

INTERNAL REVENUE SERVICE

Number: **200052021**

Release Date: 12/29/2000

Index No.: 856.00-00

CC:DOM:FI&P:1 - PLR-118175-99

September 28, 2000

Legend:

Taxpayer =

Corporation A =

a =

b =

LLC =

OP =

c =

d =

e =

f =

g =

Corporation B =

Dear :

This is in reply to your letter dated November 8, 1999, and subsequent submissions, requesting a ruling on behalf of Taxpayer. You have requested the following rulings:

1) Taxpayer's interests in real property and the timber thereon constitute "real estate assets" within the meaning of §§ 856(c)(5)(B) and 856(c)(4)(A) of the Internal Revenue Code;

2) Taxpayer's income from the disposal of timber pursuant to cutting contracts meeting the requirements of § 631(b) will be treated as gross income described in §§ 856(c)(2)(D) and 856(c)(3)(C) and not income derived from prohibited transactions under § 857(b)(6);

3) Income from disposals of timber with a holding period of

one year or less derived from cutting contracts under which the owner of the timber retains an economic interest in the timber disposed of constitutes gross income described in §§ 856(c)(2)(C) and 856(c)(3)(A); and,

4) OP's holding period in its assets will be used in determining the character of the gain allocated to Taxpayer by OP from gain recognized by OP from the sale or exchange of property used in a trade or business.

Facts:

Taxpayer is a domestic corporation that intends to elect to be treated as a real estate investment trust (REIT). Taxpayer currently is the managing general partner of OP but has no economic interest in OP and no other assets. Taxpayer will make an underwritten public offering of its stock. Following the public offering, Taxpayer will contribute the net proceeds from the public offering to OP in exchange for an increased managing general partner share. The public offering is intended to allow Taxpayer to raise equity and debt financing on more favorable terms than are currently available to OP or Corporation A and to raise equity funds to reduce indebtedness incurred, in part, to effect an acquisition of timber. It is represented that Taxpayer has no assets with a fair market value in excess of its adjusted tax basis.

OP owns or leases approximately f acres of timberlands. OP's revenues come primarily from the sale of timber cut from these timberlands. OP also owns approximately d percent of the interests in LLC. LLC owns approximately g acres of property, most of which were formerly owned by affiliates of Corporation A for use as timber properties. LLC conducts a program of land-use planning and impact management to position these properties for sale to residential, commercial, and industrial property developers.

Taxpayer's issued and outstanding stock is currently owned by Corporation A. After the public offering, Corporation A will own a percent of a special class of Taxpayer stock that will give Corporation A an approximate b percent economic interest in Taxpayer and a right to c percent of the vote (or a lesser percentage if required for Taxpayer to qualify as a REIT). As Corporation A's economic interest increases or decreases, its vote will be adjusted accordingly. The public will buy a different class of Taxpayer voting stock giving it an approximate d percent economic interest in Taxpayer.

Corporation A is a domestic corporation which, together with

its subsidiaries, is a forest products company engaged in the trading, merchandising, and manufacturing of logs, timber, and wood products, and in the production and sale of high-value-added specialty pulps. Corporation A directly and indirectly owns, leases, manages, or controls approximately e acres of timberland. Corporation A also directly and indirectly operates two pulp mills and a fiberboard plant.

As part of the transaction that includes Taxpayer's public offering, OP will form a new corporation, Corporation B, and will contribute its interest in LLC and another wholly-owned limited liability company to Corporation B. In exchange, OP will receive (a) all of the Class B, nonvoting common stock of Corporation B, representing an approximate d percent economic interest in Corporation B, and (b) the assumption by Corporation B of certain OP debt. Corporation A will contribute its member interest in LLC to Corporation B in exchange for all the Class A voting common stock of Corporation B, representing an approximate b percent economic interest in Corporation B.

Taxpayer, through OP, intends to enter into timber cutting contracts under which gain from the disposal of timber is intended to qualify as gain from the sale or exchange of property used in a trade or business under § 631(b).

Law, Analysis and Conclusions:

Section 856(c)(2) provides that at least 95 percent of a REIT's gross income (excluding gross income from prohibited transactions) must be derived from, among other sources, gain from the sale or other disposition of stock, securities, and real property (including interests in real property and interests in mortgages on real property) which is not property described in § 1221(a)(1).

Section 856(c)(3) provides that at least 75 percent of a REIT's gross income (excluding gross income from prohibited transactions) must be derived from, among other sources, gain from the sale or other disposition of real property (including interests in real property and interests in mortgages on real property) which is not property described in § 1221(a)(1).

Section 856(c)(4)(A) provides that at the close of each quarter of its tax year, at least 75 percent of the value of a REIT's total assets must be represented by real estate assets, cash and cash items (including receivables), and Government securities. Section 856(c)(4)(B) provides that not more than 25 percent of the value of a REIT's total assets may be represented by securities (other than those includible under subparagraph

(A)), for purposes of this calculation limited in respect of any one issuer to an amount not greater than 5 percent of the value of the total assets of the REIT and to not more than 10 percent of the outstanding voting securities of the issuer.

Section 856(c)(5)(B) provides that the term "real estate assets" means real property (including interests in real property and interests in mortgages on real property) and shares (or transferable certificates of beneficial interest) in other qualifying REITs. Section 856(c)(5)(C) defines the term "interests in real property" to include fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon, but does not include mineral, oil, or gas royalty interests. Section 1.856-3(d) of the Income Tax Regulations provides that local law definitions will not be controlling for purposes of determining the meaning of the term "real property" as used in § 856 and the regulations thereunder.

Section 856(c)(5)(A) provides that "value" means, with respect to securities for which market quotations are readily available, the market value of those securities; and with respect to other securities and assets, fair value as determined in good faith by the trustees, except that in the case of securities of REITs, the fair value shall not exceed market value or asset value, whichever is higher.

Under § 1.856-3(g), a REIT that is a partner in a partnership is deemed to own its proportionate share of each of the assets of the partnership and to be entitled to the income of the partnership attributable to that share. For purposes of § 856, the interest of a partner in the partnership's assets shall be determined in accordance with the partner's capital interest in the partnership. The character of the various assets in the hands of the partnership and items of gross income of the partnership shall retain the same character in the hands of the partners for all purposes of § 856.

It is a long-standing principle of law that standing timber is treated as real property for federal income tax purposes. In Hutchins v. King, 68 U.S. 53, 59 (1863) the Supreme Court stated that "timber growing upon the land constituted a portion of the realty." More recently, the court in Laird v. United States, 115 F. Supp. 931, 933 (W.D. Wis. 1953) stated that growing timber under the common law and the law of . . . the United States, has always been considered a portion of the real property, and the owner of that timber had an interest in so much of the soil as was necessary to sustain it. Also, the Service ruled in Rev.

Rul. 72-515, 1972-2 C.B. 466, that timber growing on the land is part of the land and that an exchange of timberlands of different qualities nevertheless constitutes a like kind exchange because both are land held for investment.

Accordingly, we conclude that timberlands and the standing timber thereon constitute real property and, therefore, real estate assets within the meaning of §§ 856(c)(5)(B) and 856(c)(4)(A).

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. In determining the gross income, the adjusted gross income, or the taxable income of the lessee, the deductions allowable with respect to rents and royalties shall be determined without regard to the provisions of § 631(b). The date of the 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 section, 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.

Section 1.631-2(a)(1) provides, in part, that if an owner disposes of timber held for more than one year before such disposal, under any form or type of contract whereby the owner retains an economic interest in the timber, the disposal shall be considered to be a sale of the timber. Section 1.631-2(a)(2) provides that in the case of a disposal of timber with a retained economic interest, the provisions of § 1231 apply and such timber shall be considered property used in the trade or business for the taxable year in which it is considered to have been sold, along with other property of the taxpayer used in the trade or business as defined in § 1231(b), whether or not such timber is property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

Section 1.631-2(d)(1) provides, in part, that where the conditions of § 1.631-2(a)(1) are met, amounts received or accrued prior to cutting (such as advance royalty payments or minimum royalty payments) shall be treated under § 631(b) as realized from the sale of timber if the contract of disposal provides that such amounts are to be applied as payment for

timber subsequently cut. Section 1.631-2(d)(2) provides, however, that if the right to cut timber under the contract expires, terminates, or is abandoned before the timber that has been paid for is cut, the taxpayer shall treat payments attributable to the uncut timber as ordinary income and not received from the sale of timber under § 631(b).

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)). 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.

Section 631(b) treats certain disposals of timber as sales of the timber that may qualify for capital gains treatment. To be eligible for this treatment, the taxpayer must meet the capital gains holding period and must retain an "economic interest" in the standing timber. An "economic interest" in the standing timber is retained if the taxpayer depends on the cutting of the timber for a return on its investment in the timber. See § 1.611-1(b)(1). A pay-as-you-cut contract generally accomplishes this, i.e., the taxpayer is paid only for the timber that is cut.

Section 1231(a) generally provides that gain or loss on the sale or exchange of property used in a trade or business will be treated as gain or loss from the sale or exchange of a capital asset. Section 1231(b)(2) provides that property used in a trade or business includes timber to which § 631 applies.

Section 857(b)(6)(A) provides that a tax will be imposed upon a REIT equal to 100 percent of the net income derived by the REIT from prohibited transactions. Section 857(b)(6)(B)(iii) defines the term "prohibited transaction" as a sale or other disposition of property described in § 1221(a)(1) which is not foreclosure property.

Section 1221(a)(1) provides that for federal income tax purposes, "capital asset" means property held by the taxpayer (whether or not connected with his trade or business) but does not include stock in trade of the taxpayer or other property of a kind that would properly be included in the inventory of the taxpayer if on hand at the close of the tax year, or property

held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

Assuming the timber cutting agreements covering the timber owned by Taxpayer either directly or through OP are governed by § 631(b) as submitted by Taxpayer, the timber will be treated as property used in a trade or business under § 1231. Consequently, the timber cannot be considered to be property held primarily for sale to customers in the ordinary course of business pursuant to § 1221(a)(1). Therefore, the sale of timber by Taxpayer pursuant to the agreements will not satisfy the definition of a prohibited transaction under § 857(b)(6).

When a taxpayer assigns operating rights in a mineral property or the right to cut timber but, upon such assignment, the taxpayer retains a continuing economic interest (a royalty) in the in the property or timber, the transaction constitutes a lease. Under § 631(b), if the lessor has held the timber for more than one year, payments to the lessor under the terms of the lease are treated as gain from the sale of a capital asset. In this respect, § 631(b) provides for timber an exception to the normal treatment of payments to the lessor of mineral property. Absent the application of § 631(b)(for example, where the lessor has not met the holding period requirement), the payments to the lessor are treated as royalty payments derived from the lease of the timber property.

Accordingly, provided that the timber cutting agreements covering the timber owned by Taxpayer either directly or through OP are governed by § 631(b), as submitted by Taxpayer, we conclude that gross income derived from the disposal of timber pursuant to those cutting agreements will constitute gross income derived from the sale or disposition of real property (or interests in real property) which is not property described in § 1221(a)(1), under §§ 856(c)(2)(D) and 856(c)(3)(C). Gross income from the disposal of timber with a holding period of one year or less will be considered rents from real property under §§ 856(c)(2)(C) and 856(c)(3)(A). Also, such income will not be treated as prohibited transaction income under § 857(b)(6). Finally, for purposes of § 631(b) and § 1.856-3(g), OP's holding period in its assets shall be used in determining the character of the gain allocated to Taxpayer by OP from the sale of assets by OP pursuant to timber cutting contracts governed by § 631(b).

Additional Information:

No opinion is expressed or implied as to the federal tax consequences of this transaction under any provision not specifically addressed herein. In particular, no opinion is

expressed concerning whether the timber cutting contracts referred to above are governed by § 631(b) or the character of the income derived from those contracts. Furthermore, no opinion is expressed concerning whether Taxpayer will otherwise qualify as a REIT under subchapter M, part II of Chapter 1. In addition, no opinion is expressed concerning the federal tax consequences of the sale of timber by Taxpayer or OP other than sales made pursuant to timber cutting contracts governed by § 631(b). Further, no opinion is expressed concerning whether the relationship between Taxpayer and any other party will cause Taxpayer to fail to satisfy the 10 percent voting securities requirement of § 856(c)(4)(B).

Sincerely yours,
Acting Associate Chief Counsel
(Financial Institutions & Products)
By: Alvin J. Kraft
Chief, Branch 1

Enclosure:
Copy of this letter
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cc: