

**REDACTED DECISION -- 06-098 FN through 06-101 FN -- BY R. MICHAEL REED, CHIEF ALJ -- SUBMITTED for DECISION on DECEMBER 19, 2007 -- ISSUED on MARCH 18, 2008**

## **SYNOPSIS**

**BUSINESS FRANCHISE TAX -- STATUTORY EXCEPTION FOR "AGRICULTURE AND FARMING" APPLICABLE CLEARLY TO GROWING AND MANAGING STANDING TIMBER, WITHOUT ANY TIMBERING ACTIVITY** -- The exception from the West Virginia business franchise tax set forth in W. Va. Code 11-23-3(b)(8) [1991], defining the term "doing business" for such tax purposes as excluding the activity of "agriculture and farming," applies clearly to the activities of growing and managing standing timber, without any timbering (severing) activity, when, as here, such activities are carried on to the extent required by that definition of the term "agriculture and farming" provided in that same statute for business franchise tax purposes.

## **FINAL DECISION**

This matter involves a narrow, but important, question of first impression for this independent and specialized state tax tribunal, specifically, whether the statutory exception from the West Virginia business franchise tax for the activity of "agriculture and farming" is applicable to merely growing and managing standing timber. The answer is yes, for the reasons stated below.

## **PROCEDURAL BACKGROUND**

The Field Auditing "Division" of the West Virginia State Tax Commissioner's Office ("the Commissioner" or "the Respondent") conducted an examination of the

books and records of the four related out-of-state limited partnerships involved in this matter. Thereafter, on December 02, 2005, the then Director of this "Division" of the Respondent State Tax Commissioner's Office issued a West Virginia business franchise tax assessment against each of these four related Petitioners, for the calendar years 2003 and 2004. The Respondent's "Division" issued each of these assessments pursuant to the authorization of the Respondent State Tax Commissioner, under the provisions of Chapter 11, Articles 10 and 23 of the West Virginia Code.

The business franchise tax assessment against the first Limited Partnership ("L.P."), here called L.P. # I, was for tax of \$\_\_\_\_\_ and interest of \$\_\_\_\_\_, for a total assessed tax liability of \$\_\_\_\_\_.

The business franchise tax assessment against L.P. # II was for tax of \$\_\_\_\_\_ and interest of \$\_\_\_\_\_, for a total assessed tax liability of \$\_\_\_\_\_.

The business franchise tax assessment against L.P. # III was for tax of \$\_\_\_\_\_ and interest of \$\_\_\_\_\_, for a total assessed tax liability of \$\_\_\_\_\_.

The business franchise tax assessment against L.P. # IV was for tax of \$\_\_\_\_\_ and interest of \$\_\_\_\_\_, for a total assessed tax liability of \$\_\_\_\_\_.

Note: Eventually, the State Tax Commissioner notified the Petitioners and this tribunal that he was no longer seeking any of the additions to tax which were included in each of these assessments (and which, therefore, are not set forth above).

On or about December 03, 2005, each of these Petitioners received the written notice of the West Virginia business franchise tax assessment against it.

Thereafter, by mail postmarked January 31, 2006, each of these four related Petitioners timely filed with this independent tribunal, the West Virginia Office of Tax

Appeals, a petition for reassessment. *See* W. Va. Code §§ 11-10A-8(1) [2002] and 11-10A-9(a)-(b) [2005].

Upon the filing of the petitions this tribunal sent to the parties a notice of a consolidated evidentiary hearing on the petitions, in accordance with the provisions of W. Va. Code § 11-10A-10 [2002] and W. Va. Code St. R. § 121-1-61.3.3 (Apr. 20, 2003).

Subsequently, with the concurrence of this tribunal, the parties agreed to forego an evidentiary hearing in person and, instead, agreed to submit this matter for a decision by this tribunal based upon the stipulations as to the material facts, memoranda of law, and oral argument. After an extended period of time necessary to finalize the stipulations, the parties submitted excellent memoranda of law and oral argument, with the latter occurring on December 19, 2007.

### **FINDINGS OF FACT**

The following findings of material fact are derived from the parties' filed stipulations regarding the same (numbered differently there, due to inclusion of the procedural history at the outset there).

1. Each of the Petitioners is a limited partnership organized and existing under the laws of a certain other state and qualified to do business in the State of West Virginia.
2. The sole general partner of each of the Petitioners is a certain limited liability company from that same other state. A certain other limited liability company from that same other state manages the general partner and the Petitioner, for a fee. This latter managing company filed income and business franchise tax returns in the State of West Virginia, and its tax liability is not at issue in this matter.

3. The limited partners of each Petitioner are all passive investors, comprised primarily of organizations exempt from federal and West Virginia income tax, such as college endowments, charitable foundations, pension and profit-sharing plans, and other not-for-profit entities. The remaining limited partners of each Petitioner consist of for-profit institutional and individual investors.

4. No single person or entity owns, directly or indirectly, a controlling interest in each of the Petitioners.

5. Each Petitioner has acquired for investment a diversified portfolio of commercial woodlands, with the intent to provide current income from the management and operations of such woodlands and to realize capital appreciation of the woodlands.

6. The primary product of each Petitioner's acquisition and management strategies is valuable standing saw timber.

7. The Petitioner's management plans are designed on a tract-by-tract basis, paying careful attention to each property's unique attributes, including timber quality, biological habitat, and species diversity.

8. Each management plan has two objectives: (a) To provide a competitive return to investors while being consistent with the maintenance, and potentially the enhancement, of the biological productivity of the tract; and (b) To ensure that at the end of the management period the overall condition of the forestland will be equal, or potentially superior, to the condition at the time of acquisition.

9. The management of the forestlands owned by each of the Petitioners involves multiple activities required to produce and sustain standing timber and commercially viable forestland, including, but not limited to, replanting or naturally regenerating trees

in areas that have been harvested, herbaceous weed control, woody vegetation control, fire control, the selection of individual trees for sale and removal, and the identification and maintenance of seed trees for future naturally regenerated growth potential.

10. The forest management practices utilized by each of the Petitioners are focused on the management of the space between trees to assure optimal sunlight, moisture, and soil conditions, for quality tree growth.

11. Each of the Petitioners derives income for its investors, that is, the limited partners, by periodically selling standing timber in accordance with its management plan.

12. The forest management practices of each of the Petitioners are designed to encourage the natural regeneration of the forest and must account for such variables as soil quality, light conditions, and residual stand composition, as well as spacing, climate, and existing timber volume.

13. Also, the forest management practices of each of the Petitioners are designed to produce a sustainable yield of standing timber, while maintaining habitat for wildlife, promoting biological diversity, stabilizing watersheds, and protecting soil fertility.

14. The business activities within the State of West Virginia by each of the Petitioners -- as set forth in these stipulations -- are not, themselves, subject to the severance tax. The activities of the Petitioners' customers, that is, those entities or persons who cut the trees) are subject to the severance tax.

15. During the period of time involved in this matter the West Virginia Division of Forestry has certified the Petitioners' real property in West Virginia as "managed timberland," and the real property qualifies for and receives the valuation as "managed

timberland” for *ad valorem* property tax purposes under W. Va. Code § 11-1C-11b, as amended.

16. Each of the Petitioners chooses the types and locations of standing timber to sell in order to establish a desirable species mix, maintain the ecological health of the remaining forest, and maximize long-term investment returns.

17. The Petitioners use the following tree-selection guidelines to improve the residual stand of timber that is left after harvest:

(a) Trees of the size that will increase over the management period from pulpwood to small saw timber or from small saw timber to large saw timber are not sold.

(b) Higher value species are left as crop trees in the residual stand.

Regardless of value, three to four hard and soft mast-producing stems are left on each acre as wildlife trees.

(c) Trees that have visible quality defects, such as “cat faces,” frost cracks, lightning strikes, damaged tops, or visible rot are marked for removal; on the other hand, high quality stems, such as those that have no visible quality defects and which have good prospective growth potential, are left in the residual stand.

(d) Crop trees that are left in the residual stand are those that have a high live crown ratio to respond well to release from surrounding competition.

(e) Each crop tree left in the residual stand must be well-spaced from surrounding competition, but not left open enough to be subject to “epicormic branching,” “wind throw,” ice damage, or lightning strike.

18. Each of the Petitioners never cuts the standing timber itself; in addition, each of the Petitioners does not engage others, in an agency capacity or any other capacity, to cut the timberlands on that Petitioner's behalf.

19. Instead, each of the Petitioners conveys the right (and obligation) to cut standing timber to unrelated third persons, such as independent loggers, sawmill owners, or other wood processors, in exchange for the payment of money. This conveyance of timber cutting rights is by a written contract under which each of the Petitioners retains an economic interest in the timber until it is cut, within the meaning of section 631(b) of the Internal Revenue Code.

20. Independent loggers purchase the standing timber from each of the Petitioners, cut the timber for their own account, and then sell the logs to wood processors.

21. Wood processors purchase the standing timber directly from each of the Petitioners, and either cut the timber themselves or engage loggers as their agents to harvest the timber and haul the cut logs to the mills. To ensure compliance with "Best Management Practices," as referred to and described in W. Va. Code § 11-1C-10(d)(1), as amended, each of the Petitioners requires its approval of any proposed logger and of the location, manner, and method of construction of any roads or improvements constructed by the logger.

22. Because each of the Petitioners derives its income from activities that culminate in selling standing timber pursuant to cutting contracts under which it retains an economic interest in the timber, rather than harvesting the trees and selling the logs,

the exempt investors in each of the Petitioners have not reported the income as unrelated business taxable income for West Virginia or federal income tax purposes.

23. The Petitioners' business activities in the State of West Virginia consist of managing timberland they own, producing and sustaining timber on such timberland, and selling the standing timber grown on the timberland, as set forth in these stipulations.

24. Each of the Petitioners owned many thousands of acres of land in the State of West Virginia, and the entirety of these lands were used in the activities set forth in these stipulations during the two years covered by the business franchise tax assessment in question.

25. Each of the Petitioners sells much more than \$1,000 of standing timber per year from its land.

26. The terms "forestland," "timberland," and "woodlands" are used interchangeably in these findings of fact.

27. The terms "cut" and "harvest" are used interchangeably in the timber industry and in these findings of fact to mean severing trees from the ground and removing the severed trees from the woodlands.

### **ANALYSIS**

The dispositive issue is whether the Petitioners' activities of growing and managing standing timber, without any timbering activity, are excepted clearly from the West Virginia business franchise tax. This tribunal holds in the affirmative.



The West Virginia business franchise tax is “imposed on the privilege of doing business in this state [.]” W. Va. Code § 11-23-6(a), as amended. W. Va. Code § 11-23-3(b)(8) [1991] defines the term “doing business,” in relevant part, as follows:

The term “doing business” means any activity of a corporation or partnership which enjoys the benefits and protection of the government and laws of this state, **except the activity of agriculture and farming, which shall mean the production of . . . woodland products (but not timbering activity) by means of cultivation, tillage of the soil and by the conduct of . . . any other plant . . . production . . . .**

The activity of agriculture and farming shall mean **such** activity, **as above defined** [the Petitioners emphasize these last three words], occurring on not less than **five acres of land** and the improvements thereon, used in the production of the aforementioned activities, **and shall mean the production of at least one thousand dollars of products per annum through the conduct of such principal business activities as set forth in section ten, article one-a, chapter eleven of this code.**

(This tribunal has added the bold print and underlining emphasis.)

W. Va. Code § 11-1A-10 [1983], referenced near the end of W. Va. Code § 11-23-3(b)(8) [1991], and involving the valuation of “farm” property for *ad valorem* property tax purposes, provides, in subsection (b):

(b) A person is not engaged in farming if he [, she, or it] is primarily engaged in forestry or growing timber [the Respondent emphasizes the underlined words]. Additionally, a corporation is not engaged in farming unless its **principal activity is the business of farming** [the Petitioners emphasize the words in bold print], and in the event that the controlling stock interest in the corporation is owned by another corporation, the corporation owning the controlling interest must also be primarily engaged in the business of farming.

The Respondent’s legislatively approved regulations on point, W. Va. Code St. R. §§ 110-23-3.10 – 3.10.2 (Apr. 15, 1992), indicate the proper, limited interplay between W. Va. Code § 11-23-3(b)(8) [1991] and W. Va. Code § 11-1A-10-10[1983]:

3.10. Doing business. -- The term "doing business" means any activity of a corporation or partnership which enjoys the benefits and protection of the government and laws of the State of West Virginia, except the activities of agriculture and farming.

3.10.1. For purposes of these regulations, the terms "agriculture" and "farming" shall mean the production of food, fiber, and woodland products (**but not timbering activity**) by means of cultivation, tillage of the soil and by the conduct of animal, livestock, dairy, apiary, equine or poultry husbandry, horticultural, or any other plant or animal production activity and all farm practices related, usual or incidental thereto, including the storage, packing, shipping and marketing of agricultural or farm products, but not including any manufacturing, milling or processing of such products by persons other than the producer thereof.

3.10.2. The activities of agriculture and farming shall mean such activities, **as defined herein, occurring on not less than five (5) acres of land** and the improvements thereon, used in the aforementioned activities, **and shall mean only such agriculture and farming activities** resulting in the production of **at least one thousand dollars (\$1,000.00) of agriculture or farming products per annum through the conduct of the business of farming as the principal activity** of the corporation or partnership **in the manner described in W. Va. Code § 11-1A- 10** et seq. and the regulations related thereto.

(This tribunal has added the bold print and underlining emphasis.)

It is clear that the explicit language of both the relevant statute, W. Va. Code § 11-23-3(b)(8) [1991], and of the relevant legislative regulations, W. Va. Code St. R. §§ 110-23-3.10.1 & -3.10.2 (Apr. 15, 1992), defines the term "agriculture and farming," for business franchise tax purposes, as set forth therein, including "the production of . . . woodland products (but not timbering [severing] activity), . . . and . . . plant . . . production") -- and not as set forth in W. Va. Code § 11-1A-10(b) [1983] (which, for *ad valorem* property tax purposes, excludes forestry or growing timber from "farming"). It is also clear, especially from the very wording of W. Va. Code St. R. § 110-23-3.10.2 (Apr. 15, 1992), that the referral to W. Va. Code § 11-1A-10 [1983], near the end of W.

Va. Code § 11-23-3(b)(8) [1991], is only for the purpose of incorporating the requirement of “principal activity” into the meaning of the “business of farming,” for business franchise tax purposes (as well as for property tax purposes).

For *ad valorem* property tax purposes, “farmland” and “managed timberland” are subject to very distinctive valuation methods, as authorized by W. Va. Const. art. VI, § 53 (1946) and, for example, W. Va. Code § 11-1C-11, *et seq.*, as amended. Such a distinction is not at all relevant for business franchise tax purposes, as evident from the very language used in the business franchise tax statute and in the Respondent’s own, legislatively approved regulations, quoted above, both of which include in the definition of the term “agriculture and farming,” “the production of . . . woodland products (“but not timbering [severing] activity), . . . and . . . plant . . . production[.]”

### CONCLUSIONS OF LAW

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

1. The exception from the West Virginia business franchise tax set forth in W. Va. Code 11-23-3(b)(8) [1991], defining the term “doing business” for such tax purposes as excluding the activity of “agriculture and farming,” applies clearly to the activities of growing and managing standing timber, without any timbering (severing) activity, when, as here, such activities are carried on to the extent required by that definition of the term “agriculture and farming” provided in that same statute for business franchise tax purposes.

2. In a hearing before the West Virginia Office of Tax Appeals on a petition for reassessment, the burden of proof is upon a petitioner-taxpayer, to show that the assessment is incorrect and contrary to law, in whole or in part. *See* W. Va. Code § 11-10A-10(e) [2002] and W. Va. Code St. R. § 121-1-63.1 (Apr. 20, 2003).

3. In light of Conclusion of Law No. 1, the Petitioners in this matter have carried the burden of proof with respect to the issue of whether their activities in question were, as a matter of law, excluded from the West Virginia business franchise tax. *See* W. Va. Code St. R. § 121-1-69.2 (Apr. 20, 2003).

#### **DISPOSITION**

**WHEREFORE**, it is the **FINAL DECISION** of the **WEST VIRGINIA OFFICE OF TAX APPEALS** that each of the West Virginia business franchise tax assessments issued against each of these four related Petitioners, as described in more detail above, should be and is hereby **VACATED**, and each of the Petitioners owes no further West Virginia business franchise tax liability for the two-year period in question.