

Audit Technique Guide – Single Parent Title-Holding Corporations Exempt Under IRC Section 501(c)(2)

Overview

IRC Section 501(c)(2) describes corporations organized for the exclusive purpose of holding title to property, collecting income from it, and turning over its entire, less expenses, to an organization described as exempt in section IRC Section 501(a). The organization can't have unrelated business taxable income, except as noted in "Unrelated Business Income," below. Also, an IRC Section 501(c)(2) organization can't retain its exemption if it accumulates its income rather than turning it over to its parent at least once a year.

Form of Organization

The term "corporations" in the Internal Revenue Code includes "associations." See IRC Section 7701(a)(3). Accordingly, the term also includes business or commercial trusts classified as associations. Because it doesn't include "ordinary trusts," per the regulations (Treas. Reg. 301.7701-4(a)), an ordinary trust can't qualify for exemption as an IRC Section 501(c)(2) organization. See "Relationship Required," below, for the required legal relationship between the IRC Section 501(c)(2) organization and the exempt organization for which it holds title.

Corporate Charter – Powers

IRC Section 501(c)(2) refers to corporations "organized for the exclusive purpose" of holding title to property and collecting income. This organizational purpose is established by referencing the:

- organization's activities,
- events surrounding its incorporation,
- language of its charter.

If an organization's charter allows corporate purposes and powers beyond holding property and collecting income, then the corporation isn't organized for the "exclusive purpose" of holding title to property required by the Code. When a newly organized corporation having no actual history of operations requests exemption, the charter language weighs heavily in determining the organization's purpose. See Rev. Rul. 58-566, 1958-2 C.B. 261. In this ruling, the charter language wasn't by itself, determinative, but when combined with the other facts and circumstances, it established that the corporation wasn't organized exclusively for IRC Section 501(c)(2) purposes.

The relative weight given to various factors depends on the case's circumstances. When actual operations are beyond the scope of IRC Section 501(c)(2), even an impeccable charter doesn't qualify the corporation for exemption. Similarly, if events surrounding an organization's formation reveal a purpose outside the scope of IRC Section 501(c)(2), then charter language alone can't establish exemption.

When an organization's history and activities point to an acceptable IRC Section 501(c)(2) operation but its charter does not, the IRS looks favorably upon the organization's offer to amend the charter to be recognized as exempt. If the amendment merely conforms the charter to the organizers' actual intent, IRS ordinarily recognizes exemption for all years.

An organization's refusal to relinquish charter purposes and powers which are clearly outside the acceptable scope for a title-holding company indicates the organization may intend to use those powers to engage in activities beyond those permitted by an organization recognized under IRC Section 501(c)(2).

Permissible Activities

The Code limits an IRC Section 501(c)(2) organization's activities to:

- holding title to property
- collecting the income from it
- turning over the entire amount, less expenses, to an exempt organization.

By so doing, the Code automatically limits the sources from which 501(c)(2) organizations may receive income. See Treas. Reg. 1.501(c)(2)-1(a).

Permissible Sources of Income and Holdings

The traditional source of income for title-holding companies is rent from real property. At the time IRC Section 501(c)(2) was enacted, many title-holding companies had rental income, and Congress meant to exempt this type of organization. Nothing in IRC Section 501(c)(2) prevents organizations from renting their realty to the general public. See Rev. Rul. 69-381, 1969-2 C.B. 113. In general, the definition of rent from real property for purposes of IRC Section 501(c)(2) is the same as that under IRC Section 512(b)(3). However, see "Prohibited Holdings and Sources of Income," below, for some important differences.

Generally, receiving oil or mineral production payments due to holding a royalty interest is a permissible source of income. On the other hand, holding a working interest is an impermissible source of unrelated business income (UBI) for an IRC Section 501(c)(2) title-holding corporation, and could result in revocation of exempt status under Treas. Reg. 1.501(c)(2)-1(a).

Income derived by a 501(c)(2) corporation from oil and gas production payments purchased with borrowed funds doesn't affect its exemption, but is unrelated business taxable income under IRC Section 514. See Rev. Rul. 66-295, 1966-2 C.B. 207.

Treas. Reg. 1.501(c)(2)-1(a) was amended in 1980 to address the problems of applying the UBI tax provisions of the Tax Reform Act of 1969 (Pub. L. 91-172, 83 Stat. 543) to title-holding corporations. The amended regulation permits title-holding corporations to retain exemption when they have certain types of UBI. (They are still subject to tax on their related business taxable income.) See "Unrelated Business Income," below, for the types of UBI that an IRC Section 501(c)(2) title-holding corporation may have.

IRC Section 501(c)(2) organizations may hold title to passive investments and collect the income they yield. Neither the regulations nor IRC Section 502 restrictions on "business" income imposed on feeder organizations restrict investment income. However, it's important to distinguish permissible passive investment activities from the active "business" of securities trading.

Prohibited Sources of Income and Holdings

Rules similar to those in IRC Section 501(c)(25)(G) apply for IRC Section 501(c)(2). IRC Section 501(c)(2) and IRC Section 501(c)(25) organizations may receive UBI up to 10 percent of their gross income, if the UBI is incidentally derived from holding real property (IRC Section 501(c)(25)(G)). Congress enacted IRC Section 501(c)(25)(G) believing revocation to be a harsh solution to an IRC Section 501(c)(2) or an IRC Section 501(c)(25) organization receiving small amounts of UBI that is incidentally derived from holding real property. Thus, certain incidentally derived income, such as parking and vending machine revenue, is permitted up to 10 percent of its gross income. Except as noted in "Unrelated Business Income," below, an IRC Section 501(c)(2) organization may not hold title to properties which generate UBI.

A student bookstore in *Stanford University Bookstore v. Commissioner*, 29 B.T.A. 1280 (1934), *aff'd*, 83 F.2d 710 (D.C. Cir. 1936), and a public utility in *Sand Springs Railway Co. v. Commissioner*, 21 B.T.A. 1291 (1931)) were denied recognition under IRC Section 501(c)(2) because their activities constituted business beyond merely holding title to property. It didn't matter that they turned income over to an exempt organization.

Parent Organization

An exempt title-holding corporation must turn over certain income to an organization that is "exempt under this section." (IRC Section 501(c)(2)). The phrase "exempt under this section" applies to organizations exempt under IRC Section 501(a) and therefore includes pension trusts described in IRC Section 401(a). So, a pension trust is an acceptable recipient for a title-holding corporation income.

An organization incorporated as a subsidiary of an exempt title-holding corporation for the exclusive purpose of holding title to investment property, collecting the income from it, and turning over that income, less expenses, to the parent, qualifies for recognition under IRC Section 501(c)(2). See Rev. Rul. 76-335, 1976-2 C.B. 141 and IRM 7.25.2.9(12).

Relationship Required

An exempt organization that receives support from a title-holding company must exercise some control or ownership over it. See Rev. Rul. 71-544, 1971-2 C.B. 227 and IRM 7.25.2.9(11).

Some examples of the necessary control are:

- owning the voting stock of the title-holding company
- possessing the power to select nominees to hold the voting stock

- appointing directors, etc.

This control ensures that the title-holding corporation properly distributes income.

Absence of some control by the supported organization over the title-holding corporation is fatal to the title-holding corporation exemption. For example, in Rev. Rul. 71-544, a group of philanthropists formed a nonprofit corporation to hold title to securities and turn over its income to a selected organization exempt under IRC Section 501(a). The selected organization neither owned nor controlled the title-holding corporation, which was independent and had complete discretion distributing its income. The revenue ruling held that the organization wasn't an exempt title-holding corporation under IRC Section 501(c)(2).

A parent-subsidiary relationship commonly exists, but this relationship isn't required. If the title-holding company is a stock corporation, the exempt organization doesn't need to hold its stock if both:

- The stock confers no rights to dividends or liquidating distributions.
- The title-holding company pays all income from the property, less expenses over to the exempt organization.

See Rev. Rul. 68-222 1968-1 C.B. 243 and IRM 7.25.2.9(7).

Limitations Arising from Relationship

The fact that the parent isn't subject to IRC Section 511 doesn't relieve the title-holding company of its obligation to pay the tax on its UBI for payments to the parent. See Rev. Rul. 68-490, 1968-2 C.B. 241. See IRC Section 511(a)(2)(A)), unless IRC Section 511(c) applies. See IRM 7.25.2.7(3).

The fact that the relationship between the title-holding company and its parent might be very close doesn't mean that the title-holding company may carry on all the activities its parent can. Apply the strict limitations of IRC Section 501(c)(2) and regulations, regardless of how the parent is organized and operated. See Rev. Rul. 66-150, 1966-1 C.B. 147.

Turning Over Income to Parent

Although neither the Code nor the Regulations specify the actual timing of remittance, an IRC Section 501(c)(2) organization should turn over its net income to its parent as soon as practical, and at least annually.

Accumulation Prohibition

A corporation described in IRC section 501(c)(2) can't accumulate income (Treas. Reg. 1.501(c)(2)-1(b)). It must turn over the entire amount of income, less expenses, to an organization, which is itself exempt under IRC section 501(a).

Neither the Code nor regulations specify that a 501(c)(2) corporation must turn over income as soon as earned. Distribution, however, shouldn't be delayed beyond a period

sufficient to allow the holding company to do normal accounting and administrative action.

An abnormal delay in distribution could create a hardship for the exempt recipient. It might also distort the income and therefore the support test under IRC Section 509 for organizations exempt under IRC Section 501(c)(3).

Method of Payment

The type of distribution is immaterial. It could be termed a dividend on stock or given some other description. What is important is that the income must be distributed to the exempt organization. A mere obligation to use the income for the parent's benefit, or parental control of the title-holding company doesn't satisfy this requirement.

Often, an exempt parent occupies realty that the title-holding company owns. The exempt parent generally doesn't pay rent. In this situation, the statutory requirement that income be paid over to the parent is satisfied if the title-holding company turns over whatever income is available. Though there may be no cash income, the parent's benefit from using the property is real enough.

Deductible Expenses

"Expenses" includes the operating costs that a taxable corporation could deduct, such as depreciation. See Rev. Rul. 66-102, 1966-1 C.B. 133 and IRM 7.25.2.9(2). Corporate deductions such as charitable contributions, which do not represent costs, aren't included.

The IRS has ruled that a title-holding company may retain part of its income each year to apply to indebtedness on property to which it holds title. Although a title-holding company's retirement of indebtedness is a capital outlay rather than an expense, income used for this purpose is not treated as part of accumulated earnings.

If a title-holding company were required to remit all its net income to its parent every year, it would have no funds to meet indebtedness on the property it holds. It would then have to turn repeatedly to the organization for which it holds title for additional capital contributions. This would defeat the very purpose for which most title-holding companies are set up—in other words, to serve as an administrative convenience for their parent organizations. See Rev. Rul. 77-429, 1977-2 C.B. 189 and IRM 7.25.2.9(5).

Unrelated Business Income

As a general rule, an exempt IRC Section 501(c)(2) organization may engage only in the business of holding title to property for an exempt parent and turning over the income to the parent. Ordinarily, an exempt title-holding corporation may not have UBI and would be revoked if it engaged in an unrelated trade or business.

There are several exceptions to this general rule. See Treas. Reg. 1.501(c)(2)-1(a) (note, however, that this provision doesn't fully reflect current law). A title-holding

corporation may retain exemption if it has income that is treated as UBI solely because of:

- IRC Section 512(a)(3)(C), making the UBI rules covering an IRC Sections 501(c)(7), 501(c)(17), or 501(c)(20) organization apply to its title-holding corporation;
- IRC Section 514, making income from debt-financed property subject to unrelated business income tax;
- IRC Section 512(b)(3)(B)(ii), removing rents from the IRC Section 512(b)(3)(A) rental exclusion, the amount of which are, based on the income or profits derived by any person from the leased property, from the IRC Section 512(b)(3) rental exclusion;
- IRC Section 512(b)(13), treating as UBI dividends, interest, annuities, royalties, rents, and similar payments a controlling organization receives from a controlled organization
- IRC Section 512(b)(3)(A)(ii), excluding from UBI rents from personal property leased with real property, if the rents attributable to the personal property are incidental compared to the total rents received under the lease
- IRC Section 512(b)(3)(B)(i), removing rents from the IRC Section 512(b)(3)(A) rental exclusion, if more than 50 percent of the total rent received under a lease is attributable to personal property
- IRC Section 511(c), which sets out the special rule for imposing a tax on the UBTI of an IRC Section 501(c)(2) title-holding corporation. When imposing the IRC Section 511 tax, treat an IRC Section 501(c)(2) corporation as being organized and operated for the same purposes as its exempt IRC Section 501(a) parent, in addition to the purposes described in IRC Section 501(c)(2), if:
 - it pays any amount of its net income for the tax year to the exempt parent (or would pay this amount if it were available but for expenses) and
 - the IRC Section 501(c)(2) organization and its exempt parent file a consolidated income tax return (Form 990–T) for the tax year
- IRC Section 1501, which allows an affiliated group of corporations to file a consolidated income tax return. IRC Section 1504(e) permits the consolidated filing privilege on "two or more organizations exempt from taxation under section 501, one or more of which is described in section 501(c)(2) and the others of which derive income from such 501(c)(2) organizations . . . "

Application for Exemption

A corporation applying for exemption as an organization described in IRC Section 501(c)(2) files Form 1024, Application for Recognition of Exemption Under Section 501(a).

Digests of Published Rulings

Powers and purposes—A corporation isn't considered organized as a title-holding company per IRC Section 501(c)(2) if it has broad powers and business purposes far beyond the scope necessary for a title-holding company. Furthermore, this corporation

isn't considered operated for exempt purposes if it uses part of its income to reduce indebtedness on property that ultimately will revert to private individuals. Rev. Rul. 58-566, 1958-2 C.B. 261.

Depreciation as an expense—The term "expenses" as used in IRC Section 501(c)(2), includes a reasonable allowance for depreciation determined under IRC Section 167. Rev. Rul. 66-102, 1966-1 C.B. 133.

Operating facilities for parent disqualification—An organization that holds title to a building housing its parent, a veteran organization described in IRC Section 501(c)(4), maintains the building and operates the social facilities in the building, doesn't qualify for exemption as an IRC Section 501(c)(4) organization, but does qualify as an organization described in IRC Section 501(c)(7). Rev. Rul. 66-150, 1966-1 C.B. 147.

Oil and gas production payments—An organization's acquisition with borrowed funds of oil and gas production payments from properties in which there is no ownership of working interests doesn't preclude its exemption if it otherwise meets the requirements for exemption as an organization under IRC Section 501(c)(2). Rev. Rul. 66-295, 1966-2 C.B. 207.

Accumulating income to reduce property indebtedness—An exempt title-holding corporation may retain part of its income each year to apply to indebtedness on property to which it holds title. The transaction is treated as if the parent received the income and used it to make a capital contribution to the title-holding corporation, which in turn applied this contribution to the indebtedness. Rev. Rul. 77-429, 1977-2 C.B. 189.

Exemption disqualifier—An exempt title-holding company is disqualified for exemption when one of the organizations it distributes income to ceases to qualify for exemption under IRC Section 501(a). Rev. Rul. 68-371, 1968-2 C.B. 204.

Stock held by others than an exempt organization—A corporation created to hold title to the chapter house of an exempt college fraternity may be exempt as an organization described in IRC Section 501(c)(2) even though its stock is held by members of the fraternity, as long as those members have no right to profits. Rev. Rul. 68-222, 1968-1 C.B. 243.

Unrelated leases—A title-holding corporation renting a building and trucks under separate unrelated leases to exempt fraternal beneficiary societies is engaged in the business of renting personal property independent of real property and not exempt as an IRC Section 501(c)(2) organization. Rev. Rul. 69-278, 1969-1 C.B. 148.

Leasing to general public—A title-holding corporation that derives income from renting real property to the general public, isn't precluded from exemption as an IRC Section 501(c)(2) organization. Rev. Rul. 69-381, 1969-2 C.B. 113.

Investment services—An organization regularly carrying on an investment service, that would have been unrelated trade or business if carried on by any of the exempt organizations on whose behalf it operates, isn't exempt as an organization per IRC Section 501(c)(2) or 501(c)(3). Rev. Rul. 69-528, 1969-2 C.B. 127. (But see Rev. Rul.

71-529, 1971-2 C.B. 234, for a ruling under IRC Section 501(c)(3) in which the facts are distinguishable from those in Rev. Rul. 69-528.)

Lack of parental control; securities—A nonprofit corporation formed to hold title to securities transferred to it by a group of philanthropists, and to turn over its income to a selected exempt organization that has no control over the corporation, isn't an exempt title-holding corporation. Rev. Rul. 71-544, 1971-2 C.B. 227.

Subsidiary of title-holding corporation—An organization incorporated as a subsidiary of an exempt title-holding corporation for the exclusive purpose of holding title to investment property, collecting the income from it, and turning over that income, less expenses, to the parent, qualifies for exemption as an organization per IRC Section 501(c)(2). Rev. Rul. 76-335, 1976-2 C.B. 141.

Acquisition indebtedness—Indebtedness a wholly owned tax-exempt subsidiary title-holding company owes to a labor union from a loan to pay debts incurred to acquire two income-producing office buildings isn't "acquisition indebtedness" under IRC Section 514(c). Rev. Rul. 77-72, 1977-1 C.B. 157.

Leasing to the public—A corporation that holds a leasehold interest in an office building, derives all its income from subleasing space in the building to the general public, and turns over the net rents to its exempt parent qualifies for exemption as an IRC Section 501(c)(2). Rev. Rul. 81-108, 1981-1 C.B. 327.