Internal Revenue Service

Number: **201123005**
Release Date: 6/10/2011

Index Number: 856.01-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:FIP:B03
PLR-128063-09

Date:
March 04, 2011

LEGEND:

Trust	=
Operating Partnership	=
Company	=
State X	=
State Y	=
State Z	=
Exchange	=
Date 1	=
Date 2	=
Year 1	=
Year 2	=
Year 3	=

a =

b =

c =

Dear :

This responds to a letter dated June 3, 2009, submitted on behalf of Trust, requesting a ruling regarding the treatment of certain income under under § 856 and § 857 of the Internal Revenue Code.

FACTS

Trust, a State X corporation, is engaged in the acquisition and ownership of timberland located throughout the United States. Trust has elected to be treated for federal tax purposes as a real estate investment trust (REIT) beginning with the tax year that ended on Date 1. Substantially all of Trust's business is conducted through Operating Partnership, a State Y limited partnership. Trust is the Operating Partnership's sole general partner and possesses full legal control and authority over Operating Partnership's operations. Trust owns an interest of a percent of Operating Partnership's common units.

Operating Partnership generates the majority of its income from gains from the disposal of timber under contracts with a retained economic interest, outright sales of timber, and leasing land-use rights to third parties. Operating Partnership also generates income from mineral royalties from timberland.

Company, which has no affiliation with Trust or Operating Partnership, has developed the "Program." The Program seeks to use private, well managed forests to offset carbon dioxide greenhouse gas emissions in a voluntary market. Forest landowners, like Operating Partnership, agree to manage their existing forest land and to keep the trees in forests over a set term of years. Company in turn sells the right to take credit for the carbon sequestered by the forest over this term to its individual and company customers who wish to offset their carbon footprints. Utility customers in State Z participate in the Program by paying a small surcharge as part of their monthly electric bills. The Program is contractual and participation is voluntary.

On Date 2, Operating Partnership entered into an agreement with Company (the "Agreement"). Pursuant to the Agreement, Company agrees to purchase from Operating Partnership carbon dioxide offset credits ("Credits") from a defined portion of the timberland. The amount that Company pays to Operating Partnership is based on the total amount of carbon that can be sequestered from the standing timber on the designated timberland, multiplied by the average annual closing strike price for Credits as set forth on the Exchange. The Credits are not themselves rights that are granted to Trust or Operating Partnership by any governmental authority; rather, they are simply a measure of the carbon absorption that is a natural result of the photosynthesis process.

Operating Partnership retains ownership of the designated timberland throughout the life of the Agreement. Under the Agreement, Operating Partnership is obligated to use sustainable forest management, which may include harvesting timber, thinning, clearing, or reducing the volume of the carbon or timber in the designated timberland. If the volume of carbon or timber in the designated timberland is reduced because Operating Partnership harvests, thins, clears, or reduces the timber in that portion for purposes other than forest management issues, then Operating Partnership may substitute a different designated portion of the timberland or be subject to sanctions, including "decertification" of existing credits. The sanctions also include payment by Operating Partnership to Company of b percent of the amount paid by Company to Operating Partnership for the decertified Credits.

The Agreement also provides that the parties must cause a Notice of Restricted Use to be filed or recorded in the county or counties where the designated portion of the Timberland is located. Trust has represented that it has recorded the required Notice of Restricted Use in all relevant jurisdictions.

Under the Agreement, Company can purchase Credits from time to time, at any time during the term of the Agreement. To date, Company has purchased Credits from Operating Partnership by remitting to Operating Partnership three payments, two of which were made in Year 1, and one in Year 2. Each of the payments relates to a different set of Credits associated with different acreage of timberland for a specified period of time that does not exceed c years.

The Agreement expires in Year 3. Company and Operating Partnership anticipate commencing discussions regarding extension of the Agreement. Although the parties anticipate continued participation by Trust and Operating Partnership in the Program, this participation may not continue uninterrupted once the Agreement expires.

Trust has represented that for purposes of computing REIT taxable income under § 857(b)(2), any income derived by Trust under the Agreement will be treated as ordinary income.

LAW AND ANALYSIS

Section 856(c)(2) provides that at least 95 percent of a REIT's gross income must be derived from, among other sources, rents from real property.

Section 856(c)(3) provides that at least 75 percent of a REIT's gross income must be derived from, among other sources, rents from real property.

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(d)(1) provides that rents from real property include (subject to exclusions provided in § 856(d)(2)): (A) rents from interests in real property; (B) charges for services customarily furnished or rendered in connection with the rental of real property, whether or not such charges are separately stated; and (C) rent attributable to personal property leased under, or in connection with, a lease of real property, but only if the rent attributable to the personal property for the taxable year does not exceed 15 percent of the total rent for the tax year attributable to both the real and personal property leased under, or in connection with, the lease.

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, and 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 "real property" includes land or improvements thereon, such as buildings or other inherently permanent structures thereon (including items which are structural components of such buildings or structures). Local law definitions will not be controlling for purposes of determining the meaning of "real property" for purposes of § 856 and the regulations thereunder. Under this regulation,

"real property" includes, for example, the wiring in a building, plumbing systems, central heating or central air-conditioning machinery, pipes or ducts, elevators or escalators installed in a building, or other items which are structural components of a building or other permanent structure. The term does not include assets accessory to the operation of a business, such as machinery, printing press, transportation equipment which is not a structural component of the building, office equipment, refrigerators, individual air-conditioning units, grocery counters, furnishings of a motel, hotel, or office building, etc. even though such items may be termed fixtures under local law.

Section 856(c)(5)(J), which was added to the Code by Division C of the Housing and Economic Recovery Act of 2008, P.L. 110-289, provides, inter alia, that to the extent necessary to carry out the purposes of part II of subchapter M, the Secretary of the Treasury is authorized to determine, solely for purposes of this part, whether any item of income or gain that does not qualify under §856(c)(2) or §856(c)(3) to satisfy the 95 percent and 75 percent REIT gross income tests, nevertheless may be considered as gross income that qualifies under §856(c)(2) and §856(c)(3) to satisfy the 95 percent and 75 percent REIT gross income tests.

The staff of the Joint Committee on Taxation in its General Explanation of the Tax Legislation Enacted in the 110th Congress describes §856(c)(5)(J) as follows: "The provision authorizes the Treasury Department to issue guidance that would allow other items of income to be excluded for purposes of the computation of qualifying gross income under either the 75 percent or the 95 percent test, respectively, or to be included as qualifying income for either of such tests, respectively, in appropriate cases consistent with the purposes of the REIT provisions." Footnote 309 of the General Explanation provides that income that is statutorily excluded from gross income computations under the provision is not intended to be within the authority to include as qualifying income. Joint Committee on Taxation Staff, General Explanation of the Tax Legislation Enacted in the 110th Congress, 110 Cong., 2d Sess. (2009), 239.

The legislative history underlying the REIT provisions indicates that the central concern behind the gross income restrictions is that a REIT's gross income should be largely composed of passive income. For example, H.R. Rep. No. 2020, 86th Cong., 2d Sess. 4 (1960) at 6, 1960-2 C.B. 819, at 822-823 states, "[o]ne of the principal purposes of your committee in imposing restrictions on types of income of a qualifying real estate investment trust is to be sure the bulk of its income is from passive income sources and not from the active conduct of a trade or business." In describing the 75 percent test, the report states that "[u]nder this test at least 75 percent of the [REIT's] income must, in one manner or another, be derived from real property." Id. at 822.

It is a well established principle of law that standing timber is treated as real property for federal income tax purposes. The United States Supreme Court has stated that "timber growing upon the land constituted a portion of the realty," *Hutchins v. King*, 68 U.S. 53, 59 (1863). In *Laird v. United States*, 115 F. Supp. 931, 933 (W.D. Wis.

1953), the court stated that under common law, and the law of the United States, growing timber 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. In Rev. Rul. 72-515, 1972-2 C.B. 466, the Service held 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, timberlands and the standing timber thereon constitute real property and, therefore, are real estate assets within the meaning of § 856(c)(5)(B).

Although the designated timberland under the Agreement and standing timber thereon qualify as real property under § 856(c)(5)(B), the income derived by Trust from the Agreement does not fit squarely within any of the enumerated sources listed as qualifying income under § 856(c)(2) or § 856(c)(3). Nevertheless, this is an appropriate case to invoke the authority granted in § 856(c)(5)(J) to permit other types of income that are not statutorily designated as qualifying income under § 856(c)(2) or § 856(c)(3) to be considered as qualifying income for purposes of satisfying the 95 percent and 75 percent REIT gross income tests. This treatment of income derived by Trust from the Agreement is appropriate in this case because of the relationship of the income to REIT qualifying assets. The income derived by Trust from the Agreement is inextricably linked to the underlying timberland and standing timber thereon. Further, the income derived by Trust from the Agreement is not based in whole or part on the profits or losses of any person or entity and is derived from a source that is inherently passive in nature. Therefore, treating the income derived by Trust from the Agreement as qualifying income under § 856(c)(5)(J) is consistent with the purposes of the REIT provisions.

Section 857(b)(6)(A) imposes a tax for each taxable year of a REIT equal to 100 percent of the net income derived from prohibited transactions. Section 857(b)(6)(B)(iii) provides that the term “prohibited transaction” means a sale or other disposition of property described in §1221(a)(1) which is not foreclosure property.

In this case, the income derived by Trust from the Agreement is not attributable to a sale or other disposition of property. Therefore, the income derived by Trust from the Agreement does not constitute net income derived from prohibited transactions for purposes of §857(b)(6).

CONCLUSION

Based on the information submitted and representations made, we conclude that income derived by Trust from the Agreement is considered as qualifying income under § 856(c)(5)(J) for purposes of satisfying the 95 percent and 75 percent REIT gross income tests in §856(c)(2) and §856(c)(3). Furthermore, we conclude that income derived by Trust from the Agreement does not constitute net income derived from prohibited transactions for purposes of § 857(b)(6).

This ruling's application is limited to the facts, representations, Code sections, and regulations cited herein. Except as specifically ruled upon above, no opinion is expressed concerning any federal income tax consequences relating to the facts herein under any other provision of the Code. Specifically, we do not rule whether Trust otherwise qualifies as a REIT under part II of subchapter M of Chapter 1 of the Code. Further, no implication is intended by the conclusions in this ruling with respect to §§ 864 and 954.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent. In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

Alice M. Bennett
Chief, Branch 3
Office of Associate Chief Counsel
(Financial Institutions & Products)

Enclosures:
Copy of this letter
Copy for section 6110 purposes