

# IRS Letter Rulings and TAMs (1998-2011), UIL No. 7704.03-00, Letter Ruling 9822034, LTR 199822034, Internal Revenue Service, (Feb. 26, 1998)

Letter Ruling 9822034 , February 26, 1998

CCH IRS Letter Rulings Report No. 1109, 06-03-98

IRS REF: Symbol: CC:DOM:P&SI:1-PLR-116519-97

## Uniform Issue List Information:

[ Code Sec. 7704]

UIL No. 7704.03-00

Effect of reorganization plans

This responds to a letter dated December 5, 1997, and prior correspondence submitted on behalf of X and requesting a ruling that certain income earned by a partnership will constitute "qualifying income" under §7704(d)(1)(E) of the Internal Revenue Code.

### FACTS

X owns timber and timberlands and is engaged in the business of growing and harvesting timber for sale as logs in both export and domestic markets. X, through a subsidiary partnership, operates lumber mills, plywood plants, a medium density fiberboard (MDF) facility, and a lumber finger jointing plant. X represents that it is currently a publicly traded partnership that presently receives 90% or more of its gross income from qualifying income sources.

The lumber mill operation starts with the delivery of logs to the lumber mills, where they are debarked and cut into individual boards. The boards are surfaced and graded prior to shipment. In 1990, X received a private letter ruling concluding that the income and gain from its lumber mill operations constituted qualifying income under §7704(d)(1)(E).

As part of the plywood operations, logs are delivered to the plywood mills, where they are debarked and cut into appropriate lengths. The logs are steamed to soften the wood fiber and peeled into varying thicknesses of veneer. The veneer is dried, adhesive is applied, and the veneer sheets are bonded together to form plywood panels. Finally, the panels are patched, sanded, and prepared for shipment to customers.

The MDF operation processes wood fibers that are byproducts of the lumber and plywood operations into MDF panels. The panels are produced by pressing the refined wood fibers and resin at high temperatures to make a panel. After pressing, an ammonia process removes formaldehyde. The panels are then sanded and graded. In 1993, X obtained a private letter ruling concluding that the income and gain from its plywood and MDF operations constituted qualifying income under §7704(d)(1)(E).

As the available logs decrease in size and increase in cost, X has increased production of engineered wood products to maximize its timber resources. The engineered wood products include finger jointed lumber, scarfed plywood, edge glued boards, and medium density overlay (MDO). The bonding processes used to produce these engineered wood products are similar to the process used to produce plywood. During the production process, glue, heat, and pressure are used to bond the pieces of wood together.

Finger jointing lumber mills produce premium lumber (studs) of varying dimensions. The finger jointing mill receives low grade studs (that previously would have been chipped or sold as low grade studs) from other manufacturing facilities. The studs are scanned for defects, and then sent through an optimized saw. The optimized saw receives the defect information from the scanner and cuts the pieces to lengths varying between 5 1/2 and 24 inches. The defective pieces of lumber are chipped. The remaining pieces are scored to reduce chipping and breakage, then rotary saws cut each end of the boards to create fingers. Heated glue is applied to one end, and the most recently cut piece is pressed against the end of previously bonded pieces. The bonded pieces are cut into lengths of up to twenty-eight feet. The studs are then ready for shipment, although some may be run through a planer to smooth and trim the pieces for the export market.

Scarfed plywood is an oversized panel made from smaller sheets of plywood. Scarfing involves making a serrated cut (scarf cut) in the edge of a plywood panel. Glue is applied to the scarf cuts and then two panels of plywood are bonded together in a hot press. As the panels move down the production line, a saw cuts the panels to the desired length. The panels are then sanded a final time to prepare them for packaging and shipping.

Although X does not currently produce edge glued lumber, it is planning to begin production in the near future. Edge glued boards are made by bonding two smaller boards together with heat, pressure, and adhesive to create a wider board. The process that X will use involves making finger joint cuts in the edge of the boards before bonding them together with glue in a hot press. This process was developed because the supply of large logs has decreased in recent years.

MDO is produced by taking sheets of heavy kraft paper that have been impregnated with phenolic resin and bonding them to panels of plywood using heat and pressure. The smooth surface of MDO is ideal for signs or for panels used in cement molds. Additional processing, including cutting, shaping, and painting is necessary before the MDO is ready for use.

In addition to wood products grown and harvested by X, X purchases wood fiber from unrelated third parties in various stages of processing. The wood fiber purchased includes logs, shavings, veneer panels used to produce plywood, low grade studs, and finished lumber. A significant percentage of the logs processed by the various mills are purchased from unrelated third parties.

The wood products (lumber, plywood, MDF, and other engineered wood products) are sold to domestic and foreign customers. X makes bulk wholesale shipments by truck, ship, or railcar of these products to manufacturers, wholesalers, and retailers. X provides ancillary marketing services such as transportation routing, warehousing, just-in-time deliveries, bar coding, financing terms, and special packaging. The services are provided only with respect to products purchased from X. In most instances, revenue for these services is included in the product price, although in some instances the charge for the service is separately stated.

#### RULING REQUESTED

Based on these facts, X requests a ruling that the income and gains recognized by X related to: (1) the production and sale of engineered wood products; (2) the marketing and sale of X's wood products; and (3) the provision of ancillary marketing services constitute income derived from the production, processing, refining, transportation, or the marketing of timber and therefore constitute qualifying income under §7704(d)(1)(E).

#### LAW AND ANALYSIS

Section 7704(a) treats a publicly traded partnership as a corporation for federal tax purposes. Section 7704

(b) defines the term publicly traded partnership as any partnership whose interests: (1) are traded on an established securities market; or (2) are readily tradable on a secondary market (or the substantial equivalent thereof).

Section 7704(c)(1) exempts certain partnerships from treatment as a corporation for a taxable year if the partnership meets the gross income requirements of §7704(c)(2) for such the taxable year and each preceding taxable year beginning after December 31, 1987, during which the partnership (or any predecessor) was in existence. Under §7704(c)(2), a partnership meets the gross income requirements for any taxable year if 90% or more of the partnership's gross income for the taxable year consists of qualifying income.

Section 7704(d)(1)(E) provides that "qualifying income" includes income and gains derived from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber).

### CONCLUSION

Based solely on the facts submitted and the representations made we conclude that X's income from the production and sale of engineered wood products, the marketing and sale of X's wood products, and the provision of ancillary marketing services by X will be treated as qualifying income for purposes of §7704(d)(1)(E).

Except as specifically set forth above, no opinion is expressed or implied as to the federal income tax consequences of the transaction described above under any other provision of the Code. Specifically, no opinion is expressed as to the classification of income derived from the sale of finished lumber purchased from third parties as qualifying income under §7704(d)(1)(E).

This ruling is directed only to the taxpayer on whose behalf it was requested. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent. Temporary or final regulations pertaining to the issue addressed in this ruling have not yet been adopted. Therefore, this ruling will be modified or revoked if the adopted temporary or final regulations are inconsistent with any conclusion in the ruling. See section 12.04 of Rev. Proc. 98-1, 1998-1 I.R.B. 7. However, when the criteria in section 12.05 of Rev. Proc. 98-1 are satisfied, a ruling is not revoked or modified retroactively except in rare or unusual circumstances.

This ruling is sent to you, the taxpayer's authorized representative, pursuant to a power of attorney on file with this office.

Sincerely yours, Dianna K. Miosi, Chief, Branch 1, Office of the Assistant Chief Counsel (Passthroughs and Special Industries).