

REDACTED DECISION – DK#S 10-402 SV, 10-403 SV – BY – CHRISTOPHER B. AMOS ADMINISTRATIVE LAW JUDGE II – SUBMITTED DECISION on DECEMBER 21, 2011 – ISSUED ON JUNE 12, 2012

SYNOPSIS

TAXATION -- PROCEDURE AND ADMINISTRATION -- COLLECTION OF TAX -- It is the duty of the Tax Commissioner to see that the laws concerning the assessment and collection of all taxes and levies are faithfully enforced. *See* W. Va. Code Ann. § 11-1-2 (West 2011).

TAXATION -- OFFICE OF TAX APPEALS – BURDEN OF PROOF -- In a hearing before the West Virginia Office of Tax Appeals on a petition for reassessment, the burden of proof is upon the petitioner to show that any assessment of tax against it is erroneous, unlawful, void or otherwise invalid. *See* W. Va. Code Ann. § 11-10A-10(e) (West 2011); W. Va. Code. R. §§ 121-1-63.1 and 69.2 (2003).

TAXATION -- SEVERANCE AND BUSINESS PRIVILEGE TAX -- TIMBER SEVERANCE TAX -- A person who owns the timber immediately after its severance or has an economic interest therein is the producer, and subject to the timber severance tax and the additional severance tax on timber. *See* W. Va. Code Ann. § 11-13A-2(c)(13) (West 2010); W. Va. Code Ann. § 11-13A-3b (West 2010); W. Va. Code Ann. § 11-13V-4(c) (West 2010).

WEST VIRGINIA OFFICE OF TAX APPEALS -- CONCLUSION OF LAW -- A contract logger who is subject to the complete control of the owner or lessee of property in the harvesting and sale of timber does not gain an economic interest in the timber simply by gaining a mere economic advantage in the sale of such timber.

WEST VIRGINIA OFFICE OF TAX APPEALS -- CONCLUSION OF LAW -- The Petitioner has met his burden in proving that he had no economic interest in the timber that is the subject of this matter.

WEST VIRGINIA OFFICE OF TAX APPEALS -- CONCLUSION OF LAW -- Since the Petitioner has no economic interest in the timber, he is not the producer and not subject to the timber severance tax or the additional severance tax on timber.

WEST VIRGINIA OFFICE OF TAX APPEALS -- RULING -- Based upon the above, it is the FINAL DECISION of the West Virginia Office of Tax Appeals that the severance tax assessment, issued against the Petitioner on or about August 4, 2010, in the amount of \$_____is hereby VACATED, and that the additional severance tax assessment, issued against the Petitioner on or about August 4, 2010, in the amount of \$_____is hereby VACATED.

FINAL DECISION

On August 4, 2010, the Auditing Division of the West Virginia State Tax Commissioner's Office [hereinafter the Tax Department or the Respondent] issued two separate Audit Notice of Assessment's against the Petitioner, [hereinafter Mr. A or Petitioner]. These assessments were issued pursuant to the authority of the State Tax Commissioner, granted to him by the provisions of Chapter 11, Article 10, *et. seq.*, and Article 13A, *et. seq.*, of the West Virginia Code.

The first assessment stated that during the audit period of December 1, 2005, through December 31, 2009, inclusive, Petitioner erroneously under reported and/or under remitted additional tax on the severance of natural resources. The assessment included tax in the amount of \$_____, and interest in the amount of \$_____.

The second assessment stated that during the audit period of January 1, 2005, through December 31, 2009, inclusive, Petitioner erroneously under reported and/or under remitted Timber Severance Tax. The assessment included tax in the amount of \$_____, and interest in the amount of \$_____.

The Petitioner timely filed its Petition for Reassessment with this tribunal on September 30, 2010. Subsequently, after finding good cause to delay an evidentiary hearing due to the Petitioner's request that a hearing be held in Bridgeport, an evidentiary hearing was held on July 18, 2011, in Bridgeport, WV, before Administrative Law Judge Christopher B. Amos. Thereafter, the parties submitted briefs containing proposed findings of fact and conclusions of law, the last brief being filed on December 21, 2011, and the matter became ripe for decision at that time.

FINDINGS OF FACT

1. Petitioner is a Limited Liability Corporation owned by Mr. A and his wife with a primary place of business in a West Virginia¹ county.
2. Since 2003, the Petitioner has worked exclusively as a contract logger for Company A (hereinafter Company A).
3. Company A leases the right to sever timber on the land from a third party.
4. Petitioner uses its own equipment and staff to cut timber owned by Company A on the leased property as directed by Company A. The Petitioner only cuts timber authorized by Company A or its employees.
5. Company B, a trucking Company owned by Petitioner's son, hauls the logs to Company A's mills, the pulpwood to Company C and hardwood pulp to Company D.
6. During the time period of the audit, Petitioner delivered hardwood pulpwood to Company D and softwood pulpwood to Company C at the direction of Company A .
7. Prior to 2010, and during the audit period, the Petitioner received payment for pulpwood and its delivery directly by Company C and Company D.
8. The rate of payment for the pulpwood was based upon the weight of the pulpwood plus hauling distance to the delivery location at a negotiated rate, agreed upon between Company A and the third parties and paid primarily to Mr. A.
9. Mr. A never took depletion or claimed a depletable interest in any pulpwood delivered under his contract with Company A.

¹ The record is silent as to the location of the principal activity that gave rise to these assessments.

10. Mr. A never delivered wood to any location without the explicit direction of Company A.

11. The contract between Mr. A and Company A specified explicitly that:

(6) Owner of Stumpage and Shortest Route: It is understood that Company A is the sole owner of the stumpage associated with this contract and it is also understood that Contractor will take the shortest economical route to place or places of delivery unless otherwise approved by an authorized representative of Company A.

12. The contract between Mr. A and Company A was terminable by Company A for any reason upon 10 days' notice.

DISCUSSION

This matter involves the imposition of two taxes. The first is the severance tax on the privilege of severing timber. The second is the additional severance tax on the privilege of severing timber. The Respondent alleges that the Petitioner is subject to both taxes by engaging in the cutting and delivery of timber.

The West Virginia Code provides for the imposition of both taxes. First, West Virginia Code Section 11-13A-3b, imposes a tax upon “the privilege of engaging or continuing within this state, the business of severing timber for sale, profit or commercial use . . . and shall be collected from every person exercising such privilege.” W. Va. Code Ann. § 11-13A-3b(a) (West 2010). Additionally, the Code imposes an additional tax on the privilege of severing timber. The relevant section states:

For the privilege of engaging or continuing within this state in the business of severing timber for sale, profit or commercial use, there is hereby levied and shall be collected from every person exercising this privilege an additional annual privilege tax equal to two and seventy-eight hundredths percent of the gross value of the timber produced, determined at the point where the production privilege ends for purposes of the tax imposed by

section three-b, article thirteen-a of this chapter and upon which the tax imposed by section three-b of said article thirteen-a is paid. The additional tax imposed by this subsection shall be collected with respect to timber produced after November 30, 2005: Provided, that during the period of discontinuance of the tax as provided in subsection (d), section three-b, article thirteen-a of this chapter, the additional tax imposed by this subsection shall be determined as provided in this subsection in the same manner as if the tax described under section three-b, article thirteen-a of this chapter is being imposed and collected, subject to the provisions of subsection (g) of this section.

W. Va. Code Ann. § 11-13V-4(c) (West 2010).

The Code defines “severing”, in pertinent part, as “the physical removal of natural resources from the earth or waters of this state by any means.” W. Va. Code Ann. §11-13A-2(c)(11) (West 2010).

Thus, while on its face, this Code appears to levy a tax on every person who physically removes timber from the ground, West Virginia Code Section 11-13A-3b(b) provides some clarification. That subsection provides:

Rate and measure of tax. -- The tax imposed in subsection (a) of this section shall be three and twenty-two hundredths percent of the gross value of the timber produced, as shown by the gross proceeds derived from the sale thereof by the producer, except as otherwise provided in this article: Provided, that as to timber produced after December 31, 2006, the rate of the tax imposed in subsection (a) of this section shall be one and twenty-two hundredths percent of the gross value of the timber produced, as shown by the gross proceeds derived from the sale thereof by the producer, except as otherwise provided in this article.

W. Va. Code Ann. § 11-13A-3b(b) (West 2010).

Since the tax is levied against the “producer” of timber, the “producer” is the “taxpayer” subject to the tax, as opposed to any person who merely severs the timber.

For producers of natural resources, a definition of “taxpayer” is provided:

"Taxpayer" means and includes any individual, partnership, joint venture, association, corporation, receiver, trustee, guardian, executor, administrator, fiduciary or representative of any kind engaged in the business of severing or processing (or both severing and processing)

natural resources in this state for sale or use. *In instances where contracts (either oral or written) are entered into whereby persons, organizations or businesses are engaged in the business of severing or processing (or both severing and processing) a natural resource but do not obtain title to or do not have an economic interest therein, the party who owns the natural resource immediately after its severance or has an economic interest therein is the taxpayer.*

W. Va. Code Ann. § 11-13A-2(c)(13) (West 2010)(emphasis added).

It is uncontroverted that the Petitioner, in the instant case, did not own the natural resource immediately after its severance. Therefore, the only way in which the Petitioner is a taxpayer and subject to the severance tax in the instant matter is if the Petitioner had an economic interest in the natural resource. The following definition is instructive on this point:

"Economic interest" for the purpose of this article is synonymous with the economic interest ownership required by Section 611 of the Internal Revenue Code in effect on the thirty-first day of December, one thousand nine hundred eighty-five, entitling the taxpayer to a depletion deduction for income tax purposes: Provided, that a person who only receives an arm's-length royalty shall not be considered as having an economic interest.

W. Va. Code Ann. § 11-13A-2(c)(4) (West 2010). However, Section 611 of the Internal Revenue Code makes no reference to any "economic interest ownership requirement." To this end, a definition was provided in the Treasury Regulations implementing that section, by stating in pertinent part:

An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital . . . A person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because through a contractual relation he possesses a mere economic or pecuniary advantage derived from production. For example, *an agreement between the owner of an economic interest and another entitling the latter to purchase or process the product upon production or*

entitling the latter to compensation for extraction or cutting does not convey a depletable economic interest.

Treas. Reg. § 1.611-1(b) (as amended in 1973) (emphasis added). The language of the Treasury Regulation appears to be clear. Compensation for extraction or cutting does not convey an economic interest; this should be true regardless of the amount of compensation received. However, the instant case is a little more complicated. Mr. A severed the trees, had them hauled to third party locations, and accepted payment from these third parties. Without any other information, it may appear that Mr. A is the producer. In the instant case, though, the trees were directed to the third parties by Company A. The rate of payment was set based on a contract between Company A and the third party. Mr. A was a mere beneficiary of the contract, and had no control over the rate of payment or location of delivery. Thus, it appears that Mr. A is merely receiving compensation through a third party at Company A's direction for fulfilling the requirements of his contract with Company A.

Nevertheless, the Respondent urges this tribunal to consider the regulations of the Tax Commissioner to aid in interpreting the definition of "economic interest" as provided in West Virginia Code Section 11-13A-2(c)(4). That regulation provides in pertinent part:

3.5.1. The concept of critical importance in determining who is the producer is which party has a true economic interest in the mineral. In order to have an economic interest, the taxpayer must have a direct interest in the minerals in place. One must also have a direct interest in the income from the production of the minerals and look solely to mineral sales proceeds for his income. A taxpayer does not have an economic interest simply because a contract entitles him to an economic or monetary advantage in connection with production of the minerals. For example, a person who has no ownership, title in, or leasehold interest in the mineral deposit or standing timber does not possess an economic interest merely because through a contractual relationship he possesses an economic advantage derived from production. *The pivotal question involves the*

ownership of the mineral immediately after it is severed. The owner at that point is the producer.

W. Va. Code R. § 110-13A-3.5.1 (1992). Thus, even taking the Respondent's position that we must defer to the regulation of the Tax Commissioner, the Commissioner's own regulation lays out the pivotal question for this tribunal in the instant case: *Who owned the timber immediately after it was severed?* As noted above, Mr. A testified that Company A controlled the location and price of the timber that he cut. Additionally, the contract provided by Mr. A spelled out where the timber at issue in this matter was to be sent. It seems clear that Company A retained the economic interest in the wood.

Notwithstanding, the Respondent argues that Mr. A had an economic interest because he was exclusively employed with Company A since 2003; his rate of payment was derived from current market cost as negotiated by Company A²; during the audit period he was paid directly for the pulpwood minus the stumpage; that he received the bulk of payment on the pulpwood; and that he maintained control of the pulpwood by extracting and having it delivered.

It appears that the Respondent is taking into account a variety of factors in the determination of whether an economic interest lies. However, the Tax Commissioner's own regulation lays out the following:

3.5.2. If a dispute should arise as to which party is the producer and which is the contract miner, the Tax Department shall consider, in addition to the substance of the agreements, other factors which shall include, but not be limited to the following attributes which may indicate the presence of ownership or economic interest subjecting such person to the severance tax.

3.5.2.1. An interest in the mineral in place.

² It is noted here that this is actually evidence that Company A retained an economic interest in the wood rather than establishing that Mr. A acquired such an interest.

3.5.2.2. An investment which is recoverable through depletion not recoverable through depreciation.

3.5.2.3. Contractual agreements which are not terminable without cause on short notice.

3.5.2.4. Entitlement to claim a depletion allowance for federal income tax purposes.

3.5.2.5. Obligation to pay royalties to another.

3.5.2.6. Exclusive right to sever, mine, cut or extract the natural resource product.

3.5.2.7. Income from the sale of mineral proceeds rather than from other sources.

3.5.2.8. Control over the mineral from the time of extraction to sale.

W. Va. Code R. § 110-13A-3.5.2 (1992).

Laying out these factors again leads to the conclusion that Mr. A did not have an economic interest in this timber. He had no interest in the mineral in place. He had no investment recoverable through depletion. His contractual agreements were terminable without cause on ten days' notice. He is not entitled to claim depletion on the timber. He has no obligation to pay royalties to another. It was not clear that he had an exclusive right to cut the timber. And he had no control over the mineral from the time of extraction to sale³. The only factor that is arguable is the fact that his income appears to come from the sale of mineral proceeds rather than from other sources. To that end, Mr. A testified that he received payment directly from the third parties, but that payment was a payment negotiated by Company A. Mr. A was not free to go to the open market to sell the pulpwood. Thus, the payments received by Mr. A amount to a mere economic

³ This tribunal acknowledges that Mr. A had physical control over the timber from the time of extraction through delivery. However, that physical control was subject to the legal rights of Company A which were complete. Company A directed what trees were to be cut, where they were to be sent, and what rate of payment Mr. A received. In that sense, Company A had legal control over the timber from the time of extraction to sale.

advantage from cutting the timber rather than a payment for the extraction of the mineral or severance of the timber, to which he must look for a return of his capital.

Therefore, Mr. A had no economic interest in the timber at issue in this matter, and as such is not subject to the severance tax on such timber.

CONCLUSIONS OF LAW

Based upon all of the above, it is **DETERMINED** that:

1. It is the duty of the Tax Commissioner to see that the laws concerning the assessment and collection of all taxes and levies are faithfully enforced. *See* W. Va. Code Ann. § 11-1-2 (West 2011).

2. In a hearing before the West Virginia Office of Tax Appeals on a petition for reassessment, the burden of proof is upon the petitioner to show that any assessment of tax against it is erroneous, unlawful, void or otherwise invalid. *See* W. Va. Code § 11-10A-10(e) (West 2011); W. Va. Code. R. §§ 121-1-63.1 and 69.2 (2003).

3. A person who owns the timber immediately after its severance or has an economic interest therein is the producer, and subject to the timber severance tax and the additional severance tax on timber. *See* W. Va. Code Ann. § 11-13A-2(c)(13) (West 2010); W. Va. Code Ann. § 11-13A-3b (West 2010); W. Va. Code Ann. § 11-13V-4(c) (West 2010).

5. A contract logger who is subject to the complete control of the owner or lessee of property in the harvesting and sale of timber does not gain an economic interest in the timber simply by gaining a mere economic advantage in the sale of such timber.

6. The Petitioner has met his burden in proving that he had no economic interest in the timber that is the subject of this matter.

7. Since the Petitioner has no economic interest in the timber, he is not the producer and not subject to the timber severance tax or the additional severance tax on timber.

8. Based upon the above, it is the **FINAL DECISION** of the West Virginia Office of Tax Appeals that the severance tax assessment, issued against the Petitioner on or about August 4, 2010, in the amount of \$_____is hereby **VACATED**, and that the additional severance tax assessment, issued against the Petitioner on or about August 4, 2010, in the amount of \$_____is hereby **VACATED**.

WEST VIRGINIA OFFICE OF TAX APPEALS

By: _____
Matthew R. Irby⁴
Administrative Law Judge

Date Entered

⁴ Administrative Law Judge, Christopher B. Amos, heard this matter; however, Judge Amos is no longer employed with the West Virginia Office of Tax Appeals. Therefore, this decision was written by Administrative Law Judge, Matthew R. Irby.