchange for its stock. When a qualified subsidiary becomes disqualified, the rules set out in IRC 337(d) should be considered, along with the rules governing corporate reorganizations set out in Part III of subchapter C, IRC 351 et seq.

B. Qualified Subsidiaries -- Example

X is a state retirement board, and is a permissible parent under IRC 501(c)(25)(C). X is the sole shareholder of several corporations, S1 through S5, each of which owns a single piece of real property. X requests a ruling that S1, S2, S3, S4, and S5 are qualified subsidiaries.

The corporations (S1 through S5) cannot be qualified subsidiaries because X is not itself a 501(c)(25) organization. As X now owns their stock, they can never comply with the requirement that at all times their stock has been owned by a 501(c)(25) organization. S1 through S5 may, however, be able to qualify for exemption under IRC 501(c)(25) if they otherwise meet the requirements of the statute.

C. Unrelated Business Income

Generally, the receipt of unrelated business income by an IRC 501(c)(25) title holding company will subject it to loss of exempt status because a title holding company cannot be exempt from taxation if it engages in any business other than that of holding title to real property and collecting income therefrom. Income derived 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. The exceptions to this general rule are even more limited than those discussed in the first half of this article with respect to IRC 501(c)(2).

As discussed above, IRC 501(c)(25)(F) treats as real property a limited amount of personal property that is leased with real property. For example, office furniture could be leased with office space. This exception applies only so long as the rent attributable to the personal property does not exceed 15% of the total rent. However, the definition of real property contained in IRC 501(c)(25)(F) does not apply for purposes of other Code sections. Consequently, income amounts attributable to personal property that are acceptable for purposes of IRC 501(c)(25)(A) and (F) could result in unrelated business taxable income under the provisions of IRC 512(b)(3)(A)(ii), or under the provisions of IRC 512(b)(3)(B)(ii).

OBRA amended IRC 501(c)(2) and IRC 501(c)(25) through the enactment of IRC 501(c)(25)(G). IRC 501(c)(25)(G) allows IRC 501(c)(2) and IRC 501(c)(25) organizations to receive unrelated business income of up to 10 percent of their gross income, provided that the unrelated business income is incidentally derived from the holding of real property. Examples of incidentally derived income are parking revenue and income from vending machines. Income from manufacturing, for example, would not be considered incidental to the holding of real property.

IRC 501(c)(25)(G)(i) is not an exclusion from unrelated business income for title holding companies, but is a test in determining whether exemption will be jeopardized. Title holding companies receiving incidentally derived unrelated business income must pay unrelated business income tax on that income.

IRC 501(c)(25)(G)(ii) provides that this limited exception does not apply if the amount of gross income received exceeds 10 percent of the organization's gross income for the taxable year, unless the organization establishes to the satisfaction of the of the Secretary of the Treasury that the excess UBI was inadvertent and reasonable steps are being taken to correct the circumstances giving rise to the excess unrelated business income.

D. IRC 514 – Special Rules

IRC 514(c)(9) provides that, for certain organizations, acquisition indebtedness does not include indebtedness incurred in acquiring or improving certain real property. As noted in the first section of this article, this special rule does not apply to IRC 501(c)(2) title holding companies even if the parent would receive the benefit of this rule if it held the property directly.

To the extent shareholders of an IRC 501(c)(25) title holding company are "qualified organizations" for purposes of IRC 514(c)(9), the title holding company will not be considered to have acquisition indebtedness and income from the property will not be taxable. "Qualified organizations" are schools described in IRC 170(b)(1)(A)(ii), their affiliated IRC 509(a)(3) supporting organizations, and qualified trusts under IRC 401. This difference in the treatment of acquisition indebtedness is probably the most significant reason for the existence of IRC 501(c)(25) title holding companies with single parents.

IRC 514(c)(9)(F) contains rather complicated rules for allocating income and expenses in the case of an IRC 501(c)(25) title holding company with multiple parents, some of whom are qualified organizations. However, since title holding companies with multiple parents are quite rare, implementation of these rules will rarely be necessary.

5. Distributions Demanded

The language of IRC 501(c)(25) with respect to "turning over income" is virtually identical to that of IRC 501(c)(2). Presumably, similar rules apply with respect to allowable deductions and the timing of distributions.

**EXHIBIT 1**

Articles of Incorporation

XYZ Corporation

Article I

The name of the corporation is the XYZ Corporation

Article II

This Corporation is organized under the General Corporation Law of the State of Delaware. The corporation shall have perpetual duration and shall have only one class of stock.

Article III

The Corporation is organized for the exclusive purpose of acquiring, holding title to, and collecting income from real property, and remitting the entire amount of income from such property (less expenses) to one or more organizations described in section 501(c)(25)(C) of the Internal Revenue Code.

Article IV

The Corporation shall have no more than 35 shareholders.

Article V

The Corporation's shareholders shall have the right to dismiss the investment advisor.

Article VI

The shareholder shall have the right to terminate its interest in the corporation by either or both of the following alternatives as determined by the corporation:

> (A) by selling or exchanging its stock in the Corporation to any organization described in section 501(c)(25)(C) so long as the sale or exchange does not increase the number of the Corporation's shareholders above 35, or

(II) by having its stock redeemed by the Corporation after the shareholder has provided 90 days notice to the Corporation.

Article VII

The Corporation shall be governed by a Board of Directors. The exact number of Directors and their method of selection is set out in the bylaws of the Corporation.

Article VIII

The Articles of Incorporation may be amended by an affirmative vote of Directors.

## EXHIBIT 2

Problem

U is a commercial real estate management company. The owners of U have learned that many tax-exempt organizations are unwilling to accept donations of real property because of the practical difficulties in managing or selling such property. The owners of U have therefore created B to accept donations of real property on behalf of various unrelated charities. The owners of U are B's officers and directors. Individual donors will donate real property to B for the benefit of a named charity. The charity will direct B to either sell the property, or to hold it. If the property is sold, the proceeds-, net of any commissions and other fees, will be turned over to the named charity. B has applied for exemption under IRC 501(c)(3).

B has also established Y, a title holding company. It has the same officers and directors as B. Y's sole shareholder will be B. When the unrelated charities wish to retain real property (rather than sell it immediately), it will be transferred to Y. Y will hold the property under a contract with the unrelated charity, collect the income from it, and turn the net income over to B for distribution to the charities. U will provide property management and other services to both B and Y at normal commercial rates. Y has applied for exemption under lRC501(c)(25).

What issues do you see with respect to both B and Y?

Discussion

B's sole activity is providing property management and sales services to unrelated exempt organizations for a fee. Providing such commercial services does not further an exempt purpose, unless the fee charged is substantially below B's costs. Since U is charging normal commercial rates for its services, this test is not met. Furthermore, there is substantial private benefit to U in the form of fees and commissions for its services.

Even if B qualified for exemption under IRC 501 (c)(3), it is unlikely that Y is described in IRC 501(c)(25). First, it is not clear that Y actually holds title to real property. Y's "ownership" of the property is limited by the terms of the contracts with the unrelated charities. For example, Y cannot sell the property absent permission of the charity. Second, the statute clearly requires that Y's shareholders and the recipients of its income be the same organizations. In this case, the ultimate recipients of the income are not shareholders. Although Y's income is passed through B on its way to the ultimate charitable recipients, B has no legal right to keep the income from the property. Finally, it appears that Y's contractual relationships may be a means of avoiding the 35 shareholder limit of IRC 501 (c)(25), since there is no limit on the number of charities on whose behalf Y can hold property.

## EXHIBIT 3

Dear Applicant:

This letter is in reply to your request for a ruling concerning the status, for federal tax purposes, of your qualified subsidiary, [full name of subsidiary].

Your exemption as a title-holding corporation under section 501(c)(25) of the Internal Revenue Code was recognized by our exemption letter to you dated [date of exemption letter].

Your qualified subsidiary was formed by you for the purpose of holding title to real property. The information submitted shows that 100 percent of the stock of your subsidiary has been held by you at all times during its existence.

Section 501(c)(25)(A) of the Code provides for the exemption from federal income tax of title-holding corporations or trusts that hold title to real property and otherwise meet the requirements of section 501(c)(25).

Section 501(c)(25)(E) of the Code provides that a corporation may be a qualified subsidiary of an exempt tile-holding organization if 100 percent of its stock is held, at all times during such corporation's existence, by an exempt title-holding organization. The Code further provides that the qualified subsidiary will not be treated as a separate corporation for federal tax purposes. In addition, all of the qualified subsidiary's assets, liabilities, and items of income, deduction, and credit will be treated as belonging to the exempt parent title-holding organization.

Based upon the information provided, we rule that the above-named subsidiary is your qualified subsidiary corporation as described in section 501(c)(25)(E) of the Code. Therefore, you and your qualified subsidiary shall be treated, for federal tax purposes, as a single entity as long as you and your qualified subsidiary continue to meet all of the requirements of section 501(c)(25).

Your activities and those of your qualified subsidiary corporation will be considered in the aggregate to determine whether you continue to qualify for exempt status. Consequently, any activity conducted by a qualified subsidiary corporation that is not permitted under section 501(c)(25) may cause you to lose your exempt status.

Your qualified subsidiary corporation is not required to file federal tax and information returns that are generally required under federal tax law since it is treated as part of its exempt parent title-holding organization.

As the exempt parent title-holding organization, you are required to file all federal returns, including Form 990, *Return of Organization Exempt From Income Tax,* required by section 6033 of the Code, using your Employer Identification Number. The Form 990 must include financial information applicable to your qualified subsidiary corporation. The information pertaining to your qualified subsidiary corporation should not be listed separately, but should be aggregated with the information applicable to you. Therefore, you and your qualified subsidiary corporation must be on the same annual accounting period. Form 990 should be filed with the Ogden Service Center, Ogden, UT 84201-0027.

When Form 990, *Return of Organization Exempt from Income Tax* is filed, please provide the information listed below with your return:

1. The name, address, and employer identification number, if any, of each qualified subsidiary.

2. A statement that you have held 100 percent of the stock of each named qualified subsidiary at all times during the subsidiary's existence.

3. The name and address of any previously qualified subsidiary and an explanation as to why the subsidiary is no longer a qualified subsidiary.

4. A statement describing any changes during the tax year in the purposes, character, or method of operation of each qualified subsidiary.

Please use the employer identification number indicated in the heading of this letter on all returns you file and in all correspondence with the Internal Revenue Service. Your qualified subsidiaries should not apply for their own employer identification number. Because this letter could help resolve any questions about your exempt status, you should keep it in your permanent records. If you have any questions about this letter, or about filing requirements, excise, employment, or other federal taxes, please contact the Ohio Tax Exempt and Government Entities (TE/GE) Customer Service office at 877-829-5500 (a toll free number) or send correspondence to Internal Revenue Service, TE/GE Customer Service, P.O. Box 2508, Cincinnati, OH 45201.