

INTERNAL REVENUE SERVICE

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December 18, 1998

Legend:

Company =

Timber Co. =

State A =

Date 1 =

Date 2 =

Business B =

Business C =

X =

Y =

Dear :

This letter responds to your September 2, 1997 request for rulings on behalf of Company and its affiliates in regard to certain federal income tax consequences of a proposed transaction. Additional information was submitted in letters dated February 20, 1998, June 30, 1998, October 15, 1998, and December 10, 1998. The information submitted for consideration is summarized below.

Company, a C corporation, is a privately-held timber and forest products company organized under State A law and is on the accrual method of accounting. Its

tax year ended on July 31. Company directly owns and manages large tracts of unimproved timberlands, as well as interests in x and y. Prior to a restructuring that was completed by Date 1, Company was engaged in harvesting timber from its timberlands and selling logs and pulpwood produced therefrom to customers. Company was also engaged in Business B and Business C either directly or through wholly-owned subsidiaries or controlled partnerships.

Company restructured its operations to qualify to elect to be taxed as a real estate investment trust ("REIT"). Company will change its tax year to a calendar year and elect to be treated as a REIT beginning with its taxable year starting on Date 2. Company also plans to make the election described in Notice 88-19, 1988-1 C.B. 486, so that it will be subject to rules similar to the rules of § 1374 of the Internal Revenue Code. Following Company's election to be taxed as a REIT and during the recognition period (as defined in § 1374(d)(7)), Company proposes to dispose of timber to Timber Co. pursuant to a contract entitled "Timber Harvest Agreement between Company and Timber Co" (attached and hereinafter the "Contract"). The term of the Contract is one year. Company expects the Contract to be governed by § 631(b).

Under the Contract, Company agrees to manage and maintain, at its cost, all of its timberlands in accordance with the terms of the Contract, and Timber Co. agrees to harvest from those timberlands such merchantable timber as is designated in a Harvest Plan in accordance with the Contract. The Harvest Plan specifying the merchantable timber to be cut under the Contract is prepared by Company and includes, for each geographic area subject to the Contract, information concerning acreage, estimated volume of each species to be harvested, and any special restrictions or procedures affecting harvest operations. The Harvest Plan must provide for the harvest of an agreed volume of saw timber and pulpwood timber. The Contract provides that in the event that unforeseen circumstances prevent the harvest of the agreed volume from the areas specified in the Harvest Plan, that Timber Co. will be allowed access to alternate areas in order to harvest the balance of that volume.

The Contract provides that Timber Co. shall cut, remove, and pay for the merchantable timber harvested in accordance with the Harvest Plan. Title to the timber remains with Company until it is harvested. Payment will be made monthly based upon prevailing market price during the calendar quarter for the class and species harvested. The Contract provides that the harvested timber will be scaled or weighed promptly after cutting, and that Timber Co. will submit to Company a monthly report detailing for each area subject to the Harvest Plan the total scaled volume and the total calculated price. In the event of default by Timber Co., Company has the right to pursue money damages for losses or costs caused by the default and to pursue injunctive or other equitable relief, including enforcement of Timber Co.'s contractual obligations. The Contract also provides that in the event that Timber Co. is unable to complete the harvest of the merchantable timber in a particular geographic area within the term of the Contract, and does not promptly cure that failure, Timber Co. must pay to Company an amount determined by Company representing lost revenue or damage arising from that

failure. However, such payment would be payable only if, according to an opinion of counsel, it would not jeopardize § 631(b) treatment, and would not adversely affect Company's status as a REIT.

The Contract provides that Timber Co. shall pay all of its own costs of logging and hauling. All yield taxes, harvest taxes, severance taxes, and other taxes assessed in respect of timber harvested shall be paid by Timber Co. Company shall pay all taxes, assessments, and other governmental impositions relating to the ownership, management, and operation of the timberlands. Timber Co. will not permit any lien to be enforced on or against the timberlands, any improvement thereon, or any timber, for work, labor, materials, supplies, or equipment furnished by or at the request of Timber Co. Company reserves the right during the term of the Contract to harvest timber from the timberlands, in addition to the timber to be harvested by Timber Co. as specified in the Harvest Plan.

During the term of the Contract, Timber Co. is granted full and free access at all times to the timberlands and the nonexclusive right to use all roads and other means of ingress to and egress from the timberlands. Timber Co. is also granted the nonexclusive right to use any easement, right of way, license, or permit for access belonging to Company that may be useful or necessary to Timber Co. in connection with the Contract.

It is represented that Company and Timber Co. are independent entities, and that all operations of Timber Co. will be performed entirely for Timber Co.'s account and not as an agent, employee, or contractor of Company. The Contract provides that it does not create a partnership or fiduciary relationship between the parties. The Contract further provides that a purpose of the Contract is to secure Company treatment pursuant to § 631 (b) and to harvest Company's merchantable timber.

Company requests rulings that:

- (1) Company's dispositions of merchantable timber pursuant to the Contract will satisfy the requirements of § 631(b) for timber held by Company for more than one year at the time it is cut.
- (2) If Company makes the election provided for in Notice 88-19, Company will not be subject to tax on its net unrealized built-in gains on the date that it elects REIT status, but will instead be subject to rules similar to the rules of § 1374.
- (3) Company's gain on dispositions of timber under the Contract during the 10-year recognition period will not be subject to tax under § 1374.

On November 16, 1998, the Service published Rev. Proc. 98-56, 1998-46 I.R.B. 33. This revenue procedure amplifies Rev. Proc. 98-3, 1998-1 I.R.B. 100, concerning

matters in which the Service will not issue advance rulings ("No Rule"), to include certain issues arising under the timber, coal, and domestic iron ore industries under §§ 631 and 1374. The "No Rule" covers dispositions of timber under contracts governed by § 631(b). Rev. Proc. 98-56 applies to all ruling requests, including any pending in, or received by, the National Office on or after October 31, 1998 (the date the revenue procedure was released to the public).

Company, in requesting relief from the retroactive application of Rev. Proc. 98-56, requested that the Service issue its pending letter ruling. Among the reasons and arguments presented in support of Company's request for relief was the fact that a number of taxpayers submitted requests for substantially identical rulings well after Company's submission, and received their letter rulings. Having considered all the circumstances and the arguments and explanations presented by Company, we have concluded that granting relief is appropriate.

Section 631(b) provides that in the case of the disposal of timber held for more than one year before the disposal, by the owner thereof under any form or type of contract by virtue of which the owner retains an economic interest in the timber, the difference between the amount realized from the disposal of the timber and the adjusted depletion basis thereof, shall be considered as though it were a gain or loss, as the case may be, on the sale of the timber. The date of disposal of the timber shall be deemed to be the date the timber is cut, but if payment is made to the owner under the contract before the timber is cut the owner may elect to treat the date of payment as the date of disposal of the timber. For purposes of this subsection, the term "owner" means any person who owns an interest in the timber, including a sublessor and a holder of a contract to cut timber.

In order for there to be a disposal of timber under a contract for purposes of section 631(b), the lessee must have a contractual obligation to cut specified timber. See, e.g., Rev. Rul. 77-229, 1977-2 C.B. 210 (citing Ah Pah Redwood Co. v. Commissioner, 251 F.2d 163 (9th Cir. 1957); Jantzer v. Commissioner, 284 F.2d 348 (9th Cir. 1960); Patterson v. Belcher, 302 F.2d 289 (5th Cir. 1962), opinion amended and reh. den., 305 F.2d 557, cert. denied, 371 U.S. 921 (1962)). Pursuant to the Contract, Timber Co. agrees to cut, remove, and pay for all of the merchantable timber designated in the Harvest Plan, and Company may seek monetary or other relief from Timber Co. on default of Timber Co.'s obligations under the contract. Therefore, Timber Co. has a contractual obligation to cut specified timber.

Section 1.631-2(e)(2) provides that in order to be the owner of timber a taxpayer must have a right to cut timber for sale on its own account or for use in its trade or business. Company has represented that it is the owner of the timber for purposes of § 631(b).

Neither § 631(b) nor the regulations thereunder give guidance on what constitutes a retained economic interest. Section 1.611-1(b)(1), however, provides that

an economic interest is possessed when a taxpayer has acquired by investment any interest in standing timber and secures, by any form of legal relationship, income derived from the severance of the timber, to which the taxpayer must look for a return of capital. In other words, an owner retains an economic interest under a timber cutting contract if the amount of the payment for the timber depends solely on the actual quantity of timber cut. In this case, because title to the designated timber, including the risk of loss due to casualty, stays with Company until the timber is severed and paid for by Timber Co. and because payments to Company are based on the volume of timber severed from the property as determined by scaling or weighing, Company will be treated as having retained an economic interest for purposes of § 631(b).

Notice 88-19 provides that, in the case of a C corporation that elects to be taxed as a RIC or REIT or transfers assets to a RIC or REIT in a carryover basis transaction, Treasury Regulations that are to be promulgated will require the C corporation to recognize any net built-in gain (the excess of aggregate gains (including items of income) over aggregate losses) that would have been realized if the corporation had liquidated at the end of its last taxable year in which it elects to be taxed as a RIC or REIT. In lieu of the foregoing treatment, Notice 88-19 further provides that regulations will be issued that will permit the transferred RIC or REIT to elect to be subject to rules similar to the rules of § 1374. Notice 88-19 states that the regulations will apply to conversions to RIC or REIT status or transfers to a RIC or REIT that are effective for taxable years beginning on or after June 10, 1987, unless the provisions of subchapter M apply to such corporation for the taxable year including June 9, 1987. Finally, Notice 88-19 states that it can be relied upon by taxpayers "to the same extent as a revenue ruling or revenue procedure."

Section 1374 imposes a corporate-level tax on an S corporation's net recognized built-in gain during the recognition period (generally 10 years) following (a) a C corporation's conversion to S corporation status (§ 1374(a)), or (b) an S corporation's acquisition of C corporation assets in a carryover basis transaction (§ 1374(d)(8)).

Section 1374(d)(2) provides that an S corporation's net recognized built-in gain for any taxable year is generally its taxable income for the year computed as if it were a C corporation, but taking into account only items treated as recognized built-in gain or recognized built-in loss.

Section 1374(d)(3) provides that recognized built-in gain includes any gain recognized on the disposition of an asset during the recognition period, except to the extent the S corporation shows that (a) it did not hold the asset as of the beginning of the first taxable year for which it was an S corporation (the "Conversion Date"), or (b) the gain recognized was greater than the excess of the asset's fair market value over its adjusted basis on the Conversion Date.

Section 1.1374-4(a) of the Federal Income Tax Regulations provides that § 1374(d)(3) applies to any gain or loss recognized during the recognition period in a

transaction treated as a sale or exchange for federal tax purposes.

Section 1374(d)(6) provides that if the adjusted basis of any asset is determined (in whole or in part) by reference to the adjusted basis of any other asset held by the S corporation on the Conversion Date, the asset is treated as held by the S corporation on the Conversion Date, and any determination under § 1374(d)(3) with respect to that asset is made by reference to the fair market value and adjusted basis of the other asset on the Conversion Date.

Section 1.611-3(b)(1) of the regulations provides that the depletion of timber generally takes place at the time timber is cut. To the extent that depletion is allowable in a particular taxable year, the depletion allowable is included as an item of cost in the closing inventory of the timber products for the year.

In Example 1 of § 1.1374-4(a)(3), X is a C corporation that elects to become an S corporation effective January 1, 1996. On the Conversion Date, X owns a working interest in an oil and gas property on which production of oil has not yet begun, and the fair market value of the working interest exceeds X's basis in the working interest by \$200,000. During the recognition period, X produces and sells oil from the working interest and includes \$75,000 in income on the sale. X's \$75,000 of income is not recognized built-in gain because on the Conversion Date X held only a working interest in the oil and gas property and not the oil it sold.

In Example 2 of § 1.1374-4(a)(3), Y is a C corporation that elects to become an S corporation effective January 1, 1996. On the Conversion Date, Y owns a royalty interest in an oil and gas property, and the fair market value of the royalty interest exceeds Y's adjusted basis in the royalty interest by \$100,000. During the recognition period, Y sells the royalty interest and recognizes a gain of \$75,000 on the sale. Y's \$75,000 gain is recognized built-in gain because Y held the royalty interest on the Conversion Date.

Based solely on the information submitted and authority set forth above, we rule as follows:

- (1) Company's dispositions of merchantable timber pursuant to the Contract will satisfy the requirements of § 631(b) for timber held by Company for more than one year at the time it is cut.
- (2) If Company makes the election provided for in Notice 88-19, Company will not be subject to tax on its net unrealized built-in gains on the date that it elects REIT status, but will instead be subject to rules similar to the rules of § 1374.
- (3) Company's gain on dispositions of timber under the Contract during the

10-year recognition period will not be subject to tax under § 1374.

We express no opinion about the federal tax consequences of the above described transaction under any other provision of the Code or regulations or the tax treatment of any conditions existing at the time of, or effects resulting from Company's elections or Company's disposal of timber that are not specifically stated in the rulings above. In particular, we express no opinion on whether any payments made representing lost revenue or damage arising from the failure of Timber Co. to cut the timber specified in the Contract jeopardize the Contract's qualification under § 631(b). Further, we express no opinion concerning the federal income tax treatment of (a) the character of income derived from any timber disposition or from any payment under the Contract, (b) any timber disposition occurring during the recognition period under any contract or arrangement other than the Contract, (c) any sale of logs cut before, rather than during, the recognition period, (d) income categories under § 1374 other than those described in the rulings above, and (e) the validity of the above described elections. In addition, no opinion is expressed and none was requested concerning whether Company qualifies as a REIT under subchapter M, part II of Chapter 1 of the Code. No opinion is expressed and none was requested concerning Company's pre-election restructurings under any of the nonrecognition provisions of the Code.

The rulings in this letter are based on the facts and representations submitted under penalties of perjury in support of the request. Verification of that information may be required as part of the audit process.

This ruling letter has no effect on any earlier documents and is directed only to the taxpayer who requested it. This ruling letter has no effect on Rev. Proc. 98-56. Section 6110(k)(3) provides that this ruling letter may not be used or cited as precedent.

The taxpayers involved must attach a copy of this letter to their federal income tax returns for Company's final tax year as a C corporation and for each recognition period year in which an above-described disposition occurs.

Pursuant to a power of attorney on file in this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Assistant Chief Counsel (Corporate)

By: _____
Mark S. Jennings
Senior Technician Reviewer, Branch 1

Enclosures:

Copy of this letter

Copy for § 6110 purposes