



Timber REITs and Taxation

A Briefing of Key Issues

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A real estate investment trust (REIT) is a special tax entity investing in real estate (such as shopping malls, apartments, and timberland). A timber REIT specializes in timber property investment.

Although a business entity choice (such as a corporation or a REIT) is driven by a combination of strategic, financial and investment considerations, one of the key factors for such a choice is taxation, when real estate, including timberland, is significant business asset.

REIT's Tax Advantages

A REIT is a tax efficient entity for holding real estate such as timberland:

- ▶ A REIT **does not pay federal income taxes on its income that it pays out (distributes) to its shareholders (as "dividends")**. This is because a REIT is allowed to claim a deduction on the dividend distribution, and at least 90% of its income is required to be distributed to the shareholders.

In contrast, income for a traditional corporation is taxed twice—once at the firm level and again at the shareholder level when distributed as dividends.

- ▶ A REIT **passes its timber income (from sales of timber and timberland) to its shareholders as *capital gains*** (rather than ordinary income), which is subject to the favorable tax rates of up to only 15%. Such timber income is taxed at a corporate rate of as much as 35%¹.
- ▶ **Income paid from a REIT generally does not trigger certain taxes for tax-exempt investors** (e.g., unrelated business income taxes), making it attractive to institutional pension investors.

¹ The tax law passed as part of the 2008 Farm Bill allowed a one-year 15% corporate rate for gains from timber held more than 15 years, providing temporary tax savings for timber corporations.

Qualifications for A REIT

The tax laws on a REIT qualification are complex:

- 1) Asset Requirement** At least 75% of a REIT's asset value must be real estate, cash and cash items, and government securities.

Special Rule for Timber REITs. A timber REIT is a REIT in which more than 50% of its asset value is real property in the trade or business of producing timber.

Through its subsidiaries, a REIT may have assets and engage in businesses that are not in real estate (such as forest product manufacturing). However, the securities of such subsidiaries can not be greater than 25% of a REIT's asset value.

- 2) Income Source Requirement**

- ▶ A REIT must derive at least 95% of its gross income from investment (e.g., interests, rental income from real estate, timber gains² and mineral royalty³).

Timber REITs:

- ▶ Plum Creek Timber Co. Inc.
- ▶ Weyerhaeuser
- ▶ Potlatch Corporation
- ▶ Rayonier
- ▶ Anderson-Tully Corporation
- ▶ Longview Fibre

² For a limited period of one year until May 21, 2010 by the 2008 Farm Bill. The IRS Private Letter Rulings have concluded timber gains of cutting contracts are REIT income.

³ From property held for timber production in the first taxable year beginning after May 22, 2008

- ▶ A REIT must derive at least 75% of its income from real estate sources including timber gains.

3) Dividend Distribution Requirement A REIT is required to distribute at least 90% of its ordinary taxable income to its shareholders⁴. A 4% (excise) tax is imposed for deficiency distributions (with exception).

4) Ownership and Management Structure To qualify as a REIT, the corporation, trust, or association must be otherwise taxable as a domestic corporation and be held by 100 or more persons (with exception for its first year).

Status Election A REIT tax status must be elected by calculating the entity's tax as a REIT for the first tax year on Form 1120-REIT, U.S. Income Tax Return for Real Estate Investment Trusts.

A REIT Conversion Case: Weyerhaeuser

Effective January 1, 2010, one of the world's largest vertically integrated forest product companies, Weyerhaeuser, officially converted from a corporation to a REIT. Based in Federal Way, Washington, Weyerhaeuser manages 22 million acres of timberland worldwide and owns forest product manufacturing and home construction operations.

According to its 2010 annual report, Weyerhaeuser derives REIT income from "owning and managing a timberland portfolio for the production and sale of standing timber". Other businesses, such as "the manufacture and sale by us (Weyerhaeuser) of wood products, the harvesting and sale of logs, and the development or sale of certain timberlands, the manufacture and sale of pulp products are conducted through one or more of our wholly-owned taxable REIT subsidiaries ('TRSs') because such activities could generate non-qualifying REIT income and could constitute 'prohibited transactions'". Such subsidiaries are subject to income taxes.

⁴ Capital gains of a REIT may be retained but are subject to taxes .

REIT's Tax Disadvantages

- ▶ The REIT tax rules are more complex and restrictive, which may substantially increase the tax compliance costs, burden and risks.
- ▶ A REIT's losses are not allowed to pass through to investors.
- ▶ Tax credits for a REIT cannot be passed through to the shareholders, including foreign tax credits from worldwide operations.
- ▶ The asset composition requirement (regarding no more than 25% of a REIT asset be in securities of taxable REIT subsidiaries) could limit the operation size of forest product manufacturing as such subsidiaries.
- ▶ Failure to maintain a REIT status is subject to penalties and additional taxes or termination.

For more technical information on timber REIT taxation, please go to the USDA Forest Service website at:

<http://www.fs.fed.us/spf/coop/programs/loa/tax.shtml>