

Year 3 =

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Dear :

This responds to a letter dated January 19, 2010, submitted on behalf of Trust, requesting rulings regarding the treatment of certain income under § 856 and § 857 of the Internal Revenue Code.

FACTS

Trust is a State X corporation that has elected to be treated as a real estate investment trust (REIT) beginning with its taxable year that ended Date 1. Trust is an international forest products company that is primarily engaged in activities associated with timberland operation and management. Trust has represented that Trust's non-REIT qualifying operations are conducted through a wholly-owned taxable REIT subsidiary.

Trust currently owns, leases, or manages approximately a acres of timberland and real estate located in Country Y and Country Z. Trust's Country Z timber operations are conducted through Company A, a Country Z unlimited company in which Trust has a b percent interest. Company A has elected to be treated as a partnership for U.S. federal income tax purposes. Company A, through one of its wholly-owned subsidiaries, Company B, a Country Z unlimited company that has elected to be a disregarded entity for U.S. federal income tax purposes, owns or leases approximately c acres of timberland.

Company A is a participant in the Country Z Emissions Trading Program (the Program). The Program is a regulatory program established by the Country Z government that sets a price on greenhouse gas (GHG) emissions in Country Z to create incentives to reduce such emissions. The portion of the Program pertaining to the forestry sector (the Forestry Program) was implemented on Date 2 with a retroactive effective date of Date 3.

The Forestry Program is premised on the fact that carbon dioxide, one of the GHGs that the Program seeks to reduce, can be temporarily removed from the atmosphere by forests and other woody vegetation. Specifically, as trees grow, they remove carbon dioxide present in the atmosphere through photosynthesis and store it in their trunks, branches, leaves, and roots. When trees are harvested, the carbon dioxide they have stored is returned to the atmosphere. Consequently, the Forestry Program is designed to create incentives for forest owners to not harvest trees without planting replacements.

Under the Forestry Program, the Country Z government allocates Carbon Emission Units (Units), each of which represents one ton of carbon dioxide removed from the atmosphere, to certain forest owners to account for the carbon their forests have captured. The Forestry Program effectively imposes land use restrictions on the forest owner by requiring the forest owner to surrender Units if it harvests its trees and does not plant sufficient replacement trees. The Units serve as an offset for the loss in the value of the forest owner's land as a result of the restrictions imposed by the Program.

Forest owners that are allocated Units may hold them for use in future compliance periods or sell them in the Country Z market or in an international market. Allocated Units are issued at no cost to the forest owner, and under Country Z tax law, no taxable income arises on their receipt. Under the International Financial Reporting Standards adopted by Country Z, Units are recorded as intangible assets of Company A.

The Forestry Program has two different sets of rules: one for owners of forests that were established before Date 4 ("Pre-Year 1 Forests"), and another for owners of forests established after Date 5 ("Post-Year 2 Forests"). Owners of Pre-Year 1 Forests are mandatorily subject to the Forestry Program. The number of Units that each Pre-Year 1 Forest owner will receive per acre of forest land is dependent on various factors, such as the year the land on which the trees are grown was purchased and whether Units were required to be retained to cover certain specified statutory exemptions. If an owner of Pre-Year 1 Forests deforests more than d acres of trees without replanting such trees, the owner must calculate and report the amount of carbon dioxide released into the environment and surrender an adequate number of Units. The Units that the owner surrenders may be those previously allocated to such owner by the Country Z government or they may be purchased on the open market. If an owner of Pre-Year 1 Forests sells its forest land, the owner may not retain the Units attributable to such forests; the owner will be treated as transferring to the purchaser any Units that were allocated to the owner that have not previously been sold or surrendered.

With respect to owners of Post-Year 2 Forests, participation in the Forestry Program is elective. The number of Units that will be allocated to an owner of Post-Year 2 Forests that elects to participate in the Forestry Program ("Electing Post-Year 2 Forest Owners") will be equivalent to the tons of carbon dioxide the owner's trees have

captured since Date 3 if the owner elects to join the Forestry Program by the end of Year 3, and since Date 6 if the owner elects to join the Forestry Program after Year 3. Every e years, an Electing Post-Year 2 Forest Owner must file an emissions return that reports the amount of carbon dioxide currently sequestered by its trees. If the amount of the carbon dioxide reported falls below a previously reported level, the Electing Post-Year 2 Forest Owner must surrender an adequate number of Units to compensate for the decrease in the amount of carbon dioxide sequestered by the forest owner's trees. The Units that the Electing Post-Year 2 Forest Owner surrenders may be those previously allocated to the owner by the Country Z government or they may be purchased on the open market. If an Electing Post-Year 2 Forest Owner sells its forest land, the owner may not retain the Units attributable to those forests; the owner will be treated as transferring any Units that were allocated to it from the Country Z government that have not previously been sold or surrendered, and the purchaser takes responsibility for any decrease in the amount of carbon dioxide sequestered by the trees on the land since the seller filed its last emissions return.

Company A will be allocated Units from the Country Z government attributable to its Pre-Year 1 Forests. Company A also expects to elect to participate in the Forestry Program with respect to its Post-Year 2 Forests, pursuant to which Company A will be allocated additional Units from the Country Z government. To monetize the Units allocated to Company A, Company A would open an account with the Country Z Emission Unit Registry ("the Registry") which operates like a stock share registry. The Registry records entities that hold Units and the number of Units held, the transfer of Units between holders both within the Registry and between international unit registries, and the surrender of Units by participants to meet their obligations under the Program. The sale of Units could be made directly to companies that need to acquire Units to surrender to the government (outside of any market), or Units could be traded on a secondary market to brokers who hold and trade Units or to parties that need Units to comply with the Program.

LAW AND ANALYSIS

Qualification of Units as Real Estate Assets

Section 856(c)(4)(A) of the Code provides that at the close of each quarter of its tax year, at least 75 percent of the value of a REIT's total assets must be represented by real estate assets, cash and cash items (including receivables), and Government securities.

Section 856(c)(5)(B) defines the term "real estate assets," in part, to mean real property (including interests in real property and interests in mortgages on real property) and shares (or transferable certificates of beneficial interest) in other REITs. Section 856(c)(5)(C) provides that the terms "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(d) provides that "real property" includes land or improvements thereon, such as buildings or other inherently permanent structures thereon (including items which are structural components of such buildings or structures). Local law definitions will not be controlling for purposes of determining the meaning of "real property" for purposes of § 856 and the regulations thereunder. Under this regulation, "real property" includes, for example, the wiring in a building, plumbing systems, central heating or central air-conditioning machinery, pipes or ducts, elevators or escalators installed in a building, or other items which are structural components of a building or other permanent structure. The term does not include assets accessory to the operation of a business, such as machinery, printing press, transportation equipment which is not a structural component of the building, office equipment, refrigerators, individual air-conditioning units, grocery counters, furnishings of a motel, hotel, or office building, etc. even though such items may be termed fixtures under local law.

It is a well established principle of law that standing timber is treated as real property for federal income tax purposes. The United States Supreme Court has stated that "timber growing upon the land constituted a portion of the realty," *Hutchins v. King*, 68 U.S. 53, 59 (1863). In *Laird v. United States*, 115 F. Supp. 931, 933 (W.D. Wis. 1953), the court stated that under common law, and the law of the United States, growing timber has always been considered a portion of the real property, and the owner of that timber had an interest in so much of the soil as was necessary to sustain it. In Rev. Rul. 72-515, 1972-2 C.B. 466, the Service held that timber growing on the land is part of the land and that an exchange of timberlands of different qualities nevertheless constitutes a like-kind exchange because both are land held for investment. Accordingly, timberlands and the standing timber thereon constitute real property and, therefore, real estate assets within the meaning of § 856(c)(5)(B).

Although the definitions and examples of "real property" and "interest in real property" provided in the regulations are not exclusive, the plain language of those regulations leads to the conclusion that any asset other than the physical real estate itself must be inextricably tied or connected to the real estate to fall within either of those definitions. In this case, the Units allocated to Company A by the Country Z government are intangible assets that are inextricably linked to the specific stands of growing trees that sequester carbon dioxide. Accordingly, the Units allocated to Company A by the Country Z government qualify as real estate assets for purposes of § 856(c)(5) and § 856(c)(4)(A).

Allocation of Units

Section 856(c)(5)(J), which was added to the Code by Division C of the Housing and Economic Recovery Act of 2008, P.L. 110-289, provides inter alia that to the extent necessary to carry out the purposes of part II of subchapter M, the Secretary of the

Treasury is authorized to determine, solely for purposes of this part, whether any item of income or gain that does not qualify under § 856(c)(2) or § 856(c)(3) to satisfy the 95 percent and 75 percent REIT gross income tests, nevertheless may be considered as gross income that qualifies under § 856(c)(2) and § 856(c)(3) to satisfy the 95 percent and 75 percent REIT gross income tests.

The staff of the Joint Committee on Taxation in its General Explanation of the Tax Legislation Enacted in the 110th Congress describes § 856(c)(5)(J) as follows: "The provision authorizes the Treasury Department to issue guidance that would allow other items of income to be excluded for purposes of the computation of qualifying gross income under either the 75 percent or the 95 percent test, respectively, or to be included as qualifying income for either of such tests, respectively, in appropriate cases consistent with the purposes of the REIT provisions." Footnote 309 of the General Explanation provides that income that is statutorily excluded from gross income computations under the provision is not intended to be within the authority to include as qualifying income. Joint Committee on Taxation Staff, General Explanation of the Tax Legislation Enacted in the 110th Congress, 110 Cong., 2d Sess. (2009), 239.

The legislative history underlying the REIT provisions indicates that the central concern behind the gross income restrictions is that a REIT's gross income should be largely 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." In describing the 75 percent test, the report states that "[u]nder this test at least 75 percent of the [REIT's] income must, in one manner or another, be derived from real property." Id at 822.

Section 61 of the Code generally defines gross income as "income from whatever source derived", except as otherwise provided by law. Gross income includes income realized in any form, whether in money, property, or services. Section 1.61-1(a) of the Income Tax Regulations. This definition encompasses all "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431, 75 S. Ct. 473, 99 L. Ed. 483, 1955-1 C.B. 207 (1955), 1955-1 C.B. 207.

Generally, the granting of a transferable right by a government does not cause the realization of income. Rev. Rul. 92-16, 1992-1 C.B. 15 (allocation of air emission rights by the U.S. Environmental Protection Agency does not cause a utility to realize gross income); Rev. Rul. 67-135, 1967-1 C.B. 20 (fair market value of an oil and gas lease obtained from the federal government through a lottery is not includible in income).

To the extent any amounts are otherwise includible in gross income by reason of the allocation of Units to Company A by the Country Z government, such amounts will

be considered as qualifying income under § 856(c)(5)(J) for purposes of satisfying the 95 percent and 75 percent REIT gross income tests in §856(c)(2) and §856(c)(3). This is an appropriate case to invoke the authority granted in § 856(c)(5)(J) to permit other types of income that are not statutorily designated as qualifying income under § 856(c)(2) or § 856(c)(3) to be considered as qualifying income for purposes of satisfying the 95 percent and 75 percent REIT gross income tests. This treatment of income derived by Trust from the allocation of Units to Company A by the Country Z government is appropriate in this case because of the relationship of the income to REIT qualifying assets. The income derived by Trust from the allocation of Units to Company A is inextricably linked to the underlying timberland and standing timber thereon, which are qualifying REIT assets. Further, the income derived by Trust from the allocation of Units to Company A is not based in whole or part on the profits or losses of any person or entity and is derived from a source that is inherently passive in nature. Therefore, treating the income derived by Trust from the allocation of Units to Company A by the Country Z government as qualifying income under § 856(c)(5)(J) is consistent with the purposes of the REIT provisions.

Sale of Units

Section 856(c)(2) of the Code provides that at least 95 percent of a REIT's gross income (excluding gross income from prohibited transactions) must be derived from, among other sources, gain from the sale or other disposition of stock, securities, and real property (including interests in real property and interests in mortgages on real property) which is not property described in § 1221(a)(1).

Section 856(c)(3) provides that at least 75 percent of a REIT's gross income (excluding gross income from prohibited transactions) must be derived from, among other sources, 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 § 1221(a)(1).

Section 857(b)(6)(A) provides that a tax will be imposed upon a REIT equal to 100 percent of the net income derived by the REIT from prohibited transactions. Section 857(b)(6)(B)(iii) defines the term "prohibited transaction" as a sale or other disposition of property described in § 1221(a)(1) which is not foreclosure property.

Section 1221(a)(1) provides that for federal income tax purposes, the term "capital asset" means property held by the taxpayer (whether or not connected with the taxpayer's trade or business) but does not include stock in trade of the taxpayer or other property of a kind that would properly be included in the inventory of the taxpayer if on hand at the close of the tax year, or property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

In this case, the Units allocated to Company A by the Country Z government are real estate assets, and gain from the sale of the Units is gain from the sale or other

disposition of real property for purposes of §§ 856(c)(2) and 856(c)(3). Further, we conclude that under the circumstances of this case, gain from the sale of Units allocated to Company A by the Country Z government is not income from a prohibited transaction for purposes of § 857(b)(6).

CONCLUSIONS

Accordingly, we conclude as follows:

(1) The Units allocated to Company A by the Country Z government qualify as real estate assets for purposes of § 856(c)(5) and § 856(c)(4)(A).

(2) To the extent any amounts are included by Trust in gross income by reason of the allocation of Units to Company A by the Country Z government, such amounts are considered as qualifying income under § 856(c)(5)(J) for purposes of satisfying the 95 percent and 75 percent REIT gross income tests in §856(c)(2) and §856(c)(3).

(3) Gain from the sale of Units allocated to Company A by the Country Z government is gain from the sale or other disposition of real property for purposes of §§ 856(c)(2) and 856(c)(3).

(4) Gain from the sale of Units allocated to Company A by the Country Z government is not income from a prohibited transaction for purposes of § 857(b)(6).

This ruling's application is limited to the facts, representations, Code sections, and regulations cited herein. Except as specifically ruled upon above, no opinion is expressed concerning any federal income tax consequences relating to the facts herein under any other provision of the Code. Specifically, we do not rule whether Trust otherwise qualifies as a REIT under part II of subchapter M of Chapter 1 of the Code. Further, no implication is intended by the conclusions in this ruling with respect to §§ 864 and 954.

Finally, we express no opinion on any federal income tax consequences relating to the acquisition, retention, or sale or other disposition of Units acquired by Trust or Company A other than through the allocation of Units to Company A by the Country Z government.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) 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,

Alice M. Bennett
Chief, Branch 3
Office of Associate Chief Counsel
(Financial Institutions & Products)

Enclosures:

Copy of this letter
Copy for section 6110 purposes