199945055

Internal Revenue Service

Department of the Treasury

Index Number: U.I.L. = 856.01-00

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:FI&P:2-PLR-108659-99
Date:
August 13, 1999

Legend:

MLP =

OLP =

State A =

Year 1 =

Dear :

This letter responds to your request for a private letter ruling, dated May 4, 1999. Your request concerns the treatment of income from the disposal of timber under timber cutting contracts for purposes of § 856(c) of the Internal Revenue Code, as well as a determination of the holding period of certain assets.

FACTS

MLP is a State A limited partnership whose common units are publicly traded on the New York Stock Exchange. MLP is currently engaged in the business of growing timber for sale as logs in domestic and export markets and the processing of timber principally into lumber and chips. MLP also owns and operates a wood products purchase and resale business that it intends to expand to include engineered wood products. MLP currently conducts its businesses through other entities, including OLP.

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Through a series of steps, MLP intends to transfer all of its assets to a new corporation (Company)[1] in exchange for Company voting common stock.[2] At the time of transfer, MLP's assets will consist primarily of limited partner interests in OLP.[3] MLP will then dissolve and distribute to its partners all of its Company shares in liquidation of their MLP interest. Company will elect to be treated as a real estate investment trust (REIT). Additionally, Company, through OLP, intends to dispose of timber held for more than one year pursuant to cutting contracts under which Company represents it will retain an economic interest in the standing timber consistent with requirements of § 631(b).

RULINGS REQUESTED

1. The Company's real property and timber thereon constitute real property and, therefore, constitute real estate assets within the meaning of §§ 856(c)(4)(A) and 856(c)(5)(B).

2. Gross income from the disposal of timber pursuant to timber cutting contracts meeting the requirements of § 631(b) constitutes gross income described in §§ 856(c)(2)(D) and 856(c)(3)(C), and is not income derived from a prohibited transaction as described in § 857(b)(6).

3. With respect to the OLP limited partnership interests which Company will acquire from MLP, the period for which Company will be treated as having been a member of OLP will include the period during which MLP was a partner in OLP for purposes of § 631(b) and § 1.856-3(g) of the Income Tax Regulations.

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[1] Company is expected to be organized in Year 1 under the laws of State A.

[2] MLP intends that no gain or loss will be recognized in the transaction pursuant to § 351.

[3] Prior to transfer, OLP will redeem certain limited partnership interests. Additionally, it will contribute its stock in two corporations, certain limited partnership interests and all other assets that may not be held by a real estate investment trust to a newly organized corporation (Newco) in exchange for one hundred percent of Newco's nonvoting stock.

LAW AND ANALYSIS

Requests 1 and 2

Section 856(c)(2)(D) provides that a corporation, trust, or association shall not be considered a REIT for any taxable year unless at least 95 percent of its gross income (excluding gross income from prohibited transactions) is derived from 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(1).

Section 856(c)(3)(C) 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 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(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, 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) 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.

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, Rev. Rul. 72-515, 1972-2 C.B. 466 holds 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 § 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 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 § 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 § 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.

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(1) which is not foreclosure property.

Based on the information submitted and representations made, we conclude that Company's real property and the timber thereon constitute real estate assets or interests in real property within the meaning of § 856(c)(4)(A) and § 856(c)(5)(B). Furthermore, provided the timber cutting contracts entered into by Company are governed by § 631(b), the standing timber disposed of pursuant to the cutting contracts will be treated as property used in a trade or business under § 1231. Consequently, the timberlands and standing timber will not be considered to be property held for sale in the ordinary course of business pursuant to § 1221(1). Accordingly, the sale of timber by Company will not be a prohibited transaction under § 857(b)(6).

Request 3

Section 362 provides that property acquired by a corporation in connection with a transaction to which § 351 applies shall have the same basis as it had in the hands of the transferor, increased by the amount of gain recognized on the transfer.

Section 708(b)(1)(B) provides that a partnership shall be considered terminated only if within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in the partnership capital and profits. Section 1.708-1(b)(1)(iv) provides that if a partnership is terminated by a sale or exchange of an interest, the partnership is deemed to contribute all of its assets and liabilities to a new partnership and, immediately thereafter, the terminated partnership distributes its interest in the new partnership to the purchasing partner and the other remaining partners in proportion to their respective interests in the terminated partnership in liquidation of the terminated partnership, either for the continuation of the business by the new partnership or for its dissolution and winding up.

Section 721 provides, in relevant part, that no gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.

Section 722 provides that the basis of an interest in a partnership acquired by a contribution of property to the partnership shall be the adjusted basis of such property to the contributing partner at the time of the contribution.

Section 723 provides that the basis of the property contributed to a partnership by a partner shall be the adjusted basis of such property to the contributing partner at the time of the contribution.

Section 735(b) provides that in determining the period for which a partner has held property received in a distribution from a partnership, there shall be included the holding period of the partnership, as determined under § 1223 with respect to such property.

Section 1223(1) provides that in determining the period for which a taxpayer has held property received in an exchange, there shall be included the period for which the taxpayer held the property exchanged if, under this chapter, the property received has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in its hands as the basis of the property exchanged.

Section 1223(2) provides that in determining the period for which a taxpayer has held property however acquired there shall be included the period for which such property has been held by any other person, if under this chapter such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in the taxpayer's hands as it would have in the hands of such other person.

Section 1.856-3(g) provides that a REIT which is a partner in a partnership will be deemed to own its proportionate share of each of the assets of the partnership and will be deemed to be entitled to the income of the partnership attributable to such share. For purposes of § 856, the interest of a partner in the partnership's assets shall be determined in accordance with his 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. The regulation also provides that where a partnership sells real property or a trust sells its interest in a partnership which owns real property, any gross income realized from such sale, to the extent that it is attributable to the real property, shall be deemed gross income from the sale or disposition of real property held for either the period that the partnership has held the property or the period that the trust was a

member of the partnership, whichever is shorter.

Section 1.631-2(a)(1) provides that for the purpose of determining whether or not timber disposed of was held for more that 1 year before such disposal the rules with respect to the holding period contained in § 1223 shall be applicable.

We conclude that, for purposes of § 631(b) and § 1.856-3(g), the period for which Company will be treated as having been a member of OLP will include the entire period during which MLP was a partner of OLP.

CONCLUSION

Based on the information submitted and the representations made, we conclude as follows.

(1) Company's real property and the timber thereon will constitute real estate assets or interests in real property within the meaning of § 856(c)(4)(A) and § 856(c)(5)(B).

(2) Provided that the timber cutting contracts entered into by Company are governed by § 631(b), gross income derived from the disposal of timber pursuant to those cutting contracts will constitute gross income derived from gain from the sale or disposition of real property (or interests in real property), which is not property described in § 1221(1), for purposes of § 856(c)(2)(D) and § 856(c)(3)(C). Also, such income will not be treated as prohibited transaction income under § 857(b)(6).

(3) The period for which Company will be treated as having been a member of OLP will include the period during which MLP was a partner in OLP for purposes of § 631(b) and § 1.856-3(g).

No opinion is expressed or implied as to the federal tax consequences of this transaction under any provision not specifically addressed herein. No opinion is expressed concerning whether Company otherwise qualifies as a REIT under subchapter M, part II of Chapter 1 of the Code.

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

Furthermore, no opinion is expressed concerning whether Company meets the ten percent voting securities limitation of § 856(c)(4)(B) through its interest in Newco. No opinion is expressed on the characterization under § 856 of any payments or income received by Company from Newco or on the effect under § 857 to Company of activities engaged in by Newco.

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.

In accordance with the power of attorney on file, we are sending a copy of this letter to MLP's authorized representative.

Sincerely,

Assistant Chief Counsel
(Financial Institutions & Products)

By: William E. Coppersmith
William E. Coppersmith
Chief, Branch 2

Enclosure:
Copy of this letter
Copy for § 6110 purposes