Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

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Legend

Taxpayer =

TRS 1 =

TRS 2 =

TRS 3 =

LLC 1 =

LLC 2 =

LLC 3 =

LLC 4 =

LLC 5 =

LLC 6 =

Partnership =

Owner =

State

Date 1

Date 2

Date 3

Date 4

Date 5

Date 6

Date 7

a =

b =

c =

Dear :

This responds to the letter dated March 19, 2012, submitted by your authorized representative on behalf of Taxpayer. Taxpayer requests that the Internal Revenue Service rule that certain payments described below constitute “rents from real property” under section 856(d) of the Internal Revenue Code of 1986, as amended (the “Code”), and that gain recognized from certain transactions with respect to its real property constitutes gain from the sale or disposition of real property for purposes of sections 856(c)(2)(D) and 856(c)(3)(C).

Facts

Taxpayer is a corporation incorporated in State that has elected under section 856(c) to be treated as a real estate investment trust (REIT) for federal income tax purposes. Taxpayer owns an approximately a-percent interest in Partnership, a limited partnership treated as a partnership for federal income tax purposes.

Partnership owns an approximately b-percent interest in Owner, a limited liability company treated as a partnership for federal income tax purposes. Partnership wholly owns TRS 1, a corporation that has jointly elected with Taxpayer to be treated as a taxable REIT subsidiary under section 856(l) of the Code, and LLC 1, which is a limited liability company that, for federal income tax purposes, is disregarded as an entity separate from Partnership.

Owner owns a 100-percent interest in each of LLC 2, LLC 3, LLC 4 and LLC 5, each of which is a limited liability company that, for federal income tax purposes, is disregarded as an entity separate from Owner. Owner also owns 100 percent of TRS 2, a corporation that has jointly elected with Taxpayer to be a taxable REIT subsidiary under section 856(l) of the Code. TRS 2 owns 100 percent of TRS 3, a limited liability company that has elected to be treated as a corporation for federal income tax purposes and has jointly elected with Taxpayer to be a taxable REIT subsidiary under section 856(l) of the Code. LLC 2 owns a 100-percent interest in LLC 6, a limited liability company that, for federal income tax purposes, is disregarded as an entity separate from its owner.

Taxpayer's principal activity, through its interest in Owner, is the sale of standing timber to unrelated third parties or a TRS pursuant to agreements described in section 631(b). Owner owns, directly or indirectly through its disregarded entities, approximately c acres of commercial timberlands. Owner's real property holdings generally comprise an interest in the surface and air rights above the surface (a "surface estate") as well as an interest in subsurface rights (a "subsurface estate"). In some cases however, Owner holds only a surface estate or only a subsurface estate. As a derivative of its current or prior ownership of timberland, Owner holds interests in various natural resources associated with its subsurface estates. By contract or state law, such interests typically include the use of the surface estate as necessary to explore for and exploit any identified deposit.

Mineral Leases

Owner, through its disregarded entities, entered into leases with unrelated third parties on Date 1 (three leases) and Date 4 (one lease). Each lease grants the lessee the exclusive right to enter upon and use the designated parcels for the exploration for and production of specified minerals. Each lease permits the lessee to use the surface of the leased property associated with the subsurface estate for all purposes incident to exploration, and a right, but no obligation, to produce and transport specified minerals. Taxpayer retains rights to minerals not described in a lease and retains a right of reversion pursuant to which all interests in the leased property that are conveyed to lessee revert to Taxpayer as of the termination of the Nonproducing Term (as defined below) or abandonment of any portion of the property subject to the Lease.

The lease agreements divide the term of the lease into a period before discovery and production of the covered mineral in paying quantities (the "Nonproducing Term") and the period after (the "Production Term"). The Nonproducing Term of the leases varies from 3 to 5 years. During such time, the lease grants the lessee an exclusive right of control over Taxpayer's interest in the property and use of the surface as necessary for exploration for the mineral. A lessee is permitted to enter the surface associated with the leased property at any time, and to construct certain improvements necessary for exploration for the mineral.

In consideration for such rights, a lessee makes payments specified in the lease. Upon execution of the lease, the lessee makes an initial payment of a fixed amount set forth in the lease ("Initial Rent"), which entitles the lessee to use of the property for a period of one year. For a lease to remain in effect with respect to a portion of the leased property for each remaining year of the Nonproducing Term, the lessee must, by the end of the preceding year, either (a) commence drilling operations on such portion, or (b) pay an additional fixed annual rent of a set amount per acre ("Delay Rent") for such portion. Neither Initial Rent nor Delay Rent is refundable or creditable against any amounts payable in any Production Term.

During the Nonproducing Term, Taxpayer will not (directly or through Partnership or Owner) provide any services or conduct any active trade or business with respect to its interest in real property. Taxpayer will not claim any depletion in respect of Delay Rent or Initial Rent.

The Production Term with respect to any portion of a leased property begins when the lessee commences drilling operations with respect to such portion of the property. During the Production Term, lessee has the right to enter upon and use the property for production. Taxpayer receives as compensation a royalty that represents a share, set forth in the lease, of the mineral produced.

During both the Nonproducing Term and the Production Term, a lessee is also required to compensate Taxpayer for all costs of investigation, mitigation, restoration and damage to Taxpayer's timber, improvements, and lands caused by the lessee's operations ("Lease Surface Damage Payments").

Other Agreements

Owner, directly or through its disregarded entities, has granted permission to unrelated third parties to conduct seismographic surveys on its land in agreements dated Date 3 (two agreements), Date 4 (one agreement), and Date 5 (two agreements)

("Seismic Permits"). A permittee is granted the right of ingress and egress over and across the subject land for such purpose, subject to all existing right-of-ways and leases. The agreements require a permittee to compensate Taxpayer for the value of any damage to the land, including timber removed in the exercise of the permittee's use of the land ("Seismic Permit Payments").

Owner, directly or through its disregarded entities, also entered into agreements dated Date 6 and Date 7, each granting an unrelated third party a servitude and easement for the purposes of constructing or expanding a well site or to construct, lay, maintain, operate, repair or replace pipelines and related appurtenances. Certain rights under such agreements are temporary ("Temporary Easements") and others are indefinite or for as long as still in use ("Perpetual Easements"). Neither agreement conveys an interest in any minerals in or under the lands to which the easement relates. As consideration for such agreements, Taxpayer is entitled to (a) a payment to compensate it for the value of any standing timber removed in connection with the placement of the pipeline or well pad, and (b) an agreed-upon payment representing the loss of future tree growth on the lands committed to the construction of the pipeline or well pad ("Easement Payments").

Law and Analysis

Section 856(c) provides that, to qualify as a REIT for any taxable year under part II of subchapter M, an entity must derive at least 95 percent of its gross income (excluding gross income from prohibited transactions) from the sources listed in section 856(c)(2) and at least 75 percent of its gross income (excluding gross income from prohibited transactions) from sources listed in section 856(c)(3). Section 856(c)(2) and section 856(c)(3) both list, among other sources, (1) rents from real property, and (2) 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(a)(1).

Section 856(d)(1) provides that, subject to the exclusions in section 856(d)(2), the term "rents from real property" includes (among other things) "rents from interests in real property." Section 1.856-4(a) of the Income Tax Regulations provides that, subject to the exceptions of section 856(d) and section 1.856-4(b), the term "rents from real property" means, generally, the gross amounts received for the use of, or the right to use, real property of the real estate investment trust.

Section 856(d)(2)(A) provides that, subject to certain exceptions, the term "rents from real property" does not include any amount received or accrued, directly or indirectly, with respect to any real or personal property, if the determination of such amount depends in whole or in part on the income or profits derived by any person from such property (except that any amount so received or accrued shall not be excluded from the term "rents from real property" solely by reason of being based on a fixed percentage or percentages of receipts or sales).

Under section 1.856-3(d), the term "real property" means land or improvements thereon, such as buildings or other inherently permanent structures thereon. It also includes interests in real property. Local law definitions are not 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)(C) provides that the term "interests in real property" includes 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(c) provides specifically that "a retained economic interest in coal or iron ore with respect to which the special provisions of section 631(c) apply" is within the exclusion for mineral, oil, or gas royalty interests.

Section 631(c) provides capital gain or loss treatment for certain gains or losses from the disposal of coal or iron ore mined in the United States, held for more than one year before such disposal, by the owner thereof under any form of contract by virtue of which such owner retains an economic interest in such coal or iron ore. Section 631(c) does not apply to income realized by any owner as a co-adventurer, partner, or principal in the mining of such coal or iron ore, and the word "owner" means any person who owns an economic interest in coal or iron ore in place, including a sublessor.

Section 1.631-3(c)(3) provides that bonuses received or accrued by an owner in connection with the grant of a contract of disposal shall be treated under section 631(c) as received from the sale of coal or iron ore to the extent attributable to coal or iron ore held for more than one year.

Section 1.611-1(b) provides that an economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital. A person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because through a contractual relation he possesses a mere economic or pecuniary advantage derived from production. For example, an agreement between the owner of an economic interest and another entitling the latter to compensation for extraction or cutting does not convey a depletable economic interest. See also *Palmer v. Bender*, 287 U.S. 551 (1933).

Revenue Ruling 64-75, 1964-1 C.B. 228, holds that, where the owner of mineral-bearing real property receives payments from its lessees that are determined primarily by reference to the amount of minerals mined, the owner's interests in the real properties are "mineral royalty interests" rather than "real estate assets" for purposes of section 856(c)(5), and revenues derived from its leases do not qualify as "rents from real property" under sections 856(c)(2) and (3). The owner's property interest was a mineral, oil, or gas royalty interest because the receipts fell "within the normal and ordinary meaning of the term 'royalty.'" The ruling explains "the terms 'rents' and 'royalties' are used elsewhere in the Code as denoting different concepts," citing section 543(a), section 613(a), and a predecessor to section 1362(d)(3).

Sections 543(a)(2) and (3) of the Code provide, in pertinent part, that for income tax purposes the term "personal holding company income" means the portion of the adjusted ordinary gross income that consists of, among other items, (1) rents, if certain specific conditions are met, and (2) mineral, oil, and gas royalties, if certain specific conditions are met.

Section 1.543-1(b)(11)(ii) provides that the term mineral, oil, or gas royalties means all royalties, including overriding royalties and, to the extent not treated as loans under section 636, mineral production payments, received from any interest in mineral, oil, or gas properties.

Section 543(b)(3) and section 1.543-1(b)(10) define rents for purposes of section 543 to include compensation, however designated, for the use of, or right to use, property.

Revenue Ruling 70-153, 1970-1 C.B. 139, addresses whether certain amounts received by a taxpayer are rents within the meaning of section 543(a)(2) or royalties within the meaning of section 543(a)(3). The taxpayer entered into a lease under which the lessee, a producer of natural gas and oil, would pay to the taxpayer as rental the sum of one dollar per acre per year semiannually in advance, commencing on the date of execution of the agreement, subject to diminution or abatement upon the bringing in of either a producing or nonproducing oil or gas well. No oil or other minerals were removed from the lands covered by the lease. The ruling holds that the amounts were rent because they were fixed and payable in advance for the use of, or the right to use, the property in question and were not a share of the product, or profit, reserved by the owner for use of the property.

In *Sierra Club, Inc. v. Commissioner*, 86 F.3d 1526, 1532 (9th Cir. 1996), the court found that the ordinary meaning of the term royalty is “a payment made to the owner of property for permitting another to use the property,” and that “[t]he payment is typically a percentage of profits or a specified sum per item sold; the property is typically either an intangible property right . . . or a right relating to the development of natural resources.” Therefore, the court found that it was the “nature of the property the owner is permitting another to use” that differentiates a royalty from rent. The court based its conclusion on definitions of “royalty” in Webster's Ninth New Collegiate Dictionary (“share of the product or profit reserved by the grantor [especially] of an oil or mining lease . . .”) and Black’s Law Dictionary (“compensation for the use of property, usually copyrighted material or natural resources, . . . share of product or profit reserved by owner for permitting another to use the property”).

Revenue Ruling 79-144, 1979-1 C.B. 219, holds that payments received under a lease of surface rights, even when measured by reference to coal mined from that area under a coal lease with a third party, are not proceeds from the disposal of coal within the meaning of section 631(c), but are instead ordinary income received in return for the right to use the surface overlying such coal. See also *Omer v. United States*, 329 F.2d 393 (6th Cir. 1964); *Estate of Reinke v. Commissioner*, 46 F.3d 760 (8th Cir. 1995).

Revenue Ruling 85-16, 1985-1 C.B. 180, explains that a mineral royalty is generally a payment (1) based on a fixed percentage of production, or a share of net profits from production, received by a person with a right to the minerals in place; (2) for permitting another to extract and take those minerals; and (3) payable only from the minerals produced or the proceeds derived from the disposition of those minerals.

In *Vest v. Commissioner*, 481 F.2d 238 (5th Cir. 1973), *cert. denied* 414 U.S. 1092, a lease between surface owners, as lessor, and holders of certain mineral rights, as lessee, required lessee to pay lessor specified amounts for well locations and other uses of the surface, in addition to compensation for all actual damage caused to the surface. The court concluded that payments for the surface rights were in the nature of rental income.

Section 1.612-3(a) provides generally that a bonus received upon grant of an economic interest in a mineral deposit constitutes ordinary income subject to cost depletion. As to the payor of the bonus, such payment constitutes a capital investment recoverable through depletion. Section 1.612-3(c) provides:

(1) A delay rental is an amount paid for the privilege of deferring development of the property and that could have been avoided by abandonment of the lease, or by commencement of development operations, or by obtaining production.

(2) Since a delay rental is in the nature of rent it is ordinary income to the payee and not subject to depletion.

As the regulations indicate, in the hands of the lessor (recipient), a bonus is depletable but a delay rental is not. A bonus is considered to be a payment in advance for oil and gas (or other minerals) to be extracted. *Herring v. Comm'r*, 293 U.S. 322 (1934). In contrast, delay rentals are not paid for oil and gas. They have been variously described as "paid merely for holding the lease open," *Houston Farms Dev. Co. v. U.S.*, 131 F.2d 577, 579 (5th Cir. 1942); as "payments made as a condition for the continued use and possession of a defeasible interest," *U.S. v. Dougan*, 214 F.2d 511, 514 (10th Cir. 1954); as "a penalty . . . for failure to drill," *Jefferson Lake Sulphur Co. v. Lambert*, 133 F.Supp. 197, 199, n.4 (E.D. La. 1955), *aff'd* 236 F.2d 542 (5th Cir. 1956); as for "the privilege of deferring commencement of a well" *Sneed v. Comm'r*, 33 B.T.A. 478, 482 (1935), *acq.*, XV-1 C.B. 21; and as "rents," *Comm'r v. Wilson*, 76 F.2d 766 (5th Cir. 1935). The characterization of any particular payment required under a lease agreement as a bonus or as a delay rental must be in the context of the entire agreement.

The legislative history underlying the tax treatment of REITs indicates that the central concern behind the gross income restrictions is that a REIT's gross income should largely be 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."

Section 1.856-3(g) provides that 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 will be deemed to be entitled to the income of the partnership attributable to such share. For purposes of section 856, the interest of a partner in the partnership's assets is determined by reference to its capital in the partnership. The character of the various assets in the hands of the partnership and items of gross income of the partnership remains the same in the hands of the partners for all purposes of section 856.

Revenue Ruling 68-291, 1968-1 C.B. 351, clarifying Revenue Ruling 59-121, 1959-1 C.B. 212, provides generally that the consideration received for the granting of a perpetual easement constitutes the proceeds from the sale of an interest in real property and should be applied as a reduction of the cost or other basis of the portion of the land subject to the easement.

Royalties received during a Production Term are not rents from real property. The Initial Rent and Delay Rent are paid pursuant to leases under which it is possible that minerals will be produced and royalties will be paid. Like the payments in Revenue Ruling 70-153, however, the Initial Rent and Delay Rent represent fixed per-acre amounts received by Taxpayer for the use of, or the right to use, Taxpayer's real property, each for a one-year period. They do not represent payments with respect to a retained economic interest in coal or iron ore with respect to which the special provisions of section 631(c) apply, or any other mineral, oil, or gas royalty interest held by Taxpayer.

The Lease Surface Damage Payments, Seismic Permit Payments and Easement Payments in respect of Temporary Easements are all compensation to Taxpayer for the use of Taxpayer's real property. Each of those payments is for the use of, or right to use, Taxpayer's real property, and none of those payments is in exchange for minerals or is computed by reference to any amount of mineral, production, receipts or profits.

As in Revenue Ruling 68-291, the Perpetual Easements represent sales of interests in real property even though Taxpayer retains legal title to the burdened property.

Conclusion

Based on the information submitted and the representations made, we conclude that the Initial Rent, Delay Rent, Lease Surface Damage Payments, Seismic Permit Payments and Easement Payments in consideration for granting Temporary Easements constitute rents from real property, and, thus, constitute qualifying income for purposes of sections 856(c)(2) and (3). We further conclude that gain recognized by Taxpayer from the grant of a Permanent Easement or from the sale or exchange of a portion of a leased property in a Nonproducing Term constitutes gain from the sale or other disposition of real property for purposes of sections 856(c)(2) and (3).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, no opinion is expressed on whether Taxpayer qualifies as a REIT under part II of subchapter M of Chapter 1 of the Code.

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 with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Jonathan D. Silver
Assistant to the Branch Chief, Branch 2
Office of Associate Chief Counsel
(Financial Institutions & Products)