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## Congress Includes TREE Act in Farm Bill – Temporarily Cuts Corporate Tax Rate on Timber Gains and Loosens Timber REIT Rules

On May 22, Congress overrode President Bush's veto and enacted the Food, Conservation, and Energy Act of 2008, generally referred to as the Farm Bill. Included in the Farm Bill is the essence of the Timber Revitalization and Economic Enhancement Act of 2007, or the TREE Act, which provides temporary tax benefits to the timber industry.

The TREE Act provisions included in the Farm Bill (referenced below simply as the "TREE Act") are temporary. They generally cut the tax rate payable by C corporations on "qualified timber gain" to 15 percent for a one-year period beginning on the date of enactment and liberalize several of the technical rules applicable to timber REITs. The REIT provisions are also temporary, applying only for a REIT's first taxable year beginning after the date of enactment (generally, then, for the 2009 calendar year). The temporary nature of the REIT changes will complicate affected entities' tax planning, since prospects for future extensions are, of course, difficult to predict.

### Qualified Timber Gain

Present law allows taxpayers disposing of standing timber to qualify for capital gains treatment. Under section 631(a), a taxpayer can elect to treat the cutting of standing timber as a sale or exchange that qualifies for capital gains treatment. Under section 631(b), a taxpayer that disposes of standing timber under a retained economic interest contract or through outright sales also receives capital gains treatment. Under either provision, the taxpayer must have held its interest in the timber for more than one year.

The TREE Act provides for a one-year, 15 percent alternative corporate tax rate on the portion of a corporation's taxable income that consists of qualified timber gain (or, if less, the corporation's net capital gain). The effect of this change is to lower the top tax rate payable by a C corporation on its qualified timber gain from 35 percent to 15 percent. Qualified timber gain means the net gain from section 631(a) cutting and section 631(b) dispositions of timber that the corporation has held for **more than 15 years**. This 15 percent tax rate applies for purposes of both the regular tax and the alternative minimum tax.

The 15-year holding period for the timber is a new concept in the law. It seems evident that the normal tax rules for determining the holding period of an asset apply, but the test applies to the timber being sold, not the underlying land. Given modern silvicultural methods, it is not uncommon for some thinnings or sales of pulpwood to occur prior to age 15. This could potentially complicate the record-keeping and compliance efforts of C corporations intending to take advantage of this lower tax rate.

Unlike in prior laws, the TREE Act did not provide relief from the normal rules applicable to making or revoking a section 631(a) election. Any taxpayer wishing to make a section 631(a) election will need to confirm its ability to do so. Depending on the particular facts, a taxpayer may need the consent of the IRS.

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1

## Timber REIT Changes

Also included in the TREE Act are several special provisions for real estate investment trusts (“REITs”) that invest in timberlands. An entity must satisfy numerous requirements in order to qualify and remain qualified as a REIT. Among these are two income tests, a 75 percent test and a 95 percent test, each of which requires that the REIT’s gross income be derived from certain specified sources. For purposes of both tests, gains from the sale or other disposition of real property which is not held by the REIT primarily for sale to customers in the ordinary course of its trade or business (so-called “dealer property”) constitute “good” REIT income.

The IRS has issued several private letter rulings over the years confirming that section 631(b) gains from the disposition of standing timber pursuant to “pay-as-cut” contracts constitute this type of “good” REIT income. Several rulings have also characterized such income received prior to the satisfaction of the section 631(b) one-year holding period requirement as “rents from real property.” While rents are also generally “good” REIT income, this characterization raises some technical issues for timber REITs.

The TREE Act treats all section 631(b) gains, including those from outright sales, as gains from the sale of real property. It also treats gain recognized pursuant to a section 631(a) election as qualifying income if the cutting is provided by a taxable REIT subsidiary of the REIT. Moreover, both types of income are also considered gains from non-dealer sales of real property even if the one-year holding period has not been met.

The TREE Act also liberalizes the prohibited transaction safe harbor for timber REITs. Code section 857(b)(6) imposes a 100 percent tax on a REIT’s net income derived from prohibited transactions – generally, sales of dealer property. There are two safe harbors, one specific to timber properties, pursuant to which a sale will not be a prohibited transaction even if the property was held primarily for sale. One of the requirements of the safe harbor for timberlands is that the REIT must have held the property for not less than four years in connection with the trade or business of producing timber. The TREE Act reduces this requirement to two years where the REIT is selling property to a qualified tax-exempt organization for conservation purposes. Another element of the safe harbor generally requires a REIT selling a timber property to market the property (if at all) through an independent contractor unrelated to the REIT. The TREE Act modifies this rule to permit a REIT to use its taxable REIT subsidiary to perform the marketing activity.

The TREE Act contains two further changes specifically applicable to timber REITs, which are defined for this purpose as a REIT in which more than 50 percent of the value of its total assets consists of real property held in connection with the trade or business of producing timber. For such entities, the TREE Act first adds mineral royalty income to the list of “good” REIT income for purposes of the 95 percent income test, but only if the income comes from real property owned and held, or once held, by the REIT in connection with the trade or business of producing timber. Income from retained mineral interests where the timberland itself has been sold would not appear to qualify. The statute did not change the treatment of mineral royalty income for purposes of the 75 percent test. The Conference Report suggests this might have been an oversight, but it appears a technical correction would be necessary to effect such a change.

Finally, the TREE Act modifies one of the quarterly asset tests that a REIT must satisfy to remain qualified as a REIT. In general, no more than 20 percent of the value of a REIT’s assets may consist of securities of one or more taxable REIT subsidiaries. The TREE Act increases this limitation from 20 percent to 25 percent for timber REITs (as defined). Other legislative proposals have been floating around Capitol Hill to implement a similar change for REITs generally, but the timber industry succeeded first.

As noted above, though, all of these changes are effective only for a one-year window. The REIT provisions apply only to the first taxable year beginning after the date of enactment. Taxpayers thus rely on these provisions being renewed or extended at their own peril.



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