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Legend:

Company =

State A =

Year 1 =

X =

Dear

This is in reply to a letter dated January 19, 1999, requesting rulings on behalf of Company. The requested rulings concern the treatment of income from Company's timberlands and timber cutting contracts for purposes of section 856(c) of the Internal Revenue Code, as well as the treatment of certain amounts received as reimbursement for shared personnel and administrative overhead at the time Company elects to be taxed as a real estate investment trust (REIT) under sections 856-860.

FACTS

Company currently is a State A limited partnership whose units have been traded on the New York Stock Exchange since year 1. Company is a diversified forest products company engaged in growing and harvesting timber for sale as logs in export and domestic markets, the manufacture of lumber, plywood and fiberboard products, and the sale of wood residuals such as wood chips. Company owns and manages over 3 million acres of timberland property (The "Timberlands") in seven different states and together with its affiliates, currently offers over 2,000 products to its customers.

Company currently is taxed as a partnership for federal income tax purposes and therefore, pays no federal income tax on its earnings or its share of its manufacturing partnership's earnings. Company has determined that the benefits of converting to a publicly traded real estate investment trust (REIT) outweigh the future increase in federal income tax liability attributable to the operations currently conducted by a

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downstream manufacturing limited partnership in which Company owns an X limited partnership interest. Accordingly, Company intends to convert into a real estate investment trust through a series of steps, the tax consequences of which have been approved in a previously issued private ruling by the Service.

The corporate structure resulting from the various steps referenced above will be a corporation (Newco), that will elect to be taxed as a REIT which will own, through certain entities that will be disregarded for federal tax purposes, the Timberlands, the non-voting Class B stock of a marketing corporation, and the non-voting Class B stock of three corporate manufacturing subsidiaries. Newco's assets will consist primarily of its interest in the Timberlands for purposes of section 856. It is anticipated that Newco will dispose of standing timber held for more than one year pursuant to contracts under which Newco will retain an economic interest in the standing timber consistent with the requirements of section 631(b) (Stumpage Contracts).

Persons employed by Newco will routinely perform certain services benefitting both the Newco and the corporate subsidiaries. Additionally, Newco may incur certain overhead or administrative costs on behalf of one or more of the corporate subsidiaries. Similarly, persons employed by the corporate subsidiaries will perform certain services benefitting Newco and may incur certain overhead or administrative costs on behalf of Newco.

Newco and each of the corporate subsidiaries will agree to an arrangement whereby either the corporate subsidiary will reimburse Newco or Newco will reimburse the corporate subsidiary for overhead (including salaries) and administrative costs associated with services performed on behalf of or for the benefit of the other party. The reimbursements are intended merely to make each party whole and not to generate a profit. Newco will not take these reimbursement payments into income nor claim a deduction for expenses incurred on behalf of a corporate subsidiary.

RULINGS REQUESTED

Company requests the following rulings with respect to the formation of REIT:

1. The Timberlands will qualify as real estate assets under sections 856(c)(5)(B) and 856(c)(4)(A) and REIT's interest in the Timberlands will qualify as an interest in real property under section 856(c)(5)(C).
2. For purposes of section 856(c)(4)(A), the value of Newco's interest in the Timberlands is the fair market value of the Timberlands (as subject to Stumpage Contracts), including the value of uncut and unpaid-for standing timber under Stumpage Contracts.

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3. The difference between the amount realized by Newco from the disposal of timber pursuant to a Stumpage Contract and the adjusted basis of such timber shall be considered gain or loss from the sale or disposition of real property under sections 856(c)(2)(D) and 856(c)(3)(C) and any such gain or loss will be from property used in Newco's trade or business as defined in section 1231(b).

4. Timber sold by Newco pursuant to a Stumpage Contract will not be treated as dealer property for purposes of sections 856 or 857.

5. Amounts received by Newco from the marketing corporation or the three Manufacturing subsidiaries as reimbursement for shared personnel and administrative overhead will not constitute gross income to Newco for purposes of section 856.

LAW AND ANALYSIS

Section 856(c)(2) provides that a corporation, trust, or association shall not be considered a real estate investment trust for any taxable year unless at least 95 percent of its gross income (excluding gross income from prohibited transactions) is derived from certain sources including 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 section 1221(1).

Section 856(c)(3) provides that any corporation, trust, or association shall not be considered a REIT for any taxable year unless at least 75 percent of its gross income (excluding gross income from prohibited transactions) is derived from certain sources including 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 section 1221(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); not greater than 5 percent of the value of the total assets of the REIT may be invested in one issuer; and the securities may not represent 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"

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to include fee ownership and co-ownership 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 states that local law definitions will not be controlling for purposes of determining the meaning of the term "real property" as used in section 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 to 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.

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. Finally, 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.

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 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)(2) provides that in the case of a disposal of timber with a retained economic interest the provisions of section 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 section 1231(b), whether or not such timber is property held by the taxpayer for sale to customers in the ordinary course of his trade or business.

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.

Neither section 631(b) nor the regulations thereunder provide guidance on what constitutes a retained economic interest. Section 1.611-1(b)(1), however, provides that an economic interest is possessed when the 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, Company represents that because title to the designated timber, including the risk of loss due to casualty, stays with Newco until the timber is severed and paid for and because payments to Newco are based on the volume of timber severed from the property as determined by scaling or weighing, Newco will have a retained economic interest for purposes of section 631(b). Based upon the facts and representations made by Company, Newco's dispositions of merchantable timber pursuant to the Stumpage Contracts may satisfy the requirements of § 631(b) for timber held by Company for more than one year at the time it 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 section 631 applies.

One of the principal purposes for the income restrictions imposed by sections 856(c) and 856(d) of the Code is to ensure that the vast bulk of the REIT's income is from passive sources and not from the active conduct of a trade or business. See H.R. Rep. No. 2020, 86th Cong., 2d Sess., 6 (1960), 1960-2 C.B. 822-823.

The requirement that a REIT's income be derived from passive sources is similar to the requirement under section 511 that exempt organizations derive their income from passive sources in order to avoid taxation on unrelated business taxable income (UBTI). Section 512(b)(5) excludes from UBTI all gains or losses from the sale, exchange, or other disposition of property other than stock in trade

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that would be inventory if on hand at the close of the year, or property held primarily for sale to customers in the ordinary course of the trade or business. Section 1.512(b)-1(d)(1) provides, in part, that the exclusion from UBTI under section 512(b)(5) does not apply with respect to the cutting of timber which is considered, upon the application of section 631(a), as a sale or exchange of timber. Therefore, amounts received as payments for timber under contracts governed by section 631(b) are considered to yield income from passive sources that is excluded from UBTI under section 512(b)(5). Similarly, the gains derived from a timber cutting contract governed by section 631(b), like the Contract described above, will satisfy Congressional intent that REIT income be derived from passive sources.

Revenue Ruling 84-138, 1984-2 C.B. 123, holds that where the subsidiary of a regulated investment company reimbursed its parent for amounts paid by the parent for expenses incurred on behalf of the subsidiary, the reimbursement was tantamount to the repayment of a loan, based on the theory that incurring an expense on behalf of another is in effect the extension of credit to the person for whom the expense is incurred. Thus, the reimbursement was not included in the gross income of the parent.

Accordingly, based upon the information submitted and representations made, we conclude that:

Company's timberlands, including those timber lands that are subject to the Stumpage Contracts, will be considered real estate assets or interests in real property for purposes of section 856(c)(4)(A) and (c)(5). The value of Company's timberlands and its retained economic interest in timberlands that are subject to timber cutting contracts governed by section 631(b) is the fair market value of the real estate, including the value of the uncut and unpaid-for timber under the Stumpage Contracts. Consequently, as provided under section 631(b), the difference between the amount realized by Company from the disposal of timber pursuant to a Stumpage Contract and the adjusted basis for depletion of the disposed timber, shall be considered gain from the sale or disposition of real property under section 856(c)(2)(D) and section 856(c)(3)(C). Moreover, amounts received by Newco from the marketing corporation or the three Manufacturing subsidiaries as reimbursement for shared personnel and administrative overhead will not constitute gross income to Newco for purposes of section 856.

No opinion is expressed and no determination is made regarding the application of section 631 to the taxpayer's proposed disposals of timber. This ruling is predicated on the taxpayer's representations that the proposed transactions involving timber lands will constitute disposals of timber with a retained economic interest within the meaning of section 631(b) of the Code.

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No opinion is expressed or implied as to the federal tax consequences of this transaction under any provision not specifically addressed herein. Furthermore, no opinion is expressed concerning whether Newco otherwise qualifies as a REIT under subchapter M, part II of Chapter 1 of the Code. Moreover, no opinion is expressed whether Newco meets the ten percent voting securities limitation of section 856(c)(5)(B) of the Code through its direct or indirect interest in the manufacturing subsidiaries. No opinion is expressed on the characterization under section 856 of any payments (except those discussed in the previous paragraph) or income received by Newco from the manufacturing subsidiaries or on the effect under section 857 to Newco of activities engaged in by the manufacturing subsidiaries.

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.

Sincerely,

Assistant Chief Counsel
(Financial Institutions & Products)

By: William E. Coppersmith
Chief, Branch 2