

Chapter A5 – TAXATION

Revision History

Original Standard Released in May 1999

Revision in August 2023 Main changes are:

- Changing from a standard approach that adopted post-tax cashflows to making no preference about the inclusion or exclusion of tax.
- Noting that an important consideration in whether or not to include taxation in the valuation cashflows is whether doing so may better explain the variation in observed transaction evidence.



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Taxation

Taxation is an important component of investment decisions made by tax-paying individuals and entities. However, it is often not necessary to explicitly include tax in a cashflow model used to estimate forest or crop value. The target of the valuation process is commonly to estimate market value. The level of detail required, including whether or not to include taxation and funding, should be determined by whether such additions improve the estimation process.

Chapter A4 discusses the choice of discount rate appropriate to a valuation derived using ‘pre-tax cashflows’ or a valuation derived using ‘post-tax cashflows’. It points out that there is no simple method for adjusting a valuation derived using ‘pre-tax cashflows’ to a valuation derived using ‘post-tax cashflows’ via an adjustment to the discount rate. The only valid approach is to explicitly model the tax benefits and payments in the investment model and apply an appropriately derived discount rate to the aggregate post-tax cashflows.

Entities

The usual requirement is for the forest valuer to derive a ‘market value’. In deriving a ‘market value’ using post-tax cashflows, a major difficulty arises in the choice of an appropriate capital (funding) structure and the associated conventions to apply to taxation treatment. There is no easily discoverable market norm for tax exposure. Tax is applied to the forest-owning entity and entities may be expected to have widely different tax exposures and available deductions. The tax liabilities of an entity do not necessarily arise solely from the forest asset, and other presently available or expected deductions can figure in the desirability of forest ownership to any one entity. The funding arrangements adopted will also impact on taxation; for example, the use of related party debt such as promissory notes. It is however reasonably obvious that a market price would not usually reflect a nil tax exposure. Market prices for forests can be generally expected to reflect a requirement to pay tax.

A valuation containing an entity specific tax position is useful as an advocate valuation or for setting that entity’s maximum ability to pay. It is unlikely, however, to be a ‘market valuation’. Valuations made with respect to a specific forest ownership and tax entity must clearly define the owning entity and set out the circumstances in which it remains valid (e.g. it will generally be invalid if ownership of the entity changes and/or other parts of the taxation entity are separated).

Market Model - Example assumptions and environments

One approach to take when preparing market valuations using post-tax cashflows is to adopt a standard set of tax environment assumptions for the purpose of the analysis. An example set is given below.

- 1) *‘The subject entity is always paying tax in the future on other income at the standard corporate rate at least equal to the level of deductible tax losses generated by the forest’.* (Implication - the taxpayer will always claim forest losses in cash and all forest profits are taxed in cash).
- 2) *‘The tax rates and state of law at the time of the valuation apply through the time span assumed by the valuation methodology’.*
- 3) *‘The investment in the forest is of the nature of equity’.* (Implication - there



are no external borrowings and no funded interest will appear in the analysis cashflows. The discount rate applied conceptually bundles up the return requirements of all the funding, debt (external debt, internal debt and related party debt) and equity, used in practice).

- 4) *'The investment required by the forest and cash profits available from the forest is drawn from/remitted to an owner's cash pool'*. (Implication - the only financial externality recognised by the valuation is the capital value of the asset to the owner and the related concept of its internal rate of return to the owner's funding sources).
- 5) *'The forest will continue in the ownership of the assumed entity through the time span assumed by the valuation methodology'*.
- 6) *'The owning entity has no tax losses or other deductibles at the date of the valuation'*. (A deductible arising from a proposed purchase may be included, i.e., Cost of Standing Timber Deduction [Australia], Cost of Bush [New Zealand]).

A corollary of this conventionalised approach to the treatment of tax is that the same set of tax environment assumptions, to be applied in estimating the market valuation of the target forest, should be used when analysing transaction evidence to estimate the implied discount rate or other parameter of the predictive model of forest valuation. The transactions to which the same tax modelling is applied should be limited to those for which the same taxation regime would be credible.

Important caution to forest valuers

The taxation affairs of clients are often complex and the tax impact on the forest asset is often generated outside the forest asset or by the funding adopted. Forest valuers are therefore typically not qualified to give competent tax advice to clients even solely relating to the client's existing or potential forest assets. A valuation derived using 'post-tax cashflows' arrived at by the use of a convention set such as above is not necessarily a market price expectation in all circumstances.

A valuation specific to the client's tax position should be preferably made in collaboration with the client's professional tax adviser. In any event full disclaimers as to predicted future taxation outcomes should be made. A valuation containing a tax position specific to the client could easily be construed by a client as containing advice or as a prediction of tax outcomes. This construction should be avoided by a clear and full explanation that the valuation is subject to all the limitations of the stated assumptions.

To model tax or not?

When a comparable sales approach is used for estimating market valuation the role of a discounted cash flow model is to adjust for differences between the forests for which transaction evidence is available and the target forest. In this context, a standardised, discounted cash flow model is essentially a predictive model with parameters, for example implied discount rate, estimated using transaction evidence. If an explicit representation of taxation helps to explain variation in the transaction evidence, then there is some justification for including taxation in the model. Otherwise, a simpler model may be sufficient and easier to manage.



