

Hardwood Timber Industry Audit Technique Guide

NOTE: This guide is current through the publication date. Since changes may have occurred after the publication date that would affect the accuracy of this document, no guarantees are made concerning the technical accuracy after the publication date. All references to code sections are to the Internal Revenue Code (IRC) unless otherwise specified.

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Chapter 1 - Overview of the Timber Industry

Purpose of the Audit Technique Guide

This material is for training purposes only. Under no circumstances should the contents be used or cited to sustain a technical position.

This Industry Guide is intended for Examiners conducting audits in the hardwood timber industry and as information for taxpayers and practitioners associated with the hardwood timber industry. Review of this guide is recommended prior to initiating an audit. Users of this guide may need to research specific tax issues and new tax law in addition to referencing this guideline.

Many aspects of federal tax law are relevant to the hardwood timber industry. This guide is intended only to assist with the most common timber/forest product issues.

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.

Commercial hardwood timber species such as oaks, gums, maples, hickories, and walnut are located primarily in the East, which is divided into the northern, southern, and Appalachian hardwood regions. In the Northeast, the hardwoods tend to be the most commercially valuable species. In the Southeast, the softwoods (mainly pine) are the more commercially valuable species.

In the West, most saw timber is softwood. The common softwood species are Douglas-Fir, Hemlocks, True Firs, Pines, Spruces, Cedars, and Redwoods. The forests in the West tend to contain larger size trees and have more volume of timber per acre than forests in the East.

One major difference between the forests in the East and the West is the type of forest ownership. In the East, most timberlands are privately owned, but in the West, the federal government owns most timberlands.

Another important difference is the accessibility of timberlands to loggers. The terrain in the East generally is not as steep and rugged as it is in the West, making the harvest of timber in the East easier. There also are differences in the way that timberlands regenerate after harvests in the East and the West. Eastern hardwood forests tend to regenerate themselves naturally, while Western and Southern commercially managed softwood forests usually receive site preparation and the planting of seedlings. Silviculture, the art and science of managing a forest, is required for both methods to be most productive.

Finally, the products and by-products made from hardwoods and softwoods are different. Hardwoods are used more commonly for furniture making, flooring, veneer, and pallets. Hardwoods also are used for making printing grades of paper.

Softwoods are used more commonly to produce construction lumber and plywood. Softwoods also may be used to make paper and paperboard items requiring strength, such as bags and boxes. However, hardwood and softwood fibers often are blended to make paper. Recycling paper also provides a significant source of fiber for paper makers.

Hardwood Products and By-Products

It is difficult to estimate hardwood lumber production due to 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 smaller operations that use timber from a relatively small geographic area. However, larger mills may obtain timber from as far as 75 to 100 miles away.

Hardwood lumber is manufactured for a variety of end uses. Each hardwood species has its own characteristics and types of defects that require a specific type and amount of processing. These characteristics make each hardwood species more suitable for specific uses.

To account for these variations in hardwoods and to provide a level of product standardization, grading systems have been developed. 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 can be found on the [NHLA](#) website.

Hardwood lumber traditionally is measured and sold by the thousand board feet (MBF) (a board foot is the volume equivalent to a piece of wood 1"x1"x12"). There are 12 board feet in a cubic foot of wood. However, other units besides board feet may be used. Hardwood lumber may be sold green (with relatively high moisture content) or dried (kiln-dried or air-dried). Kiln drying is a process that uses a heat source to extract moisture from lumber in a relatively short time. Air drying allows the lumber to dry under ambient conditions over a longer period. Some hardwood end products require drying prior to final manufacture. 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 also may be sold rough (the surfaces of the boards are unfinished) or surfaced by planing. As with drying, surfacing adds value, but is not desired by all types of buyers.

The furniture, cabinet, and pallet industries are major markets for hardwood lumber. Hardwood dimension lumber is used to produce parts for furniture and cabinets. Another hardwood product used in furniture and cabinets is veneer, which is sliced using sharp knives rather than sawn like lumber. Links for how veneer is made can be found in the References chapter.

The millwork industry is comprised of firms that primarily produce windows, window parts, doors, door parts, and wood moldings. Softwoods are a large component of this industry, but hardwoods also are used.

The furniture, cabinet, and millwork industries use high-grade lumber and the pallet industry uses low-grade lumber.

There is also a significant export market, primarily in Europe and the Pacific Rim, for high quality hardwood logs. Buyers in those markets generally prefer to make their own lumber or veneer from the logs rather than receiving lumber or veneer from the U.S.

The use of hardwood lumber for flooring has varied over time with fluctuations in popularity and growth in the housing market.

Hardwoods also are used in the manufacture of railroad ties. However, the use of railroad ties made out of composite materials such as recycled plastics and concrete is increasing.

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 can be used for firewood. Mills also use byproducts to provide energy for the mill. Hardwood mills may sell their products directly to customers, or through brokers, or wholesalers.

Hardwood lumber prices generally are negotiated between buyer and seller based on the market conditions for different species, grades, and the end use.

Vertical Integration of the Hardwood Timber Industry

The hardwood timber industry is a fragmented, vertically integrated industry. An analysis of the industry begins with the landowner. There are three basic types of timberland owners: nonindustrial private, industrial, and government.

Nonindustrial private landowners are primarily individuals who own both the land and the timber. They normally sell their timber directly to a logger or a mill. In some cases, a consulting forester may be used to value and market the timber for a fee, usually determined by a percentage of the sale or an hourly rate. Industrial forests are owned primarily by companies operating in the timber industry for their own needs or to sell timber to others. Timber Investment Management Organizations (TIMO's) and Real Estate Investment Trusts (REIT's) have become popular forms of ownership for timberlands. Life insurance companies also have begun to purchase timberlands for investment purposes. Finally, state and federal timberlands may be held for public use and still permit some timber sales as a part of an overall timber management strategy.

Standing timber usually is purchased in one of three ways: outright purchase of the land and timber, purchase at a specified rate per unit of timber actually cut (pay-as-cut), or purchase for a set total amount or lump sum. These methods and possible tax consequences are discussed in more detail in Chapter 3.

For tax purposes, the term timber means wood in standing trees that is available and suitable for exploitation and use by the forest industries. "Stumpage," a commonly used forestry term, has a similar meaning - the wood expected to be recovered from the forest when trees are harvested.

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 to sawmills with or without a pre-arranged contract, price, and/or order. Company loggers are logging crews employed by sawmills. However, mills with their own loggers have become rare due to the high overhead of having employees. Contract loggers provide a service. They generally are paid a fee per 1,000 board feet for logs cut from the timber and delivered to the mill.

The harvesting process can vary considerably depending on the site, the logger and the needs of the timber buyer. In general, access to the logging area from a public road is needed. The buyer or logger may need to obtain a right-of-way easement from an adjacent landowner. In the area being harvested, landing areas, temporary or permanent haul roads, and temporary skid roads may be required. Timber harvesting begins when trees are cut down. This is known as felling. The felled trees are then de-limbed and moved to the landing in a process called skidding. Skidding ordinarily is 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 that 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 tree-length logs may be cut into shorter logs and may be graded and sorted by species. This may also take place in the mill yard after delivery. At the point of grading and sorting, decisions will be made whether a log should be separated for export, resale to a veneer manufacturer, or other purchaser.

From the landing, logs are transported by truck to the sawmill. 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. As with loggers, the use of company crews is rare. The trucker is often employed by the logging contractor or may be a different contractor hired by the mill.

Logging and trucking are negotiated on a site-by-site basis depending upon a variety of factors, including the distance to the mill, the topography on the parcel being cut, the amount of timber to be cut, the time of year, etc.

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. Many mills will take orders from customers and cut what a customer has ordered.

The lumber and logs or other products must then be transported from the sawmill to the customers. There are two primary methods of transportation used: trucking and rail cars. In most cases, trucking is the less costly and the more often used means of transportation.

Chapter 2 - Records and Examination Techniques

Accounting and record keeping techniques will vary depending upon the type(s) of timber activity in which the taxpayer is involved, and may vary among companies involved in the same

or similar activities. With smaller firms, the main emphasis may be geared toward the information needed for business management purposes. While two companies may be in the same business, their operational practices may vary widely based upon a variety of factors, including the types of equipment they have and the markets in which they operate.

At the beginning of the examination of any timber-related taxpayer, it is helpful to review the company's operations and how the accounting and record keeping apply to the operations. This will be useful in tailoring initial requests for information.

Because of this potential variability, this chapter discusses some of the more common practices.

Timber Records - Form T (Timber) Forest Activities Schedule

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 Form T (Timber). Form T is specifically mentioned in Treasury Regulation § 1.611-3(h). Over the years, Form T has been modified to make it easier to use and to limit the types of taxpayers required to file it with their income tax return. Originally, if a taxpayer claimed a deduction for depletion of timber or for depreciation of plant and other improvements related to timber accounts, or elected § 631(a) treatment for the cutting of timber as a sale or exchange, the taxpayer was required to complete and attach Form T to the income tax return.

In the current versions of Form T and the Form T Instructions a taxpayer claiming a deduction for depletion of timber, making an election under § 631(a) or making an outright sale of timber under § 631(b) is required to file Form T. An exception has been added to exempt occasional timber sellers (one or two sales every three or four years) from the requirement to file Form T. However, all sellers must maintain adequate records of these transactions and other timber-related activities during the year.

Form T provides a convenient format for forest industry record keeping. It is organized into five major sections or "parts." In the current version of Form T, the form and the instructions are separate documents.

Part I - Acquisitions

Acquisitions of timber, timber-cutting contracts, or forest land should be detailed in Part I. This section 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 the assets.

The asset categories included in Part I are forested land, other unimproved land, improved land, timber, pre-merchantable timber, improvements, and mineral rights. Costs are allocated to the respective accounts according to the relative values of the assets at the time that the property was acquired. A forester can help to establish relative values and to determine allocations.

The pre-merchantable timber account should consist of sub-accounts for young growth (naturally occurring trees of pre-merchantable 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 pre-merchantable timber) and value. A reasonable amount of the basis should be allocated to the pre-merchantable 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, a forester's appraisal, etc.

Part II - Timber Depletion

Part II is used for recording changes in a timber account during a tax year and determining the basis recoverable for timber sold or lost or the depletion for timber cut during the tax year. 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 used for the allowance for depletion, or basis of sales or losses, is computed based on the volume and basis of timber that was available during the year, not just that available at the beginning of the year.

The § 631(a) election is made on Part II. This election treats the cutting of timber as a sale or exchange of the timber cut. Under this election, the taxpayer must determine the adjusted basis for depletion, and the fair market value (FMV) of timber cut during the tax year as of the first day of that year. This schedule details information the taxpayer must provide in connection with the FMV determination.

Depending on the size and complexity of the taxpayer's holdings, there may be multiple Part II's to account for different depletion blocks, species, etc. Taxpayers may need to keep much more detailed depletion records than those shown in Part II.

Part III - Profit or Loss from Land and Timber Sales

Part III provides for recording and reporting all dispositions of timber, timber-cutting contracts, or forest land (whether or not taxable). The gain or loss from a sale or exchange of timber is equal to the proceeds reduced by the adjusted depletion 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 through a cutting contract. 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 from an outright sale generally is capital gains if the timber is held for investment. If the timber is held for use in the taxpayer's trade or business, it is usually § 1231 gain.

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 § 631(b) as § 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. The cutting of timber (for sale or for use in the taxpayer's trade or business) during the tax year by the taxpayer who owns, or has a contract right to cut, the timber is considered a sale or exchange of the timber cut during the tax year. A taxpayer who has owned timber, or has held a contract right to cut timber, for more than 1 year, can make a § 631(a) election to treat the cutting of the timber for use in the taxpayer's trade or business as the sale of standing timber that will result in a § 1231 gain or loss.

Whether timber income is active, passive, or portfolio income depends on the purpose for which the taxpayer owns the timber, and whether the taxpayer materially participates in the timber trade or business.

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 the land totaled \$10,000 or \$50/MBF. An additional 10 acres of adjoining forestland 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 the timber was \$13,750. Therefore, the depletion unit rate was \$45.83/MBF (\$13,750 divided by 300 MBF).

Let us say the timber is grown in another year and the taxpayer disposes of 100 MBF on a pay-as-cut basis. As a result of the additional year's growth of 10 MBF, the depletion unit rate is reduced to \$44.35 (\$13,750 divided by 310 MBF). The taxpayer receives \$200/MBF. A consulting forester was consulted on 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 (100 MBF multiplied by \$44.35 unit rate) and the costs of sale of \$3,500 (15 percent multiplied by \$20,000 sales price plus \$500 direct sale expense), netting the landowner a \$12,065 profit.

The particulars of the transaction are reported on Part III 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.

Part IV - Reforestation and Timber Stand Activities

Part IV 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.

Chapter 7 contains a discussion of how establishment of reforestation costs can be treated under certain circumstances.

Part V - Land Ownership

Changes in the land account, due to acquisition or disposal, are reported on Part V. 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 such as roadbeds of permanent roads, land leveling, etc. The basis of such assets can only be recovered when the taxpayer sells or otherwise disposes of the land.

Examination Techniques

The examination of a tax return reflecting timber activity, whether for a sawmill, landowner, logger or trucker, should always begin with a thorough pre-audit. The examiner should obtain all necessary information and records relevant to the case, especially documents to help reconcile/verify income. Additional research should be conducted in various ways. A web search is always a good start to determine if the taxpayer has a website or engages in e-commerce activities or has been covered by the media. Local county clerk offices' websites will indicate assets owned, including real estate. Landowner and logger associations should be researched within the taxpayer's state of operation for possible resources or additional information. The most obvious but often forgotten sources are the IRS Technical Advisors for Agriculture or Forestry, an IRS Forester and co-workers that have experience with a timber audit. (IRS foresters can be found by contacting any LB&I Engineering Team.)

Using the pre-audit information, the examiner should then prepare an in-depth interview specific to the taxpayer. The following are some key questions to ask regarding timber, depending on the activity of the taxpayer being examined. Remember, any given taxpayer may fall into more than one of the categories below.

Landowner:

- How often do you sell timber?
- How much property (acres) do you own? Where is it located?
- Was the timber sold owned solely by you? If not who else shared ownership?
- Do you have a contract for the sale? Provide a copy.

- Did you receive Form(s) 1099? How many? If not, how do you determine gross receipts?
- How did you receive payment? At the beginning, on a schedule or at the end of the deal?
- Did the deal/contract cover more than one tax year? Did it cover more than one sale? Did it cover more than one payment?
- If basis in the timber is claimed, how was that determined?
- Was the sale negotiated or did it go through a bidding process?
- Did you use a consulting forester or any other agent in selling the timber or did you deal directly with the buyer? If so, provide name and contact information.
- Are you involved in any state programs that allow property tax relief for timber owners? If so, who administers this program and is there any particular individual with whom you deal?
- When did you acquire the property and was a timber inventory done at that time?
- Do you have a management plan for the timber property?
- Do you have a conservation easement on the property? If so, who holds the easement?
- Have you ever made an election under § 631(a)?
- Have you received any cost share payments under IRC § 136 for the years under audit?

Logger:

- How do you obtain new work? Word of mouth, advertising, etc?
- Do you work for one particular sawmill or several? Name them.
- Do you have contracts for each job or with each sawmill? Provide copies.
- How do you determine the cost of each job? Do you bid for jobs? Is there a negotiation process? How is final cost determined?
- How do you receive payment? By the job, by the contract, on a schedule of job completion.
- Do you receive Form(s) 1099? From all jobs? If not, how do you determine gross receipts?
- Has there been a time when you did not receive a Form 1099? What did you do to report the income?
- Do you buy timber outright from the timber owner?
- Do you enter into agreements with landowners to cut timber and sell the logs and give the owner part of the money that you receive? Are these written agreements?

Trucker:

- Are you an independent contractor or an employee?
- If independent, do you work for loggers, the sawmill or both? Provide a list for the tax year under examination.
- Do you have a contract(s)? Please provide.
- How is the cost of the job determined? Explain.
- How do you receive payment?
- Do you receive Form 1099s? From all jobs?
- If you do not receive Form 1099s, how do you determine your gross receipts?

Sawmill:

- Do you employ loggers and truckers or do you contract out for these services?
- Do you own land that is logged and/or do you purchase from other timber owners?
- Do you have contracts or agreements with these timber owners? Provide copies.
- Do you specialize in the type of logs you purchase? If so, explain.
- Do you cut for specific orders or do you cut for general production?
- If you cut for specific orders, do you have agreements with the customers? Provide copies.
- What do you do with your by-products like sawdust and bark slabs?
- When do you receive payment for an order?
- Do you have standing or recurring orders with any customers?
- Who is responsible for shipping costs?
- Is the product being shipped insured by you or the customer? What happens if the product is damaged or destroyed during shipping?
- How do you determine gross receipts?
- Do you secure Forms W-9 from all contractors? Do you issue Forms 1099? Provide copies of both. If not explain why.
- Do you issue Forms 1099 to timber sellers for lump-sum or pay-as-cut purchases? If not, explain why.
- Ask for a complete list of customers the Taxpayer did business with in the tax year under examination.

The examiner's initial interview should take place at the taxpayer's place of business and in most cases will help the examiner to determine income sources and evaluate internal controls. In addition to the questions listed above, the examiner should include questions used in other examinations regarding general income and internal controls. In addition, many other examination issues, such as depreciation and repair expense, may be present. While at the taxpayer's place of business, the examiner should conduct a tour with the taxpayer or someone familiar with the operations. The scope of the tour will depend on the type of timber operator being examined. Be sure to observe the product on site in all stages - raw goods, partially processed, processed goods ready for shipping and by products. Look for trucks and equipment and ask who owns each item and for what business activity it is used.

Most hardwood timber operators are small operations conducted in a fairly small geographic area. Some are family operations lacking certain elements of internal controls. Lack of internal controls and poor record keeping create opportunities for taxpayers to under-report income. These situations leave little or no audit trail.

If, after conducting the initial interview, touring the business site and reviewing the books and records, the examiner determines that there is little or no audit trail, the examiner may use an indirect method to verify income. The examiner should consider using the bank deposit indirect method or the source and application indirect method. The examiner also may consider expanding the scope of the audit to include related entities. For instance, if the key taxpayer is a corporate sawmill, the case may have to be expanded to include each shareholders' personal tax return.

The examiner also should consider making third party contacts with customers and other sawmills in the area. Additionally, the Examiner should evaluate the taxpayer's ability to support the expenses (deductible and non-deductible, business and personal) with the amount of income reported and any non-taxable income received.

Third party contacts are a good, reliable resource for income identification. There are four general types of timber returns. They are land/timber sellers, loggers/timber operators, truckers and sawmills. The following is a general list of third party contacts that can be used for almost all timber returns:

- Taxpayer's known customers
- Courthouse records of timber deeds
- Real property tax receipts
- Logger or broker purchase records
- Federal or state Forest Services
- Consulting foresters
- Sawmill or concentration yard purchase records
- Timber severance taxes (where applicable)
- Related timber purchases on a per job basis
- Verification of a trucker's drivers, cutters, and skidder operators, including income arrangements
- Customer purchase records

After income sources have been identified, it is necessary to contact these sources to request documentation pertaining to the taxpayer being examined. The examiner should request that these sources provide documentation such as invoices, canceled checks, contracts, etc. Use diligence in gathering all relevant data because in many cases the source records may be incomplete. Sometimes these records may have limited data such as only a name and an amount. This makes it very difficult to identify the payee; even if the payee was paid by check (checks may be cashed rather than deposited). In many cases, the examination may require a combination of third party contacts to identify unreported income. If the third party does not comply with your request, you should consult your manager to determine if a summons should be sent to that party. Summonses to banks should be considered to verify that the taxpayer has disclosed all bank accounts.

As mentioned above, land/timber sellers, loggers/timber operators, truckers and sawmills may have limited internal controls, thus increasing the probability of error. For example, often there will be missing or unavailable invoices or other documentation to support expense deductions. Standard audit techniques should be used to examine expenses. Examiners should properly consider the cost of goods sold (COGS) during their examinations as it is usually the second largest dollar volume item on a tax return after gross income.

COGS and Other Deductions easily can be used to cover a multitude of incorrectly treated expenditures. The IRM requires minimal inventory checks. See IRM 4.10.3.9.4.3 for additional information on techniques.

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

- Personal expenses of a shareholder paid out of corporate accounts but still deducted on the corporation's tax return. The examiner should keep in mind that if this situation is discovered the adjustment is two pronged. First, the personal expense must be disallowed to the C Corporation and then assessed as a dividend to the shareholder. Similarly, if the taxpayer is an S corporation the expense is still disallowed but then the personal amount must be considered in the basis computation of the shareholder.
- Expenses are overstated with no supporting documentation. Some timber industry taxpayers may deal in cash and may not keep applicable receipts. When taxpayers deal in cash, they will usually verify expenses by providing paid invoices only because they have no cancelled checks. If the Examiner has a double entry set of books, close attention should be paid to journal entries in the expense accounts. If the taxpayer is paying in cash and the cash was not deposited, they need a journal entry to book the expense. Examiners should be sure to trace all cash payments to the source of the cash.
- If an examiner has determined that their timber audit requires them to address issues under IRC 183 or 469 then they should examine those issues using either the IRC 183 Activities Not Engaged in for Profit ATG or the Passive Activity Loss ATG. These guides will address how the examiner should evaluate the facts of their case to determine if IRC 183 or 469 applies under timber industry norms. The examiner is expected to evaluate the activity as a whole and carefully determine the substance of the activity to arrive at their position.

Chapter 3 - Income Taxation of Timber Operations

Timber Income

Prices for hardwood timber rise and fall as do many commodities based upon demand and availability. Hardwood prices also will vary by species, timber quality, variability of terrain, distance from mills, distance to public roads and the knowledge of the landowner on timber value at the time.

A landowner may sell his timber in several ways. The landowner may negotiate a price with a timber buyer (connected to a specific mill or independently) or by using a consulting forester who marks the timber and puts it up for bid by advertising with buyers in the area. In these cases, the buyer will usually contract the felling and delivery of the wood to a third party contractor. A landowner may also arrange with a logger to cut the timber and haul the logs to a mill for sale and then the logger and landowner split the proceeds (sometimes referred to as a percentage sale), or the landowner may sell the timber directly to a logger who will then market the logs and keep all proceeds.

Throughout the discussion on revenue, it is important to keep in mind that timber is considered the volume of wood in the standing tree prior to severance from the stump. It is considered real property and capital gains property. On the other hand, logs are the volume of wood from trees

severed from the stump and are personal property. The sale of logs from timber held for more than one year is generally capital gains property subject to tax treatment under § 1231.

Standing timber is usually purchased in one of three ways:

- outright purchase of the land and related timber
- purchase at a specified rate per unit of timber actually cut (pay-as-cut)
- purchase for a set total amount or lump sum

When the company pays the owner of standing timber 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. This type of sale is also known as a § 631(b) sale because it is covered in § 631(b). As of May 28, 2009, when a buyer purchases standing timber for a lump sum, that payment also must be reported on Form 1099-S. The Form 1099-S reporting requirement is placed on the purchaser of the timber regardless of who the purchaser is: mill, broker, logger, etc. The instructions for Form 1099-S contain additional information. Treasury Regulation § 1.6045-4 was amended to require Form 1099-S for lump sum sales.

Payments to independent contractors for cutting timber are compensation for services performed, and payments of \$600 or more must be reported on Form 1099-MISC in the nonemployee compensation box. However, payments to independent contractors that only cover the purchase of logs and **not** the service of cutting do not need to be reported because they are payments for merchandise.

When gross income is established, the profit 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. The cost or basis of the timber and the sales expenses are considered cost of goods sold.

Sale Proceeds - Cost or Basis - Minus Sales Expenses = Net Profit or 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:

- Capitalized expenditures are entered into an asset account for recovery through depreciation, amortization, depletion or other means.
- Operating expenses generally are deductible from gross income for the tax year in which the expenditure is paid or incurred.
- Selling expenses associated with a timber disposal are deducted from gross sale proceeds to determined net profit or loss.

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 instead of being immediately expensed. It is necessary to examine accounts to ensure proper recording of the original cost, amounts recovered, and additions for improvements.

At the time of acquisition, the total cost is allocated among the assets included in the purchase. The amount allocable to land itself is the portion of the total acquisition cost attributable to the bare land. Land cannot be depreciated or depleted. The value of land can only be recovered through disposal by sale, exchange, bequest, etc. For purchases that are not made at the FMV of the property, the basis of each asset must be determined by using the proportion of the FMV of that asset compared with the FMV of all assets and compared to the total acquisition cost. This method is discussed in greater detail below under Establishing Cost or Basis.

The Land Account

Assets placed in the land account include the land itself, non-depreciable improvements, and depreciable land improvements. The value placed in this account may result from sale, exchange, bequest, etc.

Non-depreciable land improvements are primarily earthwork enhancements of a permanent character such as clearing for and constructing roadbeds of permanent roads, land leveling, and impoundments. These amounts generally may only be recovered through disposal of the land. Initial property surveys should also be capitalized into the non-depreciable land account. 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 also 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 non-depreciable 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 land improvements include bridges, trestles, fences, culverts, and surfacing. Their costs are recoverable through depreciation. Depreciation is allowable whether the road has a useful life to the taxpayer of one year. Finally, maintenance costs not related to basic construction are deductible as business expenses in the tax year incurred. However, these costs are limited to Form 1040, Schedule A, Miscellaneous Other Deductions, if the asset is held for investment purposes. Assets held for personal use are not deductible. Maintenance costs include items such as grading or adding gravel.

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 this case, if a taxpayer builds a permanent road that becomes the property of the landowner at the end of the agreement, the taxpayer may recover the depreciable portions of the road. On termination of the agreement, any remaining basis that the taxpayer has with respect to the depreciable portion of the road would be recoverable in that tax year. For the non-depreciable portion of the road, an equal 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.

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 under Asset Class 00.3. See 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 holding of Rev. Ruling 88-99, 1988-2 C.B. 33, indicates 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 part of the total cost is allocable to the timber. 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. Section 194 allows tax deductions for the cost of reforesting timberland following a harvest or for planting previously open land. A taxpayer may deduct the first \$10,000 (\$5,000 for married couples filing separately) per tax year of such costs per qualified timber property. Any additional amount may be amortized over 84 months. Establishing hardwood regeneration is

generally not as intensive as for conifers. Most of these types of costs are associated with conifer plantations and not all apply to hardwoods.

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 extends the life of these items is added to the equipment account.

Operating Expenses

Operating expenses are broad classes of costs that can be defined as all those costs that are not capital costs and are not associated with the sale or 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 § 162. The examiner should be aware that most of these expenses can lend themselves to personal use. The personal use portion of these expenses is not deductible and an allocation for business use must be made. The examiner should verify the business purpose and how it relates to the timber operation. This is done by interview questions, observation and inspection of invoices, receipts, policies and other documents.

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 § 212. The following items are examples of some types of deductible operating expenses:

- Tools of short life or small cost include axes, handsaws, sledges, wedges, etc. These are generally items replaced almost every year.
- Maintenance costs include incidental repairs of trucks, tractors, and other mechanical equipment. These costs usually are oil changes, inspection, tire rotation, tune-ups, cleaning, etc.
- 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.
- Taxes such as property, severance, gasoline, and license fees for business vehicles. Federal income tax, estate, inheritance and gift taxes, and special assessments for local benefits are not deductible.
- Interest payments on bank loans and other short-term credit, and long-term indebtedness such as mortgages. Note: Individual personal interest is not deductible.
- Premiums for fire, windstorm, theft, or other business insurance, such as public liability and workmen's compensation are deductible.
- Travel expenses while away from home on business may be deductible under certain circumstances.
- Rent or other payments for land, equipment, or other business property in which the taxpayer has no equity.

Selling Expenses

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

- Advertising the timber for disposal.
- Cruising to determine the quantity and quality of timber to be disposed.
- Marking or otherwise designating the timber for cutting.
- Marking seed trees to be retained.
- Scaling, measuring, or otherwise determining the quantity of timber cut.
- Fees paid to consulting foresters, selling agents, and others for service directly related to timber disposal.
- Supervising or checking performance under the contract.
- Other expenses 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 deduction and 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 single 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 asset individually. Note: In some cases, the sum of the FMV of the individual assets will be greater than or less than the FMV of the combined assets. The taxpayer must make a reasonable effort to estimate the FMV of each asset. A reasonable estimate for five acres of low grade timber may be based on readily available information, such as published price reports. However, for a larger tract and/or higher-value timber, this approach would be unreasonable. An appraisal by an experienced forester would be more 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. In addition, a taxpayer must consider the following factors when estimating the FMV of timber property:

- Character and quality of the timber as determined by species, age, size, condition, etc.;
- The quantity of timber per acre, the total quantity under consideration, and the location of the timber in question with reference to other timber;
- 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

- The freight rates by common carrier to important markets.

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 match income and expenses more clearly on the 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. The basis of property acquired through gift or inheritance is discussed in Chapter 4.

Detailed instructions on how timber basis should be established and adjusted are found in Treasury Regulations § 1.611-3.

The appropriate time to establish a separate cost basis for timber is when the property is acquired. It may be necessary to establish a basis later if not done at the time of acquisition. 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 by the taxpayer on a case-by-case basis.

The information needed to establish a separate cost basis for timber at a later date is the same as that needed if the allocation were 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 determine this estimate, forest measuring and mathematical techniques can be used to reverse the growth of the current forest back to the date of acquisition for a reasonable approximation of volume at time of acquisition. A professional forester should perform this task. The forester should consider factors such as growth period, growth rate, weather, insects, forest fires, etc.

After the volume by type has been estimated, the FMV of the 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 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. The FMV of the timber then has to be balanced against the FMV of the other assets at the time of acquisition, as discussed above.

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 acquisition. This is because the volume and 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 tax year of the sale.

An IRS Forester can assist the examiner with determining if the basis of the land and timber established by the taxpayer is correct.

The Form T and Form T Instructions are useful to determine and track timber volumes, basis and activities.

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. (BF = Board Feet and MBF = 1,000 BF)

Type of Expense	Amount
Purchase price of farm	\$ 135,000
Legal fee (title search)	420
Surveyor fee	1,200
Consulting forester fee (cruising, valuing timberland)	800
Misc. selling expenses	380
Total Cost or Basis	\$ 137,800

The total cost must be allocated among all the assets acquired. This allocation requires the assistance of experts.

Asset Description	FMV of Asset	% of FMV	Cost Basis
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House (realtor estimate)	\$ 12,000	6.62	\$ 9,122.36
Barn (realtor estimate)	8,000	4.42	6,090.76
Fences (taxpayer estimate)	1,400	.77	1,061.06
Timberland (90 acres at \$120/acre) (realtor estimate)	10,800	5.96	8,212.88
Pasture Land (29 acres at \$800/acre) (realtor estimate)	23,200	12.81	17,652.18
Home land (1 acre at \$1600/acre) (realtor estimate)	1,600	.88	1,212.64
Merchantable timber (12 MBF/acre at \$110/acre) (consulting forester estimate)	118,800	65.56	90,341.68
Young growth timber (\$60/acre (consulting forester estimate)	5,400	2.98	4,106.44
Total	\$ 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 tax year that they purchased it. The contract price is \$110/MBF and the volume estimate of 12 MBF/acre is used. The net gain from the sale would be:

Gross Income	Amount
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 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 tax year that it was purchased. Assuming a holding period requirement of one year, the gain would have been short-term capital gain, making 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 corresponding portion of the cost basis may be reduced. This partial reduction in cost basis is determined by multiplying the number of units (volume) sold by the depletion unit.

Example 3

Referring to Example 1, assume the Dells sell 450 MBF in year 1, instead of all the timber in Example 2. The depletion unit for the timber is \$83.65/MBF, obtained by dividing \$90,342 by 1,080 MBF. The contract price is \$110/MBF and the selling expenses total \$3,500.

Gross Income	Amount
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 obtained by dividing the basis of the timber by the volume of timber.

The calculation becomes more complicated if a year or more elapses between the acquisition 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 was 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:

- Volume of additional timber purchased or otherwise acquired during the period.
- Transfer from the young growth or plantation accounts to the merchantable timber account of the volume of timber that becomes merchantable during that period, and its basis.
- Volume gained through growth since last adjustment.
- Volume removed through sale or other disposition, or lost due to natural or other causes.

Timber companies generally make annual adjustments for growth. However, owners of smaller timber holdings who have infrequent timber transactions generally make these adjustments only in a tax year in which they cut, sell, or otherwise dispose of timber. One way for small producers to account for timber growth may be to re-cruise the entire timber tract. This can be accomplished at the same time that the timber is marked or otherwise designated for sale.

Any additions or reductions to timber basis that have occurred since the last adjustment must be reflected in the timber account before the depletion unit is calculated. The volume and cost basis used to calculate the depletion unit for a given tax 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 tax 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 of ownership. During the Dells' ownership, the following transactions have occurred:

- A timber stand improvement (TSI) was made at a net cost of \$60/acre, which was capitalized.
- Twenty-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 was added to the timber account previously established.
- The merchantable timber had an average net growth of 350 BF per acre per year. ($350 \text{ BF}/1,000 = 0.350 \text{ MBF}$)
- The young growth reached merchantable size. Its average net growth was 350 BF per acre per year. ($350 \text{ BF}/1,000 = 0.350 \text{ MBF}$)

Timber Basis Analysis	Amount
Original Cost (Tax Year 1)	\$ 90,342
Timber Sale (Tax Year 1)	(37,643)
TSI (90 acres at \$60/acre)	5,400
Purchase Jones Tract	20,000
Transfer from Young Growth (Ex. 1)	4,106
Adjusted Basis	\$ 82,205

Timber Volume Analysis	Volume
Original Volume (Tax Year 1)	1,080 MBF
Timber Sale (Tax Year 1)	(450 MBF)
Purchase Jones Tract	300 MBF
Transfer from Young Growth (.350 MBF x 90 acre x 10 years)	315 MBF
Growth (.350 MBF x 90 acre x 10 years)	315 MBF
Adjusted Volume	1,560 MBF

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

Gain Computation	Amount
Gross Income (900 MBF x \$145/MBF)	\$130,500
Allowable Basis (\$82,205/1,560 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, produces, and sells logs, the depletion allowance is calculated in exactly the same manner as the allowable basis. Although depletion occurs when timber disposal occurs, depletion is not allowable until the logs are sold or otherwise disposed. Furthermore, no depletion allowance can be claimed for timber cut for personal use such as home firewood. The basis for depletion must be reduced by the cost attributable to the personal use timber.

The tax treatment of a disposal of standing timber depends on the primary purpose for which the timber is held, the holding period and the manner in which the timber is disposed. The holding period is determined from the date the timber, or the contract right to cut the timber, is acquired until it is considered cut.

- If the timber is held for investment for more than one year and is sold either in a lump-sum sale or in a pay-as-cut contract, the disposal of timber will produce long-term capital gains or losses. If the timber is held for less than one year, it will be treated as a short-term capital gain or loss.
- If the timber is held as part of a trade or business, the treatment of the sale depends on the holding period. Timber held for use in a taxpayer's trade or business and held for more than one year is considered § 1231 property. The gains or losses on the sale of such property are netted with other § 1231 gains or losses, with the resulting net gains treated as capital gains and the resulting net losses treated as ordinary losses. No asset held for one year or less is ever given § 1231 treatment.
- Lump-sum Sale - Occurs when timber is sold for a set price regardless of the volume of timber actually cut. The timber to be disposed of may be specified by various means such as marking trees within a specified area or trees of a certain species.
- Pay-as-Cut Contract - This type of sale is also known as a "disposal with a retained economic interest" or a § 631(b) transaction. Timber is sold and payment made as it is cut and measured, with price depending on the volume cut.
- Some taxpayers may be eligible to elect to treat the cutting of their own timber for sale or use in their business as a sale or exchange of the timber under § 631(a). To be eligible to make the election, the taxpayer must have owned the timber or a contract right to cut the timber for more than one year and the timber must be for sale or for use in the taxpayer's business. If the taxpayer makes the election, the difference between the adjusted basis of the timber cut and its FMV on the first day of the tax year in which it is cut is treated as a § 1231 gain or loss. Income received by the taxpayer from additional processing of the timber once cut is ordinary income or loss. The election must be made with the original

tax return for the tax year to which it first applies. Once made the election is binding on the taxpayer for the tax year for which the election is made and all subsequent tax years. To discontinue using this method the taxpayer must receive consent from the IRS.

- If the timber is held for personal use, the sale will produce a capital gain or loss. The capital gain or loss will be either long-term or short-term depending on the length of time the timber was held.

Chapter 4 - Basis in Gifts and Inherited Property

Generally, for gifts the basis is the same as it would be in the hands of the donor. However, if the basis is greater than the FMV of the property at the time of the gift, for purposes of determining loss the basis is FMV (§ 1015(a)). Note: The adjusted basis of the gift can be 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.

Generally, the income tax basis of property acquired from a decedent is the FMV of the property on the date of decedent's death or the alternate valuation date, if elected. (§ 1014(a)). If the decedent's estate has elected to value the property under § 2032A, then the value is determined under that tax provision. Note: the value of property reported on an unexamined federal or state estate tax return is not determinative of the FMV. As with unfiled estate tax returns, the basis is determined only under § 1014. There are also special rules for decedents dying in 2010 if the executor elects to apply carryover basis rules rather than remain under the default estate tax provisions.

If timber is not separately listed on the federal estate tax return or state tax form, FMV will need to be allocated to the timber. For example, if timber and timberland have been valued together, a taxpayer must use the allocation procedure demonstrated in Chapter 3. However, the value reported on the estate tax return will be used instead of the acquisition cost.

Chapter 5 - Employment Taxes

Overview

Subcontractors are commonly used in the timber business. Some taxpayers treat workers as other than employees to avoid paying employment taxes. Employees could be misclassified as subcontractors, contract labor or independent contractors. Backup withholding could apply to subcontractors. If you have a potential employment tax issue or a worker reclassification issue, refer the issue to the Employment Tax Specialty Group to work. The discussion under Who Are Employees? is included to help you identify this issue in your case. Examiners may use the Specialist Referral System to obtain assistance.

A worker classification examination can be one of the most important and challenging issues examiners will encounter. Improper classification of workers by a business can lead to many problems.

- Statistics show that misclassified workers are less likely to file income tax returns.
- Reporting income on Form 1040, Schedule C as gross receipts rather than wages gives the worker the opportunity to deduct expenses from gross income rather than as employee business expenses.
- Misclassified workers do not receive benefits that they may be entitled to as employees, such as health benefits, pensions, etc.

Examiners will need to follow certain procedures specific to worker classification examinations. Additional information regarding procedures for worker classification issues are discussed in the next section of this chapter.

Wages paid by an employer are subject to taxes imposed under the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and under the Collection of Income Taxes at source (FITW). In addition to these federal tax requirements, the employer may be responsible for state unemployment taxes and the withholding of state and local income taxes. 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.

Reporting requirements are also different for employees and independent contractors. Some of the federal forms necessary with respect to employees are as follows:

- Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return
- Form 941, Employer's Quarterly Federal Tax Return
- Form W-2, Wage and Tax Statement (Info. Copy Only)
- Form W-3, Transmittal of Wage and Tax Statements (Info. Copy Only)
- 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 (Info. Copy Only)
- Form 1096, Annual Summary and Transmittal of U.S. Information Returns (Info. Copy Only)

Additional information on Form 1099-MISC can be found in the Instructions for Forms 1099, Form 1098, Mortgage Interest Statement (Info Copy Only), Form 5498, IRA Contribution Information (Info Copy Only), and Form W-2G, Certain Gambling Winnings.

Who Are Employees?

The following is a brief outline of the law regarding employment status and employment tax relief. It is important to note that either worker classification -independent contractor or employee - can be valid.

The first step in any case involving worker classification is to consider § 530 of the Revenue Act of 1978. An examiner must provide the taxpayer with a written notice of the provisions of § 530

(IRS Publication 1976) when examining employment status issues. If the requirements of § 530 are met, a business may be entitled to relief from federal employment tax obligations. Section 530 terminates the business' but not the worker's employment tax liability, including any interest or penalties attributable to a liability for employment taxes. See IRM 4.23.5 for more information and guidance on § 530. If the business is eligible for § 530, the examiner should discontinue the examination with regard to the qualified occupation. This discontinuance means that the worker's status has not been determined as to whether the occupation class is that of employee or independent contractor. See IRM 4.23.10.13.3.1.

In determining a worker's status, the primary inquiry is whether the worker is an independent contractor or an employee under the common law standard. Under the common law standard, the treatment of a worker as an independent contractor or an employee originates from the legal definitions developed in the law of agency - whether one party (the principal) is legally responsible for the acts or omissions of another party (the agent) - and depends on the principal's right to direct and control the agent.

Guidelines for determining a worker's employment status are found in three substantially similar sections of the Employment Tax Regulations:

- Section 31.3121(d)-1 relating to the Federal Insurance Contributions Act (FICA)
- Section 31.3306(i)-1 relating to the Federal Unemployment Tax Act (FUTA)
- Section 31.3401(c)-1 relating to federal income tax withholding

The regulations provide that an employer-employee relationship exists when the business for which the services are performed has the right to direct and control the worker who performs the services. This control refers not only to the result to be accomplished by the worker, but also to the means and details by which that result is accomplished. In other words, a worker is subject to the will and control of the business not only as to what work shall be done but also how it shall be done. It is not necessary that the employer actually direct or control the manner in which the services are performed if the employer has the right to do so. To determine whether the control test is satisfied in a particular case, the facts and circumstances must be examined.

The Service looks at facts and circumstances in the following categories to determine worker classification: behavioral control, financial control, and relationship of the parties. Rev. Rul. 87-41, 1987-1 C.B. 296, summarizes 20 common-law factors that fall within these three categories. See Exhibit 5-1.

Behavioral Control: Facts that substantiate the right to direct or control the details and means by which the worker performs the required services are considered under behavioral control. This includes factors such as training and instructions provided by the business. However, virtually every business will impose on workers, whether independent contractors or employees, some form of instruction (for example, requiring that the job be performed within specified time periods). This fact alone is not sufficient evidence to determine the worker's status. The weight of instructions in any case depends on the degree to which instructions apply to how the job is done rather than to the end result.

The degree of instruction depends on the scope of instructions, the extent to which the business retains the right to control the worker's compliance with the instructions, and the effect on the worker in the event of noncompliance. The more detailed the instructions that the worker is required to follow, the more control the business exercises over the worker, and the more likely the business retains the right to control the methods by which the worker performs the work. The absence of detail in instructions reflects less control.

Financial Control: Economic aspects of a relationship between the parties illustrate who has financial control of those activities. The items that usually need to be explored include:

- whether the worker has a significant investment
- whether the worker has unreimbursed expenses
- whether the worker's services are available to the relevant market
- whether the worker is paid by the hour as opposed to a flat fee for the services performed
- whether the worker has the opportunity for profit or loss

The first four items are not only important in their own right but affect whether there is an opportunity for the realization of profit or loss. All of these factors can bear on the issue of whether the recipient has the right to direct and control the means and details of the business aspects of how the worker performs the services.

The ability to realize a profit or incur a loss is probably the strongest evidence that a worker controls the business aspects of the services rendered. If the worker is making decisions that affect his or her bottom line, the worker likely has the ability to realize a profit or loss.

Relationship of the Parties: The relationship of the parties is important because it reflects the parties' intent concerning control. Courts often look to the intent of the parties, which usually is embodied in contractual relationships. A written agreement describing the worker as an independent contractor is viewed as evidence of the parties' intent that a worker is an independent contractor. However, a contractual designation, in and of itself, is not sufficient evidence to determine worker status. The facts and circumstances under which a worker performs services are determinative of a worker's status. The designation or description of the parties is immaterial. The substance of the relationship governs the worker's status, not the label.

For an in-depth discussion, refer to Internal Revenue Manual 4.23.5, Technical Guidelines for Employment Tax Issues, which includes the § 530 determination, and related exhibits, and Rev. Proc. 85-18, 1985-1 C.B. 518. See also IRS Pub. 15A, Employer's Supplemental Tax Guide.

The right-to-control test is crucial to determine the nature of the working relationship. The degree of control is very important, though not completely dispositive. Accordingly, the IRS must examine not only the control exercised by an alleged employer, but also the degree to which the alleged employer may intervene to impose control. In order for an employer to retain the requisite control over the details of an employee's work, the employer does not need to stand over the employee and direct every move made by that employee. In addition, the degree of control necessary to determine employee status varies according to the nature of the services provided.

During the initial interview, the examiner should gain an understanding of the taxpayer's operations, rather than simply verify the presence or absence of common law factors. Focus on what the business does and how the job is done. It is also important to understand the relationship between the employer and its clients and customers.

Saw Rents

Employees in the timber industry may furnish and maintain their own saws and related equipment and employers have been known to reimburse employees for the rental of this equipment. Typically, the employer will characterize a portion of each employee's compensation as a reimbursement for the use of saws and equipment rather than as wages to avoid both employment and income taxes on the saw and equipment payment amount. These payments customarily are called saw rental payments. However, the payments usually do not represent a payment of rent to the employee for the use of saws and equipment. Accordingly, they should be treated as wages to the employee unless made under an accountable plan.

Although the payment may be intended to reimburse the employee for the expenses incurred in purchasing and maintaining a saw, the amount generally is determined without reference to the expense incurred. It is more likely that the payments are used to provide employee compensation not subject to employment taxes. Employers do not include the saw rental payments in the employee's wages, thus, allowing the employers to reduce their liability for employment taxes.

Section 62(a) defines Adjusted Gross Income (AGI) as gross income minus certain deductions.

Section 62(a)(2)(A) allows an employee a deduction in computing adjusted gross income 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. Section 62(c) provides that, for purposes of § 62(a)(2)(A), an arrangement will not be treated as a reimbursement or other expense allowance arrangement if:

- The employee is not required to substantiate the expenses covered by the arrangement to the person providing the reimbursement, or
- The employee has the right to retain amounts in excess of the substantiated expenses covered under the arrangement.

A reimbursement or other expenses allowance arrangement will be treated as an accountable plan if it meets the requirements of business connection, substantiation, and return of excess. See Treasury Regulation §1.62-2(c)(1).

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. A reimbursement or other expense allowance arrangement will be treated as a nonaccountable plan if it fails to meet any one or more of the requirements of business connection, substantiation, or return of excess. 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.
- Are subject to withholding and payment of employment taxes.

Expenses reimbursed under a nonaccountable plan, if deductible, are deducted by the employee only as a miscellaneous itemized deduction, subject to the two percent floor. However, if the expenses are determined to be personal, they are not deductible by the employee under any provision of the Internal Revenue Code (and cannot be reimbursed under an accountable plan).

Three requirements must be met in order for the amounts reimbursed to employees for the rental of their own saws and other equipment to qualify as received under an accountable plan.

- The expenses for which the employer is making payment must be expenses that would qualify for a business expense deduction under § 162 as outlined in Treasury Regulation § 1.62-2(d) (business connection requirement).
- The substantiation requirements of Treasury Regulation § 1.62-2(e) must be met (substantiation requirement).
- The employee must be required to return, within a reasonable period of time, any amounts received in excess of those that have been substantiated under Treasury Regulation § 1.62-2(f) (return of excess requirement).

If an arrangement meets all three of these requirements, then all amounts paid under the arrangement are treated as paid under an accountable plan. 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. If an arrangement does not satisfy the three requirements, all amounts paid under the arrangement are treated as paid under a nonaccountable plan.

Payments to employees for equipment they are required to provide as a condition of employment are wages for employment tax purposes, unless paid under an accountable plan. See Rev. Rul. 2002-35, 2002-1 C.B. 1067.

An employer who designates part of an employee's compensation as a tool allowance or other equipment allowance must meet the accountable plan requirements. To be excluded from wages, amounts paid to employees to cover expenses incurred to acquire or maintain tools must be paid under a reimbursement or other expense allowance arrangement that meets the requirements of § 62(c). An arrangement that provides for a tool allowance based upon hours worked or any other estimate fails to meet both the substantiation and the return of excess requirements and does not qualify as an accountable plan. See Rev. Rul. 2005-52, 2005-2 C.B. 423. See also exhibit 5-3 for a further explanation of Rev. Rul. 2002-35 and Rev. Rul. 2005-52.

Saw rental payments generally do not satisfy the accountable plan requirements. First, the employer is making a payment regardless of whether expenses are incurred and is merely relabeling a portion of the employee's taxable wages as nontaxable reimbursement for the use of the saw. Second, no substantiation is required. Third, employees are not required to return any amounts in excess of substantiated expenses and, since no expenses are substantiated, all amounts paid are treated as excess.

Example of Saw Rents as a Nonaccountable Plan

Lyle's Logging hires employees to fell 10 tracts during the month of June. The employees provide their own saws and miscellaneous equipment. Lyle pays his employees \$10 for each tree felled and generally 50 trees are felled per day. Lyle allocates the payments to his employees 75 percent as wages and 25 percent as saw rents. Lyle does not know if the saw rents reasonably correspond with the anticipated expenses of saws and equipment. 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 of payments made as wages on the employee's Forms W-2 at the end of the year; the other 25 percent, treated as saw rents, was not reported to the employee.

The employees received the saw rental payments under a nonaccountable plan. Therefore, the total paid to the employees, wages and saw rents, is includible in income and reportable as wages subject to employment taxes.

Skidder Rentals

A skidder is a four-wheeled machine that is used to move felled trees. A skidder is not driven on the road. Skidder operators often own their own skidders and pay for the costs of operating and maintaining the skidders. The company generally pays the skidder operator a predetermined amount based on the number of logs hauled. There may be a written or a verbal agreement between the company and the skidder operator. The skidder operator may be either an employee or independent contractor based on the facts and circumstances that determine who has the right to direct and control the work that is to be performed.

It is not unusual to find the company characterizes a portion of the agreed upon amount to the skidder operators as skidder rent and the balance of the amount paid represents payment for services. For example, the company may pay 60 percent of the amount paid to the skidder operator as skidder rent and the remaining 40 percent paid represents payment for services. Whether the payment made to the skidder operator actually is the payment of rent is an issue to consider during the examination. The accurate characterization of the payment depends upon whether the relationship between the worker and company is that of an employee/employer or independent contractor and whether the worker is engaged in the trade or business of renting the skidder.

Generally, payments to employees for the use of employee-provided equipment are wages and not rent since the payments are related to the services provided as an employee and are not paid under an accountable plan. Thus, the payments should be considered wages subject to employment taxes unless the payments were made under an accountable plan.

In contrast to the general rule that rental payments to employees are wages, it is possible that a payment to an employee for equipment can be considered a valid rental in limited circumstances.

In *Welch v. Commissioner*, T.C. Memo 1998-310, the Tax Court held that Mr. Welch's equipment leasing activities in 1993 were not passive activities. Mr. Welch, a carpenter, was

hired by movie production companies as a construction coordinator. Mr. Welch and the production company would enter into a "deal memorandum" setting forth the terms of his employment including the rate that he would be paid and the rate at which he rented his equipment to the company. Typically, an inventory of his tools and equipment would be attached to the deal memo. The production company would report Mr. Welch's wages on a Form W-2 and the tool rentals on a Form 1099. As construction coordinator, he constructed movie sets, hired employees, arranged for the purchase of materials and furnished all the required tools. He was required to purchase, maintain, transport and repair the tools as needed. The facts also specify that in 1993, Mr. Welch rented tools to a third party for \$1,500 for a project for which he was not the construction coordinator.

This was not an employment tax case, but rather a case to determine whether Mr. Welch was entitled to a deduction for losses incurred from his rental business. However, the court analyzed whether Mr. Welch was merely incurring employee business expenses or whether the expenses claimed were properly attributable to a separate activity of renting the equipment. The *Welch* court case concluded that the losses claimed on Mr. Welch's Schedule C pertained to the separate activity of renting the equipment.

Mr. Welch was a rare example of someone who had been hired as an employee to perform services as a construction coordinator, and separately engaged as a lessor of tools and equipment to the company for use in set building and design. Because of Mr. Welch's dual status, payments made as compensation for services rendered were correctly reported and taxed as wages, whereas payments received as rent for the use of his tools and equipment were correctly reported and treated as self-employment income.

The facts illustrate an arrangement for the rental of equipment that was an arms length transaction memorialized in writing. A significant fact is that Mr. Welch actually rented his tools to a third party that did not also employ him as the construction coordinator. Thus, at least in that instance, his rental activity was separate from the services he performed as an employee.

The issue illustrated in *Welch* was that the employee was acting in two distinct capacities: an employee and a lessor.

Rev. Rul. 58-505, 1958-2 C.B. 728, provides additional context regarding employees who serve a company in two different and distinct capacities. In Rev. Rul. 58-505, the M Company was engaged in the sale of insurance policies. The president and the secretary of the M Company performed administrative services as officers of the company and received salaries that were subject to employment taxes. Separate and apart from these duties, these individuals also sold insurance policies to customers under the company's standard agents' contracts. In this context, these individuals were paid for sales in exactly the same manner as the company pays its regular agents, that is, by a certain commission on each policy sold. However, the officers were not required to act in this capacity as part of their official duties as officers of the M Company.

In determining whether the commissions earned by the officers were subject to employment taxes, the IRS focused on whether their services in the two capacities (as officers and sales agents) were interrelated. In Rev. Rul. 58-505, the IRS stated that if the officers' services were

found to be interrelated, it could not be said that they were acting in two separate and distinct activities. If, however, the officers' services in the two capacities are separate and distinct (if there is no interrelation as to either duties or remuneration in the two capacities) the status of each type of service must be considered separately. The IRS further provided that interrelated services which, as a whole, contain the elements establishing the existence of a common law relationship of employer and employee would result in a conclusion that, with respect to all services performed by the individuals, they are employees for federal employment tax purposes.

Generally, employees who provide tools as a condition of their employment are not offering two separate and distinct services to their employers. Their capacity as an employee is interrelated to their capacity of renting tools. Because these two roles are so interrelated, Rev. Rul. 58-505 suggests that the amounts paid as usage payments are also subject to employment taxes.

Taxpayers may attempt to raise Rev. Rul 73-576, 1973-2 C.B. 336, to show that rent paid to an employee for employee-provided equipment is proper. This ruling addressed the classification of a construction worker who provided his own backhoe to perform his duties. The worker was paid on an hourly basis for his personal services and received an additional specified amount for the use of the backhoe. The ruling includes a statement that "the worker correctly reports the amount he receives for the use of the backhoe on his income tax return as rental income."

However, at issue in Rev. Rul 73-576 is whether the worker was an employee or independent contractor. The ruling did not include any facts concerning the equipment rental and does not purport to determine whether the separate payment of rent for the use of the backhoe was proper. Although Rev. Rul. 73-576 has not been revoked, more current rulings regarding equipment rental supersede the statement in Rev. Rul. 73-576 that the reporting of the payment for the backhoe as rent is proper. Note: If this argument is raised, consult with TEGE Area Counsel or Employment Tax Branch 1.

Example of Skidder Rent Payments

Scenario 1: Lyle's Logging hires a skidder operator to skid the felled trees from 10 tracts of timber. Separately, Lyle's Logging rents a skidder from the skidder operator. The skidder operator pays for the operating expenses of his skidder and rents the skidder out to others when he is not using it himself. The skidder operator is to be paid \$20,000. Lyle designates 60 percent, or \$12,000, as skidder rental (the fair rental value of the skidder), which he does not subject to any employment taxes or withholdings. Lyle designates 40 percent, or \$8,000, as payment for services. Lyle gives the skidder operator a Form W-2 for \$8,000 at the end of the year. Lyle issued a Form 1099 for the \$12,000.

The skidder operator correctly reported on Form 1040, the wages paid to him of \$8,000. He also reported the skidder rental of \$12,000 on Schedule C. The skidder operator was in the trade or business of renting the skidder and the skidder rental is self-employment income subject to self-employment tax.

Scenario 2: Lyle's Logging hires a skidder operator to skid the felled trees and the operator is determined to be an employee. The skidder operator pays for the operating expenses of his

skidder and is the only person who uses the skidder. The skidder operator is to be paid \$20,000. Lyle designates 60 percent or \$12,000 as skidder rental, which he does not subject to any employment taxes or withholdings. Lyle designates 40 percent or \$8,000 as payment for services. Lyle does not know if the skidder rents reasonably correspond with the anticipated expenses of skidder. The skidder operator is not 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 gives the skidder operator a Form W-2 for \$8,000 at the end of the year. Lyle issued a Form 1099 for the \$12,000.

The skidder operator reported on Form 1040, the wages paid to him of \$8,000. Lyle incorrectly provided a Form 1099 and the skidder operator incorrectly reported the skidder rental of \$12,000 on Schedule C. The skidder operator was not in the trade or business of renting the skidder. The payment for skidder rent is subject to the application of rules regarding qualification as an accountable plan. As a result, the \$12,000 skidder rental payment does not qualify as a payment under accountable plan rules, and is includable in wages subject to employment and income taxes and reportable on a Form W-2.

Scenario 3: Lyle's Logging hires a skidder operator to skid the felled trees from 10 tracts of timber. Lyle does not have a right to direct how the work is done. The skidder operator pays for the operating expenses of his skidder and is in the business of providing his services to multiple logging companies. The skidder operator is to be paid \$20,000. Lyle does not know what amount corresponds with the anticipated expenses of the skidder and the skidder operator is not required to substantiate any business expenses. Lyle gives the skidder operator a Form 1099 for the \$20,000.

The skidder operator is an independent contractor and correctly reported the \$20,000 on Schedule C. The skidder operator was in the trade or business of skidding felled trees. The income received from the trade or business is self-employment income and subject to self-employment tax.

Examination Techniques

During the initial interview of a logging business the examiner should inquire about employees and independent contractors to determine if the business pays employees for equipment rental. If so, the examiner should inquire further to determine if there is an accountable plan established.

The examiner should ask questions to understand the relationship between the business and workers to determine if they should be classified as employees or independent contractors.

Employment tax forms should be reviewed to determine if the taxpayer is in compliance with filing and reporting requirements.

Exhibit 5-1 20 Common-Law Factors/Rev. Rul. 87-41

1. INSTRUCTIONS regarding when, where, and how a worker is to complete their tasks
2. TRAINING provided to the worker

3. INTEGRATION of worker's services into business operations
4. SERVICES RENDERED PERSONALLY by the worker
5. HIRING, SUPERVISING & PAYING ASSISTANTS if the persons for whom services are performed hire and pay assistants, that is indicative of an employer/employee relationship. If the worker hires, pays and supervises assistants that is indicative of an independent contractor relationship.
6. CONTINUING RELATIONSHIP between worker and the persons for whom services are rendered. There may be a continuing relationship where work is performed at frequently occurring but irregular intervals.
7. SET HOURS OF WORK the persons for whom services are rendered establishes set hours for the worker
8. FULL TIME REQUIRED the worker must substantially devote their full time to the persons for whom services are rendered (impliedly limiting the worker's ability to work for others)
9. WORKING ON EMPLOYER'S PREMISES-especially if the work could be done elsewhere
10. ORDER OR SEQUENCE SET BY EMPLOYER the employer sets or dictates the sequence of work tasks performed. This can be shown if the employer retains the right to set the order or sequence of work tasks performed.
11. ORAL OR WRITTEN REPORTS required by employer
12. PAYMENT BY THE HOUR, WEEK OR MONTH
13. PAYMENT OF BUSINESS AND/OR TRAVEL EXPENSE by employer
14. FURNISHING OF TOOLS AND MATERIALS employer furnishes significant tools & materials
15. SIGNIFICANT INVESTMENT in facilities by worker that are not normally maintained by employees is indicative of an independent contractor. The lack of investment by the worker is indicative of an employer-employee relationship.
16. REALIZATION OF PROFIT OR LOSS a worker who can realize a gain or loss as a result of their services is generally an independent contractor, but a worker who cannot is generally an employee
17. WORKING FOR MORE THAN ONE FIRM AT A TIME
18. MAKING SERVICES AVAILABLE TO GENERAL PUBLIC on a regular and consistent basis
19. RIGHT TO DISCHARGE by employer
20. RIGHT TO TERMINATE by worker without liability

Exhibit 5-2 Worker Classification Rulings

Rev. Rul. 71-273, 1971-1 C.B. 286

Piecemakers, skidders, and hired assistants engaged under an oral contract by a logging company that retained the right to control and direct their services were determined to be employees of the company. The company had the right to reassign individuals from their designated work areas, and they were required to meet specified standards set by the company. The company supervised the means by which the results of the work were accomplished through its foreman and it also had the right to discharge any worker. Accordingly, it was held that the piecemakers and

skidders, together with any assistants engaged with the express or implied consent of the company and were employees of the company for purposes of the Federal Insurance Contributions Act, the Federal Unemployment Tax Act, and the Collection of Income Tax at Source on Wages.

Rev. Rul. 71-274, 1971-1 C.B. 287

An individual who contracted to furnish men and equipment to cut, skid, and haul timber for a company that exercised no control or supervision over the individual's operation methods was not an employee of the company. Under the terms of the contract, the individual was given the right and was legally obligated to remove all of the merchantable timber from the tract of land owned by the company. The company neither exercised nor had the right to exercise control over the means and methods by which the individual was to accomplish that result. All of the equipment necessary for the operation was furnished by the individual and all of the operating expenses were borne by him. The individual hired, paid, and controlled the members of the logging crew with respect to all the details of their work. Moreover, the individual offered his services to others and was known as a "logging contractor" to the general public. Accordingly, the Service held that the individual was not an employee of the company for purposes of the Federal Insurance Contributions Act, the Federal Unemployment Tax Act, and the Collection of Income Tax Act Source on Wages. However, the individual was, for employment tax purposes, the employer of the individuals comprising the logging crew.

Exhibit 5-3 Rev. Rul. 2002-35 and Rev. Rul. 2005-52

Rev. Rul. 2002-35, 2002-1 C.B. 1067

The Service addressed the issue of whether amounts paid to employees for employee-provided equipment that are used by the employee to provide services are wages subject to federal employment taxes. The employee was required to provide equipment in connection with the performance of work for employer and the employer paid the employee an hourly wage of \$x for the performance of services as an employee. In addition, the employer paid the employee \$y for providing the equipment used in connection with performance of work for employer. The amount paid to employee was not related to the actual employee business expenses incurred in performing the service as an employee. The business did not require substantiation of actual employee expenses, and the business did not require a return of excess the actual employee expenses incurred.

Rev. Rul. 2002-25 stated that since the amounts were not paid under an accountable plan, all amounts paid under the arrangement were paid under a nonaccountable plan. Thus, the payments were includable in the employee's wages and must be reported to the employee on Form W-2 subject to withholding and payment of employment taxes.

The ruling clarified that payments to employees for equipment they are required to provide as a condition of employment are wages for employment tax purposes unless paid under an accountable plan. The ruling also states that an arrangement that merely allocates compensation

paid to an employee between wages and a reimbursement for business expenses will not meet the requirements of § 62 (c).

Rev. Rul. 2005-52, 2005-2 C.B. 423

The Service addressed the tax consequences of a tool plan in which the employer paid each employee an hourly wage plus a set amount for each hour worked as a tool allowance to cover costs the employee incurred for acquiring and maintaining tools. The employer set each employee's tool allowance annually by using a combination of data from a national survey of average tool expenses for automobile service technicians and specific information concerning tool-related expenses provided by the employee in response to an annual questionnaire completed by all service technicians who work for the employer. The employer then used a projection of the total number of hours the employee was expected to work during the tax year that would require the use of tools to convert the employee's estimated annual tool expenses into an hourly rate for the tool allowance. The tool allowance, therefore, was an estimate of the tool expense projected to be incurred per hour by the employee over the course of the coming year.

At the end of each pay period, each employee reported the number of hours worked requiring the use of tools. The employer then multiplied the number of hours reported as worked requiring the use of tools by the employee's hourly rate for the tool allowance and paid the resulting amount to the employee in addition to compensation for services performed during the pay period. Employees were not required to provide any substantiation of expenses actually incurred for tools. The employer did not require employees to return any portion of the tool allowance that exceeded the expenses they actually incurred.

The ruling concludes that the arrangement fails to meet both the substantiation and return of excess requirements because it does not require employees to substantiate the actual expenses they incur. The employees report their time worked requiring the use of tools and employer converts the hours into an amount treated as expenses incurred based on statistical data. The ruling provides that although reasonable expectations for expenses can be used to establish that a plan providing an allowance meets the business connection requirement, satisfaction of the substantiation and return of excess requirements must be based on actual expenses. The ruling emphasizes that employers may not substitute a reasonable estimate of expenses based on statistical data and hours worked for the substantiation of actual expenses as required by Treasury Regulation § 1.62-2(e)(3), absent explicit guidance permitting the use of such "deemed" substantiation.

The ruling goes on to provide that, even if employer required its employees to substantiate the actual amount of expenses incurred and treated any excess amount as additional wages, the arrangement would still fail to qualify as an accountable plan. To qualify as an accountable plan, an arrangement must require that amounts paid in excess of substantiated expenses be returned. Simply including excess amounts in wages does not satisfy the requirement of returning amounts in excess of expenses, the exception being where employee expenses are covered through a mileage or per diem allowance pursuant to Treasury Regulation § 1.62-2(f)(2).

Consequently, the ruling holds that the arrangement described is not an accountable plan and all tool allowances paid under the arrangement must be included in the employees' gross income, reported as wages on the employees' Forms W-2, and subject to withholding and payment of federal employment taxes.

Chapter 6 - Excise Taxes

Overview

The most common area of excise taxes for the timber industry applies to certain highway motor vehicles. A highway motor vehicle includes any motor vehicle designed to carry a load over public highways, whether or not also designed to perform other functions. A public highway is any road in the United States that is not a private roadway. This includes Federal, state, county and city roads.

A vehicle consists of a chassis, or a chassis and body, but does not include the load. 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.
- Vehicles designed for off-highway transportation.
- Trailers and semi-trailers designed for non-transportation functions off the public highways.

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. A truck is a motorized vehicle that usually carries cargo on the same chassis as the motor. 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 travel on public highways.

The taxpayer is subject to the highway use tax if his truck or truck tractor meets all of the following tests:

- It is a highway motor vehicle, as discussed earlier.
- It is required to be registered for highway use.
- It is used on a public highway.
- It has a taxable gross weight of at least 55,000 pounds.

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

Recordkeeping Requirements for Vehicles

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 Service.

The following is a list of recommended records that the taxpayer should keep:

- A description of the vehicle, including serial number
- The weight of loads carried by the vehicle
- The date of acquisition including the name and address from whom the vehicle was acquired
- The date in which taxable use first occurred
- The date and sale or other transfer of the vehicle including the name and address of the person to whom the vehicle was transferred
- If the vehicle was disposed of, but not sold or transferred, the records must show how and when the disposition occurred.

Computation - Excise Tax

The tax on highway motor vehicles is a graduated tax that based on the taxable gross weight of the vehicle.

- If the taxable gross weight is at least 55,000 pounds but not over 75,000 pounds then the rate of tax is \$100 a year plus \$22 for each 1,000 pounds.
- If the taxable gross weight is over 75,000 pounds then the rate of tax is \$550.

Reduction in Tax for Trucks Used in Logging

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

- During the tax period, the vehicle is used exclusively to transport products harvested from a forest
- Products are transported to and from a point within the harvested forest
- It is registered as a highway motor vehicle used in the transportation of harvested forest products

The Office of Chief Counsel has issued an opinion on the definition of trucks used for logging. See IRS CCA 200949037 released July 1, 2009. In this document, the IRS concluded that a state-registered logging vehicle used exclusively for transporting forest products from a forested site qualifies as a logging vehicle under § 4483(e) and is eligible for the reduced heavy vehicle use tax rate.

Filing Form 2290

The highway use tax is reported and paid using Form 2290, Heavy Highway Vehicle Use Tax Return. Form 2290 must be filed by the last day of the month after the month the vehicle is first used on the public highways. The tax period runs from July 1 of the current tax year through June 30 of the next tax year. 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, 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.

The following information is needed to complete the Form 2290:

- Employer Identification number (EIN)
- Vehicle identification number (VIN) of each vehicle
- Taxable gross weight of each vehicle

The instructions for Form 2290, as well as the Form 2290 itself, provide more detailed information.

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. The business use may not be for a highway vehicle registered for use on any public highway. See §§ 4041 and 6421. The following is a list of a few examples of off-highway business use vehicles:

- Skidders
- Bulldozers
- Crawler dozers
- Road graders
- Trench diggers
- Feller bunchers
- Harvesters

Recordkeeping Requirements for Fuel Tax Credit and Refunds

Treasury Regulation §§ 48.6421-1(f) and 48.6427-1(e) list the records used to verify the amount of fuel tax credit or refund due. The following records are required to be maintained by the taxpayer:

- Number of gallons purchased and used during the period of claim
- Dates of purchases
- Names and addresses of suppliers with amounts of fuel purchased from each during the period of claim
- Purpose of purchasing the fuel
- Number of gallons purchased for each purpose

- If any of the diesel fuel included in the claim contained visible evidence of dye, the claimant must attach a detailed explanation to prove that the excise tax was attached to the purchase because dyed diesel fuel is usually sold without the excise tax.

Claiming the Credit or Refund

The credit can be claimed on the income tax return through the Form 4136, Credit for Federal Tax Paid on Fuels. If the credit is at least \$750 by the end of a tax year quarter, a claim can be made by filing Form 8849, Claim for Refund of Excise Taxes (Schedule 1, Nontaxable Use of Fuels). A taxpayer may not claim any amounts on Form 4136 that have been claimed on Form 8849.

The fuel tax credit is considered prepaid, so the taxpayer will be refunded the amount claimed, even if no tax is due. If a claim for a fuel tax refund is made, and the fuel taxes were included in the deduction for fuel on the income tax return, income must be included in an amount equal to the claim.

Examination Issues

Taxpayers may fail to report their total number of trucks on Form 2290, Heavy Highway Vehicle Use Tax Return, for the Highway Use Tax. During the initial interview, the examiner should ask the taxpayer if any equipment is used off-highway and if so, identify the equipment used. Inspect Forms 2290 and compare the trucks listed to the depreciation schedule. The examiner should also verify that all required vehicles are reported.

To verify the amount of fuel tax credit that must be included in income in the tax year under examination, inspect the prior year tax return and note the amount of fuel tax credit claimed in the prior year. This is the same amount that must be included in income for the current year.

If any unusual situations occur in the excise tax area, the examiner may consult with an Excise Tax Technical Advisor.

Chapter 7 - Other Tax Considerations

Reforestation

Historically, provisions for the treatment of reforestation costs change from time to time so the provisions for the tax year under examination should be reviewed.

In general, reforestation costs play a larger role in planted conifer plantations than they do in naturally regenerated hardwood stands. However, there are some practices that are used to assist natural regeneration and establishment of hardwoods.

Section 194 allows tax deductions for reforestation expenditures, which are the direct costs incurred to plant or seed for forestation or reforestation purposes. Qualifying expenditures include amounts spent for site preparation, seed or seedlings, and labor and tool costs, including

depreciation on equipment used in planting or seeding. Only those costs that must be capitalized and are included in the adjusted basis of the property qualify as reforestation expenditures. Costs that are currently deductible do not qualify.

Under § 194(b), a taxpayer may deduct up to \$10,000 (\$5,000 for married couples filing separately) per tax year per qualified timber property for reforestation expenditures incurred. Section 194(a) allows a taxpayer to amortize reforestation expenditures (including any amounts remaining after a current year deduction up to \$10,000 under § 194(b)) over 84 months. See Notice 2006-47, 2006-1 C.B. 892, for additional details.

Forestry Incentive Cost-Share Payments

The Federal Government frequently creates programs to share the cost of tree planting and timber stand improvement with private landowners. The names and funding of these programs can change from year to year. 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 set differently for each program. In addition to the Federal Government, state and certain other government entities also can provide cost share payments. Landowners who receive these cost-share payments *may* be able to exclude them from gross income for federal income tax purposes per § 126(a).

For more information about both the amount included in gross income and the excludable portion on the receipt of a cost-share payment. See the regulations under § 126 and IRS Pub. 225. Note that to be eligible for potential exclusion under § 126, the cost share payments must be part of programs that are eligible under § 126, and the cost share payments must meet the requirements in the statute and regulations.

If the taxpayer has been reimbursed under any governmental cost sharing program, the taxpayer may not deduct these expenses unless the amount reimbursed has been included in income.

Form 1099-S Required For Lump-Sum Timber Sales

Form 1099-S is now required to be issued for lump-sum timber sales. Final regulations under § 6045 provide guidance regarding the information reporting requirements on sales or exchanges of standing timber for lump-sum payments. This change is in addition to the previously existing requirement for income reporting for pay-as-cut timber sales that qualify under § 631(b). The amendments to Treasury Regulation § 1.6045 apply to sales or exchanges of standing timber for lump-sum-payments completed after May 28, 2009.

More information can be obtained from Internal Revenue Bulletin No. 2009-24, page 1073 or in a current version of 26 CFR 1.6045-4.

A full explanation of who should file a Form 1099-S can be found in the Form 1099-S Instructions.

Christmas Trees

Christmas trees generally fall under the federal tax provisions for timber although the tax treatment of some silviculture practices may be different for Christmas trees. See chapter 8, Code and Regulations for more information about Christmas trees.

Use of Specialty Groups

Examiners need to recognize the need for specialized services of the IRS early in the audit process to allow a specialized agent as much time as possible for a review and to avoid delaying the closure of the case. The decision to make a referral should be discussed with the Group Manager. Once it is determined that a specialized service is needed, the Examiner will go to the Specialist Referral System Electronic Referral home page and submit a request for a specialist. Some of the most common specialized services needed in the hardwood timber industry are discussed below.

Engineering

Engineering services can be very useful in timber valuation and other forestry issues. The engineering program has foresters that provide these services in groups around the country.

Computer Audit Specialist (CAS)

If a large volume of timber records exist and a statistical sample is deemed useful, the examiner should contact CAS after consultation with his or her Group Manager.

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 referral may be warranted. There is a steady export of hardwood logs to destinations outside the United States including Canada, Asia and Europe.

Employment Tax Specialists

If unusual problems occur or potential issues have been identified in the employment tax area, a referral may be made after discussion with the Group Manager.

Penalties

During every examination, it is the examiner's responsibility to consider the application of penalties if the circumstances so dictate. However, in accordance with § 6751, no penalty will be assessed unless approved in writing by an immediate supervisor. Issue Leadsheet 300 should be completed by the examiner and approved by the Group Manager prior to the penalty(s) being assessed. The following penalties should be considered and planned for:

- Fraud Penalty § 6663
 - Understatement of income
 - Identify the indicators of fraud

- Discuss with Group Manager
 - Develop issue with involvement of Fraud Technical Advisor
- Accuracy Penalty § 6662
 - Considered for every tax deficiency
 - Negligence by taxpayer
 - Rules or regulations disregarded by the taxpayer
 - Leadsheet in RGS provides guidance
- Information Return Penalties §§ 6721-6723
 - Failure to file information returns
 - Filing inaccurate information returns
 - Requires a separate case file from originating file
 - Penalty assessment separate & in addition to originating file
- Failure to File/Pay Penalty § 6651
 - Original return was delinquent
 - Review original return date stamp & envelope postmark
 - Consider reasonable cause
 - Leadsheet in RGS provides guidance
- Preparer Penalties §§ 6694-6696
 - Review Notice 2009-5, 2009-1 C.B. 309
 - Review Rev. Proc 2009-11, 2009-1 C.B. 313
 - Must be a paid Preparer
 - Willful act by the Preparer to understate the tax liability
 - Reckless or intentional disregard of rules or regulations by the Preparer

Coordinated Issues

Uniformity is achieved through the issuance of coordinated issue papers (CIP). Coordinated issues should be considered as part of every examination. A listing of coordinated issues across all types of taxpayers and for specific industries can be found on www.irs.gov.

Forest Products Industry

There are specific coordinated issues for depreciation on logging roads and for losses of timber following an epidemic attack of southern pine beetles.

Coordinated issues can be added or removed so the listings should be checked periodically.

References for Federal Timber Tax

Introduction

Federal timber tax involves provisions of the Code, regulations and other authorities relevant to other industries. However, there are provisions of the Code, regulations and other authorities that deal specifically with timber. Following is a brief, general discussion of some of these authorities. This discussion is not intended to replace research and a full reading of the items discussed.

Code and Regulations

All or parts of sections 194, 611 and 631 and the Regulations there under deal specifically with timber. Below is a short description of each provision as it pertains to the timber industry.

Section 194 addresses the treatment of reforestation expenditures. Under § 194(b), taxpayers may deduct up to \$10,000 of reforestation expenditures paid or incurred on or after October 22, 2004, for each qualified timber property each tax year. Section 194(a) allows the remaining reforestation expenditures in excess of the \$10,000 per qualified timber property, or alternately, all reforestation expenditures in a given year, to be amortized over an 84-month period.

Section 611 provides an allowance of a deduction for depletion for oil and gas wells, mines, other natural deposits and timber. Treasury Regulation § 1.611-1 covers general provisions for depletion of all natural resources. Treasury Regulation § 1.611-3 provides rules applicable to timber. (Note: Treasury Regulation § 1.611-3(a) specifically identifies Christmas trees as falling under the provisions of Treasury Regulation § 1.611-3.)

Section 631(a) provides an election for a taxpayer to treat the cutting of the taxpayer's own timber (for sale or for use in the taxpayer's trade or business) as a sale or exchange. This election generally is referred to as a § 631(a) election and it must be made by the taxpayer on the income tax return for the tax year for which the election is applicable, and cannot be made on an amended return for such tax year. (Treasury Regulation § 1.631-1(c)) Section 631(a) provides that the election shall apply with respect to all timber that is owned by the taxpayer, or that the taxpayer has a contract right to cut, and is binding on the taxpayer for the tax year for which the election is made and for all subsequent tax years, unless the Commissioner, on showing of undue hardship, permits the taxpayer to revoke the election. Treasury Regulation § 1.631-1(a)(3) provides addition details regarding the conditions under which a revocation may be granted by the Commissioner.

Section 631(b) and Treasury Regulation § 1.631-2 provide the tax treatment for gain or loss upon the disposal of timber under a cutting contract, or any form of contract by which the owner retains an economic interest. This is sometimes referred to a § 631(b) or pay-as-cut sale. This tax treatment does not require the taxpayer to make an election.

Revenue Rulings, Court Cases, Coordinated Issues

For timber revenue rulings and court cases, there is a body of work for different topics and issues. These areas include basis and depletion allowance, capital gains and losses and like kind exchanges and involuntary conversions. The IRS's treatment of these types of issues can change from time to time and new issues can develop. Research with Westlaw, LexisNexis or other sources may be necessary to find the current position of the IRS regarding these issues. An examiner should also ask an IRS forester for the IRS's current position.

Forest Industry Coordinated Issues:

Specific coordinated issues exist for depreciation on logging roads and for Losses of timber following an epidemic attack of southern pine beetles.

Timber Forms

In addition to the standard tax return forms, there is an information return called the Form T. Form T Instructions are currently in a separate document. This form has existed since the beginning of the modern-day income tax and its contents and filing requirements have changed over time. Be sure to check the version of the form and instructions that apply to the tax year(s) you are examining. Currently, not all taxpayers who harvest timber are required to file Form T with their tax return but all are required to retain the information required by the form.

Report payments of timber royalties made under a pay-as-cut contract and reportable under § 6050N on Form 1099-S. Also report sales or exchanges of standing timber for lump-sum payments on Form 1099-S.

Sources on the Internal Revenue Service irs.gov web site

Timber Casualty Loss Audit Technique Guide
Timber Casualty Loss
IRS Pub. 510, Excise Taxes
IRS Pub. 15, Circular E. Employer's Tax Guide
IRS Form 940, 941, 1099 Instructions

United States Forest Service Web Sites

[National Timber Tax Website](#)
[United States Department of Agriculture Forest Service](#)
[USDA Forest Service State and Private Forestry](#)
[US Census Bureau Statistical Abstract, Forest Land and Timber-Base Manufacturing](#)

Other Sources of information

Professional Associations

[TAPPI](#) Technical Association of the Pulp and Paper Industry
[AF&PA](#) American Forest and Paper Association
[National Hardwood Lumber Association](#)
[Hardwood Plywood and Veneer Association](#)

Magazines

The Northern Logger and Timber Processor Magazine

Glossary

Acre - A unit of land comprised of 43,560 square feet.

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.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 x 1 foot wide x 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.

Bucking - The process of sawing a felled tree into logs. The length of the logs is dependent on the species of the tree and the end product.

Butt - The base of a tree or the large end of a log.

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 in the mill. The carriage travels on tracks and transports logs toward the saw line after a cut has been made.

Cherry Picker - A piece of machinery, generally attached to a truck or loading dock, which is used to load and unload logs.

Clearcutting - A process of removing all merchantable trees from an area in a logging operation for the purpose of regenerating an even-aged stand.

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 the cost of felling trees, removing limbs, bucking, skidding, loading 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 wide, containing 128 cubic feet of space. A long cord is a cord containing wood pieces longer than 4 feet and if 5 foot pieces are used this results in 160 cubic feet of space. A cord is a common unit of measure of timber.

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

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

Cruise - A survey of forestland to locate timber and estimate its quantity by species, products, size, quality, or other characteristics. A cruise should be conducted on the ground and throughout the timber land, not merely on the boundaries or roadsides that border the timber land.

Cutting Cycle - The planned intermission between harvesting operations within the same stand.

D.B.H. - This is an abbreviation for Diameter (of a tree) at Breast Height. The diameter of a tree is 4½ feet above the ground.

Deciduous - A deciduous tree has broad leaves that it loses in the fall.

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.

Firebreak - A natural or constructed barrier used to stop or check wildfires.

Girdle - To encircle the stem of a living tree with cuts to kill the tree. The cuts are made to sever the bark and cambium and cause the tree to die by preventing the passage of nutrients. Toxic materials can also be injected into the tree through the cut.

Growing Stock - The total trees in the forest.

Hardwood - Generally trees that have broad leaves such as deciduous trees. Lumber from hardwood trees is referred to as hardwood lumber.

Head Saw - The main log cutting saw in a sawmill.

Heart Rot - Decay found in the heartwood of trees.

Heartwood - The inner core of a wood stem that is usually darker in color than the outer sapwood.

Increment Borer - Instrument with a hollow bit, similar to an auger that is used to extract cores from trees to determine growth, age, etc.

Intolerant Tree - A tree incapable of growing in the shade or in competition with other trees.

Kiln Dry - A process of drying lumber by the controlled application of heat.

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

Log Deck - 1. An area or platform on which logs are placed. 2. A pile of logs. 3. A portion of a sawmill on which logs are held before they are sawed.

Log Rule - A method of estimating the amount of lumber that can be sawed from trees or logs. One must know the log's length and diameter to use a log rule. The three most common log rules are Doyle, International $\frac{1}{4}$ and Scribner.

Marking - The process of identifying trees with paint or ribbon that are to be cut and sold.

Mixed Stand - A stand in which less than a specified percentage of trees forming the main crown canopy consist of a single species.

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 and that has not suffered large disturbances.

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.

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

Pulpwood - Wood cut primarily to make wood pulp for manufacture into paper, fiber, paperboard, etc.

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

Rotation Age - Age at which a stand is considered ready for harvest under a management plan.

Reforestation - The natural or artificial activities used to replenish an area with forest trees.

Release Cutting - The process of cutting large poorly formed or diseased trees that overshadow smaller, healthier trees to allow the younger trees to grow.

Regenerate - The natural or artificial process of renewing a forest by direct seeding or planting, including through self-sown seeds, sprouts, etc.

Regeneration - The young trees that result from regenerating a site.

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 saw logs 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 saw logs 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 - New timber that develops after removing old growth by harvest, cutting, fire, or other causes.

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 and is often left during logging 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 levied on timber cut.

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

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

Skidding - The yarding of trees or logs by pulling or towing them across the ground.

Slash - The woody debris remaining on the ground after logging, including branches, bark, chunks, cull logs, uprooted stumps and uprooted trees.

Softwood - Generally trees that have needle or scale like leaves such as conifers.

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

Stumpage - Standing timber or the price paid for such timber.

Sustained Yield - The quantity of timber a forest can produce continuously under a given plan of management with a balance between growth and harvest.

Thinning - A cut in an immature stand performed to increase the growth rate and quality of growth on remaining trees, to improve yield, and to recover usable materials.

Timber - For federal tax purposes, the wood in standing trees that is available and suitable for exploitation and use by the forest industries.

Timber Stand Improvement (T.S.I.) - A term generally applied to intermediate cuttings and other cultural treatments done to improve stand conditions in a stand that are not part of a major harvest.

Underrun - A descriptive term indicating the amount by which lumber sawn from logs is less than the estimated quantity expected to be sawn.

Understory - Trees in a stand that 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.

Weed Tree - A tree with little value, if any.