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Appendix 6AL

Revenue Ruling 2003-73—Losses from Member Transactions Can Not Offset Nonmember Income, But Losses from Nonmember Transactions Can Offset Both Nonmember and Member Income

Cross Reference Data

Topical

Loss carryover**Membership organizations****Member losses****Member income****Net operating loss****Social clubs**

Citation

IRC Sections—172, 277—2F (Section 172 not included in this Guide)**Case—*Concord Consumers Housing Cooperative v. Commissioner*—41****Regulations Section—1.277-1—5F****Revenue Ruling—70-604—6H**

Summary

The IRS determined that a taxable social club was not entitled to use its losses from member transactions to offset its nonmember income. The taxpayer's investment income was deemed nonmembership income and, therefore, could not be used to offset membership losses. Pursuant to IRC Sec. 277(a), the taxpayer was required to carry forward the member losses to the next tax year as expenses incurred in providing goods and services to members. However, the taxpayer's nonmember transaction losses were fully deductible against both nonmember and member income.

Losses From Member Transactions Can Not Offset Nonmember Income, But Losses From Nonmember Transactions Can Offset Both Nonmember and Member Income

Revenue Ruling 2003-73, I.R.B. 2003-28, (Jul. 1, 2003)

ISSUE

(1) Whether a membership organization described in section 277(a) of the Internal Revenue Code may offset losses generated from the provision of goods and services to members during the current year against income earned from the provision of goods and services to nonmembers during the current year?

(2) Whether a membership organization described in section 277(a) of the Internal Revenue Code may offset losses generated from the provision of goods and services to nonmembers during the current year against income earned from the provision of goods and services to members during the current year?

FACTS

Club A is a taxable social club that operates a golf course, tennis courts and a clubhouse (including a restaurant) primarily for the benefit of its members. A has significant nonmember source income from use of the clubhouse by the general public for wedding receptions, anniversary parties and special events. The nonmember use of the clubhouse is a trade or business. A also has investment income. Over a four-year period, after deducting allowable expenses, A has the following amounts of income (or loss) derived from the provision of goods and services to members and nonmembers and from investments:

In Year 1, A has a loss of \$2,000 from member transactions, income of \$3,500 from nonmember transactions, and investment income of \$500.

In Year 2, A has income of \$1,500 from member transactions, income of \$3,000 from nonmember transactions, and investment income of \$500.

In Year 3, A has income of \$2,250 from member transactions, income of \$2,500 from nonmember transactions, and investment income of \$500.

In Year 4, A has income of \$1,000 from member transactions, a loss of \$2,000 from nonmember transactions, and investment income of \$500.

LAW

Section 277(a) applies to taxable social clubs or other taxable membership organizations operated primarily to provide goods or services to members.

Section 277(a) generally provides that 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 that year from members or transactions with members. If for any taxable year such member-transaction deductions exceed member income, the excess shall be treated as a deduction attributable to furnishing services, insurance, goods, or other items of value to members paid or incurred in the succeeding taxable year.

Section 277(a) only applies to transactions with members. As a result, deductions for a taxable year attributable to furnishing services to members in excess of member income earned during such taxable year are not permitted to offset income derived from transactions with nonmembers (nonmember income) during such taxable year. Instead, the excess deductions are permitted to reduce income derived from furnishing services to members in the next succeeding taxable year. Moreover, investment income generally constitutes nonmember income for purposes of section 277, and, therefore, investment income cannot be offset by expenses of providing goods and services to members. See *Concord Consumers Housing Cooperative v. Commissioner*, 89 T.C. 105 (1987).

Section 172 generally provides for a deduction of net operating losses, and the taxable years to which the net operating losses may be carried back or carried forward.

ANALYSIS

Section 277(a) applies to A Consistent with the analysis in *Concord Consumers Housing Cooperative*, the fact that some or all of the principal generating A's investment income came from members does not cause the investment income to be treated as member income. As A's investment income is not otherwise derived from transactions with members, A's investment income is nonmember income for purposes of section 277.

Section 277(a) applies to A's member and nonmember income and losses as follows:

	<u>Member Income</u>	<u>Nonmember Income</u>	<u>Taxable Income</u>
<u>Year 1</u>			
Income/(Loss) before loss carryover	(2,000)	4,000	
Minus loss carried forward	<u>N/A</u>	<u>N/A</u>	
Income/(loss)	(2,000)	4,000	4,000
Loss carryover	(2,000)	-0-	
<u>Year 2</u>			
Income/(Loss) before loss carryover	1,500	3,500	
Minus loss carried forward	<u>(2,000)</u>	<u>-0-</u>	
Income/(loss)	(500)	3,500	3,500
Loss carryover	(500)	-0-	
<u>Year 3^a</u>			
Income/(Loss) before loss carryover	2,250	3,000	
Minus loss carried forward	<u>(500)</u>	<u>-0-</u>	
Income/(loss)	1,750	3,000	4,750
Loss carryover	-0-	-0-	
<u>Year 4</u>			
Income/(Loss) before loss carryover	1,000	(1,500)	

	<u>Member Income</u>	<u>Nonmember Income</u>	<u>Taxable Income</u>
Minus loss carried forward	-0-	-0-	
Income/(loss)	1,000	(1,500)	(500)
Loss available for carryback or carryover	-0-	(500) ^b	

In Year 1, A has a loss of \$2,000 from providing goods and services to members. A cannot deduct this loss against nonmember income. The loss is carried forward to Year 2 as an expense of providing goods and services to members in the next succeeding taxable year. Thus, A has zero member income in Year 1. A has \$4,000 in nonmember income in Year 1 (\$3,500 + 500). A's taxable income in Year 1 is \$4,000 (\$0 + \$4,000).

In Year 2, A has income before any loss carryforward of \$1,500 from providing goods and services to members. A deducts the \$2,000 net loss carried forward from Year 1 against its member income of \$1,500, resulting in a member loss of (\$500) in Year 2 (\$1,500 - \$2,000). The \$500 unused net loss carryforward from Year 1 is carried to Year 3 as an expense of providing goods and services to members in the next succeeding taxable year. A has \$3,500 in nonmember income in Year 2 (\$3,000 + \$500). A's taxable income in Year 2 is \$3,500 (\$0 + \$3,500).

In Year 3, A has income of \$2,250 from providing goods and services to members. A deducts the \$500 net loss carried forward from Year 2 against its member income of \$2,250, resulting in member income of \$1,750 in Year 3 (\$2,250 - \$500). A has \$3,000 in nonmember income (\$2,500 + \$500). A's taxable income in Year 3 is \$4,750 (\$1,750 + \$3,000).

In Year 4, A has income of \$1,000 from providing goods and services to members and no loss carryforward deduction from Year 3. A's member income in Year 3 is \$1,000. A has a \$1,500 nonmember loss ((\$2,000) + \$500). A offsets its nonmember loss against its member income, resulting in a taxable loss in Year 4 of \$500 (\$1,000 - \$1,500). If the \$500 loss satisfies the requirements of section 172, A has a net operating loss of \$500 that, subject to the net operating loss rules of section 172, may be used in calculating taxable income for other taxable years. ^b

HOLDINGS

(1) A taxable social club's loss from transactions with members does not offset nonmember income, but instead is carried forward to the next succeeding taxable year as expenses incurred in providing goods and services to members.

(2) A taxable social club's loss from transactions with nonmembers is fully deductible against both nonmember income and member income.

DRAFTING INFORMATION

The principal author of this revenue ruling is Ronald B. Weinstock of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this revenue ruling contact Mr. Weinstock at (202) 622-4290 (not a toll-free call).

Notes:

^a If this were a homeowners' association, then the members of the association could have made an election under Rev. Rul. 70-604 (Appendix 6H) to carry this \$1,750 forward to avoid taxation in Year 3. However, given the results of Year 4 operations, the \$1,750 would still be subject to taxation, as there is no net member loss to absorb the carryover from Year 3.

^b This clearly distinguishes between a loss subject to IRC Sec. 172 and a loss subject to IRC Sec. 277 (Appendix 2F).

Additional Consideration: The four example calculations above clearly demonstrate the interaction of IRC Sec. 277 with Rev. Rul. 70-604. There is no indication in this revenue ruling that the subject organization is a homeowners' association. However, since IRC Sec. 277 applies to homeowners' associations, the same results would occur, except as noted in Note a.

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