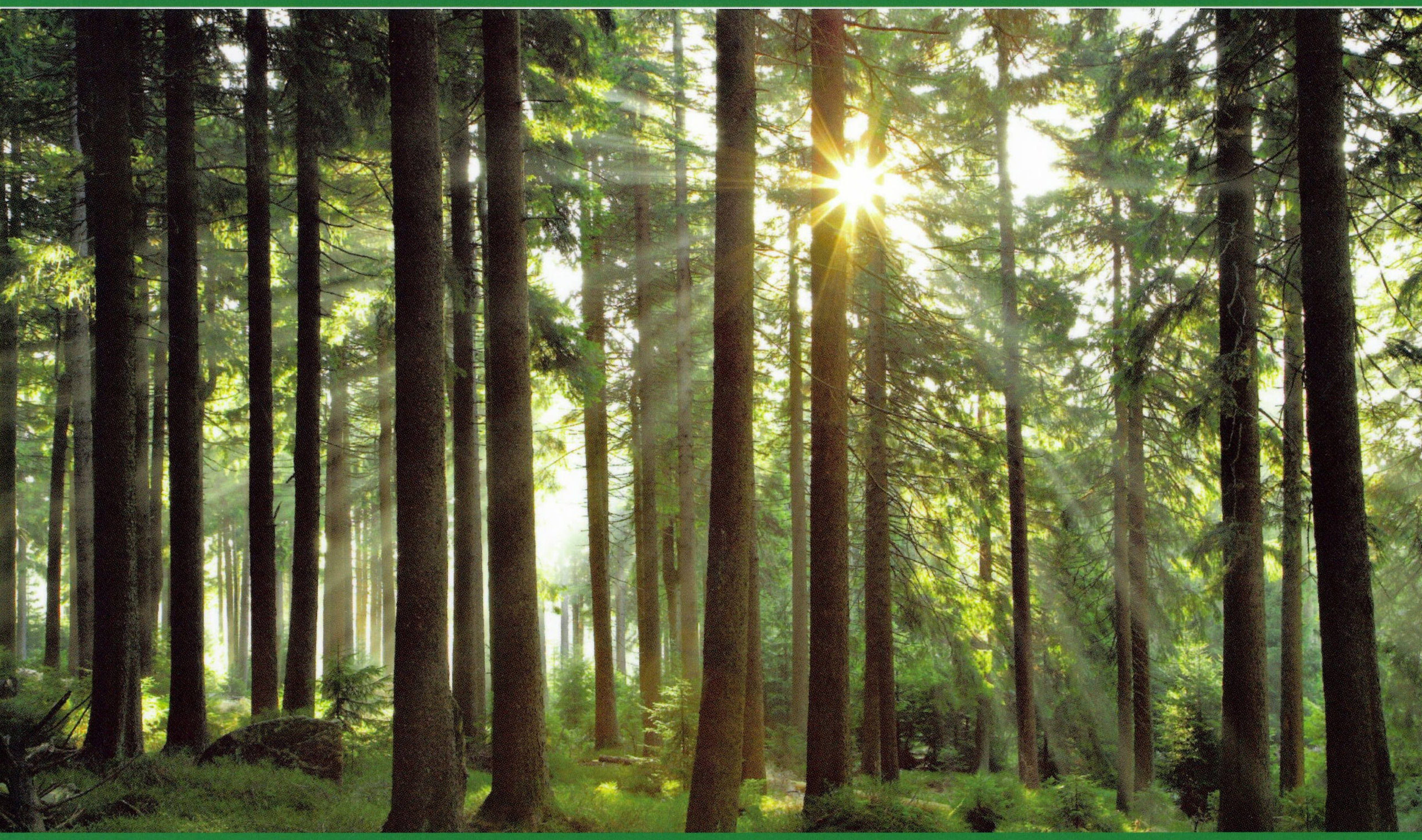
The definitive guide to

Investing in Timberland

A comprehensive intelligence source for investors, fund managers and advisers focused on forestry and commercial woodland



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Contents

Figures and tables vii

Foreword xi
By Clive Suckling and Chris Knight, PricewaterhouseCoopers LLP

Introduction xv
By Anthony O'Connor, PEI Media

1 **Why timberland?** 1
By Olli Haltia, Marko Katila and Kaisa Anttila, Dasos Capital Oy Ltd
History of modern timberland investing 1
Timberland as an asset class – key features 2
Historical timberland performance 6
Timberland investment has favourable sustainability features 7
Geography of wood demand is driving forest investment 9
Timberland and climate change 10
Biodiversity and trading of nature values 12
Bioenergy as a driver for timberland 13

2 **Fundraising outlook for the timberland asset class** 17
By Chung Hong Fu, Timberland Investment Resources
A return of capital following a drought 18
The changing face of the timberland investor 20
Fundraising by region 22
Investment trends and investor expectations in timberland 24
Capital recruitment by timberland investment managers 27
Summary 29

3 **US timberland post-recession – is it the same asset class?** 31
By Jim Rinehart, R&A Investment Forestry
Introduction 31
Part 1: Evolution of timber as an investment class 31
Part 2: A review of attributes 36
Part 3: Components of value 41
Part 4: US timberland, post-recession – is it the same asset? 47

4	**How to assess and monitor timberland before and after allocation**	53
	By Richard Standeven, Cogent Partners	
	Introduction	53
	Timber's historical returns	53
	REITs	55
	ETFs	55
	Monitoring investments	56
	After allocation – three main return drivers	56
	Product price changes	57
	Land price changes	59
	Measuring components of return	59
	Conclusion	60
5	**Routes into private funds**	61
	By Trevor McHugh and Paul Brosnan, IFS Asset Managers	
	Introduction	61
	Private forestry fund structures	62
	Current investment levels	67
	Conclusion	68
6	**Routes to investing in timberland**	71
	By Caelim Parkes, MSS Capital	
	History of fundraising	72
	Trends: old and emerging	73
	Projections of the asset class	74
	Timberland performance dynamics	75
	Types of investment	76
	Conclusion	79
7	**The role of private equity funds and their managers**	81
	By Sonya Pauls and Joshua Gregory, SJ Berwin LLP	
	Why invest in a timber fund?	81
	Tax efficiency	82
	Timber fund case studies	82
	Alignment of interests	83
	Active ownership	84
	Governance	84
	Conclusion	87
8	**Secondary investing in timberland**	89
	By Richard Bowley, Stafford Timberland	
	What is a secondary transaction in timberland?	89
	Benefits of timberland secondaries	90

Challenges with timberland secondaries 91
A comparison with private equity secondaries 92
Market participants 94
Conclusion 94

9 **Legal considerations for global timberland investment** 95
By C. Glenn Dunaway and Charles C. Connors, Morris, Manning & Martin, LLP
Introduction 95
Capital formation and fund-sponsor issues 95
The investment process 97
Conclusion 101

10 **Tax considerations for global timberland investments** 103
By C. Glenn Dunaway, Charles C. Connors and Karen Reschly, Morris, Manning & Martin, LLP; and Aldo de Cresci, Fleury Malheiros, Gasparini, De Cresci e Nogueira de Lima Advogados
Introduction 103
General cross-border planning considerations 103
Timber tax considerations applicable to any timberland investment 105

11 **Checklist: making the decision to invest in timberland** 111
By Liane Luke, FourWinds Capital Management, manager of Phaunos Timber Fund Ltd
To invest in timberland or not? 111
How much is enough? 112
Investment vehicle: public versus private? 112
Diversified or single sector? 114
Debt or no debt? 114
Dividend or no dividend? 116
What about the environment? 116
Which manager? 117
Some final thoughts... 118
Summary 118

12 **The role of the asset manager in maximising value** 121
By Edgar Marshall, Jamie Houston and Michael R. Cooper, Molpus Woodlands Group
Introduction 121
Traditional management 122
Non-timber revenue sources 125
Ancillary or emerging sources for maximising timberland value 126
Considerations for choosing a manager 127
Summary 128

Contents

13 **How carbon trading applies to the timberland asset class** 131
By Martijn Wilder and Ilona Millar, Baker & McKenzie
Introduction 131
Mechanics of creating forest carbon 132
Key legal issues in developing carbon assets 133
Formal legal frameworks for carbon 135
International compliance markets 135
Reducing Emissions from Deforestation and Degradation (REDD) 136
Domestic compliance markets 136
Voluntary market 141
Trading carbon commodities 141
Conclusion 143

14 **What can a tree be?** 145
By Miles P. Drake, Weyerhaeuser
Investment opportunity 145
The problem with alternatives 146
The need for clean energy 147
Products of the future 148
A change in attitude 150

Appendix I **Case study: Exiting timberland** 151
By Josh Wolf-Powers, Blue Wolf Capital Partners

Appendix II **Advisory and regulatory global action on sustainable timberland and forestry** 155
By Diane Phillips, PEI Media
IPF, IFF and UNFF 155
Key milestones of international forest policy 156
Multi-year programme of work (2000–2015) 157
Links between UNFF and UNFCCC 158
UNFF, UNFCCC and implementation in Indonesia 159
Key players in the developing world 161
Forthcoming actions 163
Conclusion 163

Glossary of timberland investment terms 165

About PEI Media 172

10

Tax considerations for global timberland investments

By C. Glenn Dunaway, Charles C. Connors and Karen Reschly,
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INTRODUCTION

The tax structuring considerations of timberland investments fall into two broad categories. The first is structuring the investment to allow the repatriation of profits to investors in the most tax-efficient method possible while the second is structuring the timberland investment operations to minimise tax liability in the country where the property is located.

GENERAL CROSS-BORDER PLANNING CONSIDERATIONS

Choice of entity

The choice of entity for a collective timberland investment fund can generally be distilled into a choice between two different tax regimes: partnership or pass-through taxation, versus corporate or entity-level taxation. A partnership pays no tax at the partnership level; rather its partners pay tax on their distributive shares of its income, even if the income is not distributed. A corporation pays tax at the corporate level, while its shareholders pay tax only on dividends received.

The entity decision will ultimately be based on the tax considerations of a fund's significant investors. In general, these considerations are whether the investors wish to benefit from tax treaties between their countries and the investment jurisdiction; whether they are concerned about having a permanent establishment or other taxable presence in the investment jurisdiction that may make them subject to tax there; and the relative tax treatment of dividends and gains from real property.

One additional specialised fund vehicle should be noted. If the targeted investments are located in a single country, a real estate investment trust (REIT) may be a viable alternative. REITs are essentially taxed as a hybrid between a partnership and corporation; they receive a deduction for dividends distributed to shareholders and pay tax only on income that they retain.

Treaty considerations

Most countries with significant commercial timberland investment have a fairly extensive treaty network. Whether or not it is possible to benefit from a tax treaty between an investor's home country and the investment jurisdiction is a factor that must be considered when structuring a timberland investment. In some timberland funds, the fund vehicle is fiscally transparent so that tax benefits may flow directly to the investors. In others, the fund vehicle is not fiscally transparent, but is located in a country where treaty benefits are available to the fund vehicle. Even where treaty benefits are not available at the fund level, subsidiary companies may be used to obtain treaty benefits between specific countries, usually through inter-company loans that produce deductible interest payments, or to facilitate an exit strategy.

There are several difficulties in structuring a global timberland investment that provides treaty benefits directly to a disparate group of investors through a tax-transparent fund vehicle. The most obvious is that some of the investors will be resident in a country without an advantageous treaty and that provisions in the treaty between the investment jurisdiction and the fund jurisdiction restrict non-residents (under 'anti-treaty shopping' rules) from benefiting from them. The use of a tax-transparent fund vehicle also increases the possibility that fund investors become liable to withholding or return obligations in the investment jurisdiction. For these reasons, many investors prefer that a non-transparent 'blocker' be used to insulate them from these liabilities.

Planning exit strategies

Unlike a private equity or venture capital investment that can culminate in a public offering, the exit strategy for a timberland investment is generally a choice between selling the timberland or selling the company that owns the timberland. In many countries both transactions are considered the sale of a capital asset, but there are important distinctions. In some countries a sale of land triggers the recognition of ordinary income in an amount equal to the depletion deductions previously taken by the owner. Also, in many countries a sale of company shares by a non-resident is not subject to taxation.

These two factors combine to make selling shares in the company the preferred exit strategy in most cases, but there are two caveats. First, a buyer of shares will likely expect a discount in the purchase price to reflect the absence of a stepped-up cost basis in the underlying assets. Second, many countries have laws that treat the sale of a company owning land as a sale of the land itself. It is possible to avoid these rules by selling shares in a holding company that owns the operating company, although some countries attempt to reach these upper-tier sales as well. In addition, some tax treaties treat the sale of this type of share as tax-free.

Tax haven restrictions

The status of a country as a tax haven is an important consideration in deciding whether to form a fund vehicle or subsidiary holding company there. Many institutional investors are prohibited from investing in countries denominated as tax havens. Many countries also impose higher withholding taxes against amounts distributed to tax havens.

The notion of what qualifies as a tax haven is currently in a state of flux. Typically, tax-havens have been defined by banking secrecy rules and a low tax rate. Based on these criteria, many companies formed in advanced countries not thought of as tax havens may qualify, as many countries impose little or no tax on foreign-source income earned by non-residents. Indeed, Brazil recently promulgated rules that could treat some companies formed in the US as tax havens. Conversely, many countries that have historically been considered tax havens have, in response to pressure from European countries and the US, imposed more stringent know-your-customer requirements than prevail in many non-tax-haven jurisdictions. Currently, there are no countries on the OECD list of uncooperative tax havens.[1]

Tax-exempt entities

Many tax-exempt investors are subject to rules that limit their ability to engage in managing a business and that, instead, restrict them to investment activities that are passive in nature. An investor subject to these rules may, if investing through a tax-transparent vehicle, fall foul of these rules by being treated as engaging directly in the timberland investment activity. In addition, while some tax treaties provide reciprocal tax treatment for tax-exempt organisations formed in the treaty country, these provisions are generally limited to interest, dividend and royalty income. They specifically exclude real estate activities.

TIMBER TAX CONSIDERATIONS APPLICABLE TO ANY TIMBERLAND INVESTMENT

Capitalisation rules and basis determinations

A purchaser of timberland is required to split the purchase price between amounts attributable to the land and amounts attributable to the standing timber. It is advisable to specify the allocation in the purchase agreement, as most tax authorities will defer to the parties' allocation as long as it is reasonable. The amounts that may be included in the property's cost basis are: the purchase price and reasonable acquisition expenses, such as a timber cruise (inventory); appraisal; brokerage commission; legal fees; licenses; and governmental filings. Buying shares in an operating company generally does not result in an increased, or stepped-up, basis in the underlying property, although in many countries special elections are needed to achieve this result, usually at a cost.

One area of potential complexity in cross-border acquisitions is where some acquisition expenses are incurred and/or paid outside the country where the timberlands are located, but are nonetheless included in the property's cost basis. This can cause difficulties in a country with currency-control legislation, as it creates a discrepancy between the investor's cost basis and the

[1] In May 2009, the OECD's Committee on Fiscal Affairs decided to remove all three remaining jurisdictions (Andorra, the Principality of Liechtenstein and the Principality of Monaco) from the list of uncooperative tax havens in the light of their commitments to implement the OECD standards of transparency and effective exchange of information and the timetable they set for the implementation. As a result, no jurisdiction is currently listed as an uncooperative tax haven by the Committee on Fiscal Affairs.

amount of its foreign investment registered with the central bank (or, the amount that may be repatriated without withholding tax).

Basis recovery

The investor's cost basis in the land is not recovered until its sells the land, while its basis in the timber is recovered as it sells or harvests timber for use in vertically integrated processing facilities. The owner's cost basis is allocated to a 'land' account and a 'timber' account; each is increased by capitalised expenses attributable to the land or timber and decreased to account for sales. Most accounting systems allocate a timber basis *pro rata* across all timber units owned in the same defined area. The timber unit can be denominated as a tree, a tonne, board feet or cubic metre, or some other measure. The permissible area varies from country to country (for example, in the US the tract or block is used whereas, in South Africa, it is the plantation).

Cost basis is generally recovered by reducing the timber sales proceeds by an amount equal to the seller's cost basis in the number of timber units sold. South Africa has a fairly peculiar rule, in which sales proceeds are fully offset by the seller's basis in its timber until the basis is exhausted. In countries in which commercial timberland investment is relatively new, it is not uncommon for there to be no official rules as to how the cost basis in timber is recovered, which means working with local tax advisers to determine how to account reasonably for basis recovery, and to document the reasoning in case the treatment is later questioned by tax authorities.

Standing timber versus log sales

The manner by which timber is harvested and sold generally affects the way in which income realised on the sale is characterised. Generally, there are two methods of selling timber: the sale of cut logs (log sales) and the sale of standing timber (stumpage sales). In a typical log sale transaction, the owner will arrange for the harvest of the trees and then sell the cut logs to the purchaser/mill. In most jurisdictions cut logs are treated as personal property and are considered inventory. Sales of inventory are generally considered business, rather than investment, income. In many countries, log sales implicate other taxes. In Brazil, for example, certain social contribution taxes and VAT generally apply to log sales but not to stumpage sales (see *Case study: Investing in Brazil's timberlands*).

In a stumpage sale the buyer is generally responsible for harvesting the tree; title to the timber passes to the buyer when the timber is cut. Some jurisdictions consider stumpage sales as the sale of an asset rather than a sale of inventory – this differing characterisation can produce a different after-tax result when asset-sale gains are taxed differently from inventory-sale income. In the US, for example, gains realised on stumpage sales that meet certain requirements are characterised as capital gains rather than ordinary income, the former being historically taxed at rates lower than those for the latter.

Characterisation of timberland sales

The sale of timberland is generally treated as the sale of a single asset, as the laws of most countries characterise unsevered timber as a part of the underlying property. In some countries, however, amounts attributable to the sale of standing timber are treated as received for inventory

Case study: **Investing in Brazil's timberland**

Brazil is currently a popular destination for timberland investment capital. Nevertheless, its tax system ranks as one of the world's most complicated and illustrates the manner in which alternative methods of structuring timber dispositions affect the taxes that are imposed.

Corporate income taxes in Brazil are imposed under the actual profit and presumed profit methods of tax accounting. The two methods differ in the amount of income subject to tax, the type of taxes that may apply and the rate of tax to be applied. Expenses are deductible under the actual profit method, but are not under the presumed profit method which, as its name implies, simply presumes that a specified percentage of gross income constitutes taxable income.

The differences can be illustrated by comparing how log and stumpage sales are taxed under each system. Under the actual profit method, net income from log sales is subject to an effective tax rate of 34 percent (consisting of income taxes and a social contribution tax on profits). Under the presumed profit method, log sale revenue, rather than net income, is the amount subject to tax; an income tax of 25 percent is applied to 8 percent of the revenue, and the social contribution tax on profits is applied to 12 percent of the revenue at a rate of 9 percent. In the case of stumpage sales, the actual profit method is normally used because the presumed profit method disallows any deductions other than the cost basis in the timber sold. In addition to these income taxes, two different social contributions taxes (the programme for social integration (PIS) and the contribution for the financing of social security (COFINS)) are imposed on monthly gross revenue at rates that vary depending on whether log sales or stumpage sales were made, and whether the actual or presumed profit methods are being used.

The application of different taxes at different rates to different kinds of income under different accounting methods obviously introduces a great deal of complexity into any attempt to predict future tax liabilities. Compounding the difficulty is the fact that the law permits many taxpayers to change accounting methods from year to year, depending on which method yields the more favourable result. Modelling future cash flows is a speculative endeavour under any circumstances, but the uncertainty introduced by the Brazilian tax system adds a new level of difficulty in preparing valuations and return projections.

and are subject to tax at higher rates. Many investors prefer to bypass these issues altogether and simply sell shares in the operating company owning the land, especially if doing so avoids local income tax. Yet in many jurisdictions this is not effective, as local law treats share sales in the company owning the land as a sale of the land itself.

When exiting a timberland investment one issue is whether the local tax regime distinguishes between the sale of an ongoing business and the sale of business assets. For example, in South Africa, if the sale of timberland qualifies as the sale of a going concern that is an income-generating business on the date of sale, then no VAT is due; if it does not qualify, then VAT of 14 percent of the purchase price is payable.

Finally, if an investor contemplates selling parcels of land during the term of the investment, it should be aware that some tax regimes have rules regarding dealer status. For instance, in the US, gains from land sales are ordinarily considered capital gains and taxed as such. However, if the land owner engages in sufficient land sales activity, it may be treated as owning the land as inventory and therefore as a dealer in property. Gains realised on sales of dealer property are taxable at ordinary income rates rather than as capital gains.

Taxes other than income taxes

There are often a number of taxes other than income taxes that apply to a timberland investment. The most significant of these are property, transfer, severance, VAT and social contribution taxes.

- *Property taxes.* These are typically imposed on the assessed value of the timberland, which may or may not correlate to the fair market value of the property. Property tax is almost always imposed on the land itself, and sometimes on the value of the timber, whether standing or cut. It is not unusual for tax regimes to have certain exemptions for agricultural or rural property that provide for a reduced tax rate.
- *Transfer taxes.* Transfer taxes are imposed when timberland changes ownership, and in many jurisdictions they are high. Various techniques are used to avoid or minimise these taxes. In some jurisdictions selling the company that owns the land, rather than selling the land itself, avoids transfer tax.
- *Severance taxes.* These taxes are imposed when standing timber is cut.
- *VAT.* This may be imposed on timber sales and is more likely to be imposed on sales of cut logs rather than standing timber.
- *Social contribution.* It is not uncommon for tax authorities to impose a social security or social contribution tax on revenues. In some countries (such as Brazil) these taxes can constitute a significant portion of the land owner's aggregate tax liability.

Tax subsidies

Countries looking to stimulate inbound investment or the development of a particular sector frequently provide tax benefits to encourage this. These benefits usually take the form of reduced or eliminated taxes on specific properties or specific forms of income. Occasionally, the benefits are permanent but they are more often phased out after a number of years. Uruguay used to provide generous tax benefits for timberland ownership but has reduced them in recent years, while Colombia presently offers an array of tax benefits for prospective investors.

Timber-specific planning opportunities

Depending on the country, timberland investments may present special planning opportunities. In the US, a timberland owner may sell the land for an installment note and defer taxation on the sale until it receives payment of the principal balance; the rules also allow the seller to pledge and effectively obtain most of the economic benefit from the note received in such a transaction, while delaying the recognition of income for many years. This rule has played a considerable role in the decision by most US forest-products companies to sell their timberland holdings.

Tax treaties may also play into tax mitigating strategies for cross-border timberland investors. For instance, in the US, a non-resident disposing of timberlands through either an asset or entity sale is generally taxed on the gains as if the non-resident was engaged in a US trade or business. However, if the timberlands were indirectly held by the non-resident through a variable annuity insurance contract and the timber investment is structured properly, the income from timber sales could be characterised as royalties or annuity payments, which often receive preferential tax treatment under applicable tax treaties. □

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