MSSP

Market Segment Specialization Program

Hardwood Timber Industry

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Department of the Treasury
Internal Revenue Service

Training 3147-113 (2/98)
TPDS 84917M

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Preface

PURPOSE OF REPORT

This audit technique guide was prepared by a Compliance 2000 Team consisting primarily of individuals from IRS's Examination, Collection, and Criminal Investigation Divisions, and the West Virginia Department of Tax and Revenue (WVDTR). It is based upon information gathered from a sample of examinations and historical data from throughout the nation. Input was also received from many third party sources such as other government agencies, trade associations periodicals, etc.

The primary objective of this effort was to evaluate compliance within the hardwood timber manufacturing process from standing timber through delivery to the final processor and to develop a guide to be used as a reference tool by examiners. Further, this guide provides general and technical information which should be useful to examiners in the classification, pre-planning, and examination of returns in the hardwood timber industry.

The audit areas identified and discussed in this guide were considered to be significant or unusual enough to warrant comment. The mere fact that an item is addressed in this report does not imply that it should be examined in every case. It is intended that the discussion for any one audit area will assist the examiner in deciding if the item warrants examination on a case by case basis.

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Hardwood Timber Industry
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Chapter 1

INTRODUCTION TO THE TIMBER INDUSTRY

DIFFERENCES BETWEEN SOFTWOOD AND HARDWOOD REGIONS

The United States can be divided into two primary forest regions, the forests east of the Great Plains and those west of the Great Plains including Alaska. There are many differences between these regions. Some of these are discussed below.

Hardwood timber species such as oaks, gums, maples, hickories, walnut, etc. are located primarily in the East, while in the West 97 percent of saw timber is softwood. The common softwood species are Douglas-fir, Hemlock, true Firs, Pines, Spruces, Cedars, and Redwood. In the West, the forests tend to be larger in tree size and have more volume of timber per acre than forests in the East.

A second major difference between the Eastern Hardwood Region and the Western Softwood Region is in the type of forest ownership. Nearly 70 percent of eastern forest lands are privately owned; only 15 percent of western forest lands are privately owned.

Another important difference is in how accessible forests are for loggers. The terrain in the East generally is not as steep and rugged as it is in the West, thus making the harvest of eastern timber easier.

Also, a difference exists in the way a forest regenerates after being harvested. Hardwood forests tend to regenerate themselves; softwood forests usually require some artificial reforestation actions.

Finally, the products and by-products made from hardwood and softwood forests are different. For example, hardwoods are more commonly used for making furniture, flooring, veneer, and pallets. Softwoods are more commonly used for making construction lumber and plywood. Also, hardwoods generally are used for making printing grades of paper and softwoods generally are used for making paper and paperboard items requiring strength, such as bags and boxes.

HARDWOOD LUMBER PRODUCTS AND BY-PRODUCTS

Hardwood lumber has been estimated to account for about one-third of the value of all domestically produced lumber, both hardwood and softwood. One reason for the difficulty in estimating hardwood lumber production is the fragmented nature of the industry. Some mills are part of major forest products corporations, but most are independent operations. With a few exceptions, most hardwood sawmills are small operations which draw resources from a relatively small area. In fact, the three largest hardwood lumber producers in 1989 accounted for only 4.1 percent of the hardwood production in the United States.

Hardwood lumber producers are concentrated close to the major hardwood forests in the eastern and central United States. Of the total hardwood production, 97 percent is produced in the eastern United States. This area is often separated into three regions: northern, southern, and Appalachian.

A brief study of the industry shows the proportion of total hardwood lumber production has increased in the northern region; while southern region production has decreased. This change is attributable to higher saw timber quality in the northern region, access to markets for low-quality lumber products, and emphasis on and availability of softwoods in the southern region.

While a relatively simple product, hardwood lumber is manufactured in a surprising variety. Commercially traded hardwood lumber varies by species, level of process, thickness, and length. Hardwood lumber also varies in the number and types of defects that are present. To account for this variation and provide a level of product standardization, grading systems have been developed.

In the United States, hardwood lumber is graded according to three basic marketing categories: factory lumber, dimension parts, and finished market products. Factory lumber grades differ from dimension and finished market products in that the former are based on the proportion of the lumber that can be cut into smaller usable pieces. Dimension parts and finished market products are graded assuming each piece will be used as is rather than cut into smaller pieces.

The majority of hardwood lumber is sold under the factory grade rules developed by the National Hardwood Lumber Association (NHLA). Standard NHLA lumber grades and the general requirements of each are provided in Exhibit 1-1.

Hardwood lumber is traditionally sold by the thousand board feet (MBF) in random-length, random-width loads. Standard lumber thickness varies from 3/8 inch to 6 inches and standard lengths range from 4 to 16 feet in 1 foot increments. Hardwood lumber is sold green (with a relatively high moisture content) or kiln-dried. Kiln drying is a process of using a heat source to extract moisture from lumber. Most hardwood must be dried prior to using in a final product. Kiln drying adds value to the lumber, and may reduce shipping costs since the weight of the lumber is reduced. However, some buyers prefer to purchase green lumber and dry it themselves. Hardwood lumber is also sold rough (the surfaces of the boards are unfinished) or surfaced. As with drying, surfacing adds value but is not desired by all types of buyers.

The furniture industry is a major and relatively stable market for hardwood lumber. The furniture industry (including the dimensions it buys) is the second largest market for hardwood lumber. Only the pallet industry uses more. However, the wood household furniture industry is the largest single user of high grade hardwood lumber and is one of the largest users of hardwood veneer. Usually only No. 1 Common and better grades of lumber are used in exposed solid wood parts of furniture and kitchen cabinets. Since these higher grades of lumber command high prices, the furniture industry is very important economically to the hardwood industry.

The hardwood dimension lumber is machined parts for furniture, cabinets, etc. The hardwood dimension lumber market segment is an important market for hardwood lumber. The furniture industry is the largest user of hardwood dimension materials, although its share of the market has declined due to imports of parts and furniture. The second largest use of hardwood dimension products is in the cabinet industry. The kitchen cabinet industry has grown dramatically over the last few years. Demand for kitchen cabinets and bathroom vanities is closely linked to housing starts and residential repair and remodeling activity.

The millwork industry is comprised of firms primarily producing windows, window parts, doors, door parts, and wood moldings. It buys mostly higher grades of lumber and competes with the export and furniture markets for material. The majority of millwork firms are small and many use much more softwood than hardwood lumber.

The total amount of hardwood exported from the United States has grown tremendously. From the mid-1970's to the early 1990's world demand for hardwood logs, lumber, and veneer from the United States more than tripled. This demand has resulted in a growth in exports to Europe and the Pacific Rim. Worldwide concern over the loss of tropical forests has caused many to seek our temperate hardwoods as substitutes for tropical species, further boosting demand for U.S. hardwoods.

The use of hardwood lumber for pallets has risen sharply, largely due to the increase in mechanization of shipping in the United States. This has occurred even though the actual amount of wood used in a typical pallet has declined. Although some softwood lumber is used in constructing pallets, the majority of lumber used in making pallets is hardwood. It is estimated that over 80 percent of the lumber used in pallets is hardwoods. Approximately half of the hardwood lumber used to make pallets is oak. Oak is used more often for the heavier non-expendable pallets, while other woods are used for lighter expendable pallets.

The use of hardwood lumber for flooring decreased significantly from 1960 to 1980. However, a resurgence occurred in hardwood floor use in homes in the early 1990's because of appearance and durability. Interestingly, much of the earlier use of hardwood flooring was in effect mandatory because of mortgage lending policies concerning home construction. As these policies were eased and hardwood flooring was no longer required to qualify the home for a particular mortgage, use of hardwood flooring dropped dramatically and carpeting came into more widespread use.

There has been a moderate increase in the use of railroad ties. This occurred because railroads could no longer defer track maintenance; they started upgrading tracks to improve service and safety. There has also been an increase in the size of railroad ties because a greater portion of ties has gone to main lines rather than to secondary spur lines. Spur lines use smaller ties because they do not have to bear as heavy a load or bear loads as frequently as main lines. In 1950, there was an average of 38.4 board feet in each crosstie. By 1980, the average tie used by railroads increased in size to 41.0 board feet.

Sawmill by-products are also an important part of the industry. For example, sawdust can be used to make charcoal, compressed fire logs, and compressed particle board. Bark slabs are used for firewood and in the construction of log homes.

The hardwood lumber industry, as we have already noted, is a fragmented industry consisting of many small firms. These small firms produce particular grades and species of lumber that are many times in quantities too small for efficient marketing. Most small hardwood lumber mills sell their lumber products through a broker, many of which are independent and operate out of an office with little or no storage facilities for lumber. These brokers arrange for the sale of the products from smaller mills and typically receive a 5 percent commission on the selling price of the lumber as their compensation.

Brokers and sawmill trading offices sell to a variety of customers including other intermediaries. These additional intermediaries include concentration yards and distribution yards. They differ in that concentration yards purchase lumber from sawmills, brokers, or wholesalers and may grade, sort, dry, or surface the lumber to increase its value. Distribution yards may also process the lumber they purchase but they are oriented more toward the end user. Distribution yards are often located near lumber users in larger cities and provide a variety of lumber species and sizes (one stop shopping) for small lumber users. Distribution yards typically service small accounts that purchase less than boxcar lots of lumber. The typical channels of distribution for eastern hardwood lumber are shown in Exhibit 1-2.

Hardwood lumber prices are generally negotiated between buyer and seller from a common starting point for the species, grade, and the thickness involved. This starting point is often the average price for the item published in trade publications such as ***Weekly Hardwood Review and Market Report***. In fact, negotiations often take the form of the published price plus or minus a set amount to account for local availability, weather, buyer and seller relationship, price trends, and other factors.

Lumber prices vary greatly among species. For example, the average price for poplar (No. 1 Common, 4/4, kiln-dried) in March of 1993 was $520 per thousand board feet. The same thickness and grade of walnut lumber was $1,175 per thousand board feet. Prices also differ among the various grades of lumber within a species.

Several trends are evident in the U.S. hardwood lumber industry, including shortened distribution channels, increased specialization of orders, and the shifting of the inventory carrying function from the customer or intermediary to the producer.

The decreased use of channel intermediaries and the resulting shortening of distribution channels could represent a major change in the way timber producers do business. Customer requests are also becoming more specialized. Requests for specific lengths or mixes of lengths, specific widths, and specific grade mixes are becoming more common. The final trend involves the movement of the inventory carrying function back to the producer. Adoption of just-in-time inventory systems and the increased cost of carrying inventory are pushing this trend. Movement of the inventory carrying function back to the producer may increase the competitive advantage of larger hardwood lumber companies that can provide the customer with prompt delivery of a wide variety of species and grades.

VERTICAL INTEGRATION OF THE HARDWOOD TIMBER INDUSTRY

The hardwood timber industry is a fragmented, vertically integrated industry. It begins with the landowner. There are three basic types of timberland owners: nonindustrial private, industrial, and government. Nonindustrial private landowners are primarily individual entities that own both the land and the timber. They normally sell their timber directly to a logger. However, in some cases, a consulting forester may be used to value and market the timber for a fee, usually 10 percent of the sale. In many cases, a forest products company will purchase both the land and timber. Finally, state and federal lands may be used for logging via a bidding process for the right to timber.

Standing timber is usually purchased in one of three ways: 1) Outright purchase of the land and related timber, 2) purchase at a specified rate per unit of timber actually cut (pay-as-cut), or 3) purchase for a set total amount or lump sum. Examples of contracts are included as Exhibits 1-3, 1-4 and 1-6. Exhibit 1-5 is a right of way agreement. For tax purposes, timber is the wood in standing trees that is available and suitable for exploitation and use by the forest industries. "Stumpage," a commonly used term in forestry, has similar meaning -- the wood expected to be recovered from the forest on harvest of trees.

There are three basic types of loggers: independent loggers, company loggers, and contract loggers. Independent loggers buy timber, sometimes referred to as stumpage, cut the timber, and market the cut products. This allows for added profit and risk for the logger. In some cases, sawmills may finance the independent logger's purchase of timber. Company loggers are logging crews employed by sawmills. They are normally a separate division of the sawmill. However, this is becoming less common due to the high overhead of having employees. More and more contract loggers are being used. Contract loggers provide a service. They are paid a fee per 1,000 board feet for logs cut from the timber and delivered to the mill.

The logging process can best be described as the following: Timberlands are first cruised. Cruising is defined as a survey of forest lands to locate and estimate volumes and grades of standing timber. Access to the logging area from a public road is needed. This usually requires the construction of a landing area, permanent haul roads, and temporary skid roads. Timber harvesting begins when trees are cut down. This is known as felling. These felled trees are then delimbed and bucked (cross cut) into log lengths. Logs are extremely heavy and difficult to move. For example, a log containing 150 board feet log scale will weigh about one ton. Therefore, moving of the log from the stump to the landing area is an arduous task. This process is called skidding and is ordinarily accomplished by attaching a cable or chain to one end of the log and dragging it by means of a bulldozer or rubber-tired skidder to the landing area which is accessible to trucks. Substantial planning is necessary in logging due to various factors such as topography, size of timber, skidding distance, etc.

At the landing area, the logs are usually graded and sorted by species. Using a scale stick, the scaler measures the diameter and length of each log and records the number of board feet. As logs are graded, the smaller and lower grade logs may be set aside to be sent to pulp mills. The higher grade logs generally will be made available to veneer producers. The remaining logs will be either exported or sent to local sawmills.

From the landing, logs must be transported (usually by truck) to the concentration yards or sawmills. Loading equipment, such as an end loader or a cherry picker, is needed to load the logs on trucks. There are two basic types of truckers: company truckers and contract truckers. Company truckers are usually employees of forest products mills; while contract truckers are paid a fee per mile per load to haul timber. The contract truckers market segment tends to be very unstable with a high turnover rate.

A concentration yard primarily acts as a middleman in the selling and marketing of logs. Concentration yards tend to be located near hardwood forests. Truckers bring in mixed loads of different sizes, species, and grades. When logs arrive they are sorted according to these three factors. This allows a concentration yard to create particular and specialized loads of logs to meet their customers' needs and to maximize profits.

Many sawmills tend to specialize in the type of logs that they purchase for processing (sawing, planing, and/or dry kilning) depending on their customers. For example, if a mill's primary customer needs cribbage for use in the mining industry; then that mill will purchase low grades of oak, poplar, etc. as opposed to purchasing veneer and furniture quality logs. Therefore, customer demands will set the type of logs a sawmill needs and what they will pay for a particular log. Loggers are aware of this and will market their logs to several mills, depending upon the grade and species of timber they are harvesting.

The logs or other products must then be transported from the concentration yards or sawmills to the ultimate consumers mentioned previously. There are two primary methods of transportation used: trucking and rail cars. In most cases, trucking is the less costly and often used means of transportation. However, in the export market, it is becoming more common for companies to load their product in containers that can be sent overseas. These containers are somewhat smaller and less durable than traditional tractor trailers. Many companies use flatbed rail cars to haul these full containers to major U.S. coastal ports for shipment overseas.

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Exhibit 1-1

NATIONAL HARDWOOD LUMBER ASSOCIATION

GENERAL REQUIREMENTS FOR FACTORY LUMBER GRADES

GRADE	CUTTINGS	WIDTH	LENGTH
First	91 2/3% clear	5 inches +	8-16 feet (max. 15% 8 and 9 foot)
Seconds	83 1/3% clear	6 inches +	8-16 feet (max. 15% 8 and 9 foot)
Selects	91 2/3% clear	4 inches +	6-16 feet (max. 5% 6 and 7 foot)
No. 1 Common	66 2/3% clear	3 inches +	4-16 feet (max. 5% 4 and 5 foot)
No. 2 Common	50% clear	3 inches +	4-16 feet (max. 10% 4 and 5 foot)
No. 3A Common	33 1/3% sound	3 inches +	4-16 feet (max. 25% 4 and 5 foot)
No. 3B Common	25% sound	3 inches +	4-16 feet (max. 25% 4 and 5 foot)

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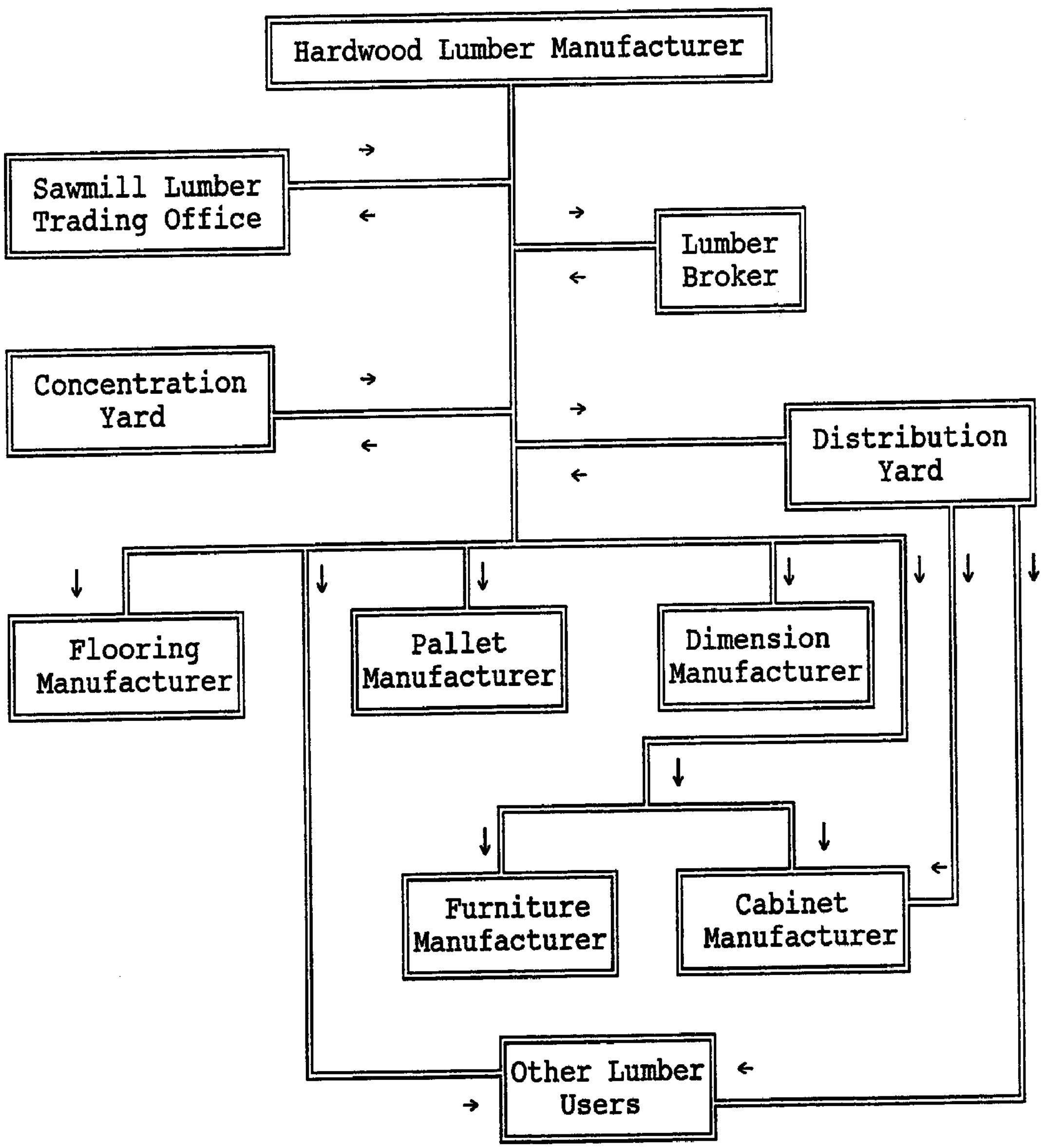
HARDWOOD LUMBER FLOW CHART



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FORM FM-10
(Rev. 10-72)

TIMBER SALE AGREEMENT
_________Scale

This AGREEMENT, made and entered into this ____ day of _______, 19_, by and between __________________ whose address is __________________________ hereinafter referred to as the SELLER, and ____________ whose address is ___________, hereinafter referred to as the PURCHASER.

WITNESSETH:

ARTICLE 1. The SELLER hereby agrees to sell and the PURCHASER agrees to purchase, according to the conditions and requirements hereinafter mentioned, all timber marked or designated for cutting in the _______________ Magisterial District,_______ County, __(state)__, and further described as follows: ________________________________
____

ARTICLE 2. The PURCHASER agrees to pay the SELLER the sum of ________ for the designated trees whose volume is estimated to be ________ board feet measure more or less.

ARTICLE 3. The PURCHASER further agrees to make payment according to the following schedule: ____
____

ARTICLE 4. All operations on the sale area, including the removal of timber and/or lumber, may be suspended by the SELLER, in writing, if conditions and requirements set forth in the AGREEMENT are disregarded. Failure to comply with any one of the said conditions or requirements, if persisted in, shall be sufficient cause to terminate this AGREEMENT.

ARTICLE 5. The PURCHASER further agrees to cut and remove said timber and/or lumber, in strict accordance with the following conditions and requirements:

(A) Cutting and removal of all marked timber, regardless of size or species, shall continue in progressive manner from a point chosen by the SELLER.

(B) All marked timber shall be removed from the premises of the SELLER and designated cull trees deadened by the PURCHASER on or before___________ unless an extension of time is granted, in writing, by the SELLER.

(C) Construct temporary truck roads necessary for the removal of the designated timber. Location of said roads to be determined by the PURCHASER and the Service Forester.

(D) Suspend operation of logging equipment on main haul roads during periods when such operations would cause excess erosion.

(E) To do all within his or his employee's power, both independently and upon request of the SELLER, to prevent and suppress forest fires on the area.

(F) Fences, fields and roads shall be protected from unnecessary damage during the logging operation, and if necessary shall be repaired to their original condition by the PURCHASER.

(G) Young growth and trees left standing shall be protected from unnecessary damage and only dead or less valuable trees shall be used for construction purposes during the operation.

(H) Brush and water bars shall be used to retard erosion when such is the result of logging operation and upon request of the SELLER.

(I) The PURCHASER shall keep all structures used in connection with this sale, and the grounds in their vicinity, in a sanitary condition. When camps or other establishments are moved or abandoned, the PURCHASER shall dispose of all debris and abandoned structures.

(J) Undesignated trees which are cut or damaged through carelessness shall be paid for at the following rate:
_____________.

ARTICLE 6. The SELLER agrees to the following conditions and requirements:

(A) To guarantee title to the forest products covered by this AGREEMENT and to defend it against all claims at his expense.

(B) To grant freedom of entry and right-of-way to the PURCHASER and his employees on and across the area covered by this AGREEMENT, provided such entry does not conflict with specific provisions of this AGREEMENT.

(C) To allow the PURCHASER to erect and operate a sawmill on the sale area for the length of time covered in ARTICLE 5, Section B and in accordance with ARTICLE 5, Section 1 of this AGREEMENT.

ARTICLE 7. In case of dispute over the terms of this AGREEMENT, final decision shall rest with arbitrators, one of whom shall be selected by each party of this contract; in case the two selected shall disagree, they shall select a third arbitrator and the decision of the majority shall be final with respect to either acts to be done or compensation to be paid by either party to the other.

IN WITNESS WHEREOF, the parties have subscribed their names on the date first above written.

____
SELLER

____
PURCHASER

WITNESSES:

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TIMBER SALES AGREEMENT
SMALL PRODUCT SALES

This AGREEMENT, made by and between ____________, whose address is __________, _________, hereinafter referred to as the SELLER, and ___________, hereinafter referred to as the PURCHASER.

ARTICLE I. The SELLER hereby agrees to sell and the PURCHASER agrees to purchase, according to conditions and requirements hereinafter mentioned, the timber products described as follows:
____
____

ARTICLE II. The PURCHASER further agrees to pay to the SELLER the sum of ______ per ______ for the above designated forest products. The volume of products harvested will be determined as follows: ____

ARTICLE III. The PURCHASER further agrees to make payments for the above described products according to the following schedule: _____________________________
____

ARTICLE IV. This AGREEMENT cannot be assigned without the consent of the SELLER.

ARTICLE V. The SELLER agrees to the following conditions and requirements:

A. To guarantee title to the forest products covered by this AGREEMENT and to defend it against all claims at his expense.

B. To grant freedom of entry and right-of-way to the PURCHASER and his employees on and across the area covered by this AGREEMENT, provided such entry and/or right-of-way does not conflict with specific provisions of this AGREEMENT.

ARTICLE VI. The PURCHASER agrees to comply with the following conditions:

A. To cut and remove all timber from the premises of the SELLER on or before _____ unless an extension of time is granted by the SELLER.

B. Undesignated trees cut or injured through negligence shall be paid for at _____ the rates specified in ARTICLE II above.

C. Fences, roads and other improvements shall be protected from damage and if damaged shall be repaired to their original condition by the PURCHASER.

D. Roads used for harvest of this designated timber shall be smoothed and drained by the PURCHASER on completion of the operation, with waterbars installed as determined necessary by the Service Forester to prevent erosion.

E. The PURCHASER agrees to protect and save harmless the SELLER from any and all liability for personal injury, death and/or property damage suffered or incurred by any person in connection with the PURCHASER'S performance of this contract.

F. In case of dispute over the terms of this AGREEMENT, final decision shall rest with arbitrators, one of whom shall be selected by each party of this contract, and in case the two selected disagree, they shall select a third arbitrator, and the decision of the majority shall be final in respect to compensation to be paid by either party to the other.

________________	____________________	_________________
(WITNESS)	(PURCHASER)	(DATE)
________________	____________________	_________________
(WITNESS)	(SELLER)	(DATE)

TAKEN, SUBSCRIBED, and SWORN TO before me this ______ day of _________, 19____. My commission expires ______, 19__.

____
(NOTARY PUBLIC)

Exhibit 1-5

RIGHT-OF-WAY AGREEMENT

This INDENTURE, MADE THIS _______ day of ____________, 19 ___ between ________________________ of the County of _______________, State of ____________, grantor, party of the first part, and ______________________, grantor, party of the first part, and ________ of the County of ______________, State of _________________, party of the second part, WITNESSETH: ___________________________ THAT FOR and in consideration of _________________________________, RECEIPT of which is hereby acknowledged; the party of the first part does hereby grant, bargain, sell, and convey unto the party of the second part and its assigns an easement and right-of-way to be in conformity with and located upon the ground according to a mutually agreed upon location which is described as follows: ___________________

____

____

1. PROVIDED: However, that if at any time this easement or any road constructed thereon shall be abandoned by the party of the second part, or its assigns, the rights and privileges hereby granted shall cease and terminate and the premises traversed thereby shall be freed from said easement fully and completely as if this agreement had not been made.

2. PROVIDED: However, that this easement shall become null and void and shall not extend beyond ______________________________.

3. PROVIDED: Also, that in the event of termination of this easement upon the satisfactory completion of the current period of use and enjoyment of its privileges by the party of the second part, another need arises for this right-of-way in the future, the party of the first part will consider favorably such a request by the party of the second part, its successors or assigns.

4. PROVIDED: That the party of the second part maintains and repairs fences, gates, and other improvements which have been damaged and broken as a result of the enjoyment of the easement and which are on the lands of the party of the first part and to the satisfaction of the party of the first part.

5. PROVIDED: That the party of the second part will not assign his rights or responsibilities under this agreement in whole or in part without the written consent of the party of the first part. IN WITNESS WHEREOF: The said grantor and the said grantee have hereunto subscribed their names and affixed their seals the day and the year herein above written.

Witness:

__________________________________ ______________________________________

__________________________________ ______________________________________

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Timber Sale Agreement

(For trees at a stump diameter limit at
an established price per thousand cut)

Agreement entered into on this ______ day of ____________, 19_____ between ________________________ and ________________________ of ____________________ in the county of __________________ and State of ___________________________, hereinafter called the Seller(s) and between _______________________ and ___________________________ of ____________ in the county of ________________ and State of _________________, hereinafter called the Purchaser(s).

WITNESSETH:

ARTICLE I -- The seller(s) agree(s) to sell to the purchaser(s) and the purchaser(s) agree(s) to buy from the seller(s), upon the terms and conditions hereinafter states all timber _______________ inches stump diameter or larger, estimated to be ___________________ more or less, located on a certain tract(s) of land situated in the town(s) of _________________ in the County(ies) of __________________ and the State of _____________, located _________________ and owned by the seller(s).

ARTICLE II -- The seller(s) agree(s) to permit the purchaser(s) access to the tract(s) hereinbefore described for the purpose of cutting and removing said timber which is the subject of this agreement.

ARTICLE III -- The purchaser(s) agree(s) to pay the seller(s) as may be determined by the actual scale, at the rate of $___________ per _____________; said payment to be made ______________________________ ____.

ARTICLE IV -- The purchaser(s) further agree(s) to cut and remove said timber in strict accordance with the following conditions:

1. Unless an extension of time is granted all timber the subject of this agreement shall be cut and removed on or before________________, _________.

2. Timber shall be scaled by the _________________ RULE and measured at ________________________ by the __________________.

3. To furnish the seller(s) a statement of actual scale volume removed each ____________, such statement to be furnished on or before ________________ following the ______________ in which such removal takes place and if requested duplicate copies of scaling records.

4. No timber shall be cut except that marked or designated by the seller(s) or his agent.

5. All trees shall be utilized in their tops to the lowest possible diameter for commercially salable material. Stump shall be cut so as to cause the least possible waste. All trees having 50 percent sound scale hall be cut and paid for.

6. Young trees shall be protected against unnecessary injury.

7. To comply with all Federal and State Laws pertaining to the operation and be liable for any action resulting from said operation.

8. Failure on the part of the purchaser to comply with any of the conditions herein contained shall, at the option of the seller be deemed a breach of this agreement.

9. The operator agrees to lop all tops within ______ feet of the ground. (The price agreed to in Article III included the cost of lopping).

10. The operator agrees to be responsible for damage caused by logging to fences, rails, trails, bridges, ditches, culverts, stonewalls, fields or other improvements damaged beyond ordinary wear and tear.

11. ____
____

12. ____
____

ARTICLE V -- It is mutually understood and agreed by and between the parties heretofore mentioned as follows:

1. All timber included in this agreement shall remain the property of the seller(s) until paid for in full.

2. All rights granted under this agreement revert to the seller(s) on the date of the termination of this agreement, whether such termination results from the full performance of said agreement, or is so declared by the seller(s) on account of breach on the part of the purchaser(s).

3. In case of disputes over the terms of this agreement, final decision shall meet with a reputable person mutually agreed upon by parties concerned and in case of further disagreement, with an arbitration board of three persons, one to be selected by each party to this contract and a third to be selected by the other two arbiters.

In witness whereof the parties hereto have set their hands on the day and year first above written.

Witnessed:	By Seller(s)
______________________________	______________________________
______________________________	______________________________
	By Purchaser(s)
______________________________	______________________________
______________________________	______________________________

Chapter 2

COMPLIANCE AND AUDIT ISSUES

METHODOLOGY/RETURN ANALYSIS

All aspects of the hardwood timber industry have been analyzed. From this analysis, market segments were measured for levels of compliance and possible common tax problem areas. In addition, input was sought from other districts with significant hardwood timber based upon their own compliance efforts and historical examination data.

Data was gathered from selected third party sources including sawmills and concentration yards for the years 1989 through 1992 to evaluate compliance problems in the timber industry. Information was compiled in a data base and refined for further evaluation. This information gathering was done to supplement current and historical compliance data.

During the classification and examination processes, audit issues were identified which appeared to be common with this industry. The following are some of the most common areas identified:

1. There were large numbers of nonfilers.

2. Operators attempt to avoid employment tax liabilities and workers compensation premiums by paying wages in cash, classifying all payments to workers as subcontractor payments, and failing to file employment tax returns.

3. Operators are underreporting income. Internal control is poor and this leads to underreporting of income earned. In addition, poor accounting records lead to both unreported income and unsubstantiated expenses. Some operators contend that they lack the expertise necessary to maintain proper books and records.

4. Returns are being prepared by preparers with little understanding of the timber industry. This leads to many returns being filed without a Form T being included.

Various technical issues were also identified and will be discussed in specific areas later within this guide.

FOREST ACTIVITIES SCHEDULE (FORM T)

Record keeping and certain procedures related to timber account management are essential components of the entire timber taxation process. The federal tax form that guides most timber taxation and procedures is Federal Tax Form T (Timber). If a taxpayer claims a deduction for depletion of timber or for depreciation of plant and other improvements related to timber accounts, or elects under IRC section 631(a) to treat the cutting of timber as a sale or exchange, the taxpayer must complete and attach Form T to the income tax return. Generally, Form T should be filed when a taxpayer sells or cuts standing timber or is involved in other timber transactions. The Forest Activities Schedules provide a convenient format for forest industry record keeping. It is organized into nine major sections or "schedules."

Schedule A - Maps

Schedule A consists of maps of a taxpayer's timber properties. Although filing maps with the income tax return is optional, the maps must be available upon examination of the return. The maps should include taxpayer's name, tax year, and other details such as timber cutting contracts acquired separately from the land, forest lands acquired, timber sold or otherwise disposed of under cutting contracts, etc.

Schedule B - Acquisitions

Acquisitions of timber, timber-cutting contracts, or forest land should be detailed in Schedule B. This schedule provides a format for recording costs associated with such acquisitions and for allocating total purchase costs to appropriate capital assets. For purchased forest property, the total amount to be allocated is the actual cost including legal fees, etc.; for inherited property, the estate's value is allocated to assets.

The asset categories included in Schedule B are forested land, other unimproved land, improved land, timber, premerchantable timber, improvements, and mineral rights. The cost is allocated to the respective accounts according to the relative values of the assets at the time the property was acquired. A forester can be helpful in establishing relative values and determining allocations.

The premerchantable timber account should consist of sub-accounts for young growth (naturally occurring trees of premerchantable size) and plantations (trees planted or seeded). Plantation accounts are generally referred to as deferred reforestation accounts. Each of the timber accounts should include entries reflecting a unit of measure (such as board feet for merchantable timber and acres for premerchantable timber) and value. A reasonable amount of the basis should be allocated to the premerchantable sub-accounts if they contribute to the overall value of the property. The quantity and value of all merchantable timber at the time of acquisition should be entered into the timber account. To verify the taxpayer's basis, review the taxpayer's documentation which should include items such as property maps, timber cruise information, forester's appraisal, etc.

Schedule C - Profit or Loss from Land and Timber Sales

Schedule C provides for recording and reporting all dispositions of timber or forest land. The gain or loss from a sale or exchange of timber is equal to the proceeds reduced by the adjusted basis of the asset and by any expenses directly related to the transaction.

Generally, a taxpayer disposes of timber through one of three methods; a lump-sum sale, a disposal with a retained economic interest, or cutting. A lump-sum sale of timber is the outright sale (usually by means of a timber deed or sale contract) of standing timber for a fixed total amount agreed to in advance. The income produced by sale generally is capital gains if the timber is held for investment, IRC section 1231 gain if the timber is held for use in the taxpayer's trade or business, and ordinary income if the timber is held for sale to customers.

A disposal of timber with a retained economic interest is the disposal of timber under any form or type of contract that requires payment at a specified rate for each unit of timber actually cut and measured. This type of transaction often is called a pay-as-cut contract. The income produced by a disposal with a retained economic interest is treated under IRC section 631(b) as IRC section 1231 gain or loss from the sale of the timber, regardless of the reason for which the timber is held.

The cutting of standing timber (felling) is part of the process by which standing timber is made into logs or other products that are sold. Proceeds from this process will result in ordinary income unless an IRC section 631(a) election is in effect. An IRC section 631(a) election treats the cutting of qualifying timber for use in the taxpayer's trade or business as though the standing timber was sold, resulting in IRC section 1231 gain or loss.

Whether timber income is active, passive, or portfolio income depends on the reason for holding the timber and whether the taxpayer materially participates in a trade or business involving the timber.

Exhibit 2-1 illustrates the important steps in calculating basis and determining the income from a sale of timber. The values shown in the tables reflect the transactions discussed in the following example.

Example 1

A taxpayer purchased a 40-acre tract of timberland 11 years ago. The value attributable to the 200 thousand board feet (MBF) of timber on that land totaled $10,000. That works out to be $50 per MBF. An additional 10 acres of adjoining forest land with 50 MBF of timber was purchased 5 years later, with $3,750 attributable to the timber. From forest inventory data collected by a professional forester, timber growth on the properties from date of purchase through last year was estimated to be 50 MBF, resulting in standing timber volume of 300 MBF. The basis in this timber was $13,750. Therefore the depletion unit rate was $45.83 per MBF ($13,750/300 MBF).

Let's say the timber is grown another year and the taxpayer disposes of 100 MBF on a pay-as-cut basis. As a result of the additional year's growth, the depletion unit rate is reduced to $44.35 ($13,750/310 MBF). The taxpayer receives $200 per MBF. In addition, a consulting forester was utilized in the sale, for which the taxpayer paid a 15 percent commission. The taxpayer also incurred another $500 of direct sale-related expenses. The gross receipts of $20,000 are reduced by the adjusted basis of $4,435 and the costs of sale of $3,500, netting the landowner a $12,065 profit.

The particulars of the transaction are reported on Schedule C of Form T and transferred to Part I of Form 4797, Sale of Business Property. If Form 4797 shows a net gain, it is reported as long-term capital gain in Part II of Schedule D (Form 1040).

<u>Schedule D - Losses</u>

If during the tax year, the taxpayer had losses from fire, wind, etc., a deduction for these losses may be claimed on the taxpayer's income tax returns. Therefore it is necessary for these losses to be documented in reference to the nature and amount of the loss on Schedule D of Form T. See Rev. Rul. 87-59, 1987-2 C.B. 59 for discussion of losses from an epidemic of attack of Southern Pine Beatles.

<u>Schedule E - Reforestation and Timber Stand Improvement</u>

Schedule E provides for reporting expenses for reforestation and timber stand activities during the tax year. The taxpayer should have on file all the detailed information reflecting items that are required to be capitalized and items elected to be capitalized. Expenses to be reported on this schedule are expenses such as for supplies, labor, overhead, transportation, tools, etc.

Deferred reforestation sub-accounts should reflect capital expenses incurred in connection with establishing timber stands by planting, seeding, or natural regeneration. Establishment costs include money spent to prepare the site for planting or seeding, costs of seedlings or seed, costs of mechanical or chemical conditioning of the site, cost of small tools, and costs of labor associated with those treatments.

Annually, a taxpayer may claim a 10 percent investment tax credit on up to $10,000 of qualified reforestation expenditures, including costs of site preparation, seeds, seedlings, labor, and tools. The site must be at least 1 acre, be located in the United States, and be capable of commercial timber production. On qualified expenditures of $10,000, the taxpayer may reduce federal income taxes owed by $1,000. In addition, up to $10,000 per year of capitalized reforestation costs may be amortized over an 84-month period. This will allow $1,428 in amortization deductions each year, except for the first and last year when half this amount is allowable. However, if both the investment tax credit and amortization are applied, the amortization allowance is reduced to an amount equal to the qualified reforestation expenditures minus one-half of the tax credit. For example, if a taxpayer has $10,000 of qualified costs and claims a $1,000 credit; then the amount available for amortization would be $10,000 - ($1,000/2) = $9,500. The reforestation credit is claimed on Form 3468, and the reforestation amortization is claimed on Form 4562.

Schedule F - Capital Returnable Through Depletion

Schedule F is used for recording changes in a timber account during a tax year and determining the basis recoverable on timber dispositions. In general, this schedule is used to reflect growth of timber, harvest activities or other disposals, acquisitions, losses, transfers of timber from other accounts, changes in standards of use, and anything else that will affect the volume or basis of timber (wood available and suitable for exploitation and use by the forest industries) in the account. It is a record of activities involving the timber account. The unit rate returnable through depletion, or basis of sales or losses, is computed based on the volume and basis of timber that were available during the year, not just that available at the beginning of the year.

The IRC section 631(a) election is made on Schedule F, which election treats the cutting of timber as a sale or exchange of the timber cut. Under this election, the taxpayer must determine the fair market value of timber cut during the year. This schedule details information the taxpayer must provide in connection with the fair market value determination.

Schedule G -- Land Ownership

Changes in the land account, due to acquisition or disposal, are reported on Schedule G. Assets that are placed in the land account include the land itself and non-depreciable land improvements. Non-depreciable land improvements include earthwork assets of a permanent character, either acquired with the property or constructed later. Examples are roadbeds of permanent roads, land leveling, etc. The basis of such assets like that of the land itself can only be recovered when the taxpayer sells or otherwise disposes of the land.

Schedule H - Road Construction; and
Schedule I - Drainage Structures

Schedules H and I are for reporting activities related to the construction of roads and water level control devices such as ditches and canals.

EXAMINATION TECHNIQUES

An examiner should begin by considering all pre-audit techniques set forth in IRM 4231, Audit Technique Handbook for Internal Revenue Agents. In addition, IRM 4232.4, Techniques Handbook for Specialized Industries -- Timber, can also be reviewed. Although the forestry information in IRM 4232.4 is dated, the principles in the handbook are still applicable.

When you are assigned a hardwood timber return and the case file does not contain an IRP transcript, one should be ordered as soon as possible. Most timber operators, truckers, sawmills, etc. have several sources of income. Some of these may be verified through the use of an IRP transcript. However, do not use the IRP document as your only source since it is most likely that the document is partially complete at best.

Income is the issue which is the most difficult to develop and verify. A lack of sufficient record keeping within the timber industry is the major contributor to this problem. Operators compute their income in several different ways. The most common methods used are:

1. The operator deposits all proceeds received into a bank account (either business or personal). It is then assumed that all income is deposited. Normally it is difficult to verify sources of deposits under this method.

2. The operator totals income amounts on all Forms 1099 received and reports this amount as income. Under this method, it is surmised that all income is subject to Form 1099 filing and that all relevant Forms 1099 were filed. We know this is not the case. Quite to the contrary, very few Forms 1099 are required to be or are filed.

3. The operator maintains a cash receipts journal supported by bank deposits identifying the deposit source. This is better control particularly if the taxpayer maintains a double entry set of books.

4. Some operators estimate their income based upon their current financial condition and prior years estimates. This tends to be the least accurate of the methods discussed.

Most timber operators are small operations conducted in a small geographic area. Many are family operations lacking essential elements of internal control. Lack of internal control and poor record keeping create opportunities for taxpayers to underreport income. These situations leave little or no audit trail.

As in most cases, your initial interview will help in determining income sources and in evaluating internal control. The majority of questions asked in reference to income will be similar to those used in other examinations. Therefore, this guide will not repeat them. However, be sure to inquire as to timber job sites and points of sale. Normally these will be in close proximity to each other.

When determining if any income has been unreported, first look to the books and records of the taxpayer to identify income that is reported. In addition, during the initial interview, obtain the taxpayer's listing of customers for whom they worked during the examination year. Also consider examining the taxpayer's duplicate deposit slips to identify income sources. This works well if the taxpayer is depositing income and is normally paid by check.

After identifying income that the operator has reported, you must probe for unreported income. Consider contacting the taxpayer's known customers as well as other sawmills and concentration yards within the area. For the most part, because of transportation cost factors and customer needs, an operator will use several different customers (sawmills, concentration yards, etc), but they usually will be within close proximity to the operator's job sites.

Another important income identification resource is the use of other third party contacts. For example:

1. Land/Timber seller's income can be identified through:

    a. Courthouse records of timber deeds

    b. Real property tax receipts

    c. Logger or broker purchase records

    d. Timber cruiser job orders

    e. Federal or State Forest Services.

2. Loggers/Timber operator's income can be identified through:

    a. Courthouse records of timber deeds

    b. Real property tax receipts

    c. Sawmill or concentration yard purchase records

    d. Timber cruiser job orders

    e. Federal or State Forest Services and IRP

f. Timber severance taxes where applicable.

3. Trucker's income can be identified through:

   a. Related timber purchases on a per job basis

   b. Verification of the trucker's drivers, cutters, and skidders, and income arrangements

   c. IRP.

4. Sawmills and concentration yards income can be identified through:

   a. Verification of the trucker's drivers, cutters, and skidders and income arrangements

   b. IRP

   c. Customer purchase records

   d. Federal or State Forest Services.

After income sources have been developed, it is necessary to contact these sources to request that documentation pertaining to the taxpayer under examination. For the most part, these sources are very cooperative in providing documentation such as invoices, canceled checks, contracts, etc. Use diligence in gathering this data to gather all relevant data because in many cases the source records may be incomplete. For example, it is not uncommon for these records to have a name and an amount and no other data. This makes it very difficult to identify the payee, even if they were paid by check (checks may be cashed rather than deposited). In many cases, it may take a combination of third party contacts to identify income not reported. If the third party does not comply with your request, you and your manager should decide if a summons should be sent to the third party.

Most timber sellers, operators, sawmills, concentration yards, etc. maintain their own books and records. When they have their tax return prepared by a return preparer, they normally will provide the preparer with a list of their income and expenses. As mentioned previously, most of these operations have limited internal controls. Therefore, the probability of error is great. For example, many times there will be missing or unavailable invoices or other documentation to support expense deductions.

Standard audit techniques may be used to examine expenses. (IRM 4231) Many examiners fail to properly consider the cost of goods sold (COGS) during their examinations. However, in the timber industry, COGS is usually the second largest dollar volume item on a tax return next to gross income.

COGS can easily be used to cover a multitude of incorrectly treated expenditures. The IRM requires minimal inventory checks, but you may want to extend probes further. Techniques are found in IRM 4231, Section 4(10)2. Inventory and COGS are unique areas within the timber industry.

The other types of expenses a timber industry taxpayer can deduct are very similar to those of any other business. Differences do exist but for the most part these expenses are expenditures necessary to produce income. Some of the most common areas of high noncompliance are:

1. Personal expenses are often paid out of business accounts but still deducted on the taxpayer's return.

2. Expenses are overstated with no supporting documentation. Timber industry taxpayers frequently deal in cash and fail to keep applicable receipts.

COMPLIANCE 2000 OPPORTUNITIES

The West Virginia Timber Industry Prototype became a Compliance 2000 Project in 1992 as a result of an Information Gathering Project (IGP) to determine if timber sales were being properly reported. Because of such widespread noncompliance within the timber industry, it was believed that traditional enforcement methods would have limited success in improving the overall compliance level without the use of substantial resources. At the same time, the West Virginia Department of Tax and Revenue (WVDTR) was conducting a similar project. These similar goals and objectives contributed to a joint Compliance 2000 approach. The Joint Timber Compliance Team also utilized the West Virginia Forestry Division in improving compliance in the timber industry.

Data was gathered from selected third party sources, including sawmills and concentration yards. This information was compiled in a data base and refined for further evaluation to determine the compliance problems in the timber industry.

The project increased awareness and cooperation with both internal and external customers (taxpayers). This project indicated a need for assistance to taxpayers who want to voluntarily comply in tax filing and that the service should aggressively pursue those who do not comply. A comparison of the initial and final baseline measurements showed a substantial improvement in all four areas measured: percentage of nonfilers, percentage of inaccurate returns file, percentage of returns not timely filed, and percentage of returns not fully paid.

The team developed strategies to increase the level of compliance within the timber industry. Market segment taxpayers and both external and internal stakeholders in West Virginia were reached through the use of short-term strategies focusing on education.

Through the use of mass media, almost 100 percent of the taxpayer population may be reached with messages to bring about compliance in the timber industry. Efforts in this project illustrate the range of techniques that can be used to educate and inform taxpayers. Major strategies included:

1. Posters and flyers were distributed to IRS and state tax offices, forestry department offices and over 500 sawmills and concentration yards. The objective of this strategy was to publicize the free tax assistance being offered to timber operators.

2. Workshops were conducted at state and federal agencies, timber associations, and tax practitioner and CPA chapter meetings. These presentations were held to educate timber industry taxpayers concerning the requirements of filing tax returns and of maintaining adequate records.

3. Media coverage was utilized focusing on timber industry participation in the district's Nonfiler Program "Opportunity Get Right." Through media releases, taxpayers received information on responsibilities to file tax returns and to maintain adequate records. In addition, taxpayers were informed on how to obtain assistance from both IRS and WVDTR.

4. A Timber Telephone Hotline was established and staffed by team members to provide specialized assistance. This service was publicized in many of the other strategies.

5. A series of four Letters of Inquiry were used to contact known logger underreporters and nonfilers. The first letter was informal and nonthreatening and offered federal and state tax assistance to all known timber-related individuals. The second letter contacted a sample of timber-related taxpayers who had not filed federal income tax returns. The third letter contacted a sample of timber-related taxpayers who had filed federal income tax returns, but may not have reported all gross receipts. Finally, letter four was sent under the signature of the District Director to all taxpayers who had not responded to the issuance of either letter two or three. With the issuance of the series of letters, many taxpayers came into compliance by voluntarily filing returns and amending returns. However, not all taxpayers voluntarily complied and traditional enforcement efforts were used on chronic noncompliers.

6. Record keeping requirements were issued to all sawmills and concentration yards

in the district. Essentially, this letter requires that the name, address, identification number, and legible signature be maintained on file for all purchases of timber or logs.

7. Letters of congratulations were sent to all entities registering in West Virginia as a licensed logger. This letter welcomed the taxpayer into the timber industry, offered tax assistance, and provided a tax reference guide.

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TABLES

Table 1: Calculating basis in the timber account

	Quantity (MBF)	Cost or Basis
Estimated quantity (Purchased Year 0)	200	$10,000
Growth (10 years)	45	-
Timber acquired (Purchased Year 5)	50	$ 3,750
Growth (5 years)	5	-
Total (Year 10)	300	$13,750
Reductions (sales)	-	-
Net quantity and value (December, Year 10)	300	$13,750

Basis (December, Year 10) = $13,750.00
Depletion unit rate = $13,750.00/300 MBF; = $45.83 MBF

Table 2: Determining gain or loss on a sale of timber

	Quantity (MBF)	Cost or Basis
Estimated quantity (December, Year 10)	300	$13,750.00
Growth (Year 11)	10	-
Total before depletion (December, Year 11)	310	$13,750.00
Unit rate	-	44.35
Quantity sold (Fall, Year 11)	100	-
Allowable basis of sale	-	$ 4,435.00
Reductions (sales)	100	$ 4,435.00
New quantity and value	210	$ 9,315.00

(December, Year 11)

Gross Receipts	$20,000
Adjusted basis	-4,435
Sale expense (consultant)	-3,000
Sale expense (seller)	- 500
Profit	$12,065

Chapter 3

INCOME TAXATION OF TIMBER OPERATIONS

TIMBER INCOME

The timber industry in the northeastern United States experienced a substantial resurgence in the late 1980's and early 1990's and is anticipated to continue to grow at a rapid pace. Data from this project and available historical examination data indicate that there are instances of sales of standing timber, logs, and timber products for cash or checks payable to nominees for the purpose of tax avoidance or evasion. Further, numerous self-employed timber operators operate strictly on a cash basis, including payments to their employees, and frequently do not file applicable federal returns.

Within Parkersburg District's Timber Compliance 2000 Project, a significant compliance problem was identified in two areas. It was established that over 40 percent of identified timber industry entities failed to file an income tax return. Of the entities that did file, over 30 percent appeared to report less than their total gross income. It was the opinion of the team that many instances of this noncompliance was due to lax record keeping and failure to meet reporting requirements of the Internal Revenue Service.

Companies in the business of buying and selling timber, logs, and pulpwood, etc. accomplish this in many different ways. For example, a company may purchase timber from landowners. The company then may hire contractors to cut the timber and deliver the logs. In some instances, the company will pay the landowner for the timber cut by the contractors and will pay the contractor for cutting the timber. In other cases, the company will pay the contractors for both the timber and the cutting. Standing timber is usually purchased in one of three ways: 1) outright purchase of the land and related timber, 2) purchase at a specified rate per unit of timber actually cut (pay-as-cut), or 3) purchase for a set total amount or lump sum. The company may also purchase logs from independent contractors rather than from landowners.

When the company pays the owner of standing timber at a specified rate for each unit of timber actually cut under a pay-as-cut contract, the payment for that timber is a royalty and it must be reported on Form 1099-S unless the recipient is a corporation. See Ann. 90-129, 1990-48 I.R.B. 10. When a company purchases standing timber for a lump sum, the transaction is considered a real estate transaction and no reporting is required because that transaction is excluded from the real estate reporting requirements.

The purchase of logs for a lump sum is not a royalty arrangement, and need not be reported because they are payments for merchandise under Treas. Reg. section 1.6041-3(d). The payments to contractors for a total amount that covers the purchase of timber and the service of cutting are also excludable from reporting as the payment of a bill for merchandise. Finally, payment to independent contractors for cutting timber is compensation for services performed, and payments of $600 or more must be reported on Form 1099-MISC in the nonemployee compensation box.

The Timber Compliance 2000 Team recommended that the information reporting requirements for the timber industry be expanded to cover all significant transactions or circumstances within the industry. This expansion would encourage companies to maintain better records and to report all income received.

When gross income is established, the gain or loss on the sale or other disposition of timber is determined by reducing the amount received for the timber by the cost or other basis of the timber and any expenses incurred in making the sale. See below:

SALE PROCEEDS
-COST OR BASIS
<u>-SALES EXPENSES</u>
NET GAIN (LOSS)

TIMBER EXPENSES

The basic rule is that ordinary and necessary expenditures associated with the production of timber held with the intention of making a profit can be recovered in three basic ways:

1. <u>Capitalized expenditures</u> are entered into a capital account for recovery through depreciation, amortization, depletion or other means.

2. <u>Operating expenses</u> generally are deductible from gross income for the tax year in which the expenditure occurs.

3. <u>Selling expenses</u> associated with a timber disposal are used to offset the amount received.

CAPITAL EXPENDITURES

Capital expenditures are costs incurred for acquisition of property (or property rights) or permanent improvements that increase the value of property already owned. Capital expenditures must be capitalized. It is necessary to examine accounts to ensure proper recording of original cost, amounts recovered, and additions for improvements.

The Land Account

Assets placed in the land account include the land itself, nondepreciable improvements, and depreciable land improvements. The value placed in this account may result from purchase, gift, inheritance, etc.

At the time of acquisition, the total cost is allocated among the assets included in the purchase. The proportion allocable to land itself is the portion of the total acquisition cost attributable to the bare land. Land cannot be depreciated or depleted. Its value can only be recovered when it is disposed of by sale, exchange, etc.

Nondepreciable land improvements are primarily earthwork ameliorations of a permanent character such as clearing for and constructing roadbeds of permanent roads, land leveling, and impoundments. Like the land itself, these amounts generally can only be recovered when the land is disposed of. Depreciable land improvements include bridges, culverts, graveling, fences, firebreaks, etc. These types of improvement costs are recoverable through depreciation.

There are two basic types of logging truck roads for tax purposes -- permanent and temporary. Permanent roads, sometimes called long-term, are those with an undeterminable useful life to the taxpayer. They are intended not only for timber harvesting, but for general management activities, including fire control. A temporary or timber access logging road, by contrast, is constructed solely to remove certain timber and is then abandoned.

The tax status of permanent roads is clear. Construction costs of the nondepreciable portions must be capitalized and are not recoverable unless the road is sold or abandoned (for adequate reason). The parts that must be replaced from time to time are depreciable. These include such items as bridges, trestles, fences, culverts, and surfacing. Their costs are recoverable through depreciation. Depreciation is allowable whether or not the road is used in a year. Finally, maintenance costs not related to basic construction are deductible as business expenses in the year incurred.

The tax treatment of permanent logging truck roads differs somewhat if, rather than owning the land and timber to which the road is associated, the taxpayer only has the right to timber by means of a long-term lease or cutting contract. In such a case, if a taxpayer builds a permanent road that is to become the property of the landowner at the end of the agreement, the taxpayer may recover the depreciable portions of the road in the normal manner. On termination of the agreement, any remaining basis with respect to the depreciable portion would be recoverable in that year. For the nondepreciable portion of the road, an aliquot part may be taken as a business deduction over the life of the agreement. If, for some reason, the road does not revert to the landowner at the end of the agreement, the taxpayer continues to recover any depreciable basis in the normal manner.

The costs of temporary logging truck roads are recoverable through depreciation. Under the modified accelerated cost recovery system (MACRS), the costs are recoverable over 15 years as a land improvement, Asset Class 00.3 in Rev. Proc. 87-56, 1987-2 C.B. 674, clarified and modified by Rev. Proc., 88-22, 1988-1 C.B. 785, or by a unit-of-production method. Under the unit-of-production method, recovery of cost occurs in proportion to the removal of the volume of timber for which the road was constructed.

According to Rev. Rul. 68-281, 1968-1 C.B. 22, the total costs of a temporary road, including the costs of clearing, grubbing, rough cut, and fill grading, are recoverable. The IRM states in part that:

> "If the life of a temporary road depends on the logging of a certain quantity of timber, the unit-of-production method of depreciation is perhaps the most logical means of apportioning costs to operations."

Rev. Ruling 88-99, 1988-2 C.B. 33, further clarified Rev. Rul. 68-281 to indicate that any road regardless of its physical attributes, must have a useful life to the taxpayer that is determinable in order for depreciation to be available.

The Timber Account

When a timber tract is purchased, a reasonable part of the total cost is allocable to the timber, that is, stumpage or recoverable wood. This allocation is based on the relative value of the timber to the total value of the assets acquired. This cost is recovered by the taxpayer through allowable basis if the timber is disposed of on the stump or depletion if cut by the owner.

If the value of the young growth is significant, a portion of the purchase cost should also be allocated to it, based on its relative value at the time of acquisition. When the young growth trees become merchantable, the volume and basis of the timber in these trees are transferred to the "merchantable" timber account.

The Plantation Sub-Account

The Plantation sub-accounts are used to record the costs associated with reforestation or forestation by natural or artificial means, such as planting or seeding. All costs associated with regeneration are included, for example, site preparation (tree girdling, brush or stump removal, land leveling, and conditioning), seed or seedling, pro-rated cost of equipment used, and paid labor. Up to $10,000 of qualified expenditures may be transferred to a reforestation amortization account and amortized over an 84-month period, per IRC section 194.

The Equipment Account

Assets placed in the equipment account include the cost of durable equipment such as a sawmill, trucks, tractors, power saws, etc. Sub-accounts are normally used by larger companies. The cost of any major repairs or reconstruction that materially increases the value or prolongs the life of these items is added to the equipment account.

OPERATING EXPENSES

Operating expenses are broad classes of costs which can be defined as all those which are not capital costs and are not associated with the disposal of an asset. The ordinary and necessary expenses paid or incurred during the tax year in carrying on a trade or business may be deducted per IRC section 162. In addition, an individual may deduct ordinary and necessary expenses for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income per IRC section 212. The following items are some types of deductible operating expenses:

1. Tools of short life or small cost including axes, handsaws, sledges, wedges, etc.

2. Maintenance costs including incidental repairs of trucks, tractors, and other mechanical equipment.

3. Salaries or other compensation for services rendered by others, such as hired labor, fees for consulting foresters, lawyers, accountants, etc., provided these expenditures are not directly related to any activity, such as timberland purchases, reforestation projects, or timber sales. These expenses would be capital in nature if so related.

4. Taxes such as property, yield, severance, sales, gasoline, and license fees for business vehicles. Federal income tax, estate, inheritance and gift taxes, and special assessments for local benefits are not deductible.

5. Interest payments on bank loans and other short-term credit, and long-term indebtedness such as mortgages. <u>Note:</u> Individual personal interest is not deductible.

6. Premiums for fire, windstorm, theft, or other insurance, such as public liability and workmen's compensation are deductible.

7. Travel expenses while away from home on business may be deductible under certain circumstances.

8. Rent or other payments for land, equipment, or other business property in which the taxpayer has no equity.

SELLING EXPENSES

All costs associated with a specific timber sale are sale expenses. These costs are recovered by deducting them from the proceeds of the sale. The following is a listing of items which are considered directly attributable to a disposal of timber per Rev. Rul. 71-334, 1971-2 C.B. 248.

1. Advertising the timber for disposal.

2. Cruising to determine the quantity and quality of timber to be disposed of.

3. Marking or otherwise designating the timber for cutting.

4. Marking seed trees to be retained.

5. Scaling, measuring, or otherwise determining the quantity of timber cut.

6. Fees paid to consulting foresters, selling agents, and others for service directly related to timber disposal.

7. Supervising or checking performance under the contract.

8. Other items directly attributable to the disposal.

ESTABLISHING COST OR BASIS

The basis (book value) of timber should be established at the time it is acquired. This is needed to calculate the depletion unit used to determine the taxable gain (loss) when timber is sold on the stump, cut, or disposed of involuntarily, such as by a casualty or condemnation.

Real estate is usually acquired for a lump-sum amount, even though more than one asset is included. To recover the portion of the basis attributable to any one asset, such as timber, a separate basis must be established for that asset. In the case of timber, this most often means separating the amount paid for the land from the amount paid for the timber.

The allocation of basis between assets should be based on the proportion of the fair market value (FMV) of the asset to the total FMV of the property acquired. This requires estimating the FMV of each of the assets individually. Note: In some cases, the sum of the FMV of the individual assets will be greater than FMV of the combined assets. The taxpayer is expected to make a "reasonable effort" to estimate the fair market values. What is reasonable for five acres of low grade timber may be an estimate based on readily available information, such as published price reports. This approach would be unreasonable for a larger tract and/or higher-value timber, in which case an appraisal by an experienced forester would be appropriate.

FMV is the price at which an asset would change hands between an unrelated willing buyer and an unrelated willing seller. Sales of similar property (comparables) on or about the valuation date are the best indicators of FMV. If a tract contains a mix of high value and low value species of merchantable size, consideration should be given to establishing separate cost basis for each type of timber. This will allow the taxpayer to more clearly match income and expenses on disposition of any timber.

The procedure used to allocate the available basis between assets is the same no matter how the property is acquired. However, the total basis available for allocation will depend on how the property was acquired. The basis of purchased property is the amount paid to the seller, plus any additional costs incurred in the process of acquiring property. The purchase price may have been in the form of cash, other property, or a combination of both. Additional acquisition costs include amounts paid for attorney's fees, surveying, a timber cruise, real estate taxes owed by seller, and any other costs directly associated with the acquisition.

In a perfect world, the appropriate time to establish a separate cost basis for timber is when the property is acquired. However, we don't live in a perfect world. It may be necessary to establish a basis at a later time. This can be done if the necessary information as of the date of acquisition is available. Taxpayers who acquired timber several decades ago and have not previously established a separate basis, may find the cost of doing so now exceeds the benefits. This is a determination that should be made on a case by case basis, however. The larger the tract and/or the more valuable the timber, the further back in time it would pay to go to establish available basis.

The information needed is exactly the same as that needed if the allocation was made at the time of acquisition. To estimate the FMV of the timber at the time of acquisition, it is necessary to estimate the volume and type of timber that was present on the land at that time.

The taxpayer is required to estimate, with respect to each separate timber account established, the total units (board feet, cords, or other units) of timber reasonably known, or on good evidence, believed to have existed on the date of acquisition of the property. If records do not exist to readily do this, forest measuring techniques can literally reverse the grow of the current forest back to the date of acquisition. This is a task a professional forester will need to perform. The forester will consider factors such as growth period, weather, insects, forest fires, etc.

After the volume by type has been estimated, the FMV of this timber on the date of acquisition must be estimated. The best available evidence of timber values on this date must be used. Ideally, the price actually paid for timber similar in character and quality in the location of the subject property on or near the valuation date should be used. Consulting foresters or timber buyers with records dating back to that time period may be good sources of this data. Otherwise, published price reports may be used to develop acceptable estimates if the average prices are adjusted to reflect differences between averages and the particular location and timber in question.

In addition to the FMV of the assets as of the date of acquisition, it is also necessary to determine the volume of timber disposed of, if any, since the acquisition. This is because the basis must be reduced by the basis allowable for any previous sales, even if the basis was not claimed on the tax return for the year of the sale.

Four examples follow.

Example 1

Mr. and Mrs. A. Dell purchased a tract of rural land. The land was purchased primarily as an investment. The tract produces income from several sources. The pasture and barn are rented to a local farmer and the house is rented to a local family. In addition, the woodlands include many prime stands of mixed hardwoods.

The 120 acre tract was purchased for $135,000. The costs associated with the purchase include the purchase price and fees paid to professionals for services rendered. See below.

Purchase price of farm	$135,000
Lawyer fee - title search	$ 420
Surveyor fee	$ 1,200
Consulting forester fee for cruising & valuing timberland	$ 800
Misc. selling expenses	$ 380
Total Cost or Basis	$137,800

In addition, this cost would have to be allocated among all assets acquired. This allocation would require the assistance of experts. See below.

ASSET DESCRIPTION	FMV OF ASSET	% OF FMV	COST BASIS
House - Per realty company estimate	$12,000	6.62	$9,122.36
Barn - Per realty company estimate	8,000	4.42	6,090.76
Fences - estimated by Mr. Dell	1,400	.77	1,061.06
Timberland, 90 acres @ $120/acre per realty co. estimate	10,800	5.96	8,212.88
Pasture Land, 29 acres @ $800/acre per realty co. estimate	23,200	12.81	17,652.18
Home land, 1 acre @ $1600 per realty co. estimate	1,600	.88	1,212.64
Merchantable time 12 MBF/acre @ $110/MBF per Cons Forester	118,800	65.56	90,341.68
Young growth timer @ $60/acre per Cons. Forester	5,400	2.98	4,106.44
Totals	$181,200	100.00	$137,800.00

Example 2

Continuing with Example 1, assume that the Dells sell all the merchantable timber on the 90 acres in the same year that they purchased it. The contract price is $110 per MBF and the volume estimate of 12 MBF per acre is used. The net gain from the sale would be:

Gross Income:	
90 acres x $110/MBF x 12 MBF	$118,800
Allowable basis (cost basis):	($ 90,342)
Sales expenses	($ 5,940)
NET GAIN	$ 22,518

The computation of the net gain in Example 2 was simplified by the assumption that all of the merchantable timber was sold at the same time and in the year it was purchased. This made it possible to reduce the sale proceeds by the entire cost basis of the timber. If only a portion of the timber is sold, only a similar portion of the cost basis written off against a particular sale other disposal of timber is determined by multiplying the number of units (volume) sold by the depletion unit. See Example 3 below.

Example 3

Referring to Example 1 again, assume the Dells sell 450 MBF in year 1, instead of all the timber as was assumed in Example 2. The depletion unit for the timber is $83.65 per MBF, obtained by dividing $90,342 by 1,080 MBF. The contract price is $110 per MBF. Selling expenses total = $3,500. The net gain from the sale would be:

Gross Income:	
450 MBF x $110/MBF	$49,500
Allowable basis:	
450 MBF x $83.65/MBF	($37,643)
Sales Expenses	($ 3,500)
NET GAIN	$ 8,357

As shown in Example 3, the depletion unit is the cost per unit of volume. It is obtained by dividing the basis of the timber by the volume of timber.

The situation becomes more complicated if a year or more elapses between the purchase and the sale of the timber. It is necessary to adjust the volume of timber for growth. It also is necessary to adjust the cost basis if any costs were capitalized during the period or a portion of the basis recovered.

The initial volume entered in the timber account should be the estimated total volume that the tract would produce on the date of acquisition if all the timber was cut and utilized in accordance with the standards of utilization prevailing in the region at the time.

The timber account must be adjusted as needed to reflect the following charges:

1. Volume of additional timber purchased or otherwise acquired during the period.

2. Transfer from the young growth or plantation accounts to the merchantable timber account the volume that becomes merchantable during that period, and its basis.

3. Volume gained through growth since last adjustment.

4. Volume removed through sale or other disposition, or lost due to natural or other causes.

Timber companies would generally make annual adjustments for growth. However, owners of small holdings who have infrequent timber transactions would generally make these adjustments only for a year in which they cut, sell, or otherwise dispose of timber. The easiest way for small producers to account for timber growth may be to simply recruise the entire timber tract. This can be accomplished most easily at the same time timber is marked or otherwise designated for sale.

Any additions or reductions to the basis which have occurred since the last adjustment should be reflected in the account before the depletion unit is calculated. The volume and cost basis used to calculate the depletion unit for a given year must be the adjusted volume and adjusted cost basis. The adjustments should be made to reflect the actual volume available for harvest and the unrecovered cost basis as of the end of the year (before depletion or other reduction of basis) for which the depletion unit is calculated.

Example 4

Referring to Example 3, assume that the Dells sell 900 MBF in the 10th year. During the period since the initial purchase the following transactions have occurred:

1. A timber stand improvement was made at a net cost of $60 per acre, which was capitalized.

2. A 20-acre tract containing 300 MBF of timber was purchased for $30,000. The timber accounted for 2/3 of the purchase price or $20,000, and it was added to the timber account previously established.

3. The merchantable timber had an average net growth of 350 bf per acre per year.

4. The young growth reached merchantable size. Its average net growth was 350 bf per acre per year.

BASIS ANALYSIS

ORIGINAL COST - YEAR 1	$90,342
TIMBER SALE - YEAR 1	($37,643)
TSI 90 ACRES @ $60/ACRE	$ 5,400
PURCHASE - JONES TRACT	$20,000
TRANSFER FROM YOUNG GROWTH	$ 4,106
ADJUSTED BASIS	$82,205

VOLUME ANALYSIS

ORIGINAL VOLUME - YEAR 1	1,080 MBF
TIMBER SALE - YEAR 1	(450) MBF
PURCHASE - JONES TRACT	300 MBF
TRANSFER FROM YOUNG GROWTH	315 MBF
GROWTH	315 MBF
ADJUSTED VOLUME	1,560 MBF

If the contract price for the sale is $145 per MBF and selling expenses are $8,000, the net gain would be computed in the following way:

GAIN COMPUTATION

Gross Income:	
900 MBF x $145/MBF	$130,500
Allowable basis:	
$82,205 adj. basis/1,560 MBF	
= $52.70	
900 MBF x $52.70/MBF	($47,430)
Selling expenses	($ 8,000)
NET GAIN	$ 75,070

If, instead of selling the timber, the owner cuts the timber, producing logs, and sells the logs, the depletion allowance is calculated in exactly the same manner as the allowable basis. Although depletion occurs when the timber is cut, the depletion is not allowable until the logs are sold or otherwise disposed of. No depletion allowance can be claimed for timber cut for personal use, such as home firewood, and basis for depletion should be reduced by the cost attributable to the personal use timber.

The tax treatment of a disposal of standing timber held for more than 1 year depends on the primary purpose for which the timber is held and the manner in which the timber is disposed of.

1. If a taxpayer holds timber for investment and it is a capital asset in the hands of the owner per IRC section 1221, a sale of the timber will produce long-term capital gains or losses.

2. If the timber is held for use in the taxpayer's trade or business it is IRC section 1231 property, a sale of which will produce gains or losses that are netted with other IRC section 1231 gains or losses. If this netting results in a net gain, these timber gains or losses are treated as long-term capital gains or losses. However, if there is a net IRC section 1231 loss, the timber gains and losses are treated as ordinary income or losses.

3. If the timber is held primarily for sale to customers in the ordinary course of a trade or business, a sale of the timber will result in ordinary income or losses.

4. Regardless of the reason for which timber is held, a disposal of it with a retained economic interest under IRC section 631(b) is treated as a disposal of IRC section 1231 property, the gains or losses from which are netted with other IRC section 1231 gains and losses per item 2.

5. If the taxpayer cuts its timber, all income therefrom is ordinary income unless the taxpayer elects under IRC section 631(a) to treat the cutting of the timber as a sale or exchange of the timber cut. If IRC section 631(a) is elected, the difference between the adjusted basis of the timber cut and its fair market value on the first day of the tax year is treated as IRC section 1231 gains or losses, which are netted as per item 2. Subsequent income or loss from the cut timber is ordinary income or loss.

Chapter 4

BASIS IN GIFTS AND INHERITED PROPERTY

The basic rule for gifts is that if the FMV of the gift is less than the donor's basis, then the basis for depreciation, depletion or amortization and for gain on its sale or other disposition is the same as the donor's adjusted basis in the asset (IRC section 1015(a)). The basis for loss for such property is its FMV at the time of the gift. If, however, the FMV of the gift is greater than the donor's adjusted basis at the time of the gift, then the basis for depreciation, depletion, or amortization and for gain or loss on its sale or other disposition is the same as the donor's adjusted basis in the asset, increased by the amount of any gift tax paid on the gift. But this total cannot exceed the FMV at the time of the gift.

The basis in inherited property is usually its FMV on the date of death of the person granting the property (IRC section 1014(a)). If the decedent's estate has elected to value the property under IRC section 2032A, then the value is determined under this section. If a federal estate tax return was filed, and if the property had to be included in the gross estate, the FMV for estate tax purposes should be used. If a federal estate tax return did not have to be filed, the appraised value on the date of death reported on the state tax form for inheritance or transmission taxes should be used.

If timber is not listed separately on the federal estate tax return or state tax form, you will need to make an allocation to timber. For example, the timber and timberland may have been valued together. The allocation procedure demonstrated in Chapter 3, Example 1 would be used, but the value reported on the estate tax return will be used instead of the acquisition cost.

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Chapter 5

EMPLOYMENT TAXES

OVERVIEW

The potential for raising significant employment tax issues during an audit of a timber industry tax return is very good. This is so for many reasons. One of the most common reasons is the misclassification of employees as independent contractors.

An employer must withhold, under the Federal Insurance Contributions Act ("the FICA"), social security and Medicare taxes from wages paid to employees, and is liable for an equivalent amount of social security and Medicare taxes on the wages. The employer must also pay the taxes imposed under the Federal Unemployment Tax Act ("the FUTA") and must withhold federal income taxes from the wages. In addition to these federal requirements, the employer may be responsible for state unemployment taxes and the withholding of state and local income taxes. Employees may also be eligible for certain tax-favored company benefits that are not available to independent contractors. Independent contractors do not have taxes withheld from their remuneration and the "employer" is not liable for the employer's share of FICA taxes or the FUTA tax. Their responsibilities under state law also change. Consequently, the employer can save money by treating the workers as independent contractors.

The employer also saves time, money, and energy on significantly reduced paper work. With employees, in addition to the bookkeeping, the employer must deal with many tax forms. With independent contractors, the only paper work is the writing of a check and entering it into the Cash Disbursements Journal.

Some of the Federal forms necessary to be filed with respect to employees are as follows:

- Form 940, Employer's Annual Federal Unemployment Tax Return

- Form 941, Employer's Quarterly Federal Tax Return

- Form W-2, Wage and Tax Statement

- Form W-3, Transmittal of Wage and Tax Statement

- Form W-4, Employee's Withholding Allowance Certificate.

Employers who pay independent contractors, whether misclassified or not, may be required to file the following forms:

- Form 1099-MISC, Miscellaneous Income Statement

- Form 1096, Annual Summary and Transmittal of U.S. Information Returns.

Form 1099-MISC is required to be filed for each person to whom at least $600 in rents, services (including parts and materials, see Rev. Rul. 81-232, 1981-2 C.B. 231), prizes and awards, and medical and health care payments has been paid. Payments are to be reported only by persons engaged in a trade or business when the payments are made in the course of such trade or business. Personal payments are not reportable. In addition, Form 1099-MISC is not required to be filed if the recipient of the miscellaneous income receives less than $600 per year; however, it is still taxable to the recipient. Also, Form 1099-MISC is not required to be filed if the recipient is a corporation.

Form 1099-MISC is to be filed with the Internal Revenue Service by February 28; Form 1099-MISC is to be furnished to the recipient by January 31.

There is no penalty for filing a Form 1099-MISC that is not required to be filed. However, there is a penalty for failing to file or filing with incorrect information any required Form 1099-MISC. The amount of the penalty is based on when the correct information returns are filed. The penalty is:

- $15 for each information return if correctly filed within 30 days after the due date with a maximum penalty of $75,000 per year ($25,000 for small businesses).

- $30 for each information return if correctly filed more than 30 days after the due date but by August 1, with a maximum penalty of $150,000 per year ($50,000 for small businesses).

- $50 for each information return if correctly filed after August 1 or not filed at all, with a maximum penalty of $250,000 per year ($100,000 for small businesses).

- At least $100 for each information return if the failure is due to intentional disregard of the filing requirements, with no maximum penalty.

For further information on Form 1099-MISC, request "Instructions for Forms 1099, 1098, 5498 and W-2G."

WHO ARE EMPLOYEES?

Guides for determining a worker's employment status are found in three substantially similar sections of the Employment Tax Regulations; namely, sections 31.2121(d)-1, 31.3306(i)-1, and 31.3401(c)-1, relating to the FICA, the FUTA, and federal income tax withholding, respectively.

In general, it should be noted that section 3121(d)(2) requires the application of the common law rules in determining the employer-employee relationship. In determining whether an individual is an employee under the common law rules, 20 factors have been identified as indicating whether sufficient control is present to establish an employer-employee relationship. The 20 factors have been developed based on an examination of cases and rulings considering whether an individual is an employee. The degree of importance of each factor varies depending on the occupation and the factual context in which services are performed, as explained in Rev. Rul. 87-41, 1987-1 C.B. 296, which sets forth the factors. (The 20 factors are discussed in detail in IRM Section 4646 and Exhibit 4640-1.) The 20 factors are not to be applied mechanically, like a scorecard. Rather, they are to be used as an aid in applying the common law. See also ***Nationwide Mutual Insurance Co. v. Darden***, 112 S.Ct. 1344, 1348 (1992).

Although a variety of factors may be used to analyze employment status for tax purposes, the regulations provide that the relationship of employer and employee generally exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished.

You begin by gaining an understanding of the way a company operates rather than simply trying to verify the presence or absence of common law factors. Focus on what the business does and how the job gets done. It is also important to understand the relationship between the employer and its clients or customers.

Next, you should establish which of the "20 common law factors" listed in Rev. Rul. 87-41 are relevant in analyzing control for this kind of work. Also consider whether factors not listed in Rev. Rul. 87-41 may also be relevant. For example, required attendance at meetings may be relevant in determining whether the employer has retained the right of control.

After determining the relevant factors, consider the relative weight of these factors in determining worker status. You then needs to weigh the facts and circumstances of each case and determine worker status accordingly. For an in-depth discussion, see the training materials on determining employment status. “Independent Contractor or Employee?” Training 3320-102 (Rev. 10/96) TPDS 84238I.

STATUTORY EMPLOYEES

"Statutory employees," described in section 3121(d)(3) of the Code, are not employees under the common law rules. The Code treats statutory employees as common law employees for purposes of imposing taxes under the Federal Insurance Contributions Act ("FICA"); however, the Code does not allow employers to withhold income tax from payments to statutory employees just as the employer does not withhold income tax from payments to independent contractors. Employers may be required to pay taxes under the Federal Unemployment Tax Act ("FUTA") for certain statutory employees.

Once a person realizes that he or she does have workers who are employees, the person should obtain an Employer Identification Number (EIN). The EIN is a nine-digit number the IRS issues to identify accounts for employers. To obtain an EIN, request Form SS-4, Application for Employer Identification Number.

Example 1

You are given the tax return of Madison Lamar, Incorporated to examine. During your pre-contact you note that the corporation does $3 million in gross receipts, yet pays minimal wages, salaries, and cost of labor. However, in the schedule detailing other deductions, sub-contracting expense is over $500,000. Per the return, depreciation is several hundred thousand dollars. The depreciation schedule is attached to the return, which reflects numerous trucks, logging equipment, etc. Also, during the review of the tax return, you notice that insurance, fuel, repair, and tire expense is substantial.

As a result, you informed Mr. Steele that his workers have been misclassified as independent contractors and that you will prepare reports to correct the misclassification for the prior years. Mr. Steele will now be responsible for withholding Federal income tax and the Federal Insurance Contribution Act (FICA) taxes from his workers; he will also be responsible for paying FICA taxes and paying into unemployment funds. In addition, you asked him for the names of his competition.

Example 2

You are given the tax return of W. Cutters, Inc. to examine as a result of an Information Report filed by an informant. The informant states that the owner of W. Cutters, Inc., Mr. Brown, treats all of his workers as independent contractors, when, in fact, they are employees. W. Cutters Inc. hires workers to fell trees using his equipment. To make it appear that the workers are contractors, Cutters requires them to lease his saws for a fee. Cutters does issue Forms 1099-MISC.

As a result, you decide to audit the return, limiting the scope to employment taxes only.

At the initial interview, Mr. Brown informs you that W. Cutters, Inc. has no employees. His wife maintains the books and records and takes care of all business calls. Mr. Brown maintains his office in the home. Neither Mr. nor Mrs. Brown receives any compensation. All of his workers are independent contractors who lease Mr. Brown's equipment. In addition, you learn the following:

– W. Cutters, Inc. does not require the workers to use their own equipment. As a matter of fact, Cutters requires that they use its equipment, which it leases to them for a fee. Mr. Brown states that this is to ensure that the equipment is properly maintained.

– The workers are paid every other Friday; W. Cutters, Inc. deducts from their paycheck the value of the leased equipment.

– None of the workers are required to have liability insurance; coverage is provided by a group policy through W. Cutters, Inc.

– The workers often purchase oil, gas, etc. Cutters reimburses them only if they provide original receipts for reimbursement.

- W. Cutters, Inc. requires that the workers wear protective eyeglasses and steel-toed shoes. Anyone who does not wear the protective clothing is not permitted to work. W. Cutters, Inc. gives each worker who has been with the company one year $100/yr. for protective clothing.

– The work day begins at 7:30 a.m. and ends at 4:30 p.m.; those who frequently report to work late are fired.

At the conclusion of this interview, you asked Mr. Brown why these workers were not treated as employees. He responded that they were not employees because they had to lease W. Cutters, Inc. equipment; therefore, they must be independent contractors.

You informed Mr. Brown that the common law rules govern whether a worker is an employee or an independent contractor. As an aid in making this determination, the Service uses a list of 20 employment related factors. It may be true that the workers provide their own equipment, by leasing them from W. Cutters, Inc. However, there are numerous other factors which clearly establish the employee-employer relationship. For instance, W. Cutters, Inc. has the right to fire; it furnishes the insurance; it reimburses documented business expenses; it requires protective clothing be worn; and it determines the method and result of the services. Based on the circumstances of the employment relationship between W. Cutters, Inc. and its workers, W. Cutters, Inc. has the right to control its workers, and accordingly, the workers are W. Cutters, Inc.'s employees.

W. Cutters, Inc. acquiesced to the reclassification. Therefore, inform Mr. Brown that the workers have been misclassified as independent contractors and that you will prepare reports to correct the misclassification for the prior years. However, W. Cutters, Inc. will now be responsible for withholding federal income tax and social security taxes (FICA) from its workers; it will also be responsible for matching the FICA taxes and paying into unemployment funds.

Example 3

You are given the tax return of Mr. Lawrence to examine. Mr. Lawrence sold 100 acres of timber to Graves' Logging for a lump sum price of $150,000. Graves' Logging contracts Burke's trucking to haul the logs from the landing to Bullock Sawmill for a fee of $75 per MBF, totaling $75,000. Bullock Sawmill purchases the logs for $345,000 and is requested to cut three checks as follows:

To:	Mr. Lawrence	$150,000
	Graves' Logging	120,000
	Burke's Trucking	75,000

Who is responsible for the filing of Form 1099-MISC?

a. Mr. Lawrence is not required to file the Form 1099-MISC.

b. Graves' Logging is required to file Form 1099-MISC to Burke's Trucking for $75,000. However, Graves' Logging is not required to report the lump sum purchase of standing timber; this transaction is considered to be a real estate transaction and no reporting is required because the transaction is excluded from the proposed real estate reporting requirements.

c. Burke's Trucking is not required to file Form 1099-MISC.

d. Bullock Sawmill is not required to file Form 1099-MISC. However, had Mr. Lawrence been paid by Grave's Logging at a specified rate for each unit of timber actually cut under a pay-as-cut contract, the payment for that timber would be a royalty, which must be reported on Form 1099-S provided the recipient is not a corporation.

In addition, the purchase of logs for a lump sum is not a royalty arrangement and the payment is not required to be reported because it is a payment for merchandise under Treas. Reg. section 1.6041-3(d). The payment to a contractor for a total amount that covers the purchase of timber and the service of cutting is also excludable from reporting as the payment of a bill for merchandise. Finally, the payment to an independent contractor for cutting timber is compensation for services performed, and payments of $600 or more must be reported as Non-Employee Compensation on Form 1099-MISC.

SAW RENTS

It is common in the timber industry for employees to furnish and maintain their own saws and related equipment. Employers frequently reimburse their employees for the "rental" of the employee-owned saws and related equipment. Typically, the employer will treat a certain percentage of each employee's wages as a reimbursement. These reimbursement payments are customarily called "saw rental payments"; however, the payments usually do not represent a payment of rent made by the employer to the employee for the employer's use of the saw. Although the payment may be intended to reimburse the employee for the expenses incurred in purchasing and maintaining a saw, the amount is generally determined without reference to the expense that might be incurred. It is more likely that the reimbursements are used to provide employee compensation that is not subject to employment taxes. Employers do not include the reimbursements in the employees' wages. Consequently, the employers reduce their liability for employment taxes.

IRC section 62(a) defines Adjusted Gross Income (AGI) as gross income minus certain deductions. These deductions are allowed without regard to whether or not the taxpayer itemizes; nor are the deductions subject to the 2 percent AGI floor.

Section 62(a)(2)(A) of the Internal Revenue Code allows an employee a deduction in computing adjusted gross income (an above-the-line deduction) for expenses paid by the employee, in connection with the performance of services as an employee, under a reimbursement or other expense allowance arrangement with the employer, that is, an accountable plan.

The issue with respect to saw rents is whether employees who furnish and maintain their own saws and other equipment are reimbursed for such expenses under an accountable plan. This is because IRC section 62(c) provides that a nonaccountable plan will <u>not</u> be treated as a reimbursement or expense allowance arrangement for purposes of IRC section 62(a)(2)(A). Nonaccountable plans are those under which (1) the employee is not required to substantiate the expenses covered by the arrangement to the person providing the reimbursement, or (2) the employee has the right to retain amounts in excess of the substantiated expenses covered under the arrangement.

Amounts received under a nonaccountable plan are included in the employee's gross income for the taxable year, must be reported to the employee on Form W-2, and are subject to withholding and payment of employment taxes. Expenses reimbursed under a nonaccountable plan, if deductible, are deductible by the employee only as a miscellaneous itemized deduction, subject to the 2 percent floor imposed by IRC section 67. However, if the expenses are determined to be personal, they are not deductible by the employee under any provision of the Internal Revenue Code.

The amounts reimbursed to employees for the rental of their own saws and other equipment will not qualify as received under an accountable plan unless three requirements are met. First, under section 1.62-2(d) of the Income Tax Regulations, the expenses for which the employer is making payment must be expenses that would qualify for a business expense deduction under IRC section 162. Second, the substantiation requirements of section 1.62-2(e) must be met. Third, under section 1.62-(f), the employee must be required to return, within a reasonable period of time, any amounts received in excess of those that have been substantiated.

If an arrangement meets all three of these requirements, section 1.62-2(c)(2) provides that all amounts paid under the arrangement are treated as paid under an accountable plan. Under section 1.62-2(c)(4), the amounts treated as paid under an accountable plan are excluded from the employee's gross income, are not required to be reported on the employee's Form W-2, and are exempt from the withholding and payment of employment taxes. Section 1.62-2(c)(3) provides that if an arrangement does not satisfy one or more of the three requirements, all amounts paid under the arrangement are treated as paid under a nonaccountable plan.

Saw rental payments do not satisfy the accountable plan requirements for two reasons. First, the employer is making a payment for expenses that may not be incurred. This violates the requirement that the expenses for which the employer is making payment must be deductible under IRC section 162. Second, there is no substantiation required. Accordingly, the saw rental payments are paid under a nonaccountable plan.

Example 4

Lyle's Logging hires employees to fell 10 tracts of timber during the month of June. The employees provide their own saws and miscellaneous equipment. Lyle pays his employees $10 for each tree felled; generally, 50 trees per day are felled. Lyle apportions the payments to his employees 75 percent as wages and 25 percent as saw rents. Lyle has no idea if the saw rents reasonably correspond with the anticipated expenses of saw rents. None of the employees are required to substantiate any business expenses. Lyle frequently pays cash allowances and relies on the expectation that the allowance will be used for bona fide business expenses. Lyle reported only the 75 percent wages paid on the employees' Forms W-2 at the end of the year. No consideration was given to the 25 percent saw rents.

During the audit of this company, you determine that the employees were reimbursed for employee business expenses under a nonaccountable arrangement. Therefore, the total paid to the employees, wages and saw rents, is includible in income and reportable as wages subject to employment taxes. Your Revenue Agent's Report reflects the employment taxes due.

In addition, you request RTVUEs of the employees' returns to determine if the total paid by the employer to the employee was correctly reported. The employees are entitled to claim any unreimbursed employee business expenses only if they itemize subject to the 2 percent AGI floor.

SKIDDER RENTALS

A skidder is a four-wheeled machine which is used to move felled trees. A skidder is not driven on the road. New skidders cost approximately $100,000; used skidders, $25,000. Skidder operators often own their own skidders and pay for the costs of operating and maintaining the skidders.

It is common in the timber industry to find skidder operators who provide their own skidders to perform services as employees. The employer generally pays the skidder operator a predetermined amount based on the number of logs hauled. Often, there is no written agreement between the employer and the skidder operator; the agreement is usually verbal. It is customary to find employers paying 60 percent of the amount paid to the skidder operators as "skidder rent." The balance or 40 percent of the amount paid represents wages. Of course, the employer does not subject the 60 percent skidder rent to any employment taxes. The employer may or may not report the skidder rental to the operator on a Form 1099-MISC.

Unlike the saw rent discussed earlier, skidder rental payments may not be a reimbursement for employee business expenses governed by IRC section 62. The rental paid to a skidder operator will be considered self-employment income to the skidder operator who is engaged in the trade or business of renting the skidder. Whether a skidder operator is engaged in a trade or business is a factual question and requires an examination of the facts in each case to determine whether the operator was engaged in the activity with continuity and regularity and with a primary motive for income or profit. If the operator is engaged in a trade or business, the operator does not have to report the skidder-rental as wages. The skidder operator must report the skidder-rental as self-employment income and subject to self-employment tax.

Whether the payment made to the skidder operator actually is the payment of rent is also an issue to consider with skidder rental payments. An analysis of the arrangement may reveal that the payments look more like a reimbursement for employee business expenses. In that case, the IRC section 62(c) analysis is appropriate.

Example 5

Lyle's Logging hires a skidder operator to skid the felled trees from the 10 tracts of timber as in the previous example. The skidder operator is to be paid $20,000. Of the $20,000, Lyle designates 60 percent or $12,000 as skidder rental, which he does not subject to any employment taxes or withholdings. Lyle's designates 40 percent or $8,000 as wages. Lyle gives the skidder operator a Form W-2 for $8,000 at the end of the year. As Lyle assumed the skidder operator was incorporated, he did not issue him a Form 1099.

During the audit, you verify that the skidder operator, who is not incorporated, correctly reported on Line 7 of Form 1040, the wages paid to him of $8,000. You also learn that the skidder operator reported the skidder rental of $12,000 on Schedule E. You inform the skidder operator that the skidder rental is not rental income to be reported on Schedule E. Instead, the skidder rental is self-employment income subject to self-employment tax as the skidder operator was in the trade or business of renting the skidder. As a result, the skidder rental should have been reported on Schedule C, as the operator is not incorporated.

Your Revenue Agent's Report reveals self-employment tax due attributable to the misclassification of skidder rental as rental income rather than self-employment income. In addition, you advise Lyle's Logging that a Form 1099-MISC should have been issued to the skidder operator as the operator was not incorporated and his services exceeded $600 for the year.

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Chapter 6

EXCISE TAXES

OVERVIEW

For timber industry tax returns, the most common area of excise taxes applies to certain highway motor vehicles. A highway motor vehicle includes any self-propelled vehicle designed to carry a load over public highways, whether or not also designed to perform other functions. Treas. Reg. section 48.4061(a)-1(d)(1).

A vehicle consists of a chassis, or a chassis and body, but does not include the load. It does not matter if the vehicle is designed to perform a highway transportation function for only a particular type of load, such as passengers, furnishings, personal effects, cargo, goods, supplies, or material. It does not matter if machinery or equipment is specially designed and permanently mounted to perform some off-highway task unrelated to highway transportation. Examples of vehicles that are designed to carry a load over public highways include: buses, highway-type trucks, and truck tractors.

The following vehicles are generally not considered highway vehicles:

- Specially designed mobile machinery for non-transportation functions. (Treas. Reg. section 48.4061(a)-1(d)(2)(i).)

- Vehicles designed for off-highway transportation. (Treas. Reg. section 48.4061(a)-1(d)(2)(ii).)

- Trailers and semi-trailers designed for non-transportation functions off the public highways. (Treas. Reg. section 48.4061(a)-1(d)(2)(iii).)

A trailer or semi-trailer is not a highway vehicle if it is designed only as an enclosed stationary shelter for conducting a function at the off-highway site of construction, manufacturing, mining, processing, framing, drilling, timbering, or similar operations.

Only certain trucks and truck tractors are subject to excise tax. Treas. Reg. section 48.4061(a)-1(b).

a. TRUCK -- A truck is a motorized vehicle that usually carries cargo or special equipment on the same chassis as the motor.

b. TRUCK TRACTOR -- A truck tractor usually does not carry cargo on the same chassis with the motor. It is used mainly to pull a trailer or semi-trailer.

A truck would NOT include a skidder, which is a four-wheeled machine used to skid felled trees. In addition, a truck would not include a bulldozer. These vehicles do not on travel public highways.

The taxpayer is subject to the highway use tax if his truck or truck tractor meets ALL of the following tests: (Treas. Reg. section 41.4481-1(a)(1)).

a. It is a highway motor vehicle, as discussed earlier.

b. It is required to be registered for highway use. The vehicle must either be registered or required to be registered under the law of any state, District of Columbia, Canada, or Mexico in which the vehicle is used or located.

c. It is used on a public highway. The vehicle must be used on a public highway in the United States and be powered by its own motor. (Treas. Reg. section 48.4061(a)-1(d)(1).)

d. It has a taxable gross weight of at least 55,000 pounds. (Treas. Reg. section 41.4481-1(a)(1).)

The truck or truck tractor, together with any semi-trailer or trailer customarily used with it, must have a taxable gross weight of at least 55,000 pounds.

Generally, the taxable gross weight of the vehicle is the total of the unloaded weight of the vehicle and the weight of the maximum load usually carried on the vehicle. (Treas. Reg. section 41.4482(b)-1(a).)

If any highway motor vehicle with a taxable gross weight of at least 55,000 pounds is registered, or required to be registered, the taxpayer must keep sufficient records for the IRS to decide whether he or she is liable for tax and, if so, the tax due. The taxpayer should keep the records for at least 3 years after the date the tax is due or paid, whichever is later. The following is a list of recommended records which the taxpayer should keep:

a. A description of the vehicle, for example, serial number or other manufacturer's number.

b. The weight of loads carried by the vehicle in the same form as required by any state in which the vehicle is registered or required to be registered.

c. The date of acquisition and the name and address from whom the vehicle was acquired.

d. The first month of each tax period in which a taxable use occurred and any prior month in which the vehicle was used in such tax period while registered, with proof that the prior use was not a taxable use.

e. The date of sale or other transfer of the vehicle and the name and address of the person to whom the vehicle was transferred. If it was not sold or transferred, the records must show how and when it was disposed of.

COMPUTATION - EXCISE TAX

The tax on highway motor vehicles is a graduated tax that is based on the taxable gross weight of the vehicle. The tax rates for a full year are: (Treas. Reg. section 41.4481-1(b)(2) and (c)(2)).

Taxable Gross Weight	Rate of Tax
At least 55,000 pounds but not over 75,000 pounds	$100 a year plus $22 for each 1000 pounds (or fraction thereof in excess of 55,000 pounds)
Over 75,000 pounds	$550

The highway use tax is reduced by 25 percent for any highway motor vehicle if:

a. During the tax period, the vehicle is used exclusively to transport products harvested from a forest.

b. Products are transported to and from a point within the forest.

c. It is registered as a highway motor vehicle used in the transportation of harvested forest products under the laws of the state in which the vehicle is, or is required to be registered.

Reference: Treas. Reg. section 41.4483-6 and IRC section 4483(e).

FILING FORM 2290

Every person in whose name a highway motor vehicle is registered at the time of its first taxable use in any tax period must file Form 2290, Heavy Vehicle Use Tax Return, and pay the tax.

Form 2290 must be filed by the last day of the month after the month the vehicle is first used on the public highways, even if the taxpayer is filing the return just to suspend the tax for his vehicles. The tax period runs from July 1 of the current year through June 30 of the next year. If any due date falls on a Saturday, Sunday, or legal holiday, the due date is extended to the next succeeding day that is not a Saturday, Sunday, or legal holiday.

For all vehicles owned and used in July, the due date is August 31. If the vehicle is first used in November, a tax return for it is due by December 31. File a single return for all vehicles first used in the same month.

File a separate Form 2290 for each month in which a taxable vehicle is first used during the tax period. If additional taxable vehicles are placed in use during a month in the tax period after filing Form 2290 for the other vehicle(s), file an additional Form 2290 for this vehicle. An additional vehicle may be one that was bought new or used, or one that was previously owned but just placed in service.

Example 1

Mitchell's Logging has three trucks which it owns and has registered in the corporation's name. The state required that a specific gross weight be declared for each truck. The trucks are registered in only one state. The declared gross taxable weights in pounds were:

Truck A, Vehicle ID #1234567890 --- 90,000 pounds
Truck B, Vehicle ID #0987654321 --- 54,900 pounds
Truck C, Vehicle ID #1223344556 --- 60,000 pounds

All three trucks were used in July.

Mitchell's Logging reasonably estimates that Truck A will be driven less than 5,000 miles on public highways during the current tax period. During the last period, the tax on Truck A was suspended. The actual mileage drive on public highways was 4,555 miles in the last tax period. Mitchell's Logging fills in the Statement in Support of Suspension of Tax. On line 1, Mitchell's Logging lists the vehicle identification number of Truck A. Since the truck was listed that year as suspended, Mitchell's Logging also checks the box on line 2.

Truck B has a taxable gross weight of less than 55,000 pounds. Therefore, it is not subject to tax.

The tax on Truck C is $157.50.

Mitchell's Logging files the return August 30 and elects the installment privilege. With the Form 2290, Mitchell's Logging sends a check for $39.27. In November, Truck C was sold to another person. However, Mitchell's Logging will continue to make installment payments, since they are still responsible for the entire tax due.

FUEL TAX CREDITS AND REFUNDS

A taxpayer may be eligible to claim a credit or refund of excise tax included in the price of fuel purchased if the fuel was used in an off-highway business use. (IRC sections 4041(b) and 6421(a)). The business use may not be for a highway vehicle registered for use on any public highway.

Generally, the following vehicles are not considered to be highway vehicles: (Treas. Reg. section 48.4061(a)-1(d)(2)(i), (ii), and (iii)).

a. Specially designed mobile machinery for non-transportation functions.

b. Vehicles designed for off-highway transportation.

c. Trailers and semi-trailers designed for non-transportation functions off the public highways.

Once again, skidders, bulldozers, road graders, and trench diggers would be categorized as off-highway business use vehicles.

To claim a credit or refund of excise taxes, the taxpayer must have a taxpayer identification number. The taxpayer may use his or her Social Security Number (SSN) or his or her Employer Identification Number (EIN). To apply for an SSN, the taxpayer must complete Form SS-5; to apply for an EIN, the taxpayer must complete Form SS-4.

The Internal Revenue Service requires that the following records be maintained by the taxpayer to enable the IRS to verify the amount claimed per Treas. Reg. section 48.6421-1(f):

a. Number of gallons purchased and used during the period of claim

b. Dates of purchase

c. Names and addresses of suppliers with amounts of fuel purchased from each during the period of claim

d. Purpose of purchasing the fuel
e. Number of gallons purchased for each purpose.

CLAIMING THE CREDIT

A taxpayer claims the credit on Form 4136 and attaches it to his or her income tax return in the year the fuels were used. Generally, a taxpayer must amend his or her return by the later of 3 years from the date he or she filed the original return or within 2 years from the date he or she paid the tax. Treas. Reg. section 48.6421-3(d)(1).

How to claim the credit:

Individuals -- Line 59 of Form 1040 for 1993.

Partnerships -- Attach statement to Form 1065 detailing the number of gallons allocated to each partner and the applicable tax rate. Then, the credit is claimed on the partners' individual income tax returns.

Corporations -- Line 32g of Form 1120
Line 28g of Form 1120-A.

S-Corporations -- Line 23c of Form 1120S.

CLAIMING THE REFUND

A taxpayer may also claim a refund rather than claim a credit when he or she files his or her income tax return. Beginning in 1994, a taxpayer files a claim for refund using Form 8849. Form 8849 replaces Form 843, which was used for tax years prior to 1994.

SIGNIFICANT AUDIT ISSUES

During the survey of the Timber and Logging Industry by both the Atlanta and Parkersburg Districts, significant audit issues have been determined to be as follows:

a. Highway Use Tax -- Taxpayers frequently fail to report the total number of trucks on Form 2290.

b. Highway Use Tax -- For vehicles with dual use, part taxable and part nontaxable, auditors have frequently found false certification.

c. Retail Truck -- Excise Tax of 12 percent is due on the first retail sale of manufactured logging trucks.

Chapter 7

OTHER CONSIDERATIONS

REFORESTATION TAX INCENTIVES

Up to $10,000 of the costs which must be capitalized to the deferred reforestation account may be recovered as an adjustment to gross income over an 84-month period, and may qualify for the 10-percent investment tax credit. The costs included are those for tree planting or seeding, and the other activities required to reestablish timber stands after a harvest (reforestation), or to establish timber stands on land previously devoted to nontimber uses (afforestation). This favorable treatment is provided by IRC sections 194 and 48(b). The following example demonstrates the procedure used.

Example 1

Mr. Martin owns a 35-acre tract of timberland which he manages for the commercial production of timber as an investment. The timber was cut a few years ago. However, a new crop of trees has not developed because of the competing vegetation that grew after the timber harvest. Therefore, Mr. Martin contracted a forester to prepare the site and to plant seedlings in year number 1. The cost was $150 per acre, making the total expenditure $5,250.

Mr. Martin determined that the facts in his particular case qualified his reforestation expenditure for the investment tax credit and amortization. He calculated the tax credit by multiplying the total cost ($5,250) by 10 percent (.10). This amount ($525) would be allowed as a reduction in tax in year number 1. Mr. Martin's recoverable basis must be reduced by half of this tax credit, or by $626.50, (IRC section 50(c)(3)(A)). He computes the amortization deduction as follows:

Reforestation Costs	$5,250.00	
less:		
½ of credit	($ 262.50)	($525/2)
Amortization Amount	$4,987.50	

Using 84 months and the half-year convention, Mr. Martin's amortization schedule is shown below:

Year	Applicable Percentage	Deduction
#1	.071	$ 354.12
#2	.143	$ 713.21
#3	.143	$ 713.21
#4	.143	$ 713.21
#5	.143	$ 713.21
#6	.143	$ 713.21
#7	.143	$ 713.21
#8	.071	$ 354.12
Totals	1.000	$ 4,987.50

OTHER FORESTRY INCENTIVES

The Forestry Incentives Program (FIP), Agricultural Conservation Program (ACP), and Stewardship Incentive Program (SIP) are programs established by the Federal Government to share the cost of tree planting and timber stand improvement with private landowners. The Federal share of these costs depends upon the cost-share rate set in a particular state and county. The maximum cost-share payment that a taxpayer can earn annually is normally $10,000. Landowners who receive these cost-share payments may be able to exclude them from gross income for Federal Income Tax purposes per IRC section 126(a).

USE OF SPECIALTY GROUPS

Examiners need to recognize the need for specialized services of the IRS as early as possible so as to allow the specialized agent as much time as possible to avoid holding up the closure of the case. Some of the most common specialized services needed in the hardwood timber industry are discussed below.

Engineering

Form 5202, Request for Engineering Services, should be used to request services when any complex or significant issue is noted on the return. Engineering services can be very useful in timber valuation cases.

Computer Audit Specialist (CAS)

If a large volume of records exist and a statistical sample is deemed useful, the agent should contact his or her CAS after consultation with his or her group manager. For example, the Virginia-West Virginia District used a CAS to select a "stat sample" in relationship to a third party data base.

International Examiner

If the examiner can ascertain that the taxpayer under audit is engaged in a business outside the United States through related affiliates, a request for International assistance should be made on Form 2962 per IRM 42(10)4. Increasing amounts of hardwood logs are being exported outside the United States.

Employment Tax Specialists

If unusual problems occur in the employment tax area, a referral should be made through the agent's group manager.

PENALTIES

During and at the conclusion of every examination, it is your responsibility to consider the application of penalties to be assessed if the circumstances so dictate. The following penalties should be considered and planned for during the examination:

Fraud Penalty	IRC section 6663
Accuracy Penalty	IRC section 6662
Information Return Penalties	IRC sections 6721-6723
Failure to File/Pay Penalty	IRC section 6651
Preparer Penalties	IRC sections 6694-6696

COORDINATED ISSUES

Coordinated issues should be considered as part of every examination. Below is a listing of coordinated issues for all industries in general and the Forest Products Industry in particular.

All Industries

1. Amortization of assembled workforce
2. Covenants not to compete
3. Customer based intangibles
4. Employment contracts
5. Amortization of market based intangibles
6. Amortization of order backlog (inventory)
7. Meal Allowances.

Forest Products Industry

1. Depreciation on Logging Roads

   Only logging roads with a determinable useful life are fully depreciable. See Rev. Rul. 88-99, 1988-2 C.B. 33. For roads with an indefinite useful life, the cost of clearing, grubbing, rough cut, and fill is a part of the cost base of the land and is nondepreciable.

2. Timber Losses Following Tree Mortality Brought On By Insects

   The loss of timber following an epidemic attack of southern pine beetles does not qualify as a casualty loss. See Rev. Rul. 87-59, 1987-2 C.B. 59. However, an IRC section 165(a) non-casualty loss may be allowable. Also, IRC section 1033 treatment is allowable on gains from salvage of the affected timber but not the healthy trees cut to isolate the beetle infestation.

3. Computation of Timber Casualty Losses

   When timber is damaged or destroyed in a qualifying casualty loss, the "single identifiable property" damaged or destroyed, for purposes of computing the basis limitation under Treas. Reg. section 1.165-7(b)(2)(1), is the marketable units of affected timber and not the entire block.

4. Paper Machine Structure - Depreciation and ITC

   The typical structure containing a paper machine is a building rather than "other tangible property." Thus it does not qualify for the investment tax credit and its applicable recovery period is the period prescribed for nonresidential real property. Certain costs relating to the craneway support columns and foundations, however, do qualify as other tangible property and thus can qualify for the investment tax credit and shorter recovery periods. Rev. Rul. 79-181, 1979-1 C.B. 41; Rev. Rul. 79-182, 1979-1 C.B. 42; Rev. Rul 79-183; 1979-1 C.B. 44.

Chapter 8

SELECTED TIMBER RULINGS AND COURT CASES

ACCESS ROADS

***D.C. Regan*, CA-9, 69-1 U.S.T.C. P9369, 410 F.2d 744, *Cert. denied*, 396 U.S. 834, 90 S.Ct 91, *J.T. Casey*, (Ct.Cls.) 72-1 U.S.T.C. P9419, 459 F.2d 495** -- The taxpayer was a member of a joint venture that acquired timber cutting rights. Subsequent to building access roads to the timber, the cutting rights were transferred to the joint venturer's wholly-owned operating corporation in return for the corporation's payment of specified royalties. The taxpayer was not entitled to deduct as business expenses its proportionate share of the amortized cost of constructing access logging roads. The construction of access logging roads is capital in nature, constituting part of the adjusted depletion basis (cost of the timber), thus reducing the capital gain resulting from the disposition of the timber.

ADVANCE ROYALTIES

Rev. Rul. 77-400, 1977-2 C. B. 206 -- Advance royalties paid or accrued by a lessee under a timber-cutting contract are treated as part of the cost of timber under Treas. Reg. section 1.631-2(e)(1) and constitute part of the lessee's depletable basis in the timber. The advanced royalties are not deductible under Treas. Reg. section 1.612-3(b)(3) as that provision applies to payments in connection with mineral property.

CAPITAL ASSETS

***Blodgett*, 13 BTA 1388, Dec. 4539 (*Acq*., VIII-1 C.B. 3)** -- Dead and down timber owned by a taxpayer who was not in the timber or logging business was a capital asset.

See **IRC section 631** for information concerning the election to treat the cutting of timber as a sale or exchange. If an election is made to treat the cutting of timber as a sale or exchange using IRC section 631, the timber is treated as used in the trade or business under IRC section 1231 to determine if capital gains treatment is available.

CAPITAL GAIN VERSUS ORDINARY INCOME

***C. J. Snider*, 34 Tax Ct. Mem. 530, Dec. 33.156(M), Tax Ct. Mem. 1975-111** -- Sales of timber contracts not in the ordinary course of the taxpayers' trade or business resulted in taxable capital gains.

***Patterson v. Belcher*, (CA-5) 62-1 U.S.T.C. P9426, 302 F.2d 289, *rev'g. in part* (DC) 60-2 U.S.T.C. P9733, *Rehearing denied (per Curiam)*, (CA-5) 62-2 U.S.T.C. P9585, 305 F.2d 557, *Cert. denied*, 371 U.S. 921 (1962), *W A. Belcher, Jr.*, 24 Tax Ct. Mem. 1, Dec. 27,199(M), Tax Ct. Mem. 1965-1** -- For a partnership whose principal business activity was the sale of real estate and timber, gain from timber sales is ordinary income.

***W. J. Wineberg*, (CA-9) 64-1 U.S.T.C. P9156, 326 F.2d 157, *Aff'g* 20 Tax Ct. Mem. 1775, Tax Ct. Mem. 1961-336, *Rutland v. Tomlinson*, (CA-5) 64-1 U.S.T.C. P9267, 326 F.2d 189, *Aff'g per Curiam* 63-1 U.S.T.C. P9173 (M.D. Fla 1962)** -- A taxpayer sold timber in which he retained no economic interest. He was in the business of selling timber. As a result, the sale of timber resulted in ordinary income.

***W. Ouderkirk*, 36 Tax Ct. Mem. 526, Dec. 34,376(M), Tax Ct. Mem. 1977-120** -- Timberland was not real property used in a trade or business but was held for investment and, as such, was a capital asset.

Rev. Rul. 62-81, 1962-1 C.B. 153 -- Taxpayer contracted with a paper company for a period of 60 years allowing the paper company to grow timber and to cut timber on the taxpayer's land. The paper company agreed to pay the taxpayer each year, regardless of the quantities of timber cut. When the contract originated, there was a stand of timber on the tract with a known FMV. Payments equal to the FMV of the timber at the origination of the contract represent proceeds of sale of timber and any gain is capital gain provided IRC sections 1221 or 1231 are met. Any excess payments over FMV is ordinary income.

Rev. Rul. 78-267, 1978-2 C.B. 171 -- The application of IRC section 483, unstated interest provision, to long-term timber contracts is described in situations where the taxpayer is:

a. A landowner who receives the total contract price in full on the date the contract is signed;

b. A landowner who is to receive payments over a 60-year period under a contract for the sale of timber and the lease of the land on which the timber is growing; and

c. A paper company which makes payments similar to those in situation b.

***P.E. Godbold, Jr.*, 82 T.C. 73, Dec. 40,918** -- A timber cutting company contracted for a period of 62 years to pay a taxpayer for cutting a minimum of 640 cords of wood per year. The timber cutting company, per contract, had to pay the taxpayer even if the cutting company did not sever any trees. As the taxpayer did not retain an economic interest that was contingent on the severance of the timber, payments received by the taxpayer in excess of the value of the timber in existence at the execution of the contract were taxable as ordinary income.

***G. Jantzer*, (CA-9) 60-2 U.S.T.C. P9802, 284 F.2d 348, *aff'g* 32 T.C. 161 (1959)** -- An oral agreement between a partnership that held timber cutting rights and a corporation whereby the corporation was given the rights to cut timber and to buy the cut timber at a stated price was not a disposal with a retained economic interest. The oral agreement was in the nature of a continuing offer to sell rather than a disposal conveying a right and obligation to cut. Profit therefrom resulted in ordinary income.

J.R., Simplot Co.*, 26 Tax Ct. Mem. 488, Dec. 28,458(m), Tax Ct. Mem. 1967-104** -- A sawmill business holding timber cutting contracts realized losses upon the transfer of timber cutting contracts. These losses are ordinary losses per the doctrine of ***Corn Products Refining Co., 55-2 U.S.T.C. P9746. This doctrine states that an asset may result in ordinary income or loss when the asset is an integral part of the taxpayer's business.

***M. Schnitzer*, (DC) 69-1 U.S.T.C. P9160** -- Taxpayers who acquired title to timber under a timber production agreement but did not have the right to cut timber on their own account or for use in their own trade or business were not owners of the timber for purposes of IRC section 631(b). Profits in respect of the timber was not entitled to capital gains treatment.

Rev. Rul. 56-434, 1956-2, C.B. 334 -- An independent pulpwood contractor was licensed to cut pulpwood at specific rates per cord from the tree tops and limbs remaining from a timber harvest. The contractor was also licensed to cut designated standing trees to convert into pulpwood. The benefits of IRC section 631(b) did not apply to the cutting of pulpwood from the tops and limbs lying on the ground as there was no disposal of standing timber.

CONTRACT CUTTING

Rev. Rul. 77-247, 1977-2 C.B. 211 -- A subsidiary that had a contract with its parent providing that future timber cutting rights acquired by the subsidiary be immediately transferred to the parent was not the owner of an interest in timber with regard to cutting rights obtained after the date of the contract.

DATE OF FELLING

Rev. Rul. 58-135, 1958-1, C.B. 519 -- The general practice in the timber industry is to determine the quantity of timber cut for depletion computations when the timber is first actually measured. This may occur at the log landing or mill, at which time the quantity of logs may be inventoried. For the election to treat the cutting of timber as a sale or exchange of the timber cut, the timber is considered to be cut, when in the ordinary course of business, the quantity of felled timber is first definitely determined, rather than at the time of felling. Taxpayers may not shift the scaling point to obtain a tax advantage and must apply a consistent scaling practice.

Rev. Rul. 73-267, 1973-1 C.B. 306, distinguished by Rev. Rul. 73-489 -- The taxpayer was considered to have first definitely determined the quantity of timber cut, for purposes of the election to treat the cutting of timber as a sale or exchange, when truck scale was made using the bureau scaler at the time the logs arrived at the sawmill even though a mill deck scale was made later by a scaler from the U.S. Forest Service.

Rev. Rul. 73-489, 1973-2 C.B. 208 -- The volume of timber cut by the taxpayer was first definitely determined when the U.S. Forest Service scaled at the mill deck the logs cut from the timber. Under the IRC section 631(a) election to treat the cutting of timber as a sale or exchange of the timber cut, the timber was considered cut when the logs from the timber were scaled on the mill deck.

INSECTS

Rev. Rul. 87-59, 1987-2 C.B. 59 -- Loss of timber in trees killed by an unexpected and unusual attack of southern pine beetles was not a casualty loss because the entire process of attack by beetles, death of trees, and eventual physical destruction of wood in the trees was not sudden. However, because the loss of timber was unexpected and unusual, it was allowable as a noncasualty loss in the year the timber became worthless. The timber was real property used in the taxpayer's trade or business, and the loss was netted with other IRC section 1231 gains and losses.

***Weyerhaeuser v. United States*, 94-2 U.S.T.C. P50,471** -- Alleged loss of timber due to insects was denied where taxpayer failed to substantiate the claimed loss.

IRC SECTION 631(a)

Section 311(d)(2) of the Tax Reform Act of 1986 -- Any IRC 631(a) election made for a tax year beginning before January 1, 1987, may be revoked on a one-time basis by the taxpayer without the permission of the Secretary of the Treasury for any tax year ending after December 31, 1986. Such a revocation is to be disregarded in determining whether the taxpayer may make a subsequent election. Revocation of a subsequent election requires permission from the Secretary.

EXTRACT

GAIN OR LOSS IN THE CASE OF TIMBER, COAL, OR DOMESTIC IRON ORE.

(a) ELECTION TO CONSIDER CUTTING AS SALE OR EXCHANGE -- If the taxpayer so elects on his return for a taxable year, the cutting of timber (for sale or for use in the taxpayer's trade or business) during such year by the taxpayer who owns, or has a contract right to cut, such timber (providing he has owned such timber or has held such contract right for a period of more than 1 year) shall be considered as a sale or exchange of such timber cut during such year. If such election has been made, gain or loss to the taxpayer shall be recognized in an amount equal to the difference between the fair market value of such timber, and the adjusted basis for depletion of such timber in the hands of the taxpayer. Such fair market value shall be the fair market value as of the first day of the taxable year in which such timber is cut, and shall thereafter be considered as the cost of such cut timber to the taxpayer for all purposes for which such cost is a necessary factor. If a taxpayer makes an election under this subsection, such election shall apply with respect to all timber which is owned by the taxpayer or which the taxpayer has a contract right to cut and shall be binding on the taxpayer for the taxable year for which the election is made and for all subsequent years, unless the Secretary, on showing of undue hardship, permits the taxpayer to revoke his election; such revocation, however, shall preclude any further elections under this subsection except with the consent of the Secretary. For purposes of this subsection and subsection (b), the term "timber" includes evergreen trees which are more than 6 years old at the time severed from the roots and are sold for ornamental purposes.

Rev. Rul. 74-271, 1974-1 C.B. 151 -- The taxpayer acquired the unrestricted right to cut and to use timber in its lumber manufacturing business. The terms of the contract were not relevant in determining the fair market value of timber cut for purposes of IRC section 631(a).

***J.A. Carpenter*, 36 T.C. 797, Dec. 24,960 (*Acq.*, 1962-1 C.B. 3)** -- Logger received the option to purchase a tract of timber and the right to cut it. However, this timber tract was subject to the consent of one party involved in litigation over this tract. The logger maintained the requisite "contract right to cut" the timber per IRC section 631(a).

STEWARDSHIP INCENTIVE PROGRAM

Rev. Rul. 94-27, 1994-1, C.B. 26 -- The Stewardship Incentive Program is substantially similar to the type of program described in IRC section 126(a)(1) through (8). IRC section 126 improvements made in connection with small watersheds under the SIP are within the scope of IRC section 126(a)(9). A small watershed is a watershed or subwatershed that does not exceed 250,000 acres and does not include any single structure providing more than 12,500 acre-feet of floodwater detention capacity, nor more than 25,000 acre-feet of total capacity.

Extract

Treas. Reg. section 1.631-2

Gain or loss upon the disposal of timber under cutting contract.--(a) *In general*. (1) If an owner disposes of timber held for more than 1 year (* * *) before such disposal, under any form or type of contract whereby he retains an economic interest in such timber, the disposal shall be considered to be a sale of such timber. The difference between the amounts realized from disposal of such timber in any taxable year and the adjusted basis for depletion thereof shall be considered to be a gain or loss upon the sale of such timber for such year. Such adjusted basis shall be computed in the same manner as provided in section 611 and the regulations thereunder with respect to the allowance for depletion. See paragraph (e)(2) of this section for the definition of "owner." For the purpose of determining whether or not the timber disposed of was held for more than 1 year (* * *) before such disposal the rules with respect to the holding period of property contained in section 1223 shall be applicable.

(2) In the case of such a disposal, the provisions of section 1231 apply and such timber shall be considered to be 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), regardless of whether such timber is property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Whether gain or loss resulting from the disposition of the timber which is considered to have been sold will be deemed to be gain or loss resulting from a sale of a capital asset held for more than 1 year (* * *) will depend upon the application of section 1231 to the taxpayer for the taxable year.

(b) *Determination of date of disposal*. (1) For purposes of section 631(b) and this section, the date of disposal of timber shall be deemed to be the date such timber is cut. However, if payment is made to the owner under the contract for timber before such timber is cut, the owner may elect to treat the date of payment as the date of disposal of such timber. Such election shall be effective only for purposes of determining the holding period of such timber. Neither section 631(b) nor the election thereunder has any effect on the time of reporting gain or loss. See subchapter E, chapter 1 of the Code and the regulations thereunder. See paragraph (c)(2) of this section for the effect of exercising the election with respect to the payment for timber held for 1 year (* * *) or less. See paragraph (d) of this section for the treatment of payments received in advance of cutting.

(2) For purposes of section 631(b) and this section, the "date such timber is cut" means the date when in the ordinary course of business the quantity of timber felled is first definitely determined.

(c) *Manner and effect of election to treat date of payment as the date of disposal*. (1) The election to treat the date of payment as the date of disposal of timber shall be evidenced by a statement attached to the taxpayer's income tax return filed on or before the due date (including extensions thereof) for the taxable year in which the payment is received. The statement shall specify the advance payments which are subject to the election and shall identify the contract under which the payments are made. However, in no case shall the time for making the election under section 631(b) expire before the close of March 21, 1958.

(2) Where the election to treat the date of payment as the date of disposal is made with

respect to a payment made in advance of cutting, and such payment is made 1 year (* * *) or less from the date the timber disposed of was acquired, section 631(b) shall not apply to such payment, irrespective of the date such timber is cut, since the timber was not held for more than 1 year (* * *) prior to disposal.

(d) *Payments received in advance of cutting*. (1) Where the conditions of paragraph (a) of this section 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. Such amounts will be so treated irrespective of whether or not an election has been made under paragraph (c) of this section to treat the date of payment as the date of disposal. For example, if no election has been made under paragraph (c) of this section, amounts received or accrued prior to cutting will be treated as realized from the sale of timber, provided the timber paid for is cut more than 1 year (* * *) after the date of acquisition of such timber.

(2) However, if the right to cut timber under the contract expires, terminates, or is abandoned before the timber which has been paid for is cut, the taxpayer shall treat payments attributable to the uncut timber as ordinary income and not as received from the sale of timber under section 631(b). Accordingly, the taxpayer shall recompute his tax liability for the taxable year in which such payments were received or accrued. The recomputation shall be made in the form of an amended return where necessary.

(3)(i) Bonuses received or accrued by an owner in connection with the grant of a contract of disposal shall be treated under section 631(b) as amounts realized from the sale of timber to the extent attributable to timber held for more than 1 year (* * *).

(ii) The adjusted depletion basis attributable to the bonus shall be determined under the provision of section 612 and the regulations thereunder. This subdivision may be illustrated as follows:

Example. Taxpayer A has held timber having a depletion basis of $90,000 for two months when he enters into a contract of disposal with B. B pays A a bonus of $5,000 upon the execution of the contract and agrees to pay X dollars per unit of timber to A as the timber is cut. A does not exercise the election to treat the date of payment as the date of disposal. It is estimated that there are 50,000 units of timber subject to the contract and that the total estimated royalties to be paid to A will be $95,000. A must report the bonus in the taxable year it is received or accrued by him. The portion of the basis of the timber attributable to the bonus is determined by the following formula:

$$\frac{\text{Bonus}}{\text{Bonus + amount of expected royalties}} \text{ X Basis of timber} = \text{Basis attributable to bonus}$$

$$\frac{\$5{,}000}{\$100{,}000} \text{ x } \$90{,}000 = \$4{,}500$$

(iii) To the extent attributable to timber not held for more than 1 year (* * *), such bonuses shall be treated as ordinary income subject to depletion. In order to determine the amount of the bonus allocable to timber not held for 1 year (* * *), the bonus shall be apportioned ratably over the estimated number of units of timber covered by the contract of disposal. This subdivision may be illustrated as follows:

Example. Assume under the facts stated in the example in subdivision (ii) of this subparagraph that B cuts 10,000 units of timber that have been held by A for 1 year (* * *) or less. The amount of the bonus (as well as the royalties) attributable to these units must be reported as ordinary income subject to depletion. The amount of the bonus attributable to these units is determined by the following formula:

$$\frac{\text{Number of units cut held for 1 year (* * *) or less}}{\text{Total units covered by contract}} \times \text{Amount of bonus} = \text{Amount of bonus treated as ordinary income subject to depletion}$$

$$\frac{\$10{,}000}{\$50{,}000} \times \$5{,}000 = \$1{,}000$$

The amount of the depletion attributable to the portion of the bonus received for timber held for one year (* * *) or less is determined by the following formula:

$$\frac{\text{Amount of bonus attributable to timber held for one year (* * *) or less}}{\text{Total bonus}} \times \text{Adjusted basis for depletion of bonus} = \text{Depletion allowance on timber held for 1 year ((* * *)) or less}$$

$$\frac{\$1{,}000}{\$5{,}000} \times \$4{,}500 = \$900$$

(iv) If the right to cut timber under the contract of disposal expires, terminates, or is abandoned before any timber is cut, the taxpayer shall treat the bonus received under such contract as ordinary income, not subject to depletion. Accordingly, the taxpayer shall recompute his tax liability for the taxable year in which such bonus was received. The recomputation shall be made in the form of an amended return where necessary.

(e) *Other rules for application of section.* (1) Amounts paid by the lessee for timber on the acquisition of timber cutting rights, whether designated as such or as a rental, royalty, or bonus, shall be treated as the cost of timber and constitute part of the lessee's depletable basis of the timber, irrespective of the treatment accorded such payment in the hands of the lessor.

(2) The provisions of section 631(b) apply only to an owner of timber. An owner of timber means any person who owns an interest in timber, including a sublessor and a holder of a contract to cut timber. Such owner of timber must have a right to cut timber for sale on his own account or for use in his trade or business in order to own an interest in timber within the meaning of section 631(b).

(3) For purposes of section 631(b) and this section, the term "timber" includes evergreen trees which are more than 6 years old at the time severed from their roots and are sold for ornamental purposes such as Christmas decorations. Tops and other parts of standing timber are not considered as evergreen trees within the meaning of section 631(b). The term "evergreen trees" is used in its commonly accepted sense and includes pine, spruce, fir, hemlock, cedar, and other coniferous trees.

Extract

Treas. Reg. section 1.611-3

Rules applicable to timber.--

* * * * * * *

(b) *Computation of allowance for depletion of timber for taxable year.* (1) The depletion of timber takes place at the time timber is cut, but the amount of depletion allowable with respect to timber that has been cut may be computed when the quantity of cut timber is first accurately measured in the process of exploitation. To the extent that depletion is allowable in a particular taxable year with respect to timber the products of which are not sold during such year, the depletion so allowable shall be included as an item of cost in the closing inventory of such products for such year.

(2) The depletion unit of timber for a given timber account in a given year shall be the quotient obtained by dividing (i) the basis provided by section 1012 and adjusted as provided by section 1016, of the timber on hand at the beginning of the year plus the cost of the number of units of timber acquired during the year plus proper additions to capital, by (ii) the total number of units of timber on hand in the given account at the beginning of the year plus the number of units acquired during the year plus (or minus) the number of units required to be added (or deducted) by way of correcting the estimate of the number of units remaining available in the account. The number of units of timber of a given timber account cut during any taxable year multiplied by the depletion unit of that timber account applicable to such year shall be the amount of depletion allowable for the taxable year. Those taxpayers who keep their accounts on a monthly basis may, at their option, keep their depletion accounts on such basis, in which case the amount allowable on account of depletion for a given month will be determined in the manner outlined herein for a given year. The total amount of the allowance for depletion in any taxable year shall be the sum of the amounts allowable for the several timber accounts. For a description of timber accounts, see paragraphs (c) and (d) of this section.

(3) When a taxpayer has elected to treat the cutting of timber as a sale or exchange of such timber under the provisions of section 631(a), the taxpayer shall reduce the timber account containing such timber by an amount equal to the adjusted basis of such timber. In computing any further gain or loss on such timber, see paragraph (e) of section 1.631-1.

(c) *Timber depletion accounts on books.* (1) Every taxpayer claiming or expecting to claim a deduction for depletion of timber property shall keep accurate ledger accounts in which shall be recorded the cost of other basis provided by section 1012 of the property and land together with subsequent allowable capital additions in each account and all other adjustments provided by section 1016 and the regulations thereunder.

(2) In such accounts there shall be set up separately the quantity of timber, the quantity

of land, and the quantity of other resources, if any, and a proper part of the total cost or value shall be allocated to each after proper provision for immature timber growth. See paragraph (d) of this section. The timber accounts shall be credited each year with the amount of the charges to the depletion accounts computed in accordance with paragraph (b) of this section or the amount of the charges to the depletion accounts shall be credited to depletion reserve accounts. When the sum of the credits for depletion equals the cost or other basis of the timber property, plus subsequent allowable capital additions, no further deduction for depletion will be allowed.

(d) *Aggregating timber and land for purposes of valuation and accounting.* (1) With a view to logical and reasonable valuation of timber, the taxpayer shall include his timber in one or more accounts. In general, each such account shall include all of the taxpayer's timber which is located in one "block." A block may be an operation unit which includes all the taxpayer's timber which would logically go to a single given point of manufacture. In those cases in which the point of manufacture is at a considerable distance, or in which the logs or other products will probably be sold in a log or other market, the block may be a logging unit which includes all of the taxpayer's timber which would logically be removed by a single logging development. Blocks may also be established by geographical or political boundaries or by logical management areas. Timber acquired under cutting contracts should be carried in separate accounts and shall not constitute part of any block. In exceptional cases, provided there are good and substantial reasons, and subject to approval or revision by the district director on audit, the taxpayer may divide the timber in a given block into two or more accounts. For example, timber owned on February 28, 1913, and that purchased subsequently may be kept in separate accounts, or timber owned on February 28, 1913, and the timber purchased since that date in several distinct transactions may be kept in several distinct accounts. Individual tree species or groups of tree species may be carried in distinct accounts, or special timber products may be carried in distinct accounts. Blocks may be divided into two or more accounts based on the character of the timber or its accessibility, or scattered tracts may be included in separate accounts. If such a division is made, a proper portion of the total value or cost, as the case may be, shall be allocated to each account.

(2) The timber accounts mentioned in sub-paragraph (1) of this paragraph shall not include any part of the value or cost, as the case may be, of the land. In a manner similar to that prescribed in subparagraph (1) of this paragraph, the land in a given "block" may be carried in a single land account or may be divided into two or more accounts on the basis of its character or accessibility. When such a division is made, a proper portion of the total value or cost, as the case may be, shall be allocated to each account.

(3) The total value or total cost, as the case may be, of land and timber shall be equitably allocated to the timber and land accounts, respectively. In cases in which immature timber growth is a factor, a reasonable portion of the total value or cost shall be allocated to such immature timber, and when the timber becomes merchantable, such value or cost shall be recoverable through depletion allowances.

(4) Each of the several land and timber accounts carried on the books of the taxpayer shall be definitely described as to their location on the ground either by maps or by legal descriptions.

(5) For good and substantial reasons satisfactory to the district director, or as required by the district director on audit, the timber or the land accounts may be readjusted by dividing individual accounts, by combining two or more accounts, or by dividing and

recombining accounts.

(e) *Determination of quantity of timber.* Each taxpayer claiming or expecting to claim a deduction for depletion is required to estimate with respect to each separate timber account the total units (feet board measure, log scale, cords, or other units) of timber reasonably known, or on good evidence believed, to have existed on the ground on March 1, 1913, or on the date of acquisition of the property, whichever date is applicable in determining the basis for cost depletion. This estimate shall state as nearly as possible the number of units which would have been found present by careful estimate made on the specified date with the object of determining 100 timber which the area covered by the specific account would have produced on that date if all of the merchantable timber had been cut and utilized in accordance with the standards of utilization prevailing in that region at that time. If subsequently during the ownership of the taxpayer making the return, as the result of the growth of the timber, of changes in standards of utilization, of losses not otherwise accounted for, of abandonment of timber, or of operations or development work, it is ascertained either by the taxpayer or the district director that there remain on the ground, available for utilization, more or less units of timber at the close of the taxable year (or at the close of the month if the taxpayer keeps his depletion accounts on a monthly basis) than remain in the timber account or accounts on the basis of the original estimate, then the original estimate (but not the basis for depletion) shall be revised. The depletion unit shall be changed when such revision has been made. The annual charge to the depletion account with respect to the property shall be computed by using such revised unit for the taxable year for which the revision is made and all subsequent taxable years until a change in facts requires another revision.

(f) *Determination of fair market value of timber property.* (1) If the fair market value of the property at a specified date is the basis for depletion deductions, such value shall be determined, subject to approval or revision by the district director upon audit, by the owner of the property in the light of the most reliable and accurate information available with reference to the condition of the property as it existed at that date, regardless of all subsequent changes, such as changes in surrounding circumstances, and methods of exploitation, in degree of utilization, etc. Such factors as the following will be given due consideration:

(i) Character and quality of the timber as determined by species, age, size, conditions, etc.;

(ii) The quantity of timber per acre, the total quantity under consideration, and the location of the timber in question with reference to other timber;

(iii) Accessibility of the timber (location with reference to distance from a common carrier, the topography and other features of the ground upon which the timber stands and over which it must be transported in process of exploitation, the probable cost of exploitation and the climate and the state of industrial development of the locality); and

(iv) The freight rates by common carrier to important markets.

(2) The timber in each particular case will be valued on its own merits and not on the basis of general averages for regions; however, the value placed upon it, taking into consideration such factors as those mentioned in this paragraph, will be consistent with that of other similar timber in the region. The district director will give weight and consideration to any and all facts and evidence having a bearing on the market value, such as cost, actual sales and transfers of similar properties, the margin between the cost

of production and the price realized for timber products, market value of stock or shares, royalties and rentals, valuation for local or State taxation, partnership accountings, records of litigation in which the value of the property has been involved, the amount at which the property may have been inventoried or appraised in probate or similar proceedings, disinterested appraisals by approved methods, and other factors.

(h) *Information to be furnished by taxpayer claiming depletion of timber*. A taxpayer claiming a deduction for depletion of timber and for depreciation of plant and other improvements shall attach to his income tax return, a filled-out Form T-Timber for the taxable year covered by the income tax return, including the following information:

(1) A map, where necessary, to show clearly timber and land acquired, timber cut, and timber and land sold;

(2) Description of, cost of, and terms of purchase of timberland or timber, or cutting rights, including timber or timber rights acquired under any type of contract;

(3) Profit or loss from sale of land, or timber, or both;

(4) Description of timber with respect to which claim for loss, if any, is made;

(5) Record of timber cut;

(6) Changes in each timber account as a result of purchase, sale, cutting, re-estimate, or loss;

(7) Changes in improvements accounts as the result of additions to or deductions from capital and depreciation, and computation of profit or loss on sale or other disposition of such improvements;

(8) Operation data with respect to raw and finished material handled and inventoried;

(9) Statement as to application of the election under section 631(a) and pertinent information in support of the fair market value claimed thereunder;

(10) Information with respect to land ownership and capital investment in timberland; and

(11) Any other data which will be helpful in determining the reasonableness of the depletion or depreciation deductions claimed in the return.

Extract

IRC section 194
AMORTIZATION OF REFORESTATION EXPENDITURES

(a) ALLOWANCE OF DEDUCTION.--In the case of any qualified timber property with respect to which the taxpayer has made (in accordance with regulations prescribed by the Secretary) an election under this subsection, the taxpayer shall be entitled to a deduction with respect to the amortization of the amortizable basis of qualified timber property based on a period of 84 months. Such amortization deduction shall be an amount, with respect to each month of such period within the taxable year, equal to the amortizable basis at the end of such month divided by the number of months (including the month for which the deduction is computed) remaining in the period. Such amortizable basis at the end of the month shall be computed without regard to the amortization deduction for such month. The 84-month period shall begin on the first day of the first month of the second half of the taxable year in which the amortizable basis is acquired.

(b) LIMITATIONS.--

(1) MAXIMUM DOLLAR AMOUNT.--The aggregate amount of amortizable basis acquired during the taxable year which may be taken into account under subsection (a) for such taxable year shall not exceed $10,000 ($5,000 in the case of a separate return by a married individual (as 0 defined in section 7703)).

(2) ALLOCATION OF DOLLAR LIMIT.--

(A) CONTROLLED GROUP. - For purposes of applying the dollar limitation under paragraph (1)--

(i) all component members of a controlled group shall be treated as one taxpayer, and

(ii) the Secretary shall, under regulations prescribed by him, apportion such dollar limitation among the component member of such controlled group.

For purposes of the preceding sentence, the term "controlled group" has the meaning assigned to it in section 1563(a), except that the phrase "more than 50 percent" shall be substituted for the phrase "at least 80 percent" each place it appears in section 1563(a)(1).

(B) PARTNERSHIPS AND S CORPORATIONS.-- In the case of a partnership, the dollar limitation contained in paragraph (1) shall apply with respect to the partnership and with respect to each partner. A similar rule shall apply in the case of an S corporation and its shareholders.

(3) SECTION NOT TO APPLY TO TRUSTS.--This section shall not apply to trusts.

(4) ESTATES.--The benefit of the deduction for amortization provided by this section shall be allowed to estates in the same manner as in the case of an individual. The allowable deduction shall be apportioned between the income beneficiary and the fiduciary under regulations prescribed by the Secretary. Any amount so apportioned to a beneficiary shall be taken into account for purposes of determining the amount allowable as a deduction under this section to such beneficiary.

(c) DEFINITIONS AND SPECIAL RULES.--For purposes of this section--

(1) QUALIFIED TIMBER PROPERTY.--The term "qualified timber property" means a woodlot or other site located in the United States which will contain trees in significant commercial quantities and which is held by the taxpayer for the planting, cultivating, caring for, and cutting of trees for sale or use in the commercial production of timber products.

(2) AMORTIZABLE BASIS.--The term "amortizable basis" means that portion

of the basis of the qualified timber property attributable to reforestation expenditures.

(3) REFORESTATION EXPENDITURES.--

(A) IN GENERAL.--The term "reforestation expenditures" means direct costs incurred in connection with forestation or reforestation by planting or artificial or natural seeding, including costs--

(i) for the preparation of the site;

(ii) of seeds or seedlings; and

(iii) for labor and tools, including depreciation of equipment such as tractors, trucks, tree planters, and similar machines used in planting or seeding.

(B) COST-SHARING PROGRAMS.--Reforestation expenditures shall not include any expenditures for which the taxpayer has been reimbursed under any governmental reforestation cost-sharing program unless the amounts reimbursed have been included in the gross income of the taxpayer.

(4) BASIS ALLOCATION.--If the amount of the amortizable basis acquired during the taxable year of all qualified timber property with respect to which the taxpayer has made an election under subsection (a) exceeds the amount of the limitation under subsection (b)(1), the taxpayer shall allocate that portion of such amortizable basis with respect to which deduction is allowable under subsection (a) to each such qualified timber property in such manner as the Secretary may by regulations prescribe.

(d) LIFE TENANT AND REMAINDERMAN.--In the case of property held by one person for life with remainder to another person, the deduction under this section shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant.

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GLOSSARY

A

ACRE -- A unit of land comprising 43,560 square feet.

AGE, ROTATION -- Age at which a stand is considered to be ready for harvesting under the plan of management.

ANNUAL RING -- A tree's layer of wood growth for one year. Annual rings can be seen on the cross sections of tree stems or branches.

B

B.F. -- This is an abbreviation for "board feet."

B.M. -- This is an abbreviation for "board measure," which usually refers to the board feet of lumber.

BOARD FOOT -- A unit of measurement represented by a board, which is typically unfinished and unsurfaced, 1 foot long, 1 foot wide and 1 inch thick. In practice, the working unit is 1,000 board feet, which normally is abbreviated MBF.

BOARD FOOT, LOG SCALE -- A unit of measure of the content of a log determined using a log rule; also the common unit of measure of timber volume.

BOARD FOOT, GREEN CHAIN TALLY -- A unit of measurement represented by unfinished lumber as it comes from the saw.

BOLE -- The trunk of a tree; typically where the usable wood is located.

BOLTS -- Short logs or sections of a large log, usually less than 8 feet long.

BUCK -- To saw felled trees into smaller units, such as logs or bolts.

BUTT -- The base of a tree; the large end of a log.

C

C.F.I. -- An abbreviation for Continuous Forest Inventory, a system of periodically monitoring the forest for growth, volume, composition, and mortality of the forest stands.

CARRIAGE -- The frame for holding a log while it is being sawed. The carriage also advances logs toward the saw line after a cut has been made. It travels on tracks.

CHERRY PICKER -- A piece of machinery, generally attached to a truck, loading dock, etc., which is used to load and unload logs.

CLEARCUTTING -- A process of removing all merchantable trees from an area in a logging operation.

CONIFER -- Usually an evergreen tree that bears cones and needle-shaped leaves. Coniferous trees are known as softwood trees, and softwood lumber is produced from them.

CONVERSION COSTS -- Costs of converting standing timber to a saleable product. Conversion costs include: costs of felling trees, removing limbs, bucking, skidding, loading logs, and transporting logs.

CORD -- A unit of measurement of stacked wood (typically pulpwood). The standard cord consists of a pile of wood whose pieces are 4 feet long stacked 4 feet high by 8 feet long, containing 128 cubic feet of space. A long cord is a cord containing wood pieces longer than 4 feet; pieces 5 feet long result in 160 cubic feet of space. A common unit of measure of timber.

CORE -- 1. The inner layer(s) of plywood; it is commonly of low quality material.
2. That portion of a veneer bolt remaining in the lathe after rotary cutting in veneer production.

CRIBBAGE -- Rough cut lumber often used in coal mines for support purposes.

CROWN -- The upper part of a tree, including branches, foliage, etc.

CRUISE -- To survey forest lands for the purpose of locating and estimating volumes and grades of standing timber.

CYCLE, CUTTING -- The planned intermission between harvesting operations within the same stand.

D

D.B.H. -- This is an abbreviation for Diameter (of a tree) at Breast Height; diameter of a tree at 4 ½ feet above the ground.

DECIDUOUS -- A deciduous tree is one that loses its leaves in the fall.

DECK, LOG -- 1. Area or platform on which logs are placed. 2. A pile of logs. 3. Portion of a sawmill on which logs are held before they are sawed.

E

ECOLOGY -- The science of the relationships between plants and animals and their environment.

EVEN-AGED -- A term to describe a stand in which the individual trees are relatively the same age.

F

FELLED TIMBER -- Timber which has been cut.

FIREBREAK -- A barrier used to stop or check wildfires which may occur. The barrier can be natural or constructed.

G

GIRDLE -- To encircle the stem of a living tree with cuts with the intention of killing the tree. The cuts are made to sever the bark and cambium. The tree dies by preventing the passage of nutrients. Toxic materials be injected into the tree through the cut also.

H

HARDWOOD -- Generally trees which have broad leaves - deciduous trees. Lumber from hardwood trees is referred to as hardwood lumber.

HEAD SAW -- The main log cutting saw in a sawmill.

HEARTWOOD -- The inner core of a wood stem; usually darker in color than the outer sapwood.

I

INCREMENT BORER -- An instrument with a hollow bit, similar to an auger. It is used to extract cores from trees to determine growth, age, etc.

INTOLERANT TREE -- A tree incapable of growing in the shade of or in competition with other trees.

K

KILN DRY -- A process of drying lumber by the controlled application of heat.

L

LOG -- 1. A verb meaning to cut and deliver logs. 2. A noun meaning a segment of a tree.

LOG RULE -- A table which shows the estimated amount of lumber which can be sawed from logs. One must know the log's length and diameter to use a log rule. The tables are divided into four groups as follows:

1. Diagram rules
2. Formula rules
3. Actual Output rules
4. Hybrid rules.

M

MARKING -- The process of identifying trees which are to be cut and sold.

O

OLD GROWTH -- Also known as first growth timber or virgin timber. It refers to a forest in which little, if any, cutting has been done.

OVERCUT -- The excess of the quantity of timber cut from a tract over the estimated quantity on the tract.

OVERRUN -- The excess of the lumber sawn from logs over the quantity estimated that could be sawn.

OVERSTORY -- Refers to trees in a stand forming the upper crown cover.

P

PEELER -- The log used in the manufacture of rotary-cut veneer.

PULPWOOD -- Wood that is cut primarily to make wood pulp, which may be manufactured into the following: paper, fiber, paperboard, etc.

R

REFORESTATION -- The replenishing of an area with forest trees. It can be a natural or artificial process.

RELEASE CUTTING -- The process of cutting large trees which over-shadow smaller, usually younger trees, thus allowing the younger trees to grow better.

REPRODUCTION -- The process of renewing a forest. It can be artificial, renewed by direct seeding, or planting by man, or it can be natural, renewed by self-sown seeds, sprouts, etc.

ROT, HEART -- Decay found in the heartwood of trees.

S

SAPLING -- A young tree 2 to 4 inches D.B.H.

SAPWOOD -- The light-colored outer ring of wood in a tree. It consists of living cells, and it is necessary to conduct water and minerals to the tree crown.

SAW TIMBER -- Trees from which sawlogs may be cut. Saw timber stands generally are stands where saw timber-sized trees are the most important component.

SAWYER -- The person who controls the sawing of sawlogs into lumber.

SCALER -- The person who determines the volume of logs.

SCALING -- The process of determining the volume of logs. Measuring the dimensions of the logs is part of the process.

SECOND-GROWTH -- The new timber which develops after removing old-growth. Old-growth may be removed by cutting, fire, or other cause.

SECTION -- A unit of land measurement generally equaling one mile square or 640 acres.

SEEDLING -- A young tree grown from seed that is smaller than a sapling.

SEED TREE -- A tree that produces seed; usually trees left during logging to provide seed for reforestation.

SELECTIVE LOGGING OR CUTTING -- The selective removal of a single tree or small groups of trees during a timber harvesting operation. These trees may be removed because they are mature, large, or diseased.

SEVERANCE TAX -- A state excise tax. It is levied on timber cut.

SITE -- An area generally chosen for its ecological factors and ability to produce timber.

SKID -- To pull logs from the stump. The logs are pulled to a skidway, landing, or mill.

SKIDDER -- A four-wheeled or other self-propelled machine which is used to skid felled trees or logs. Also, one who skids logs.

SLASH -- The woody debris remaining on the ground after logging: slash includes branches, bark, chunks, cull logs, uprooted stumps, and uprooted trees.

SOFTWOOD -- Generally trees which have needle or scale-like leaves, conifers. Also, see Conifer.

STAND -- An aggregation of trees occupying a specific area of land and sufficiently uniform in species, composition, age, density, and other conditions so as to be easily distinguishable from the forest or other growth on adjoining areas.

STAND, MIXED -- A stand in which less than a specified percentage of trees forming the main crown canopy consists of a single species.

STAND, PURE -- A stand in which at least a specified percentage of trees forming the main crown canopy is of a single species.

STOCK, GROWING -- The total trees in the forest.

STUMPAGE -- Standing timber (from an exploiter's point of view).

STUMP-WOOD -- The resinous stump and root of longleaf or slash pine. It is often used to extract turpentine and rosin.

T

THINNING -- A selective cut in an immature stand. A thinning is performed to increase both the rate and quality of growth, to improve composition, to promote sanitation, to improve yield, and to recover usable materials.

TIMBER -- For federal tax purposes, it is the wood in standing trees which is available and suitable for exploitation and use by the forest industries. See, IRM 4232.4-121(3).

T.S.I. -- Timber Stand Improvement is a term generally applied to intermediate cuttings in a stand that are not part of a major harvest; it is done to improve stand conditions.

U

UNDERRUN -- The amount by which lumber sawn from logs is less than the estimated quantity expected to be sawn; descriptive term indicating this condition.

UNDERSTORY -- Trees in a stand which grow under the trees forming the main crown canopy.

UNEVEN-AGED -- A term to describe a stand in which there are significant differences in the age of the trees and three or more age classes exist.

W

WEED TREE -- A tree with little value, if any.

Y

YIELD, SUSTAINED -- The quantity of timber a forest can produce continuously under a given plan of management; a continuous production of timber with a balance between growth and harvest.