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Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:ITA:B04
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Date:
March 30, 2009

Legend

Taxpayer =
$X =

Dear :

This letter is in response to Taxpayer's request for a letter ruling that it may carry forward its net operating losses incurred in years in which Taxpayer was a tax-exempt entity to years when Taxpayer is a taxable entity.

FACTS

Taxpayer is a California mutual benefit corporation currently recognized as an organization exempt from federal income tax under § 501(a) of the Internal Revenue Code by virtue of being a social club described in § 501(c)(7). Taxpayer reports its income using the accrual method of accounting.

In recent years Taxpayer claims that the use of its facilities by nonmembers has grown such that Taxpayer no longer satisfies the requirements for exemption under § 501(c)(7). Consequently, Taxpayer will relinquish its tax-exempt status under § 501(c)(7), and retain its legal status as a mutual benefit corporation. Taxpayer now requests a ruling that it may carry forward losses from its unrelated trade or business activities to years when it is a taxable organization. Taxpayer represents that it has

over $X of net operating losses from its unrelated trade or business activities to carry-forward.

LAW and ANALYSIS

Section 172(a) provides as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year.

Under § 172(b)(1)(A) a net operating loss for any taxable year is generally carried back to each of the two taxable years preceding the taxable year of such loss, and carried forward to each of the 20 taxable years following the taxable year of the loss. Generally, a NOL is carried back or carried forward only by the taxpayer sustaining the loss.

Section 172(b)(2) provides that the entire amount of the net operating loss for any taxable year must be carried to the earliest taxable year to which such loss may be carried under § 172(b)(1). The portion of such loss that may be carried to each of the other taxable years is the excess, if any, of the amount of such loss over the sum of the taxable income (as computed in accordance with the modifications set forth in § 172) for each of the prior taxable years to which such loss may be carried.

Under § 172(c), a net operating loss is the excess of a taxpayer's allowed deductions over its gross income, computed with the modifications specified in § 172(d).

Section 277 provides that in the case of a social club which is operated primarily to furnish services or goods to members and which is not exempt from taxation, deductions for the taxable year attributable to furnishing services, insurance, goods, or other items of value to members shall be allowed only to the extent of income derived during such year from members or transactions with members. If for any taxable year such deductions exceed such income, the excess shall be treated as a deduction attributable to furnished services, insurance, goods or other items of value to members, paid or incurred in the succeeding taxable year.

Section 501(c)(7) describes "[c]lubs organized for pleasure, recreation, and other nonprofitable purposes, substantially all the activities of which are for such purposes and no part of the net earnings of which inures to the benefit of any private shareholder." Since 1976, social clubs are permitted to derive up to 35% of their receipts from non-member sources, which includes investment income (interest, passive rents, dividends, and royalties), and unrelated trade or businesses income including providing goods and services to nonmembers. No more than 15% of the receipts can be from nonmembers for goods and services. [1]

[1] This 35%/15% requirement is not in the Code or the Regulations but rather in the legislative history to the 1976 changes in section 501(c)(7). *See* Pub. L. 94-568 (Oct. 20, 1976), Sen. Report No. 94-1318, 4-

Unrelated business taxable income under § 512 is generally defined as the gross income from an unrelated trade or business as defined by § 513, less any deductions directly connected with the carrying on of such trade or business subject to the modifications provided by § 512(b).

In general, § 511 imposes a tax on the unrelated business income of organizations described in §§ 401(a) and 501(c), as well as certain state colleges and entities. Within the context of a § 501(c)(7) organization, unrelated business taxable income is defined to be its gross income, including investment income, less its exempt function income and income from providing goods and services to members, whether or not arising from an unrelated trade or business.

Section 512(b)(6) provides that the net operating loss deduction[2] under § 172 shall be allowed without taking into account any amount of income or deduction that would be excluded as a result of its exemption from income tax.

In computing its unrelated business taxable income, a social club is permitted to deduct expenses incurred with respect to the unrelated business taxable income. In addition to the expenses attributable to the unrelated taxable business activities generating the income, they are allowed to allocate, pursuant to a reasonable method of allocation, a portion of certain expenses of the club, attributable to both exempt function income and unrelated business taxable income, as directly connected with the unrelated business taxable income. Section 1.512(a)-1(c) of the Income Tax Regulations; *Rensselaer Polytechnic Institute v Commissioner*, 732 F2d 1058, 1059 (2d Cir 1984) ; *Inter-Com Club, Inc. v. United States*, 721 F. Supp. 1112 (D. Neb. 1989).

Section 512(b)(6)(B) and § 1.512(b)-1(e)(2) provide that an organization subject to the unrelated business income tax provisions may not use a net operating loss carryover or net operating loss carryback from a year that the organization was not subject to the unrelated business income tax provisions. However, nothing in § 512 or the regulations thereunder provides that net operating losses incurred in the carrying on of an unrelated trade or business while the organization was subject to the unrelated business income tax provisions precludes the organization from using the net operating losses in years in which the organization is not exempt from tax under § 501(a).[3] Also, nothing in

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5, 1976-2 C.B. 598, 599.

[2] The existence of deductible losses presumes the activity is a trade or business, an activity carried on with a profit-motive. *Portland Golf Club v. Commissioner, 497 U.S. 154 (1990); West Virginia State Medical Ass'n v. Commissioner,* 882 F.2d 123 (4TH Cir. 1989)

[3] We note that § 1.512(b)-1(e)(4) states that, in determining the years to which a net operating loss may be carried under § 172(b), all years, including those in which the organization is not subject to the provisions of § 511, are taken into account.

§ 501(c)(7) prohibits the use of a net operating loss in years in which the organization is not exempt from tax under § 501(a).

Additionally, a social club that loses its exemption is likely to be subject to § 277. Nothing in § 277 prohibits an entity from using a net operating loss incurred in a year in which the entity is subject to the unrelated business income tax provisions of § 511 in years in which the entity is subject to § 277. Finally, there is nothing under § 172 that would prohibit Taxpayer from using its net operating losses in years in which it is a taxable entity.

CONCLUSION

Based solely on the submitted documents and representations made by Taxpayer, we conclude that if Taxpayer incurred a net operating loss in a year in which Taxpayer was subject to the provisions of § 511, Taxpayer may take a net operating loss deduction for such loss in taxable years in which Taxpayer is not exempt from tax under § 501(a) if the NOL is eligible to be used in such carryover years under § 172(b)(1)(A) and § 172(b)(2).

No opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item not discussed or referenced in this letter. In particular, we express no opinion as to whether Taxpayer incurred a net operating loss, as defined in § 172(c), in the years in which Taxpayer was subject to the provisions of § 511. In addition, we express no opinion regarding whether Taxpayer was a tax-exempt entity when the net operating loss was incurred or whether Taxpayer is a taxable entity in the years in which Taxpayer intends to use its net operating loss. Finally, we express no opinion as to whether the net operating loss has been absorbed by taxable income in eligible carryback or carryover years in accordance with the rules in § 172(b)(2).

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed

by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Michael J. Montemurro
Branch Chief
Office of Associate Chief Counsel
(Income Tax & Accounting)

cc: