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

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Date: AUG 13 2001

Contact Person:

Identification Number:

Telephone Number:

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631.01-00
631.02-00

T:EO:B2

Employer Identification Number:

LEGEND:

M =
N =

Dear Sir or Madam:

This letter responds to your attorney's letter dated October 31, 2000, and previous correspondence requesting rulings pertaining to the tax treatment of income you receive from various timber-cutting contracts.

You have been recognized as exempt under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(3), and you have been classified as other than a private foundation under sections 509(a)(l) and l70(b)(l)(A)(ii).

You and M, a for profit corporation, have established N, a limited liability corporation. You and M are the only members of N. You own a 99% membership interest in N, and M has a l% interest. M is the manager of N and is responsible for managing the land and entering into contracts with other companies to harvest the timber. N has elected to be treated as a partnership.

N, which is referred to as the "Seller" in the timber-cutting contracts, acquires and holds timberland. The timber harvesting company, which is referred to as the purchaser in the contracts, will pay only for the timber it actually severs and removes. The representative copy of a timber-cutting contract you submitted provides that, "[n]o timber shall be cut except that marked or otherwise designated by the Seller or his Agent." The income you earn is based on the amount of timber that is cut. Such contracts are generally referred to in the industry as "pay-as-cut" contracts.

You have represented that many of the cutting contracts will involve timber that has been held by N for more than one year prior to the date on which the timber is cut. These contracts will be referred to in this letter as "qualifying section 631(b) contracts." Other contracts will involve timber that has been held for one year or less. These contracts will be referred to in this letter as "first-year transactions." In all respects the contracts for the cutting of timber are the same, other than the holding period.

The LLC Agreement provides that the manager has been granted certain rights and responsibilities to run the business. Section 4.2 of the LLC Agreement provides that the manager shall have full, exclusive and complete discretion, power and authority to manage, control, administer and operate the business as limited by section 4.4. Section 3.6 of the agreement, which pertains to the treatment of income and losses, indicates that allocations to members are made on a pro rata basis.

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Section 5.3 provides for the removal of the manager by majority vote of the members.

You have made the following representations:

1. The parties with which N contracts for harvesting the timber are not controlled by you, and therefore the provisions of section 512(b)(13) of the Code are not applicable;

2. None of the property or timber should be considered debt-financed property within the meaning of section 514 of the Code;

3. N has a retained economic interest in the timber that is subject to the various timber cutting contracts; and,

4. The contracts under which the timber cutting will occur are "pay as cut" contracts.

You have requested the following rulings:

1. The gains or losses that N realizes from timber dispositions that qualify under section 631(b) of the Code will be excluded from your unrelated business taxable income pursuant to section 512(b)(5), and

2. The income that N realizes from first-year transactions pursuant to cutting contracts under which N retains an economic interest in the timber will be either rent from real property under section 512(b)(3) of the Code or royalties under section 512(b)(2) and will be excluded from your unrelated business taxable income.

Section 501(c)(3) of the Code provides, in part, for exemption from federal income tax for a corporation organized and operated exclusively for educational purposes.

Section 511(a) of the Code imposes a tax on the "unrelated business taxable income" of organizations described in section 50l(c).

Section 512(a)(l) 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 computed with the modifications listed in section 512(b).

Section 513(a) of the Code defines the term "unrelated trade or business" as any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of the functions constituting the basis for its exemption.

Section 512(b)(2) of the Code excludes from the computation of unrelated business taxable income all royalties (including overriding royalties) whether measured by production or by gross or taxable income from the property and all deductions directly connected with such income.

Section 512(b)(3) of the Code excludes from the computation of unrelated business taxable income rent from real property and certain incidental personal property.

Section 512(b)(5) of the Code excludes from the computation of unrelated business taxable income 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 for sale to customers in the ordinary course of the trade or

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business. Section 512(b)(5) also states that it will 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 1.512(b)-1(d)(1) of the Income Tax Regulations provides that the exclusion of gains shall 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 512(c)(1) of the Code provides that if a trade or business regularly carried on by a partnership of which an organization is a member is an unrelated trade or business with respect to such organization, such organization in computing its unrelated business taxable income shall, subject to the exceptions, additions, and limitations contained in subsection (b), include its share (whether or not distributed) of the gross income of the partnership from such unrelated trade or business and its share of the partnership deductions directly connected with such gross income.

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 that 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 that in the case of the disposal of timber held by the owner for more than one year under a contract by which the owner retains an economic interest in the 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 the timber. In determining the gross income, the adjusted gross income, or the taxable income of the lessee, the deductions allowable with respect to rents and royalties shall be determined without regard to the provisions of section 631(b). The date of the disposal of the timber shall be deemed to be the date the timber is cut, but if payment is made by the owner under the contract before the timber is cut, the owner may elect to treat the date of payment as the date of disposal of the timber. For purposes of this section, the term "owner" means any person who owns an interest in the timber, including a sublessor and a holder of a contract to cut timber.

Section 1.631-2(a)(1) of the regulations provides, in part, that if an owner disposes of timber held for more than one year before such disposal, under any form or type of contract whereby the owner retains an economic interest in the timber, the disposal shall be considered to be a sale of the timber. Section 1.631-2(a)(2) provides that in the case of a disposal of timber with a retained economic interest, the provisions of section 1231 of the Code apply, and such timber shall be considered 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), whether or not such timber is property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

Section 1.631-2(d)(1) of the regulations provides, in part, that where the conditions of section 1.631-2(a)(1) are met, amounts received or accrued prior to cutting (such as advance royalty payments or minimum royalty payments) shall be treated under section 631(b) as realized from the sale of timber if the contract of disposal provides that such amounts are to be applied as payment for timber subsequently cut. Section 1.631-2(d)(2) provides, however, that if the right to cut timber under the contract expires, terminates, or is abandoned before the timber that has been paid for is cut, the taxpayer shall treat payments attributable to the uncut timber as ordinary income and not received from the sale of timber under section 631(b) of the Code.

Rev. Rul. 81-178, 1981-2 C.B. 135, describes the term royalty for the purposes of section 512(b)(2) of the Code. To be a royalty, a payment must relate to the use of a valuable right. Payments for the use of trademarks, trade names, service marks, or copyrights, whether or not payment is based on the use made of such property, are ordinarily classified as royalties for federal tax purposes. On the other hand, royalties do not include payments for personal services.

Announcement 90-129, I990-48 I.R.B. 10, provides that a "pay-as-cut" contract is defined as a contract which calls for payment at a specified rate for each unit of timber cut and the payments made to the owner under such a contract are considered a royalty payment. This announcement specifically refers to reporting the income and does not provide a definition of the term "royalty."

The submitted information establishes that M and N are engaged in the sale of harvesting timber rights through N, an LLC in which you hold a 99% interest. As the manager of N, M is actively involved in N's operations, and N has elected to be treated as a partnership for federal tax purposes. The harvesting is carried on under contract with other organizations doing the actual cutting of timber. You do not control the timber harvesting companies, and the timber is not debt-financed property within the meaning of section 514 of the Code. In accordance with the "look-through" rule of section 512(c)(1), amounts derived by you from N would constitute income from an unrelated trade or business, unless one of the exceptions contained in section 512(b) is applicable

As indicated above, section 512(b)(5) of the Code contains a specific exception for income received from the cutting of timber that is considered on the application of section 631 as a sale or exchange of such timber. In order to qualify, such property must be held for more than one year. Section 631(b) treats certain disposals of timber as sales of the timber that may qualify for capital gain treatment. To be eligible for this treatment, the taxpayer must meet the capital gains holding period and must retain an "economic interest" in the standing timber. An "economic interest" in the standing timber is retained if the taxpayer depends on the cutting of the timber for a return on its investment in the timber. See section 1.611-1(b)(1) of the regulations. A "pay-as-cut" contract generally accomplishes this, i.e., the taxpayer is paid only for the timber that is cut. Many of the contracts with the timber-cutting companies are considered "pay-as-cut" contracts, revenues from which fall within section 631(b) and are excluded from the computation of unrelated business taxable income pursuant to section 512(b)(5). Therefore, any income N realizes from such qualifying section 631(b) contracts will be excluded from your unrelated business taxable income pursuant to section 512(b)(5). However, some of the timber-cutting contracts are described as concerning property that has been held for less than one year (the "first year transactions)."

The first year transactions do not meet the requirements of sections 631(b) and 512(b)(5) of the Code. Therefore, unless otherwise excluded, income derived from the first year transactions would be included in computing your unrelated business taxable income for purposes of section 512(a)(1). One of the modifications to the definition of unrelated business taxable income is royalty income under section 512(b)(2). For income to be treated as royalty income, the payment must relate to the use of a valuable right. Here, the timber rights are recognized as valuable rights for purposes of determining whether the amounts in question should be treated as royalty income. See Rev. Rul. 81-178, supra. Furthermore, N will have little or no involvement in the actual cutting of the timber, and the payment to be received will be set at a specified rate for the timber being cut. Income received under a pay-as-cut contract has all the characteristics of a royalty payment, and the right to harvest trees is at the discretion of the timber harvesting company. In addition, Announcement 90-129 provides that payments received under a "pay-as-cut" contract are considered royalty payments. Although this Announcement focuses on reporting requirements and does not directly address the substantive issue, it still lends authority to the conclusion that the income received with respect to first year transactions should be considered royalty income. Accordingly, as royalty income, the amounts N receives from such first year transactions will be excluded from your unrelated business taxable income pursuant to section 512(b)(2).

Re:

Inasmuch as we have determined that income earned from the sale of timber held for less than one year is royalty income, there is no need to consider any of the other grounds you have raised to exclude this income from the definition of unrelated business taxable income.

Accordingly, based on the information submitted and the representations you have made, we conclude that:

1. The gains or losses N realizes from timber dispositions that qualify under section 631(b) of the Code will be excluded from your unrelated business taxable income pursuant to section 512(b)(5); and

2. The income N realizes from first-year transactions pursuant to cutting contracts under which N retains an economic interest in the timber will be excluded from your unrelated business taxable income pursuant to section 512(b)(2) of the Code.

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 TE/GE Customer Service office. Because this letter could help resolve any questions concerning your federal income tax status, it should be kept in your permanent records.

Except as specifically ruled upon above, no opinion is expressed concerning the federal income tax consequences of the transactions described above under any other provision of the Code

No opinion is expressed and no determination is made regarding the application of section 631(b) to the taxpayer's disposals of timber. This ruling is predicated on the taxpayer's representations that the proposed transactions involving timber lands held for more than one year will constitute disposals of timber with a retained economic interest within the meaning of section 631(b) of the Code. In addition, no opinion is expressed as to the character of any gain or income derived from the taxpayer's disposals of timber.

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. For other matters, including questions concerning reporting requirements, please contact the Ohio TE/GE Customer Service office at 877-829-5500 (a toll free number).

Sincerely yours,

Terrell M. Berkovsky

Terrell M. Berkovsky
Manager, Exempt Organizations
Technical Group 2