

## **C. IRC 501(c)(25)(E) - QUALIFIED SUBSIDIARIES**

by

**Ward L. Thomas and Kenneth J. Earnest**

### 1. Introduction

What is a qualified subsidiary under IRC 501(c)(25)? What is the reason for having them? What are the consequences of qualified subsidiary status? This article discusses these matters.

### 2. Background to IRC 501(c)(2) and (25)

To understand the purpose of qualified subsidiaries, it is helpful to review the history of IRC 501(c)(2), as well as IRC 501(c)(25).

IRC 501(c)(2) exempts corporations that hold title to property on behalf of another exempt organization. The statutory predecessor to IRC 501(c)(2) goes back to 1916. The statute was enacted largely to overcome state law obstacles against the direct holding of title by an exempt organization, including property used in the organization's exempt function (e.g., a church's church building). Thereafter, IRC 501(c)(2) organizations increasingly came to be used for holding investment property, and the Service approved such use in Rev. Rul. 69-381, 1969-2 C.B. 113.

A major reason for having a title-holding company is for the company's owner to limit its liability resulting from ownership (by placing the property in the title-holding company, a separate entity). Other reasons are to improve the owner's ability to borrow; clarify title; simplify accounting; or comply with state law requirements. See 1986 CPE at 21.

Can a 501(c)(2) entity own subsidiaries? Generally, ownership of subsidiaries will not affect exemption under IRC 501(c)(2), as a 501(c)(2) organization may hold personal property. See Rev. Rul. 76-335, 1976-2 C.B. 141. Stock is generally regarded as personal property. See Am. Jur. 2d, Corporations 431, 432, Property. 26; Black's Law Dictionary, Property (6th Ed. 1991). Although a 501(c)(2) organization cannot actively carry on a trade or business, the business activity of a subsidiary is ordinarily not attributed to its 501(c)(2) parent, except in certain circumstances where the subsidiary may be considered a mere agent or integral part of the 501(c)(2) parent. See G.C.M. 36107 (Dec. 16, 1974); G.C.M.

39326 (Jan. 17, 1985); G.C.M. 39598 (Jan. 23, 1987); 1994 CPE at 110.

But whether a 501(c)(2) entity can have multiple owners is a different matter. G.C.M. 37351 (Dec. 20, 1977) set forth the Service position that a 501(c)(2) organization generally cannot have multiple owners. In response, Congress enacted IRC 501(c)(25) in the Tax Reform Act of 1986 as a title-holding company alternative to IRC 501(c)(2). S. Rep. No. 313, 99th Cong., 2d Sess. 885 (1986), 1986-3 (Vol. 3) C.B. 885; H.R. Rep. No. 841, 99th Cong., 2d Sess. II-824 (1986), 1986-3 (Vol. 4) C.B. 824. The committee reports explain that IRC 501(c)(25) allows smaller tax-exempt organizations to pool their investment funds for purposes of investing in real estate and so obtain the same tax treatment that larger tax-exempt organizations have with a 501(c)(2) subsidiary.

Congress capped the number of shareholders or beneficiaries of an IRC 501(c)(25) organization at 35. Testimony at the hearings suggests that a reason for the cap was to ensure that the owners are sufficiently small as a group in order that they, instead of the investment advisor, actually control the organization. See, e.g., House Comm. on Ways and Means, "Miscellaneous Tax Bills," Hearings before the Subcommittee on Select Revenue Measures, May 12 and 19, H.R. Doc. No. (Serial) 98, 99th Cong. 2d Sess. 189, 267 (1986) (Statement of Richard D'Avino, Acting Deputy Tax Legislative Counsel, Treasury Department).

An IRC 501(c)(25) organization must be organized for the exclusive purposes of acquiring, holding title to, and collecting income from real property. However, as the 1989 CPE at 64 indicates, IRC 501(c)(25) originally permitted an IRC 501(c)(25) organization to be owned by another IRC 501(c)(25) organization. This provision appeared to allow for multi-tier or pyramid arrangements that would effectively circumvent the 35-shareholder limitation in IRC 501(c)(25). For instance, an IRC 501(c)(25) organization that held real property could have up to 35 shareholders that were IRC 501(c)(25) organizations, each of which was held by 35 more shareholders. For this reason, in the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"), Congress eliminated 501(c)(25) organizations as permissible parents generally, but added subparagraph (E), allowing for qualified subsidiaries.

TAMRA 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, although it did allow, under IRC 501(c)(25)(F), for a certain amount of personal property (e.g., office furniture) to be held in connection with real property leased to others. Thus, an IRC 501(c)(25) organization must own its

real property solely and directly, and not through an interest in a partnership, trust, or corporation, except as provided in IRC 501(c)(25)(E).

### 3. Discussion of IRC 501(c)(25)(E) Provisions

IRC 501(c)(25)(E) defines a "qualified subsidiary" as any corporation that is 100% owned by an IRC 501(c)(25)(A) organization (the parent) and was so owned during its entire past existence. Thus, an IRC 501(c)(25) parent cannot acquire a pre-existing corporation from the pre-existing corporation's shareholder.

A qualified subsidiary is not treated as a separate entity for federal tax purposes. Rather, all its assets, liabilities, and tax items are treated as belonging to the parent. Thus, a qualified subsidiary should not have its own employer identification number separate from its parent's, and should not file separate Form 990's or other federal tax or information returns.

A qualified subsidiary must abide by the rules pertaining to 501(c)(25) organizations generally (e.g., it cannot operate a trade or business) for the parent to retain exemption. However, the qualified subsidiary's activities are not viewed in isolation, but are considered along with the other activities of the parent (and any other qualified subsidiaries). For instance, if the qualified subsidiary received unrelated business taxable income from parking (in a tax year beginning on or after January 1, 1994), but such income was incidentally derived from its holding of real property and did not exceed 10% of the combined gross income of the parent and all qualified subsidiaries, then the parent would retain its exemption.

Guidance on the tax attributes of a qualified subsidiary that becomes disqualified is also provided. The qualified subsidiary is treated as a new corporation that, immediately before disqualification, received all its assets and liabilities from its parent in exchange for its stock. The rules governing corporate organizations generally (Part III of subchapter C, IRC 351 et seq.), among others, would appear applicable in determining the (dis)qualified subsidiary's tax attributes.

How might a qualified subsidiary become disqualified? One way would be for the parent to transfer any of the qualified subsidiary's stock to another person. If the parent transferred less than all the stock, however, it would then be holding an impermissible interest in personal property and would no longer meet the requirements for exemption. Another method of disqualification would be for the qualified subsidiary to issue stock to anyone other than the parent. Again,

disqualification of the subsidiary in this manner would affect the parent's exempt status. However, if a qualified subsidiary conducted an unrelated trade or business which was not incidental to its holding of real property, then such activity would not result in disqualification of the subsidiary per se, but in loss of exemption of the parent along with all qualified subsidiaries (unless the requirements of IRC 501(c)(25)(G)(ii) were satisfied).

#### 4. Other Issues Regarding Qualified Subsidiaries

Why are qualified subsidiaries needed? Instead of creating a qualified subsidiary, why don't the owners of the 501(c)(25) parent simply create another 501(c)(25) parent? One reason cited by tax practitioners is that the board of directors of a 501(c)(25) organization may decide to put some of its property in a separate corporation for liability purposes, and may find it easier to create a subsidiary rather than deal with multiple parents in setting up a brother/sister title-holding company. There might also be advantages under state or local law for having qualified subsidiaries.

However, if the 501(c)(25) parent falls out of exemption for any reason, then all its subsidiaries also lose exemption. Conversely, if a subsidiary becomes disqualified, or if the subsidiary engages in prohibited activity, then the parent (along with any other qualified subsidiaries it may have) loses exemption. Perhaps for this reason, the Service has not seen many title-holding companies with subsidiaries apply for exemption under IRC 501(c)(25).

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

Some of the problems pertaining to qualified subsidiaries arise in the exemption application process. Some state tax authorities require a qualified subsidiary (which is generally regarded as a separate entity under state law) to have its own exemption letter from the Service to qualify for exemption from state tax. Representatives of 501(c)(25) organizations have requested that the Service develop a procedure for recognizing the exemption of a qualified subsidiary. Also, Rev. Rul. 67-390, 1967-2 C.B. 179, could be construed as requiring a 501(c)(25) organization that obtains a qualified subsidiary after it has received an exemption letter to file a new exemption application.

The Service believes that it cannot recognize the exemption of a qualified

subsidiary in a ruling letter addressed to the qualified subsidiary, since the Code expressly provides that the qualified subsidiary is not to be treated as an entity separate from its 501(c)(25) parent for federal tax purposes. However, the Service has issued rulings to 501(c)(25) parents that their subsidiaries are qualified subsidiaries under IRC 501(c)(25)(E).

There are no regulations under IRC 501(c)(25). Notices 87-18, 1987-1 C.B. 455, and 88-121, 1988-2 C.B. 457, which provide general guidance on 501(c)(25) organizations, do not shed light on qualified subsidiaries. Because regulations or other guidance have not been published, the Service requires that all IRC 501(c)(25) exemption applications be referred to the National Office. IRM 7664.31(15).

## 5. Conclusion

Qualified subsidiaries provide some flexibility to IRC 501(c)(25) organizations in their corporate structure. Such subsidiaries, however, are far more closely regulated by statute than subsidiaries of IRC 501(c)(2) organizations.