C. IRC 501(c)(2) - TITLE-HOLDING CORPORATIONS

1. Introduction

The subject of title-holding corporations has not been discussed in prior CPE texts. But for the issue of multiple parents, it has been a relatively trouble-free area. Our records indicate that there are only approximately 5000 exempt title-holding corporations nationwide. However, we have seen a growing trend toward the use of these organizations as investment vehicles for pension plans and other exempt organizations, and very substantial investments may be involved. This trend has raised various technical questions in this area, the most important of which, concerning multiple parents, currently remains under study. This topic focuses primarily on that problem.

Chapter 200 of IRM 7751, Exempt Organizations Handbook, contains a technical discussion of this subject. See also p. 83 of the 1983 CPE text for a discussion of the related question of feeder organizations denied exemption by IRC 502.

2. Background

IRC 501(c)(2) exempts from federal income tax corporations (as defined in IRC 7701(a)(3), "corporations" include associations) 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 IRC 501(a).

The statutory provision exempting title-holding corporations has remained substantially the same through successive enactments beginning with section 11(a) Twelfth of the Revenue Act of 1916, in which it originated.

The legislative history surrounding the original enactment of the provision makes no specific reference to the provision or to the purpose it was intended to serve. The general observation is made, however, that organizations accorded exemption in the 1916 Act were difficult to secure returns from, and that the Treasury collected little or no revenue from them. (See H. Rep. No. 922, 64th Cong., 1st Sess.)

The statute has always authorized the turning over of income by title-holding corporations to any organization exempt under IRC 501(a) (or its predecessors), but we have been unable to find information indicating the numbers or kinds of exempt organizations that may have utilized title-holding subsidiaries at the time of the original enactment.

It seems reasonable to assume that provision for the exemption of a title-holding corporation owned by an organization itself exempt from income tax was made by Congress in recognition of the existence of a number of factors that might impel an exempt organization to segregate its investments and property in separate corporations. These factors would include limitation of liability from potential damage suits; enhancement of ability to borrow; limitations imposed in gifts and bequests to exempt organizations that effectively require such gifts to be kept in separate entities; clarity of title; accounting simplification; and limitations imposed by various state laws on organizations that would be recognized as exempt under the federal revenue laws.

The exemption provisions were enacted over a period of eighty years by a variety of legislators for a variety of reasons. While it is clear, in retrospect, that many of the provisions have long outlived their historic justification, it is also clear in contemporary application that many of them continue to play a very crucial role in the law of tax-exempt organizations. IRC 501(c)(2) organizations, for example, currently provide a very popular means for unrelated IRC 401(a) pension trusts to collectively hold title to property. In addition, as one author has noted, "The title-holding company. . . may be ideal for many organizations seeking a tax-exempt haven for their headquarters building. Presumably the tax writing committees of Congress are not aware of the contemporary application of any of the statutes, and also presumably, they and the Congress will most likely be content to maintain the status quo unless there is significant abuse." McGovern, "The Exemption Provisions of Subchapter F," 29 Tax Lawyer 523, 547 (1976).

In any event, beginning with the earliest interpretations of the statutory provision, it has never been questioned that only companies acting as investment and holding companies, as opposed to operating companies, are exempt under this section. Where the active operation of any business other than the rental of real estate has been involved, exemption has consistently been denied. In addition to the exclusivity of purpose imposed by the statutory language and the evidence reflected in the precedents of a restrictive interpretation of the permissible ambit of operations for a title-holding corporation, there is evidence of a similarly restrictive philosophy with respect to the permissible scope of a title-holding corporation's

charter powers - with the result that broad business powers in a charter have generally formed a basis for denial of exemption. In our opinion, moreover, any current applicant for exemption as a title-holding corporation should, as a condition of qualification, be required to submit appropriately restricted charter provisions in this regard.

Regulations under IRC 501(c)(2) were first written in response to the Revenue Act of 1950, which imposed the unrelated business income tax on these organizations. These Committee Reports state that: "Since these organizations are presently limited to holding title to property, collecting income from it, and turning the proceeds over to other exempt organizations, the only trade or business in which they can engage is the rental of property." Thus, the rental of real property was clarified as being a permissible activity, which preserved the exemption from tax for those title-holding corporations already in existence that engaged in the rental of real property by excluding them from the feeder provisions of IRC 502. It should also be noted that other types of investments are permissible, including stocks, bonds, etc.

The regulations also provide that an IRC 501(c)(2) organization cannot have unrelated business income other than income which is treated as unrelated because of the application of IRC 512(a)(3)(C); or debt-financed income which is treated as unrelated because of IRC 514; or certain interest, annuities, royalties, or rents which are treated as unrelated because of IRC 512(b)(3)(B)(ii) or (13); and certain rents from personal property leased with real property which are treated as unrelated because of IRC 512(b)(3)(B)(i) or because of failure to meet the "incidental amount" exception in IRC 512(b)(3)(A)(ii).

An IRC 501(c)(2) organization formed by certain pension trusts and educational organizations is not subject to the tax on income from debt-financed property under IRC 514(c)(9). See that section for the requirement to qualify under it.

3. Issue of Multiple Parents*

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* In this context the term "parent" has traditionally been used, perhaps somewhat loosely, to refer to an organization that holds an interest in, but does not necessarily control, a corporation (or association within the meaning of IRC 7701(a)(3)).

As stated above, a major problem currently in the area of IRC 501(c)(2) involves the issue of whether a title-holding corporation may have multiple parents and, if so, under what circumstances.

The issue was considered in GCM 33604 (8-28-67), in which a corporation organized by ten lodges of a fraternal organization exempt under IRC 501(c)(8) was granted exemption under IRC 501(c)(2). The corporation held title to a building used in part by the lodges as their meeting hall and in part by commercial tenants on short term leases. The GCM concluded that this type of mutual undertaking by the lodges of a single fraternal organization, so long as it is confined to the operation and maintenance of real property, should not of itself preclude exemption under IRC 501(c)(2).

The GCM observed further that there is a distinct break in the logic that supports exemption between the case of the holding company whose only asset is a building designed to provide quarters for one exempt parent or even several exempt parents, and the holding company for, say, fifty different organizations exempt under IRC 501 having in common only the fact that each owns some portion of a piece of rental property tenanted by unrelated third parties, title to which is in a holding company for the fifty owners.

Rev. Ruls. 68-371, 1968-2 C.B. 204 and 68-490, 1968-2 C.B. 241, each involved title-holding corporations organized and operated for the benefit of two exempt organizations, but, the relationship between the organizations is not discussed in either situation, and neither revenue ruling was addressed specifically to the issue of multiple unrelated parents. Briefly, Rev. Rul. 68-371 states that a title-holding company will not continue to qualify for exemption when one of its two parents ceases to qualify, thereby recognizing implicitly that the existence of more than one parent is not per se disqualifying. Likewise, Rev. Rul. 68-490 holds a title-holding company subject to unrelated business income tax if one of its two parents is subject.

The issue of multiple unrelated parents was again considered in GCM 37351 (12-20-77). The organization described in this GCM was incorporated by a for-profit brokerage company to operate as a real estate investment trust in which exempt organizations, primarily employee benefit pension trusts described in IRC 401(a), were to be solicited to invest. The participating organizations were not related to each other.

Pension trusts were to be solicited to purchase or subscribe to shares of the organization. The amounts paid by subscribers became the initial assets of the organization, which could not commence operations until such time as a set minimum number of shares were issued. The organization would then purchase improved real property, including office buildings, shopping centers, etc. The income from the rental of these properties was to be paid to the organization's shareholders. The organization's articles of incorporation specified that its income would be paid at least annually to its shareholders and that if a shareholder lost its exempt status, it must sell or otherwise transfer its shares to any other exempt organization. Thus, the organization's articles attempted to conform to the obvious requirements of the statute and of Rev. Rul. 68-371, discussed above.

In holding that the organization did not qualify for exemption under IRC 501(c)(2), GCM 37351 referred to GCM 33604, supra, which dealt with the multiple ownership issue, and the fact that the organization would be engaged in the business of operating a real estate investment trust. GCM 37351 referred to the legislative history of IRC 501(f), which provides for the exemption of cooperative service organizations that invest funds for schools, stating:

> Section 501(f) is limited to organizations formed and controlled by the investing educational institutions themselves, and is not to apply to any organization formed to promote the furnishing of investment services by private interests even though those services might be made available only to educational organizations. In other words, if the schools that were involved formed their own cooperative investing organization, then it would be exempt under Section 501(f). However, if a private brokerage company or investment advisory company were to initiate the formation of a cooperative investing organization, in order to obtain customers for its business, such an organization would not be exempt . . . (Emphasis added.)

It concluded that this was an expression of Congressional disapproval of tax exempt status for commercially initiated organizations designed to create cooperative investment opportunities for exempt organizations.

The GCM stated that the organization did not qualify for exemption under IRC 501(c)(2) based on its projected multiple ownership and the fact that it would be engaged in the business of operating a real estate investment trust.

In GCM 38253 (1-23-80), this issue was again considered but was resolved in a manner that, some have argued, is difficult to reconcile with GCM 37351. The organization discussed in GCM 38253 applied for exemption under IRC 501(c)(2). It was owned by a single parent, an IRC 401 group trust exempt under IRC 501(a). However, the group trust was composed of and controlled by eleven pension or profit sharing trusts that were described in IRC 401 and exempt under IRC 501(a). The IRC 501(c)(2) applicant and the group trust were formed by a for-profit corporation that provided investment advice, handled the acquisition of real property, and provided property management services. In this respect, the facts do not differ from those of GCM 37351. GCM 38253 reaffirmed the position of GCM 37351 that, with minor exceptions in the nature of those implicitly recognized in Rev. Ruls. 68-371 and 68-490, supra, a corporation owned by more than one parent is not described in IRC 501(c)(2). The presence of multiple parents evidences a pooling of assets for a cooperative venture, and thus alters the fundamental character of the corporation from the mere holding of title to property to the active conduct of trade or business for profit. However, the GCM concluded that the group trust was the title-holding company's sole parent and, accordingly, the case did not present a multiple parent issue. It has been argued that form triumphed over substance in this situation.

In processing a proposed revenue ruling based on GCM 37351 it was subsequently contended that there is no substantive difference between ownership by a group trust and direct ownership by several exempt trusts or exempt organizations. The revenue ruling project is currently suspended for a policy decision on this subject.

As stated earlier, the only trade or business in which a title-holding company can engage is the rental of real property and limited amounts of personalty leased with the realty. If a title-holding corporation was formed by an investment management company to engage in securities trading for multiple unrelated exempt parent organizations, but not real estate transactions, the organization would not qualify for exemption under IRC 501(c)(2). Such an investment vehicle would be operated for the primary purpose of carrying on a trade or business and would be a feeder organization as described in IRC 502. The same rationale would apply to an organization engaging in the subdivision of real estate.

GCM 37351 notes that a title-holding corporation with multiple related, or even unrelated, parents all of whom are exempt organizations, which holds title to property used in full or part by the parents, may in certain circumstances qualify for exemption under IRC 501(c)(2). An exception to the general rule discussed in

GCM 37351 was envisioned in cases where the property was used directly by the parents in furtherance of their tax-exempt purposes. However, in GCM 39341 (2-27-85), this exception did not apply to a situation in which the real property had been acquired by the tax-exempt parents for investment purposes.

GCM 39341 notes that a proposed Senate amendment to the Tax Reform Act of 1984 (Pub. L. 98-369) would have provided, in certain cases, tax exemption for title-holding corporations with more than one parent. The organizations that would have been eligible to invest in a title-holding corporation included (1) a qualified pension plan, (2) a governmental pension plan, (3) the United States or any State or political subdivision, or (4) any charitable organization described in IRC 501(c)(3). The final measure passed by Congress did not contain this Senate amendment. See Conference Report accompanying the Tax Reform Act of 1984 published in H.R. Rep. No. 861, 98th Cong., 2d Sess. at 1097 and 1098.

GCM 37351 also provided that a title-holding corporation could qualify under IRC 501(c)(2) if related organizations, such as the lodges of an exempt fraternal organization, create it for a mutual undertaking. This exception only applies to organizations that are structurally related so that they may be viewed as constituting segments of the same organization, for example members of a group ruling. Common membership in an IRC 501(c)(6) trade association is not that type of structural relationship. If members of a trade association own stock in an organization that provides services to them and transfer their stock to a title-holding corporation, they have not transferred their interests in property they own jointly, but have merely transferred their shares of stock. Thus, the jointly held property exception would not apply. Such an organization would not qualify under IRC 501(c)(2).

It is important to bear in mind that this area is currently under review and the technical positions discussed in this topic may ultimately be changed. In this regard, there is a bill pending before the House Ways and Means Committee that would create a new subsection under IRC 501(c) to grant exemption to the type of organization described in GCM 37351.