



Timber REITs and Taxation

Technical Report

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A real estate investment trust (REIT) in general is a special tax entity investing mainly in real estate (such as shopping malls, apartments, office buildings). A timber REIT specializes in timberland investment and is subject to general and special timber REIT tax laws and rules.

The choice of corporate forms—a C-corporation or a REIT—is driven by a combination of financial, investment and strategic business consideration. Taxation is a key factor when real estate, including timberland, is a significant asset.

REIT's Tax Advantages

From a tax standpoint, 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 it is required to distribute at least 90% of its ordinary income by the tax law. Thus a REIT can essentially eliminate income taxes at the firm level.

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 may pass its timber income (from timber sales) 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 (P.L. 110-246) allowed a one-year 15% corporate rate for gains from timber held more than 15 years, providing temporary tax savings for timber corporations.

The tax law imposes multiple requirements for a REIT qualification ranging from asset composition, income source, ownership and management structure, and dividend distribution.

REIT Qualifications

1) Asset Requirement

A REIT must meet the asset requirement at each quarter of the tax year:

- ▶ At least 75% of a REIT's asset value must be real estate, cash and cash items (including receivables), and Government securities.

Special asset requirement for a timber REIT. 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.

- ▶ No more than 25% of a REIT's asset value can be securities (excluding those representing real estate and Government securities).
- ▶ No more than 25% of a REIT asset value can be securities of taxable REIT subsidiaries (TRS).

A taxable REIT subsidiary is a subsidiary that may engage in certain non-real estate businesses without violating the REIT status.

Timber REITs:

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

- ▶ Except for Government securities and Taxable REIT Subsidiary securities:

- 1) no more than 5% of a REIT's asset value can be invested in securities by any one issuer; and
- 2) a REIT cannot invest in more than 10% of securities of any one issuer (by voting power or value) (Sec. 856(c)(4)).

Reasonable cause exception. If the asset requirement is not met but the failure is due to reasonable cause and not due to willful neglect, this requirement may nonetheless be considered to be met if the REIT pays a tax (the higher of \$50,000 or the income generated by the asset taxed at the highest corporate rate) and disposes of the asset within 6 months (Sec. 856(c)(7)).

2) Income Source Requirement

A REIT must derive at least 95% of its gross income from investment and real estate sources (dividends, interest, rents from real property, gains from the sale of stock, securities or real property including timber sales (of Sec. 631(a) and 631(b) for a limited period of one year until May 21, 2010 by the 2008 Farm Bill (P.L. 110-246). The IRS Private Letter Rulings concluded timber sale income of Sec. 631(b) cutting contracts are REIT income for the 95% and 75% income tests (below)). Qualified income also includes mineral royalty for a timber REIT in the first taxable year (beginning after May 22, 2008).

A REIT must derive 75% of its income from real estate sources including gains from timber sales as discussed above.

Reasonable cause exception. If it fails the income requirement, an entity may still qualify as a REIT if the failure is due to reasonable cause and not due to willful neglect and it pays a tax (the greater of the proportionate taxable income by such failure from either the 95% or the 75% income requirement) (sec. 857(b)(5)).

3) Dividend Distribution Requirement

A REIT is generally required to distribute to its shareholders at least the sum of 90% of its taxable income (net capital gains excluded) and 90% of the excess of the net income from foreclosure property over the taxes on such

income, net of any excess noncash income (Sec. 857 (a)). Net capital gains of a REIT may be retained but are taxed.

Failure to meet the distribution requirement. The IRS may waive the distribution requirement if the REIT made distributions previously of 85% of its ordinary income and 95% of its capital gain net income (Sec. 4981). A 4% (excise) tax is imposed on the deficiency distributions.

4) Ownership and Management Structure

To qualify as a REIT, the corporation, trust, or association must: 1) be managed by one or more trustees or directors; 2) show its ownership by transferable shares or certificates of beneficial interest; 3) be otherwise taxable as a domestic corporation; 4) be held by 100 or more persons (with exception for its first year).

Status Election Requirement

A REIT tax status must be elected for it to apply. The election is made by calculating the entity's tax as a REIT on its return for the first tax year for which the election is to apply. A REIT uses calendar year and files Form 1120-REIT, U.S. Income Tax Return for Real Estate Investment Trusts. A REIT status can be revoked for any tax year after the first tax year for which the election is effective. Once revoked or terminated (because failure of meeting the REIT requirements), the entity may not make a new election before the 5th year following the year of revocation or termination.

Failure to Qualify

If an entity fails one or more of the REIT qualification requirements (other than the income source and asset requirements), the REIT status may be retained if such failures are due to reasonable cause and not due to willful neglect and a \$50,000 penalty for each failure is paid.

Prohibited Transaction

A 100-percent (excise) tax is imposed when a REIT engages in an active business (vs. passive investment)

type of transaction (i.e., sale of property that is stock in trade, inventory, or property held primarily for sale to customers in the ordinary course of a trade or business). This tax can be avoided if certain conditions are met (regarding the property's holding period, basis, expenditure and marketing).

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 C-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.

To set up as a REIT, Weyerhaeuser structured its business segment in timber production as a REIT because sale of standing timber qualifies for REIT income. Other business segments, mainly in wood and pulp product manufacturing and homebuilding, are organized through taxable REIT subsidiaries (because these activities do not qualify for REIT income and may be subject to the "prohibited transaction" rules). Such subsidiaries continue to pay income taxes.

REIT's Tax Disadvantages

- ▶ REIT tax laws are complex, increasing 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. For timber companies with worldwide operations, this means foreign taxes credits may not be passed through to the shareholders.
- ▶ The asset composition requirement (regarding no less than 25% of a REIT asset be in securities of taxable

REIT subsidiaries) could limit the operation size of forest product manufacturing businesses as such subsidiaries.

- ▶ Distribution of almost all of its income may leave a REIT much less of its profits for business use if without stock dividends to meet the required distribution.
- ▶ The limitation of only 25% of a REIT income be from non-timber sources (75% or more must be from sale of timber and timberland) affects the ability of a REIT to receive cash flow from all sources to fund cash distributions.
- ▶ Failure to maintain a REIT status is subject to penalties, additional taxes and termination.

Conversion from a C corporation with forest products manufacturing operations to a REIT may entail fundamental business structural changes in order to meet and continue to maintain the intricate qualifications for a REIT. Accumulated C corporation earnings and profits are required to be distributed no later than the end of the first REIT year, impacting the REIT's capital structure.

Although a REIT largely avoids double taxation of its income, it continues to pay the following taxes:

- ▶ Undistributed taxable income are taxable.
- ▶ Pre-REIT gains of a C corporation may be taxable for 10 years after conversion to a REIT ("built-in gains" tax) (IRS Notice 88-19).
- ▶ Although a REIT is required to distribute at least 90% of its ordinary taxable income, capital gains may be retained but are subject to taxes.
- ▶ Taxable REIT subsidiaries are subject to corporate income tax.

For a brief summary of key issues on timber REIT taxation, please go to the USDA Forest Service website at:

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