DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Release Number: **201213034**
Release Date: 3/30/2012
Date: January 5, 2012

Employer Identification Number:

Person to Contact and ID Number:

Contact Telephone Number:

FAX Number:

UIL: 501.07-02
512.09-03

Legend:

M =
Year 1 =
Year 2 =

Dear

This ruling revokes and supersedes our prior ruling that was issued to M as *PLR 200451031* on September 21, 2004. The ruling was issued in response to M's letter dated December 15, 2003, regarding whether any gain realized by M on the sale of certain property would cause M to lose its tax exempt status and would be considered unrelated business taxable income under § 512 of the Internal Revenue Code.

The December 15, 2003, request indicated that M was incorporated in Year 1 under the nonprofit statute of the State in which in conducted its activities. In Year 2, it received a determination letter from the Internal Revenue Service (Service) recognizing it as tax exempt under § 501(a) of the Code as an organization described in section 501(c)(7). M's purposes, as outlined in its Constitution, were "...to promote boating and social recreation, to encourage members to become proficient in navigation and all matters pertaining to seamanship and to advance the cause of boating in its broadest sense."

M charged dues and annual assessments to its members in order to cover the costs of maintaining its facilities, making any necessary improvements, and for the retirement of debt. M also required members to meet certain work crew requirements to maintain the club premises. In addition, M stated that it operated a "Members' Bar" on the premises for the benefit and enjoyment of its members.

Despite the foregoing, M found it increasingly difficult to maintain its existence as its membership had aged, new membership had dwindled (primarily attributed to the various work requirements), and the costs of operation had increased. For these reasons, club members approved the sale and liquidation of M's assets to its members, complete cessation of operations, and the dissolution of the corporation. The membership was not considering any improvements to the property to facilitate a sale. At the time of M's ruling request, it had a contract to sell the property.

Based on the information furnished by M, we ruled in our September 21, 2004 letter that:

1. Any gain which M realizes on the sale of its assets will not cause it to lose its tax exempt status under § 501(c) (7).

2. Any gain which M realizes on the sale of its assets will not be treated as unrelated business taxable income under § 512.

LAW:

Section 501(c)(7) of the Code provides for the exemption of clubs organized and operated 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.

Section 511 imposes a tax on the unrelated business taxable income (as defined in section 512) of organizations exempt from tax under section 501(c) of the Code, including those described in § 501(c)(7).

Section 512(a)(3)(A) provides, in part, that with respect to an organization described in §501(c)(7), the term "unrelated business taxable income" means the gross income (excluding any exempt function income), less the deductions allowed by this chapter which are directly connected with the production of the gross income (excluding exempt function income), both computed with certain modifications provided in § 512(b).

Section 512(a)(3)(B) defines "exempt function income" to mean the gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members of their dependents or guests goods, facilities, or services in furtherance of the purposes constituting the basis for the exemption of the organization to which income is paid.

Section 512(a)(3)(D) provides, in part, that if property used directly in the performance of an exempt function of a organization described in section 501(c)(7) is sold by the organization, and within a period beginning one year before the date of the sale and ending three years after it, other property is purchased and used by such organization directly in the performance of its exempt function, gain (if any) from such sale shall be recognized only to the extent that such organization's sales price of the old property exceeds the organization's cost of purchasing the other property.

Section 512(b)(5), in part, excludes from the term "unrelated business taxable income" all gains or losses from the sale, exchange, or other disposition of property, other than property held primarily for sale to customers in the ordinary course of trade or business.

Section 1.501(c)(7)-1(a) of the Income Tax Regulations states that the exemption provided to organizations described in § 501(c)(7) applies only to clubs which are organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, but does not apply to any club if its net earnings inures to the benefit of any private shareholder. The regulation also states that, in general, this exemption extends to social and recreation clubs, which are supported solely by membership fees, dues, and assessments. However, a club otherwise entitled to exemption will not be disqualified because it raises revenue from members through the use of club facilities or in connection with club activities.

Section 1.501(c)(7)-1(b) provides that a club which engages in business, such as making its social and recreational facilities available to the general public or by selling real estate, timber, or other products, is not organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, and is not tax exempt. Solicitation by advertisement or otherwise for public patronage of its facilities is prima facie evidence that the club is engaging in business and is not being operated exclusively for pleasure, recreation, or social purposes. However, an incidental sale of property will not deprive a club of its exemption.

Rev. Rul. 58-501, 1958-2 C.B. 262, holds that where a social club described in § 501(c)(7) finds it impracticable to continue to conduct its exempt activities and sells its property and liquidates, such a sale is incidental to its exempt purposes. The revenue ruling states that the club is still considered to be operating exclusively for pleasure, recreation, and similar purposes up through the date of the sale and distribution of the liquidated asserts to its active members. The revenue ruling concludes that profit from the sale by the club of all its property in conjunction with the termination of its activities and liquidation does not deprive the club of the exemption provided by § 501(c)(7).

Section 13.04 of Rev. Proc. 2011-4, 2011-1 I.R.B. 123, states, in part, that a letter ruling found to be in error or not in accord with the current views of the Service may be revoked or modified. A letter may be revoked or modified due to a notice to the taxpayer to whom the letter ruling was issued.

Tamarisk Country Club v. Commissioner, 84 T.C. 756 (1985), involved an organization exempt under § 501(c)(7) that used realized gain from a property sale to purchase other property for an amount less than the consideration it received from the land sale taking into account selling expenses. Both sold and purchased properties were used directly in the performance of the organization's exempt function activity. The court found that § 512(a)(3)(D) requires that gain realized on the sale of property used directly in the performance of the exempt function of a § 501(c)(7) organization be recognized, to the extent that the consideration for the sale, less selling expenses and expenses for work performed to assist in the sale of the property, exceeds the cost of other property purchased by the organization and used directly in the performance of its exempt function. This case was the first judicial consideration of the 1969 Tax Reform Act provision, § 512(a)(3)(D), which sheltered gain on the sale of property by a social club. The court held that the amount of gain reinvested by a club in new property for its exempt purpose was sheltered from tax, but the amount of gain distributed to the members was subject to tax.

In Atlanta Athletic Club v. Commissioner, 980 F.2d 1409 (1993), the court held that a gain on the sale of land that was fully reinvested in other exempt property qualified for non-recognition of gain under § 512(a)(3)(D), even though it had not been in continuous or direct use before the sale.

In Deer Park Country Club v. Commissioner, 70 T.C.M. (CCH) 1445 (1995), the court held that the sale of land that was never actually used for club purposes was not qualified for non-recognition of gain under § 512(a)(3)(D) regardless of the fact that the organization originally purchased the land with the intent of using it for its exempt function.

Public Law 91-172 (1969) extended §501(c)(7) of the Code, the Senate Report 91-552 (1969), 1969-3 C.B. 423, at 470, stated:

> ...where the organization receives income from sources outside the membership, such as income from investments..., upon which no tax is paid, the membership receives a benefit not contemplated by the exemption...the extension of the exemption to such investment income is, therefore, a distortion of its purpose.

However, Congress afforded social clubs a special exception for revenue earned by the sale of exempt function property that had been used directly in the performance of its exempt function. If the proceeds are used within a specified period to purchase other property used in the performance of its exempt function, no tax is assessed. Section 512(a)(3)(D). The legislative history discusses the reason to protect proceeds that are reinvested in the exempt purpose. Proceeds that are reinvested in the exempt function of the club:

> ...are not being withdrawn for gain by the members of the organization. For example, where a social club sells its clubhouse and uses the entire proceeds to build or purchase a larger clubhouse, the gain on the sale will not be taxed if the proceeds are reinvested in the new clubhouse within three years. Senate Report 91-552 (1969), 1969-3 C.B. 423, at 471.

ANALYSIS:

Organizations exempt under § 501(c)(7) are subject to a particular unrelated business income tax regime which treats gain on sale of their property differently from gain received by other types of § 501(c) organizations. Section 512(a)(1) provides the general rule for unrelated business income tax, which applies to § 501(c) organizations and is defined narrowly as gross income derived by any organization from any unrelated trade or business that is regularly carried on. The statute further states that the modifications under § 512(b) apply.

In contrast, § 512(a)(3)(A), which provides the unrelated trade or business income tax rule for taxing organizations exempt under § 501(c)(7) (as well as §§ 501(c)(9), (c)(17), and (c)(20) entities), defines gross income broadly by not referencing the more narrow "unrelated trade or business regularly carried on" standard. Rather than isolating the actual unrelated business income and taxing it, § 512(a)(3)(A) instead isolates "exempt function income" for exemption and taxes all other income. It does so by negatively defining unrelated business taxable income for social organization to mean all income that is not "exempt function income," irrespective of whether the income generating activity meets the "trade or business regularly carried on" standard that is generally applicable under the unrelated business income tax regime.

Hence, the only § 501(c)(7) income excluded from tax is "exempt function income" and the only applicable modifications are specifically listed as §§ 512(b)(6), (10), (11), and (12). This list explicitly does not include § 512(b)(5), which excludes from unrelated business income tax all gains or losses from the sale, exchange, or other disposition of property, (excluding stock or other property, held primarily for sale to customers in the ordinary course of trade or business, and gains and losses from investment activities) and which, in this case, would have allowed M an entity level exemption for its dissolution proceeds.

Several courts have ruled on the application of the unrelated business income tax to the sale of property by a social club. In Tamarisk Country Club, 84 T.C. 756, the court ruled that the club did owe tax on the portion of the proceeds from sale of its property that exceeded the amount used to purchase new exempt property because it was not reinvested, but withdrawn for gain by the members of the organization. The court applied the principle that revenue from the sale of property will be taxed, except if it is reinvested in exempt function property.

In Atlanta Athletic Club,980 F.2d 1409, the property did qualify for non-recognition of gain because the property was used in exempt functions and reinvested in other property used in exempt functions within three years after the sale. In Deer Park Country Club, 70 T.C.M. (CCH) 1445, the property had never been used for exempt functions, and so was not eligible for the non-recognition of gain.

The facts surrounding the proposed sale of M's assets show that its property has been used to carry out M's exempt activities, but circumstances have changed, specifically the aging of the club membership, inability to attract a sufficient number of new members, and increased costs of operation.

Thus, M now wishes to sell its assets in conjunction with the dissolution of the club. As in the case of the sale of club property by the organization described in Rev. Rul. 58-501, supra, the purpose of the sale of M's assets is to facilitate the club's dissolution rather than to make a profit. As noted in § 1.507(c)(7)-1(b), an incidental sale of property will not adversely affect a social club's tax exempt status. Furthermore, the distribution of liquidated assets to M's members will not result in the revocation of the club's tax exempt status.

However, Rev. Rul. 58-501, supra, does not address unrelated business income tax. Also, it was issued prior to the 1969 Act's enactment of the special unrelated business income tax rules, codified in § 512(a)(3)(D). Since M's property was intended to be sold and the income not used to purchase other property to be used by M directly in the performance of its exempt function, the gain from the sale must be recognized as unrelated business taxable income. Section 512(a)(3)(D). Thus the conclusion regarding unrelated business income that was expressed in our ruling issued to M as *PLR 200451031* on September 21, 2004, is in error.

Pursuant to Rev. Proc. 2011-4, supra, *PLR 200451031* should be revoked.

CONCLUSION:

Based on the foregoing, we rule as follows:

(1) Any gain which M realizes on the sale of its assets will not cause it to lose its tax exempt status under s§ 501(c)(7).

(2) The gain on the sale of M's property is considered to be unrelated business taxable income under § 512.

This ruling revokes and supersedes our prior ruling that was issued to M as *PLR 200451031* on September 21, 2004.

This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described above.

If M or its authorized representative has any questions about this letter, contact the person whose name and telephone number are shown in the heading. We understand, based on a phone conversation with M's authorized representative on December 20 , that M has not acted in reliance on the letter ruling dated September 21, 2004. If however, you, M, believe that you are entitled to relief under section 7805(b) of the Code from the retroactive revocation of the letter, you may request section 7805(b) relief pursuant to section 13.09 of Rev. Proc. 2011-4, 2011-1 I.R.B. 123, 153.

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

Sincerely yours,

Michael Seto
Acting Manager,
Exempt Organizations
Technical

cc: