DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

200151062

Date: SEP 28 2001

Contact Person:

Identification Number:

Telephone Number:

Uniform Issue List No:
512.10-00

T:EO:B2

Employer Identification Number:

Dear Applicant:

This letter is in reply to the letter from your authorized representative dated August 27, 1999, in which you requested a ruling under section 512 of the Internal Revenue Code with respect to the amounts you will receive from the disposal of timber.

Our records indicate that you are an organization recognized by the Internal Revenue Service as exempt from federal income tax under section 501(c)(4) of the Code.

You state that upon your formation, you leased property for your use in your social welfare activities, and subsequently purchased such property. In 1993, this property was no longer usable for your purposes as a result of flooding. You thereupon sold such property and used the proceeds to purchase a parcel of undeveloped, heavily wooded real property. You cleared portions of this property for your exempt purposes. You have been advised by your state conservation commission that certain of your forested property should be thinned for conservation purposes. You are in need of funds to permit you to enhance your facilities in furtherance of your exempt purposes, and the funds generated by the sale of timber from your forested property would generate funds to permit such enhancement. You state that the timber to be cut will have been held by you for more than one year at the time such timber is cut and that any timber cut will be more than one year old. Previously, you have not sold any of your standing timber.

You have entered into a timber harvesting contract with a timber cutting contractor. The provisions of the contract include the following:

(1) You have agreed to sell and the contractor has agreed to cut those trees which have been designated and marked for cutting by representatives of the state conservation commission.

(2) You will be paid at the rate of 50% of the log sales revenue as documented by the mill tally tickets and receipts.

(3) Title to the timber will not pass until the timber is actually severed.

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You state that you are requesting a ruling solely on the application of section 512(b)(5) of the Code to the income attributable to the disposition of timber pursuant to the timber harvesting contract as though such income would have otherwise constituted unrelated trade or business income.

Section 501(c)(4) of the Code provides for the exemption from federal income tax of civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare.

Section 511(a) of the Code imposes a tax on the unrelated business taxable income of organizations described in section 501(c).

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" as the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less certain allowable deductions and modifications.

Section 512(b)(5) of the Code provides, as one of the modifications referred to in section 512(a)(1), that there shall be excluded all gains or losses from the sale, exchange, or other disposition of property other than (A) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, or (B) property held primarily for sale to customers in the ordinary course of the trade or business. There shall also be excluded all gains or losses recognized, in connection with the organization's investment activities, from the lapse or termination of options to buy or sell securities (as defined in section 1236(c)) or real property and all gains or losses from the forfeiture of good-faith deposits (that are consistent with established business practice) for the purchase, sale, or lease of real property in connection with the organizations's investment activities. This paragraph shall not apply with respect to the cutting of timber which is considered, on the application of section 631, as a sale or exchange of such timber.

Section 631(a) of the Code, in general, allows a taxpayer who owns timber to elect to treat the cutting of such timber as a sale of the timber cut during the year provided the timber was owned for a period of more than one year. Under this election, gain or loss is recognized as the difference between the fair market value of the timber as of the first day of the tax year and its adjusted basis for depletion.

Section 631(b) of the Code provides, in part, that in the case of the disposal of timber held for more than one year before such disposal, by the owner thereof under any form or type of contract by virtue of which such owner retains an economic interest in such timber, the difference between the amount realized from the disposal of such timber and the adjusted depletion basis thereof, shall be considered as though it were a gain or loss, as the case may be, on the sale of such timber.

Section 1201(a) of the Code provides, in part, for an alternative tax for a corporation which has a net capital gain and any rate of tax imposed by section 511 exceeds 35%.

Section 1231(a) of the Code, regarding property used in the trade or business and involuntary conversions, provides that if the section 1231 gains for any taxable year exceed the section 1231 losses for such taxable year, such gains and losses shall be treated as long-term capital gains or long-term losses, as the case may be, but that if the section 1231 gains for any taxable year do not exceed the section 1231 losses for such taxable year, such gains and losses shall not be treated as gains and losses from sales or exchanges of capital assets.

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Section 1.512(b)-1(d)(1) of the Income Tax Regulations provides that there shall be excluded from the computation of unrelated business taxable income gains or losses from the sale, exchange, or other disposition of property other than (i) stock in trade or other property of a kind which would properly be included in the inventory of the organization if on hand at the close of the taxable year, or (ii) property held primarily for sale to customers in the ordinary course of the trade or business. The regulation continues that this exclusion does not apply with respect to the cutting of timber which is considered, upon the application of section 631(a) of the Code, as a sale or exchange of such timber.

Section 1.611-1(b)(1) of the regulations provides, in part, that an "economic interest" is an interest 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.

Section 1.631-2(a)(2) of the regulations provides that in the case of a disposal of timber under section 631(b) of the Code, the provisions of section 1231 apply and such timber shall be considered to be property used in the trade or business for the taxable year in which it is considered to have been sold, along with other property of the taxpayer used in the trade or business as defined in section 1231(b), regardless of whether such timber is property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Whether gain or loss resulting from the disposition of the timber which is considered to have been sold will be deemed to be gain or loss resulting from a sale of a capital asset held for more than one year will depend on the application of section 1231 to the taxpayer for the taxable year.

Section 1.1201-1(c) of the regulations provides that in applying section 1201 of the Code in the case of tax-exempt trusts or organizations subject to the tax imposed by section 511, the only amount which is taken into account as capital gain or loss is that which is taken into account in computing unrelated business taxable income under section 512. The regulation continues that under section 512, the only amount taken into account as capital gain or loss is that resulting from the application of section 631(a), relating to the election to treat the cutting of timber as a sale or exchange.

It is clear that you will receive income from the sale of your timber, which will not be substantially related to your exempt purpose under section 501(c)(4) of the Code, and therefore the income would be regarded as unrelated business taxable income under section 512(a)(1). Gain which is subject to section 631(b), however, is excluded from the computation of unrelated business taxable income under section 512(b)(5). Section 631(b) applies to the disposal of timber by a land owner under circumstances in which the land owner has owned timber for a period of more than one year prior to disposition and the disposition is under any form or type of contract by virtue of which the land owner has retained an economic interest in the timber. Since the consideration you will receive will not be fixed, but rather will be based on the amount of timber cut and the price at which the timber can be sold at the mill at the time of cut, you will have retained an economic interest in the timber within the meaning of section 631(b).

Accordingly, based on the facts and circumstances concerning this activity as stated above, we rule that the amounts you will receive from the disposal of the timber from your land as described above will be excludable from the definition of unrelated business taxable income under section 512(a)(1) of the Code by reason of section 512(b)(5).

This ruling is based on the understanding that there will be no material changes in the facts upon which it is based. Any such change should be reported to the Ohio Tax Exempt and Government Entities (TE/GE) Customer Service office. Because it could help resolve questions concerning your federal income tax status, this ruling should be kept in your permanent records. A copy of this ruling is being forwarded to the Ohio TE/GE Customer Service office.

Except as we have specifically ruled herein, we express no opinion as to the consequences of these transactions under the cited provisions or under any other provisions of the Code.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely yours,

(signed) Terrell M. Berkovsky
Terrell M. Berkovsky
Manager, Exempt Organizations
Technical Group 2

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