Timberland Report

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Farm Bill "TREE Act": Implications for the Forest Industry and Timber REITs

Tax policy and subsidy programs matter in forestry. Initiatives such as the Conservation Reserve Program (CRP), the Forest Legacy Program and state-level forestland tax programs directly affect the attractiveness of and returns from timberland investments. As such, corporate forest industry tax policies and the recent passage of the new Farm Bill "TREE Act" rate a close look.

THE TAX MAN COMETH

Forest products companies operate in a world market. Their competitiveness, economic returns and attractiveness to investors directly relate to legislation and regulations put in place by domestic policymakers. One of these policies is the corporate tax rate.

As evident from Table 1, the US tax code puts US forest products firms at a disadvantage when competing internationally. Aside from Canada (the quoted rate applies to Ontario only), US companies face the highest corporate income tax rate in the world. Naturally, the forest industry has developed various ways to deal with this issue, from converting to real estate investment trusts (REITs) to using special targeted provisions (namely 631(a) and 631(b)). The former eliminates double taxation by removing taxes on qualifying income at the corporate level. The latter allows for capital gains tax treatment on qualified income arising from converting, selling or otherwise disposing of standing timber.

Table 1. Marginal effective income tax rates by country for forest industry C-corporations, 2005[1]

US	Brazil	Canada*	China	Finland	Germany	Indonesia	Russia
37%	22%	51%	17%	31%	30%	8%	9%

*Tax applicable to investments in Ontario

Weyerhaeuser, the "last of the Mohicans" in the traditional vertically-integrated forest products industry, lobbied extensively for changes to level the playing field for itself. The addition of REIT expert Debra Caffaro to the Board of Directors nearly two years ago and the appointment of Dan Fulton (whose background is in Weyerhaeuser's real estate operations) as President and CEO, were signs to Wall Street and investors that the firm was evaluating alternative ownership structures. A separate bill was introduced last year, appropriately named the Timber Revitalization and Economic Enhancement Act – TREE Act. The Act just missed being included with energy legislation last December, but was included as a provision of the new Farm Bill and signed into law in May 2008.

[1] PriceWaterhouseCoopers LLP, originally appeared on ecoecon.wordpress.com 5/25/2008.

The TREE Act of the new Farm Bill provides two salves for timberland owners. The first provision “eases” the tax burden on timberland owning companies. The second provision effectively lowers the corporate tax rate on certain timber income, and to a lesser extent lowers taxes levied on timber REITs. The first provision lowers the tax bill for Weyerhaeuser, a primary sponsor of the bill, in its current, C-corporation structure. The second provision makes qualifying for REIT status easier, given Weyerhaeuser’s large manufacturing base. Some have surmised that this two-step bill was part of the horse trade for Sen. Baucus’s support of the bill, given close ties between Plum Creek and the Senator’s home state of Montana.[2]

Largely under-analyzed by the media is the fact that the Act is valid for only one year, as clarified by Sutherland Asbill & Brennan (see detailed explanation below). Taxpayers have to rely on these provisions to be renewed or extended at their peril as they are scheduled to expire in 2010. Meanwhile, Weyerhaeuser has not dismissed the idea of converting to a REIT after this date.

TIMBER REITS EXPLAINED

REITs that specialize in timber represent one avenue for the average investor to invest in timber-exposed assets.[3] REITs own and manage income producing real estate such as buildings, warehouses, rental properties, and, since 1999, timberlands. To qualify under IRS statutes, a firm must satisfy specific criteria, the most important of which to shareholders is the requirement to distribute annually at least 90% of its taxable income in the form of dividends.

According to the National Association of Real Estate Investment Trusts (NAREIT), about 200 REITs are registered with the Securities and Exchange Commission (SEC) in the US that trade publicly on one of the major stock exchanges, such as the New York Stock Exchange. Total assets of these listed REITs exceed $475 billion.

Unlike traditional C-corporations like Weyerhaeuser, qualified REITs like Plum Creek may deduct the dividends they pay to shareholders from corporate taxable income. Therefore, most REITs pay out most taxable income to shareholders, and therefore owe no corporate tax. For this reason, REITs have been popular with individual and institutional investors interested in relatively tax-efficient income stocks.[4] In the end, shareholders pay taxes on dividends received and any capital gains generated, but there is no double-taxation. Currently, three publicly-traded REITs focus on growing timber and managing timberlands: Plum Creek, Rayonier and Potlatch (Table 2). Together they manage nearly 12 million acres, which constitutes about half of the conservatively estimated acres under management by the top 10 timberland investment management organizations (TIMOs) in the US.

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[2] Les Blumenthal. Farm Bill gives timber giant Weyerhaeuser new hope. McClatchy Newspapers.

[3] Mendell, B.C, Sydor, T. and S. Freeman. Timber Real Estate Investment Trusts (Timber REITs). Timber Mart-South Market News Quarterly, Q1 2007, pp.13-15.

[4] Results of the latest study on timber-holding REITs conclude that investors prefer industrial timberlands to be held in REIT structures rather than traditional C-corps. (Mendell,B.C., Mishra, N., and T. Sydor. 2008. Investor Responses to Timberlands Structured as Real Estate Investment Trusts. J. For., 106(5), pp. 277-280).

Table 2. Summary statistics of publicly-traded timber REITs

	Plum Creek	Rayonier	Potlatch
US Timberlands (million acres)	8	2.2	1.7
Market capitalization (millions as of 8/22/08)	$7,910	$3,400	$1,790
Revenue, 2007 (millions)	$1,675	$1,224	$1,654

2008 FARM BILL "TREE ACT" PROVISIONS: DETAILS FOR THE UNINITIATED

The new Farm Bill includes TREE Act provisions that cover two main topics: timber income and timber-related REIT provisions.

Timber Income Provisions

The current law includes two sections, 631(a) and 631(b) that allow taxpayers to treat income from standing timber as capital gains. Under 631(a), standing timber can qualify as a sale or exchange and fall under capital gains treatement. Under 631(b), capital gains treatment can be received for the disposal of standing timber under a "retained economic contract." Only timber that was owned for more than one year can qualify for either treatment.

The new TREE Act allows companies to apply an alternative 15 percent corporate tax rate to qualified (e.g. falling under 631(a) and (b)) timber gains. This in effect lowers the top corporate rate that companies pay on timber gains from 35 to 15 percent. It applies only to timber (and not the underlying land) held for more than 15 years, which will likely exclude some pulpwood and early thinning revenues for many forestry companies.[5]

The TREE Act provisions largely benefit C-corporations with significant timberland bases. Table 3 lists the largest publicly-held US corporate timberland owners, and their timber base, income, and historical tax rates.

Table 3 identifies several potential beneficiaries of the new Act. Weyerhaeuser, by virtue of its size, stands to benefit most from the Act, although some portion of its timber income includes Canadian operations and intersegment sales. Most peculiar is the trend in effective tax rates among the five companies over the past three years. While Weyerhaeuser saw its effective tax rate decrease from 35.9% to just over 12% in 2007, likely due to heavy losses on foreign operations, most other forestry companies experienced tax rate increases. In this respect, the largest marginal effect of the Act may be realized by Deltic, which has the largest effective tax rate and the largest portion of its revenues coming from timber.

[5] D. McKeithen. United States: Congress Includes TREE Act in Farm Bill – Temporary Cuts Corporate Tax Rate On Timber Gains And Loosens Timber REIT Rules, www.mondaq.com, 10 July 2008.

Table 3. US timberlands, timber incomes and effective tax rates, 2007 (Source: 2007 annual reports)

Firm	Timberlands (million acres)	Timber income (millions)	Effective tax rate (2007)	Effective tax rate (2006)	Effective tax rate (2005)
Weyerhaeuser	6.4	$2,238	12.1%	31.1%	35.9%
MeadWestvaco	0.8	-	29%	5%	11.9%
International Paper	0.3	$25*	30%	29%	20%
Deltic Timber	0.4	$30.5	40%	37%	30%
Abitibi-Bowater	0.1	-	5%	(17.3%)	(43.5%)

*Operating income, includes recreational income

Timber REIT Provisions

The following provisions of the TREE Act liberalize timber transactions for timber-holding REITs:

a) All timber gains under section 631(b) are treated as sales of real property. In addition, timber gains under section 631(a) are qualified income if the harvest was conducted within a taxable REIT subsidiary.
b) Holding time requirements for safe-harbor timberland transactions are reduced to two years if timberlands are sold to a tax-exempt organization for conservation purposes. In addition, the marketing of safe-harbor timberland transactions can be done by a taxable REIT subsidiary.
c) The Act adds mineral royalty income to the list of "good" income for a REIT income test, but only if the income comes from the property owned or once held in connection with timber production. This simplifies the ability to retain REIT status under IRS rules.
d) The Act increases the asset test held in a taxable REIT subsidy from 20 to 25 percent. This simplifies the ability of firms to qualify and retain their status as timber REITs.

These four provisions are part of the TREE Act, but they were signed into law by the President as a part of the Housing and Economic Recovery Act of 2008 on July 31 2008.[6] This makes the REIT provisions permanent, whereas the timber income provisions of the TREE Act expire in a year.

The Act provisions appear to simplify the REIT conversion process for firms other than Weyerhaeuser. Deltic Timber is such an example. The company has two lumber mills and a 50% stake in an MDF manufacturing joint venture. To help support its manufacturing raw material needs, it owns 438,600 acres of timberlands in Arkansas and Louisiana; it also participates in regional real estate development and derives additional income from mineral leases.

[6] Goodwin Procter LP, Unites States: New Law Liberalizes REIT Provisions. www.mondaq.com, 1 August 2008.

With respect to non-industrial private timberland owners, none of the above mentioned Act provisions have significant impacts on forest management. Although provisions give significant corporate tax breaks to timberland-owning C-corporations, it is unlikely that they provide an advantage over no-tax TIMOs or timber REITs.

WHAT ABOUT PRIVATE TIMBERLAND OWNERS?

Another Farm Bill addition provides support through tax incentives for conservation easements and directly applies to private timberland owners. The tax incentive is not new, but rather renews the incentive that expired on January 1st. The tax incentive applies to landowners' federal tax income by doing the following:

- Raises the maximum deduction for a conservation easement donation to 50% of adjusted gross income (AGI) in any year;
- Provides additional benefit specifically to farmers and ranchers by allowing them to deduct up to 100% of their adjusted gross income (AGI) income; and,
- Increases the number of years to which the deduction can be applied to 16.

The conservation tax incentive, while available to all landowners, may be considered a particularly beneficial subsidy for agricultural farms and ranches. The incentive is a targeted effort designed to further support the operations of farms and ranches where the market may not otherwise support conservation efforts.

CONCLUSIONS

Tax policy affects forestry and the forest industry from the individual forest owner to institutional investors to publicly traded timber REITs and C-corporations. The challenge for forestry investors, who are often attracted to the longer investment time horizons associated with timberland-related investments, is that tax policy remains a moving target. Several of the changes described herein – specifically the TREE Act provisions – are temporary. Conservation easement legislation, the most directly relevant to individual forest owners, continues to evolve at both the federal and state levels. Corporate tax policy reflects a battle of wills, as investment assets move to their most efficient corporate structure. U.S. federal income tax policy is non-competitive compared to the rest of the world. Not only are corporate rates relatively high here, but the U.S. remains one of the few nations where reforestation costs must be capitalized instead of expensed in the year incurred. While few foresters have studied tax policy extensively, it has become increasingly important to understand the impact of forest tax law on land ownership structure and investment returns, both at home and abroad..

The *Timberland Report* looks at the timberland investment industry with an emphasis on the United States. The opinions expressed may not reflect the opinions of James W. Sewall Company.
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