F. UPDATE ON TITLE-HOLDING ORGANIZATIONS

1. Introduction

As noted in the 1986 CPE text, pp. 20-27, title-holding organizations are the practical means by which exempt organizations and pension trusts may transfer away title to property that they would otherwise own directly, while still enjoying the benefits of ownership. The purposes of separate organizations may be to shelter the parent organization from liability from potential damage suits arising from the property being held; to enhance the ability of the parent to borrow; to achieve clarity of title or accounting simplification; or to comply with specific requirements of state law. Increasingly, title-holding organizations have been used as investment vehicles. It was largely due to dissatisfaction of investment practitioners with the limitations of IRC 501(c)(2) status that Congress enacted IRC 501(c)(25), a new exemption provision for organizations that hold title to real property. Because of problems with the IRC 501(c)(25) statute as originally enacted in the Tax Reform Act of 1986, the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) has made important revisions.

Because regulations or other guidance have not been developed to implement IRC 501(c)(25), all applications are currently being referred to the National Office per IRM 7664.31:(17).

2. Background

The 1986 CPE text contained a general discussion of IRC 501(c)(2) title-holding corporations, with particular focus on the issue of whether such corporations could have more than one parent organization. Except in limited situations where the property held by the IRC 501(c)(2) corporation is used directly by two or more related parent organizations for their exempt purposes, such as a building occupied by both parents and used in furtherance of their exempt activities, the Service position is that multiple parents are not permitted. This position is exemplified in G.C.M. 37351 (12-20-77).

In G.C.M. 39460 (12-26-85), the Service reapplied its interpretation that IRC 501(c)(2) exemption is not available to a corporation with multiple parents if the exception of G.C.M. 37351 is not met. In G.C.M. 39460, a group of IRC 501(c)(3) hospitals that were all members of the same IRC 501(c)(6) association formed seven title-holding corporations. In providing that these corporations could not qualify for IRC 501(c)(2) exemption, the G.C.M. noted that mere membership in the same association does not bring the parents within the exception of G.C.M. 37351 for structurally related organizations that use the property for their exempt purposes.

The Service position has been a source of inconvenience to pension and investment practitioners. Certainly, if an IRC 501(c)(2) corporation can be used as an equivalent to a mutual fund or a real estate investment trust, it can be packaged and sold by fund promoters, even if the community of prospective clients is limited to organizations exempt under IRC 501(a). While inconvenient, however, it has not proved to be an absolute bar to title-holding corporations used as investment vehicles on behalf of multiple entities. In G.C.M. 38252, a group pension trust composed of a number of separate pension trusts successfully obtained IRC 501(c)(2) exemption for a title-holding corporation on the grounds that a group trust is considered a single entity. The 1986 CPE text notes that it has been argued that this is a triumph of form over substance.

3. The Legislative Response -- IRC 501(c)(25)

As a solution to the multiple parent problem, Congress enacted IRC 501(c)(25) in the Tax Reform Act of 1986. This new exemption provision has similarities to, and important differences with, IRC 501(c)(2). One of its principal features is that up to 35 "parents" are allowed. IRC 501(c)(2) was left unchanged by the legislation.

The Senate explanation to the legislation called current law unclear as to whether unrelated organizations could be the parents of an IRC 501(c)(2) corporation, and cited G.C.M. 37351 as the IRS position. The explanation stated that present law is not amended with respect to IRC 501(c)(2) corporations holding title to property for one or more related tax-exempt organizations. This appears to endorse the exception of G.C.M. 37351 for multiple related parents. Although it does not specifically endorse the basic rule of G.C.M. 37351 that prohibits exemption for IRC 501(c)(2) organizations with multiple unrelated parents, the fact that Congress considered the Service position and left it undisturbed at least to some degree appears to solidify our position with respect to multiple parents of IRC 501(c)(2) organizations.

IRC 501(c)(25) provides exemption for corporations or trusts organized for the exclusive purposes of acquiring real property and holding title to, and collecting income from, such property, and remitting the entire amount of income from the property, less expenses, to its shareholders (in the case of corporations) or beneficiaries (in the case of trusts). The statute contains the following additional provisions:

a. **IRC 501(c)(25)(A)(i)**: The organization can have no more than 35 shareholders or beneficiaries.

b. **IRC 501(c)(25)(A)(ii)**: There can be only one class of stock or beneficial interest.

c. **IRC 501(c)(25)(C)**: Its shareholders or beneficiaries must be:

   1. qualified pension, profit sharing, or stock bonus plans that meet the requirements of IRC 401(a);

   2. governmental plans described in IRC 414(d);

   3. the United States, a state or political subdivision thereof, or an agency or instrumentality of the foregoing; or

   4. IRC 501(c)(3) organizations. (**NOTE:** A provision allowing IRC 501(c)(25) organizations to be shareholders or beneficiaries of other IRC 501(c)(25) organizations was deleted by TAMRA.)

d. **IRC 501(c)(25)(D)(i)**: The shareholders or beneficiaries must be permitted to dismiss the investment advisor, upon reasonable notice, upon a vote of the shareholders or beneficiaries holding a majority interest.

e. **IRC 501(c)(25)(D)(ii)**: The shareholders or beneficiaries must be permitted to terminate their interest by either or both of the following alternatives, as determined by the corporation or trust:

   1. by selling or exchanging their stock or beneficial interest to an appropriate shareholder or beneficiary, provided that the sale or exchange does not increase the number of shareholders or beneficiaries above 35; or

2. by having the stock or beneficial interest redeemed by the corporation or trust upon 90 days notice to the corporation or trust.

f. **IRC 501(c)(25)(A)**: Real property to be held by the corporation or trust is not to include any interest as a tenant in common (or similar interest) or any indirect interest. (NOTE: This provision was added by TAMRA, and applies only to property acquired after June 10, 1987.)

g. **IRC 501(c)(25)(F)**: The term "real property" may include personal property leased under or in connection with a lease of real property, but only if the rent attributable to the personal property does not exceed 15 percent of the total rent attributable to both the real and personal property. This provision was added by TAMRA.

h. **IRC 501(c)(25)(E)**: If an IRC 501(c)(25) organization has a wholly-owned subsidiary, the subsidiary will not be treated as a separate corporation, and all assets, liabilities, and items of income, deduction, and credit will be treated as belonging to the IRC 501(c)(25) organization. This is another provision added by the TAMRA.

The drafting of IRC 501(c)(25) was subject to the strong influence of pension fund promoters, who desired an alternative to IRC 501(c)(2) that was more suited to their needs. Also enacted at the request of these fund promoters, a companion amendment to IRC 514(c)(9) effectively excepted IRC 501(c)(25) organizations from liability for tax on unrelated debt-financed income.

From the government's perspective, the IRC 514(c)(9) provision had serious flaws. It could have been used as a loophole to allow any IRC 501(c)(3) organization to avoid IRC 514 taxation on unrelated debt-financed income by judicious creation and use of IRC 501(c)(25) organizations. As will be discussed later, TAMRA scaled back the IRC 514(c)(9) exception so that it only applies to the pro rata share of income passed on to those share-holders and beneficiaries that are already excepted from the application of IRC 514 taxation if they hold the property directly; i.e., IRC 170(b)(1)(A)(ii) educational institutions and their IRC 509(a)(3) affiliates, and IRC 401 trusts. Other shareholders and beneficiaries are liable to taxation on their pro rata share of unrelated debt-financed income of the

IRC 501(c)(25) organization, but only with respect to interests acquired in the IRC 501(c)(25) organization after June 10, 1987.

4. Organizational Requirements

IRC 501(c)(2) title-holding organizations must be corporations or unincorporated associations that are treated as corporations under the provisions of IRC 7701(a)(3) and Reg. 301.7701-2. An IRC 501(c)(2) organization cannot be a trust. In contrast, IRC 501(c)(25) organizations can be either trusts or corporations (including unincorporated associations treated as corporations).

IRC 501(c)(25)(B) specifically provides that the IRC 501(c)(25) entity may qualify for exemption without regard to whether organized by an organization that is a permissible shareholder or beneficiary. This provision appears to contemplate that a private fund promoter may be the motivating force in the establishment of an IRC 501(c)(25) title-holding organization. The promoter will in many cases serve as investment advisor and, if so, will receive compensation for services. In order to ensure that underlying control of the organization rests with the shareholders or beneficiaries rather than the investment advisor, IRC 501(c)(25)(D)(i) allows the shareholders or beneficiaries to dismiss the investment advisor upon majority vote of shares or interests held. Likewise, IRC 501(c)(25)(D)(ii) allows shareholders or beneficiaries to terminate their interests in the organization by suitable, sale, exchange, or redemption.

Notice 87-18, 1987-1 C.B. 455, provides that the articles of incorporation or trust instrument of an IRC 501(c)(25) organization must include provisions to permit the dismissal of the investment advisor, as well as to permit shareholders or beneficiaries to terminate their interests by either or both of the methods listed in IRC 501(c)(25)(D)(ii). However, some representatives of IRC 501(c)(25) organizations complained that under the law of some states, these provisions could not be included in articles of incorporation. In these cases, the Service will accept the provisions in corporate bylaws. We expect that this revised position will be published soon, along with a clarification that IRC 501(c)(25) status is available for both stock and nonstock corporations.

5. Permitted Shareholders

Both IRC 501(c)(2) and IRC 501(c)(25) place restrictions on the type of organizations for which property is held.

a. IRC 501(c)(2)

A title-holding corporation described in IRC 501(c)(2) must hold title to property for, and turn over the income to, an organization that is exempt under the provisions of IRC 501(a). Organizations exempt under IRC 501(a) include qualified pension, profit-sharing or stock bonus plans described in IRC 401(a) in addition to all IRC 501(c) and (d) organizations.

As discussed earlier, with the limited exception for structurally related organizations that hold property used for their exempt purposes, G.C.M. 37351 does not allow more than one parent or shareholder.

b. IRC 501(c)(25)

The class of organizations that are permitted shareholders or beneficiaries of an IRC 501(c)(25) title-holding organization is broader in some respects than the class of permitted IRC 501(c)(2) parents, but it is significantly narrower in others. A governmental unit (such as the federal government, a state, political subdivision, or an agency or instrumentality of the foregoing) or a governmental plan is specifically permitted to be an IRC 501(c)(25) shareholder or beneficiary. However, with the exception of IRC 501(c)(3) organizations, IRC 501(c) and (d) organizations are not permitted to be shareholders or beneficiaries.

While IRC 501(c)(2) corporations generally may have only one exempt organization for which it holds title and to which it turns over income, IRC 501(c)(25) organizations can have up to 35 shareholders or beneficiaries. The language of the statute as originally enacted in 1986 provided that IRC 501(c)(25) organizations could hold shares or beneficial interests in other IRC 501(c)(25) entities. This created the possibility that a pyramiding arrangement of IRC 501(c)(25) organizations might be used to avoid the 35-shareholder limitation. For example, if A, an IRC 501(c)(25) corporation with 30 shareholders, is one of 35 shareholders of B, another IRC 501(c)(25) corporation, then B, in effect, has 65 shareholders.

For this reason, TAMRA eliminated the provision that allowed IRC 501(c)(25) organizations to hold shares or interests in other IRC 501(c)(25) organizations. However, Congress apparently recognized that IRC 501(c)(25) organizations may find it useful to hold property in separately organized entities. In order that such entities could be created and used without being considered toward the 35-shareholder limit, TAMRA permits IRC 501(c)(25) organizations to have wholly-owned subsidiaries, the assets, liabilities, and items of income and deduction of which are treated as belonging to the parent IRC 501(c)(25) organization. If such a subsidiary should subsequently cease to be wholly-owned by the IRC 501(c)(25) organization, it will then be treated as a new corporation that acquired all of its assets and liabilities in exchange for its stock.

6. Permissible Holdings

IRC 501(c)(2) title-holding corporations are organized for the exclusive purpose of holding title to property, collecting the income therefrom, and turning over the entire amount of the income, less expenses, to a parent organization that is exempt under IRC 501(a). There are no express restrictions on the type of property that may be held, except for the clear prohibition of Reg. 1.501(c)(2)-1(b) against the accumulation of income.

Thus, an IRC 501(c)(2) corporation cannot hold cash, except for strictly defined purposes. Clearly, it can retain cash to pay expenses. Under Rev. Rul. 77-429, 1977-2 C.B. 189, it can also retain cash to reduce indebtedness on property that it holds.

There are no other expenses restrictions on property holdings of an IRC 501(c)(2) corporation. Both real and personal property may be held. However, because an IRC 501(c)(2) corporation will lose its exemption if it receives any amount of unrelated business income other than of a type permitted by Reg. 1.501(c)(2)-1(a), it must be careful not to derive such income from property that it holds. Thus, if rental income is derived from personal property that is not leased with real property, exemption will be lost because such income is not excepted under IRC 512 from unrelated business income taxation, nor is it expressly permitted by Reg. 1.501(c)(2)-1(a). See Rev. Rul. 69-278, 1969-1 C.B. 148.

On the other hand, it is clear that an IRC 501(c)(2) corporation may hold personal property such as stocks and bonds, and derive dividend and interest income from them, because such income is excluded from unrelated business taxable income under IRC 512(b). Again, such income, less expenses, must be turned over to the parent organization.

An IRC 501(c)(25) title-holding organization, in contrast, is expressly restricted to acquiring and holding title to real property. Further, the interests it holds in real property must be direct interest rather than indirect interests, and cannot include any interest as a tenant in common or any similar interest. The

House Ways and Means Committee explanation of this provision, which was added in the Technical Correction Act of 1987, states that it is intended to ensure that the real property is directly held rather than held through the use of partnerships, trusts, or other entities.

It is clear from TAMRA, however, that some personal property can be held, as long as it is leased under, or in connection with, a lease of real property. In such a case, the rent attributable to the real property cannot exceed 15 percent of the total rent for the taxable year attributable to both the real and personal property.

With respect to the buying and selling of mortgages, or the making of mortgage loans, the Service position is that these are not direct interests in real property. However, an option to purchase real estate will be treated as a direct interest in real property if it is acquired in accordance with a plan to purchase the particular real estate and not for the purpose of options trading.

Although an IRC 501(c)(25) organization, like an IRC 501(c)(2) corporation, must turn over its income, less expenses, to its shareholder/beneficiaries, the IRC 501(c)(25) statute appears to contemplate that a reasonable cash reserve may be retained. For example, cash may be required to acquire real property or, if the organizational document so provides, to redeem the shares or interests of one or more shareholders or beneficiaries. Thus, a reasonable reserve to meet operational requirements may be retained by the organization. Under Notice 88-121, whether the amount and the time for holding cash reserves is reasonable will depend on the facts and circumstances of each case. It will be considered reasonable if the necessary amount to purchase the property is held for less than one year before the investment.

Notice 88-121 limits the reserves to cash and short-term investments. The generally lower interest rates on such investments should be a disincentive to the holding of large reserves.

7. <u>Unrelated Business Income</u>

In general, an IRC 501(c)(2) title-holding corporation will lose its exemption if it receives unrelated business income. However, Reg. 1.501(c)(2)-1(a) lists several exceptions where loss of exemption will not apply, and the corporation will merely be taxed on the income. These are:

a. IRC 514 debt-financed income.

b. Income treated as unrelated business taxable income solely because of IRC 512(a)(3)(C), pertaining to title-holding corporations for IRC 501(c)(7), (9), (17), or (20) organizations.

c. Certain interest, rents, annuities, or royalties, which are treated as unrelated business taxable income solely because of IRC 512(b)(13), dealing with income from controlled organizations, or IRC 512(b)(3)(B)(ii), dealing with rental income the amount of which is based in whole or in part on the income or profits derived by any person from the property (other than an amount based on a fixed percentage of receipts or sales).

d. Rents from personal property leased with real property that are treated as unrelated business taxable income under IRC 512(b)(3)(A)(ii) solely because such rents attributable to personal property are more than incidental when compared to the total rents under the lease, or under IRC 512(b)(3)(B)(i) solely because such rents attributable to personal property exceed 50 percent of the total rents under the lease.

We do not yet have regulations under IRC 501(c)(25), and it is unclear whether there will be comparable exceptions that will permit the receipt of unrelated business income for IRC 501(c)(25) organizations. However, it is clear that at least the receipt of IRC 514 unrelated debt-financed income will not cause loss of exempt status. It is also apparent that the above IRC 512(a)(3)(C) exception can apply only to IRC 501(c)(2) corporations, and has no bearing on IRC 501(c)(25) organizations, since the latter cannot hold property for IRC 501(c)(7), (9), (17), or (20) organizations.

One of the primary advantages of IRC 501(c)(25) exempt status when compared to IRC 501(c)(2) exemption is the treatment of unrelated debt-financed income derived from real property. An IRC 501(c)(2) organization is subject to the tax on such income whether or not the parent organization would be subject to the tax if the parent held the property directly. For a qualified organization described in IRC 514(c)(9)(C), such as an educational institution described in IRC 170(b)(1)(A)(ii), an IRC 509(a)(3) affiliate of such an institution, or a qualified IRC 401 trust, real property acquired or improved by the organization is excepted from the application of IRC 514. However, if the property is acquired or improved by an IRC 501(c)(2) title-holding corporation on behalf of the IRC 514(c)(9)(C) qualified organization, the exception does not apply and the IRC 501(c)(2) corporation is subject to the tax.

The Tax Reform Act of 1986, effective for taxable years beginning after December 31, 1986, added IRC 501(c)(25) organizations as qualified organizations described in IRC 514(c)(9)(C). This had the effect of allowing all shareholders or beneficiaries, whether or not IRC 514(c)(9)(C) qualified organizations themselves, to enjoy an exception to IRC 514 taxation of real property held by the IRC 501(c)(25) title-holding organization. Thus, some organizations that would otherwise be subject to unrelated debt-financed income taxation if they held property directly or through an IRC 501(c)(2) corporation could avoid it by using an IRC 501(c)(25) subordinate.

That Congress did not intend the exception to IRC 514 taxation to extend to shareholders or beneficiaries that are not qualified organizations described in IRC 514(c)(9)(C) is evidenced by the fact that TAMRA scaled back the IRC 514 exception for IRC 501(c)(25) title-holding organizations. It did this through the enactment of new IRC 514(c)(9)(E). (NOTE: Another provision designated "IRC 514(c)(9)(E)", dealing with disproportionate partnership allocations, was enacted in the Revenue Act of 1987. We expect one of these provisions will be redesignated).

IRC 514(c)(9)(E) distinguishes between a "disqualified holder" of an interest in an IRC 501(c)(25) organization and other holders. Briefly, a disqualified holder is any IRC 501(c)(25) shareholder or beneficiary that is not an IRC 170(b)(1)(A)(ii) organization or an IRC 509(a)(3) affiliate of such an organization, or is not a qualified IRC 401 trust. As a practical matter, the term "disqualified holder" will virtually always apply to any IRC 501(c)(3) organization that is not a school, college, university, or supporting organization of such an educational institution.

A disqualified holder of an interest in an IRC 501(c)(25) organization will take into account as gross income from an unrelated trade or business its pro rata share of income that would be treated as unrelated debt-financed income but for the application of IRC 514(c)(9). The pro rata share of deductions allowable in computing unrelated business taxable income will also be taken into account by the disqualified holder.

Thus a disqualified holder, after TAMRA, is put in the same position with respect to unrelated debt-financed real property held by an IRC 501(c)(25) organization that the disqualified holder would be in if it held the property directly. However, because IRC 514(c)(9)(E) applies only with respect to interests in the IRC 501(c)(25) organization acquired after June 10, 1987, certain disqualified holders have a grandfathered exception to the application of IRC 514 with respect to shares or interests held before that date.

8. Conclusion

TAMRA corrected flaws in the IRC 501(c)(25) statute and in the IRC 514(c)(9) exception to the application of unrelated debt-financed income taxation with respect to IRC 501(c)(25) organizations. It has also provided additional guidance in the interpretation of IRC 501(c)(25) provisions, particularly with respect to the definition of real property.

Additional questions remain. We are without regulations to implement IRC 501(c)(25). In their absence, the Service is considering publishing interim guidance on questions that recur in its administration of the statute.