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What a difference a REIT makes

Weyerhaeuser conversion makes it more tax-efficient, but shareholders took a hit on dividend

By Robert N. Gordon

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Sometime this year, Weyerhaeuser Co. Ticker:(WY) will transform itself from a C corporation into a real estate investment trust. There is good news and bad news in the conversion. First, the bad news:

Whoever owned the company's shares July 22 paid a hefty price for the conversion. In order to wind down the C corporation, the company had to distribute all of the earnings that hadn't been paid out to shareholders over its 110-year history. This amounted to $5.6 billion, or $26.42 a share, on stock that closed at $38.86 on July 12, the day of the announcement.

Although the company is paying only 10% of its special dividend in cash, the entire $26.42 dividend, coming in September, will be taxable. The number of shares outstanding will balloon from 211.6 million to approximately 526.6 million, equating to a 2.5-for-1 stock split. While a stock split creates dilution across the shareholder base and is thought to have no economic value, this stock split will be taxable.

Taxable shareholders will feel the pain next April when they realize they must pay a tax on what turned out to be mostly phantom income.

Now the good news. Owners of Weyerhaeuser will go from paying two levels of taxation on lumber profits to just one. Better still, because of the unique tax attributes of timber, that single layer of tax will be at long-term-gains rates.

Weyerhaeuser, the second-largest holder of U.S. timberland, follows several of its competitors in going the REIT route: Plum Creek Timber Co. Inc., the nation's largest timberland owner, became the first in 1999, followed by Rayonier Inc. in 2004 and then Longview Fibre Paper and Packaging Inc. and Potlatch Corp.

As a REIT, Weyerhaeuser will be required to pass along at least 90% of its income to shareholders. Similar to the rules governing mutual funds, if REIT income is not distributed, it is taxed at the corporate rate. Any long-term capital gains earned by the REIT from cutting down or selling timber will be passed along to shareholders and retain their long-term character.

Taxpayers owning Weyerhaeuser shares with a cost basis of $15.58 ($41 minus $26.42) or more should have avoided the dividend record date. Anyone holding the shares with a higher cost basis would have been well-served by selling at $41 or so July 19 — the day before the stock went ex-dividend — and buying in again the next morning.

On a continuing basis, Weyerhaueser's holders will have increased after-tax income on their timber holdings by at least 50%. Here's why:

If the company had retained its C corporation status, the government's two levels of tax would have taken 48 cents out of every 100 cents of timber profit — 35 cents in the form of corporate income tax and 13 cents as a 20% tax on the dividend the individual shareowner received.

As owners of a timber REIT taking long-term gains, company shareholders get to keep 80 cents out of every 100 earned (assuming the same 20% tax on dividends). This comparison assumes that dividends will continue to be taxed at long-term-gains rates; if not, the comparison is even more striking, especially if the double tax on corporate profits rises to the old 61% total tax on dividends after both the corporate and individual tax are paid. Under an even more dire scenario, if dividends reverted to being taxed as ordinary income, shareholders would keep only $39 of every $100, assuming a 35% tax at the corporate level and a 39.6% federal tax on individuals.

Compare that with a stream of long-term gains that could be taxed at just 15% or 20%, and you can see why Weyerhaeuser and the other timber companies became REITs.

Certainly, converting a timber company to a REIT was a true stroke of tax-efficient genius. I just hope that taxable holders were smart enough not to stay around July 22 and did not voluntarily pay the toll for the conversion.

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