

**The Timber Reform
Research Project**

**Collecting the Timber
Severance Tax: Are We
Getting Cheated?**

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Introduction

The “timber severance” tax plays a vital role in funding the work of the Division of Forestry. However, despite the growth of the timber industry over the past decade the actual revenue from timber severance taxes is low. The timber severance tax is not properly implemented. The numerous loopholes in the system frustrate the purpose of the tax which is to raise the money to regulate and promote the timber industry. This inadequacy means that the people of West Virginia have to pay higher taxes to cover 32% of the work of the Division of Forestry.

There have been questions raised about the fairness and poor enforcement of severance tax regulations, about other tax credits to the timber industry. This report lays out the basics of the timber severance tax; explains why not enough timber severance tax money comes into state coffers; and makes suggestions as to how the situation might be improved.

According to the West Virginia Development Office, forest products is a \$1.3 billion dollar industry in West Virginia. Timberland acreage and timber volumes have increased steadily for more than 40 years, and both are currently at the highest levels in a century. Timber production quadrupled from 1949-1995, and wood exports increased 44.7% from 1992 to 1997. The Development Office ranks wood exports fifth among West Virginia’s export commodities, and characterizes wood exporting as the fastest growing segment in the West Virginia economy.

West Virginia, with 76% of its surface covered by trees, is the third most forested state in the nation after Maine and New Hampshire. West Virginia’s forests are more than 90% hardwood (oaks, maple, hickory, walnut, cherry, yellow poplar), the most valuable type of timber. Unlike other natural resource industries, the forest industry extends into every county in West Virginia. (From the West Virginia Forest Resource FACT BOOK of the W.V. Forestry Association.)

Most direct tax revenue from timbering comes from the timber severance tax, which is levied once on each tree cut. To most West Virginians, “severance tax” means a tax on coal. However, West Virginia has had a severance tax on timber production for many years, just like the per-ton severance tax on mined coal.

Definition of Timber Severance Tax

The timber severance tax, charged on the “gross value” of severed timber, has existed since the 1970s. As defined under W.Va. Code Section 11-13A, it is a tax levied “for the privilege of engaging in or continuing, within West Virginia, the activity of severing, extracting, reducing to possession and producing for sale, profit or commercial use, any natural resource product or products,” in this case, timber. Beginning in July 1987, the West Virginia Tax Department collected the timber severance tax at a rate of 2.5% of the gross value of timber. The rate was changed in 1993 with passage of the Logging Sediment Control Act and now stands at 3.22%.

The Severance Tax Collection System & Use of the Tax

Taxpayers who buy, cut and sell timber learn about the severance tax system when they get a business license. Like all West Virginians buying or selling products, landowners and companies commercially cutting timber in West Virginia must get a business license from the Secretary of State; and in addition, a timber license from the Division of Forestry. The business license form asks if timber is being severed, and that information when supplied by the taxpayer is passed on to the Tax Department, which uses it to track timber production and sales.

Until recently, anyone who had gross timber sales not exceeding \$15,528 could apply for a timber license exemption to the Division of Forestry. In December of 2001, the West Virginia

Supreme Court ruled that these operators are not exempt. Therefore, they must now report total sales and volumes of timber cut to the Tax Department. Most will not owe severance tax, because the first \$500 of tax owed is exempted as a tax credit. ($3.22\% \times \$15,528 = \500).

According to the West Virginia Code, it is the responsibility of the Division of Forestry, in cooperation with the State Tax Department, to collect information on and determine “the amount of timber severed and the tax liability thereon.” In describing how timber severance taxes are to be used, the 1993 revisions state only that they shall “...be appropriated by the Legislature for purposes of the Division of Forestry.” **The Division of Forestry currently receives 47% of its funding from timber severance taxes.**

In addition to business licenses information, the Tax Department receives copies of timber notifications from the Division of Forestry. Under the 1993 Logging Sediment Control Act, companies must file a Harvesting of Timber Notification Form with the Division of Forestry for each logging job. The form must be filed within three days of commencing the harvest of trees. The form asks who is responsible for the severance tax. This information can be used by the Tax Department to ensure that timber severance taxes are paid. However the logger is not required to give notice when a timber job is finished, making enforcement using these forms more difficult.

Who Pays the Timber Severance Tax?

--A person who has title to or an “economic interest” in the timber.

--Even when the timber is cut or processed by someone other than the person who has title to the timber, such as by a contract cutter, the person who has the economic interest is still responsible for the severance tax.

--A review of various factors is necessary to determine who has an “economic interest” in the timber. The person who has the right to depletion, paying royalties to the landowner, and who has control over the sale of the timber, is typically considered to have an “economic interest” in the timber and is the person who is responsible for the severance tax. * A person who is merely providing cutting services for another is not responsible for the severance tax.

**Such a person or company would typically lease the timber from the landowner.*

Source: Timber Severance Tax Return Form (WV/SEV_401T)

Who Pays the Severance Tax, Continued

1. Who actually pays the timber severance tax is determined by who owns the timber.
2. If a logging company leases the timber from a landowner, the company is responsible for paying the tax when it is cut.
3. If a logging company is contract logging for a larger company, the larger company pays the severance tax.
4. If the logging company is cutting trees under a percentage agreement with the landowner, then both are responsible for paying the severance tax on a percentage basis.

Although 83% of the timber in West Virginia is owned by farmers, individuals, and private landowners or businesses, most timber severance tax is paid by large wood product companies. In fact, **90% of the timber severance tax is paid by the top quarter of timber companies ... those with over \$230,000 in gross timber receipts.**

Why do these large companies pay most of the tax? The method of computing eligibility for reductions to the timber severance tax as explained below, gives most of the answer.

How is the Timber Severance Tax Computed?

Timber receipts are taxed at varying rates, depending on where the timber is sold but -- **cut trees are only taxed once**. Computation starts at 100% of the value of receipts from cutting trees, with no “value-added” activities (see below) beyond the trimming of the branches. In other words, taxpayers that cut trees and sell them where they fall pay taxes on 100% of the sale price of the timber. But as soon as the logs begin moving to a collection point, the percentage of sale value taxed drops to 75%. If the timber is cut and delivered to a sawmill, it is taxed at 50% of value. The biggest tax reduction comes when a harvester cuts timber and that he/she will process into wood products (e.g., slabs, 2x4s, beams, veneer, rustic rail fencing, cabinets, tables, pressure treated lumber—railroad ties, posts, deck boards, etc). In this case, company pays tax on only 25% of the value of the timber. These reduced rates are called “safe harbors”. (Table I).

Table I “Value added” tax rates by activity (“safe harbor system”)

HARVEST ACTIVITY	% of timber value taxed
Cut the timber sell in the woods	100%
Cut and move timber to collection point	75%
Cut and delivered to sawmill	50%
Cut and process into other products	25%

This system of ever-growing tax rate reductions is supposed to credit timber companies for expenses like the cost of gas and trucks. In explaining this system, the State Tax Department notes that, “Unlike the former state business and occupation tax on most natural resources, the timber severance tax is a ‘value added’ tax.” The “value” is added, according to this configuration, as the timber moves from standing trees to being processed into wood products that can be sold for higher prices. This system was put in place by the Legislature to encourage the development of wood processing companies in the state. The result of this “value added” system, however, is that large companies that include processing of timber of any kind and even at the most minimal level, have more “safe harbors”(that is, tax breaks) on their income, and end up paying a much lower severance tax rate. What is the downside of this system?

The safe harbor system of reducing the tax rate reduces the severance tax revenue to the state by two-thirds.

An example in Table II: According to Tax Department and Division of Forestry records, in 1999, 635 million board feet (a unit of lumber measurement 1 foot long, 1 foot wide and 1 inch thick) of saw wood was cut. Valued at \$400 for 1000 board feet, the total value of saw wood in 1999 was \$254,000,000. In this same year, a total of 85 million board feet of peeled veneer logs were harvested. Valued at \$350 per 1000 board feet, the total value of these veneer logs was \$29,750,000. In 1999, 2.5 million tons of pulpwood were reportedly cut. Valued at \$22 per ton, the value of pulpwood totaled \$55 million.

Table II. Timber Severance Tax Revenues Before and After Safe Harbor Reductions Based on Total Timber Harvest Figures for 1999.

Product	Amount harvested	Value	Total
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Type		Per unit	value
Saw wood	635,000,000 BF	\$400/1000 BF	\$254,000,000
Peeled veneer logs	85,000,000 BF	\$350/1000 BF	\$ 29,750,000
Pulpwood	2,500,000 Ton	\$22/T	\$ 55,000,000
TOTAL VALUE			\$338,750,000
Tax Revenues	Timber severance tax rate = 3.22% of total value or	.0322 x \$338,750,000 =	Tax revenue before safe harbors and tax credits <u>\$10,907,750</u> Actual revenue <u>\$3,136,907</u>

The total value of timber harvested in 1999 was \$338,750,000. Using the timber severance tax rate of 3.22% times the total value of the timber, the state should have received \$10,907,750 in timber severance taxes. Yet as reported by the Tax Department, only \$3,136,907.19 was collected. Most of the remaining \$7,770,843 was uncollected due to “safe harbor” tax reductions. **The Tax Department estimates that “safe harbor reduces tax revenues by 63%.”**

An additional item that is relevant to the state’s timber severance tax computation and discounting is the \$500 exemption given to all taxpayers. The Legislature has enacted a \$500 annual tax exemption for all timber harvesters. **The Tax Department indicates that this exemption reduces the total tax liability on timber after safe harbors by nearly 7% (3% loss on before safe harbor gross tax). With these 2 reductions the timber severance tax revenue takes a loss of 66%.**

THE CORPORATE VEIL: Who Gets “Super Tax Credits”?

Severance tax reductions don’t stop here.

After receiving “safe harbor” tax reductions and the \$500 general tax credit, large companies are also eligible for further tax reductions through various tax credit programs. This is another reason for the large timber companies to take on the severance tax liability --- they qualify for more tax breaks that can be applied against severance taxes.

Two of the state’s largest tax credit programs are the Industrial Expansion and/or Revitalization Program and the West Virginia Capital Company Credit Program (“super tax credits”). The West Virginia Economic Development Authority certifies companies as being a Capital Company worthy of these credits. Similar programs are administered by the Tax Department. These “super tax credits” are available to “companies that sever trees and also own sawmills and manufacturing companies.”

In his 1998 co-authored history of the Division of Forestry, former Division Director William Maxey described the timber severance tax and discussed tax credits for the industry, stating: “The tax partially funds the Division of Forestry and is used for the forest industry for in-state expansion and/or new plants.”

Under current state policies, the exact amount of deductions given to specific companies through “super tax credits” is not available to the public, or to our elected officials.

On two occasions in 2001, John Snider, former Executive Director of the WV Development Office, spoke to the Forest Management Review Commission, the joint legislative oversight committee on timber matters. In June, addressing the Commission on Bruce Hardwood’s investment credits, Mr. Snider explained that specific tax information was confidential and was not available to the

Commission. In July, Mr. Snider stated that he could not disclose the amount of super tax credits given to Georgia Pacific.

In fact, reports on these “super tax credits” are not issued until well after the fact. The last information released (in April 2001) was from the 1997 reporting period. Even then no dollar amounts were given. This report indicated that the top timber company recipients of “super tax credits” were Weyerhaeuser, Georgia Pacific, and Allegheny Wood Products. The latter company (AWP) stood at the top, with credits available as high as \$1,350,000.

Several categories of tax credits are available to timber companies. The credits can be used to deduct money from the payment of severance tax, business franchise tax, corporate net income tax, and personal income tax.

Table III. Tax Credit Categories & Number of Timber Companies Using Them in 1997

Figures derived from the 1997 WV Tax Credit Disclosure list Released April 2001

Timber Tax Credit	Range of Amounts Deducted from Gross Tax	Number of Companies Participating
Super Tax Credits (Severance Tax line 2a)	\$1.00 - 500,000	22
Credit for Industrial Expansion and/or Revitalization (Severance Tax line 2b)	\$1.00 - 100,000	21
Credit for Research and Development Projects (Severance Tax line 2c)	None listed.	None listed.
West Virginia Capital Company Credit (Severance Tax line 2d)	\$1.00 - 50,000	1
Business Franchise Tax	\$1.00 - 250,000	7
Corporate Net Income Tax	\$1.00 - 50,000	1
Personal Income Tax	\$1.00 - 500,000	3 (Individuals)

More exact figures on the total amount of these tax credits comes from the State Tax Department whose records indicate that in 1998, \$1.1 million in tax credits were awarded to timber harvest companies to offset the timber severance tax.

The Department currently estimates that tax credits offset 30% of the industry’s already reduced gross tax liabilities annually. This roughly decreases total timber severance tax lost to state coffers by another 10%, for a total loss of 76%.

How Much Severance Tax Is the Timber Industry Actually Paying?

Historical Tax Department Figures on Timber Severance Tax Receipts

The tax table below shows a steady growth in timber tax revenues, with revenue more than doubling over the past 8 years. However, tax credits have also doubled, reducing tax income by one third after safe harbor reductions. With more timber being cut comes a greater need for inspections by the Division of Forestry but the tax revenue is inadequate to pay for the state mandated oversight of timber operations.

Table IV. Historic West Virginia Timber Severance Tax Collection Figures

Fiscal Year	# returns filed	Gross Timber Severance Tax COLLECTED	Timber Severance Tax Credits GRANTED	Timber Severance Tax NET REVENUE
1992	614	1,926,000	615,000	\$1,312,000
1993	738	2,623,000	711,000	\$1,912,000
1994	615	2,948,000	980,000	\$1,968,000
1995	663	3,419,000	945,000	\$2,473,000
1996	687	3,142,000	989,000	\$2,153,000
1997	717	4,221,000	1,267,000	\$2,954,000
1998	809	4,100,000	1,144,000	\$2,967,000
1999*	811*	4,204,000	1,282,000	\$2,922,000
2000*	774*	4,414,000	1,286,000	\$3,129,000

*Includes information from accounts without annual returns.

Who's in Charge, and Is Someone Not Paying That Should Be?

In recent years, the severance tax law enforcement of both the Division of Forestry and the Tax Department has been questioned. A study released by the Tax Department in 1996 found that ONE THIRD of loggers were not registered to pay severance taxes. The report also noted that some out-of-state companies were not paying their fair share.

In a report to the West Virginia Senate Finance Committee, the Division of Forestry blamed underpayment of timber severance tax on: deliberate under-reporting by taxpayers, logs going out of state, timber theft, use of different calculation method, and waiver of license. The license waiver is no longer a problem. Under-reporting can only be addressed by getting all loggers into the system, which is the job of the Division of Forestry.

Beginning in 2000, there is evidence that the Tax Department is taking some action to gather better information on the amount of timber harvested. A new section in the timber severance tax return asks how much saw timber and pulpwood were harvested by the taxpayer in the previous year. When the first new forms were returned, the portion asking for these production numbers was left blank by nearly 75% of tax filers. The Department sent out another form to those who did not respond correctly. Corrected information is not available to the public at this time but should be available in the next year.

The Tax Department says it is now routinely auditing concentration yards (where timber products are held for shipment to another location or for resale) and sawmills, to be sure that all companies are paying their fair share. Mark Muchow, Property Tax Commissioner, announced

to the legislature in November of 2001 that his department was now reaching almost 100% of the severance taxpayers.

Tax collection seems to have improved and timber volume tracking is being worked on, but **no one is addressing the issue of how to change a discount and loophole-ridden tax system that delivers so little revenue.**

The Division of Forestry receives only 43.8% of its revenue from the Severance Tax and the Division is extremely under funded.

Proposed Funding Sources	Percentage	Amount
Federal	12.2	\$959,366
Forestry Fund	9.9	\$782,040
License Fees	2.2	\$170,000
General Revenue	31.9	\$2,508,819
Severance Tax	43.8	\$3,450,620

Table 5: Proposed Funding Sources, FY 2002; Total Funding: \$7,870,845

Who Would Benefit From Increased Timber Severance Tax Revenue?

The Division of Forestry desperately needs more inspectors, to monitor all logging jobs to make sure that loggers are licensed and have filed notifications, and to prevent serious accidents, devastating erosion, flooding, and water pollution. The Division needs statisticians to calculate how much timber is being cut annually to keep the timber industry sustainable. They need fully trained loggers to protect water quality and worker safety. All this takes money that should be paid for by the timber severance tax -- but instead comes from the general fund.

If the timber industry is doing well, it can pay the full severance tax rate. If big timber wants to be a good neighbor in all 55 West Virginia counties, it must pay for the training, planning and inspection that keep all timber companies honest, safe, and environmentally friendly.

The timber severance tax system should be easy to understand. Annual reporting can yield important information about the amount and type of timber being cut. This will help the industry plan for sustainable harvests. All West Virginians would benefit from increased timber severance tax revenue if it was used to fund the Division of Forestry's training programs and logging job monitoring.

The following chart lists the key committees and departments handle timber severance tax issues.

Table VI

Major Players in Timber Severance Tax Decisions

- The State Legislature passes the laws and confirms regulations on the tax.
- A joint House-Senate Legislative committee, the "Forest Management Review Commission," plans and oversees policy and operations related to the state's timber resources and wood products industry. Organizations such as the WV Forestry Association who lobby during legislative sessions are regular attendees at meetings. The forestry industry itself is well represented by 3 members on the committee.
- The Division of Forestry and the State Tax Department jointly set policy on the timber severance tax by configuration of the tax form itself.
- The WV Economic Development Authority certifies wood product companies as eligible for secret "super tax credits" that reduces the amount of timber severance tax paid by large companies.

- The WV Development Office offers information on applying for “super tax credits” to wood product companies that in turn reduce the amount of severance tax paid.

RECOMMENDATIONS

By all accounts the timber industry in West Virginia is healthy, prosperous, and in high gear. Companies (especially the large ones) are hard at work and making substantial profits. They are also profiting from the considerable benefits -- tax exemptions, credits, discounts -- made available to them.

At the same time, the agency set up to regulate this industry is strapped for funds and can only visit two-thirds of the timber operations currently logging -- and then only once. In 2001, Randy Dye, Division of Forestry Director, reported to a legislative finance committee that the high price of gasoline, which is a large expense to the Division, along with the leveling off of revenue from logger licensing, severance tax, and federal reimbursements, will harm the work of his department. He said, “We will not have the ability to react to emergencies, or improve the quality or quantity of our programs (in 2002)”.

Under these circumstances it is a financially unsound practice for the state to give back to the logging industry 76% of the tax revenue that is generated by logging. Such a thriving industry can pay its fair share. The money is needed to protect the public from rogue loggers who pollute our state’s waterways, cause stream sedimentation, steal timber, and cause soil erosion, and flooding. Logger training, inspection of all logging jobs, and stiff fines for violators are the best ways to prevent bad logging practices.

The West Virginia Highlands Conservancy suggests that the safe harbor tax reduction be removed, and that the full 3.22 percent timber severance tax be paid on all timber sales. **For simplicity, the tax should be paid at the point of milling, by the company that will process it.** Logs going out of state would be taxed as they leave. Additionally, super tax credits should be a matter of public record. Credits should only go to companies that are creating good jobs with benefits especially those manufacturing products and not just those cutting timber and shipping raw materials overseas.

The timber severance tax system should be reformed and all loopholes should be removed so that the Division of Forestry can be adequately funded and West Virginia tax payers don’t have to foot the bill.