# AEB Event – The true cost of an office fit-out:

*Hidden Costs – managing the tax aspects of leasehold improvements*

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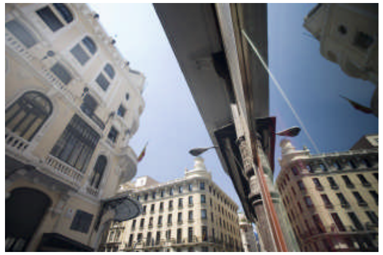
# 1. Leasehold Improvements - Overview

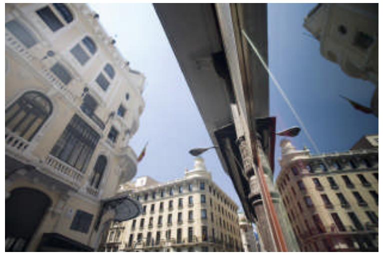
- Due to defects in the existing legislation, combined with normal market practice, leasehold improvements are associated with a number of potential added tax costs and risks.
- The tax treatment of leasehold improvements depends on a number of factors.  The following are typically the key issues to consider:
  - Term of the lease;
  - Nature of the leasehold improvements (e.g. “detachable” vs. part of the building)
  - The party that bears the costs of the (particularly non-detachable) leasehold improvements and how the arrangement is documented
- Because of the above issues, it is important to understand the issues <u>in advance</u> to arrive at a mutually agreeable solution to give all parties the best answer – but take care, the best answer might not be obvious!



# 2. Nature of Leasehold Improvements

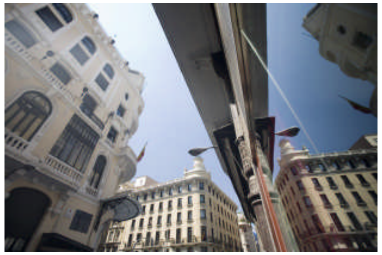
- For tax purposes it is important to distinguish between the following types of leasehold improvements:

  - Non-detachable leasehold improvements;
  - Separate fixed assets;
  - Low-value items;
  - Repairs(?)



# 2. Nature of Leasehold Improvements

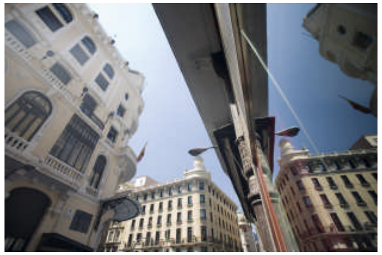
- Separately identifiable fixed assets
  - Certain non-permanent (detachable) improvements may potentially qualify as separate fixed assets;
  - For such assets, depending on their useful life (e.g. if it exceeds lease term) and degree of detachability, it may be preferable for the tenant to finance and own such assets directly;
  - For such assets, from a tax perspective the Tenant:
    - Would depreciate the asset for profits tax purposes considering the statutory useful life of each such fixed asset;
    - Should be able to apply the 10% depreciation premium in the first year;
    - Should be able to recover input VAT under general VAT recoverability rules;
    - Would be required to account for and pay property tax on the asset;
  - Should the statutory useful life of the asset exceed the lease term, the tax treatment would depend on the "fate" of the asset – if it goes with the tenant for continued use in the business vs. disposal of the asset.



# 2. Nature of Leasehold Improvements

- Low-value items and repairs
  - Certain detachable items may be potentially qualified as low value items if their cost is equal or below RUR 20,000. In such case the cost of such items may be potentially deducted for profits tax purposes after putting them into use.
  - Certain works such as, e.g. painting, tiling may be potentially seen as repairs. Repairs costs are generally deducted for profits tax purposes as an on-going expense.
  - However, if the building is newly constructed and the Tenant is the first occupant such an approach would be risky, as the term repairs (although not defined in the civil or tax law) implies that the asset was previously used and lost its normal working conditions and thus is subject to repair.
  - However, there are risks with taking this approach since in practice the tax authorities could take a position that such works should be considered part of non-detachable improvements.

# 2. Nature of Leasehold Improvements (4 of 4)



- Non-detachable leasehold improvements
  - Non-detachable leasehold improvements are generally defined as improvements that cannot be detached from a piece of real property (building) without damage (article 623 of the Civil Code).
  - These are the types of improvements that potentially carry the highest potential tax costs/inefficiencies
  - Discussions on this point typically start with which party (commercially) agrees to bear the costs - tenant or landlord?
  - However, the tax treatment of leasehold improvements will depend not only on whether relevant costs are borne by the Tenant or Landlord, but also on the form in which the overall arrangement takes.
- Once the economics are agreed, it is usually in both parties interest to identify the issues upfront and to reach a commercially and legally acceptable arrangement that minimises tax costs on both sides!



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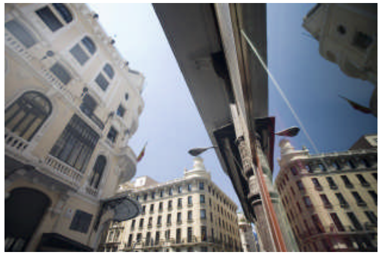
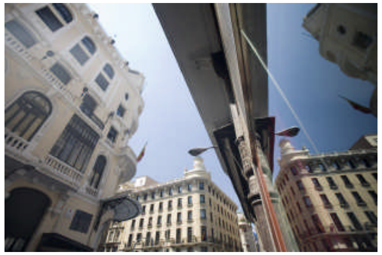
# 3. Tax treatment of non-detachable Leasehold Improvements



A. <u>Non-detachable leasehold improvements costs borne by Landlord</u>

- The non-detachable Leasehold Improvements which are financed by the Landlord should generally be added to the cost of the building and hence depreciated together with the building (i.e. during at least 30 years plus 1 month for new office buildings).
- 10% depreciation premium may potentially be applied.
- Property tax basis of the Landlord would increase.
- The VAT to be claimed for recovery (if applicable) would also be with Landlord.
- If leasehold improvement costs are borne by Landlord at a Tenant's request the Landlord would likely seek compensation through higher rents and advances.

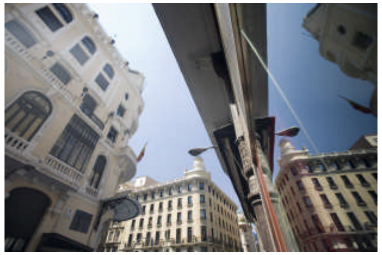
# 3. Tax treatment of non-detachable Leasehold Improvements



B. Non-detachable leasehold improvements costs borne by Tenant

- Generally relevant costs would be depreciated by the tenant during the lease term at the rate applicable to the building (i.e. minimum 30 years plus 1 month if office bldg).
- As a result, potentially a significant portion of the costs might not be utilised for tax purposes. For example, assuming that the Lease agreement is concluded for 5 years there is a risk that only 5/30 of non-detachable Leasehold improvements cost could be utilized (deducted for profits tax purposes) by the Tenant.
- The 10% depreciation premium also might not be available.
- There are additional risks of non-deductibility given the market practice with timing of occupying premises/concluding leases.
- Property tax to be paid by the tenant (assuming costs are kept on balance sheet as fixed assets)

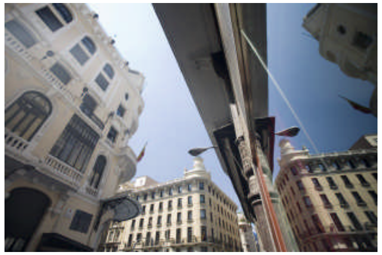
# 3. Tax treatment of non-detachable Leasehold Improvements



B. <u>Non-detachable leasehold improvements costs borne by Tenant (continued)</u>

- Landlord is specifically excluded from profits tax with respect to leasehold improvements received, but there may be risks in relation to VAT on such transfer.
- VAT incurred on the costs of leasehold improvements would generally be recoverable by the party that purchases them (assuming other general recovery requirements are met).
- However, it is not clear what happens when the improvements are "transferred" to the landlord.
  - The Russian tax authorities issued a number of clarifications which provide that transfer of inseparable improvements to the Landlord is subject to VAT (not clarifying the moment when such transfer occurs and thus the moment when VAT should be charged).
  - Alternatively, if tenant had recovered the input VAT, there is a risk that at the end of lease period the tax authorities may require the Tenant to restore input VAT in respect of the portion of inseparable improvements not fully depreciated.

# Sample calculation of potential tax costs



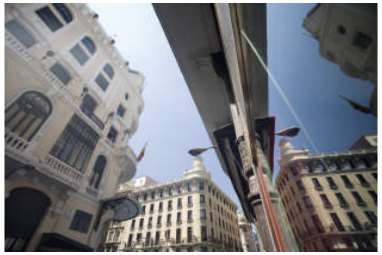
| | |
|---|---|
| **Assumptions** | |
| **Non-detachable Leasehold improvement costs** | **30,000** |
| **Lease term** | **5 years** |

| **Scenario 1. Costs borne by Tenant** | |
|---|---|
| **Leasehold improvement costs** | **-30,000** |
| **VAT charge** | **-5,400** |
| **Profits tax saving due to depreciation** | |
| **(30,000/30*5*24%)** | **1,200** |
| **VAT recovery** | **5,400** |
| **VAT potentially at risk** | **-4,500** |
| **Total potential outflow for Tenant** | **-33,300** |

| **Scenario 2. Costs borne by Landlord** | |
|---|---|
| **recovered through rent** | |
| **Leasehold improvement costs** | **-30,000** |
| **Profits tax deduction due to depreciation** | |
| **(30,000*24%) - over 30 years*** | **7,200** |
| **Rent income** | **30,000** |
| **Profits tax charge on rent income** | **-7,200** |
| **Total for Landlord** | **0** |
| **Rent costs** | **-30,000** |
| **Profits tax saving due to rent costs deductible** | **7,200** |
| **Total outflow for Tenant** | **-22,800** |

Notes to Scenarios:
* Timing of cash flows ignored, but obviously would have an impact on the Landlord costs (so would be point of negotiation to compensate landlord for TVM of added tax cost)
** Property tax ignored for both scenarios
*** VAT ignored in scenario 2 as should wash

# 3. Tax treatment of non-detachable Leasehold Improvements



Some points for further consideration:

- As can be seen on the previous slide, having the tenant pay for and "own" the improvements may not be as efficient as having the landlord pay and work the compensation into the rent payment.
- Market practice is currently that tenants bear the cost of improvements.
- However, even if the commercial agreement between the parties is for the tenant to bear the costs, there are ways to structure the arrangements so that tenant can achieve tax savings (or more appropriately stated, avoid unintended tax costs).
- From a tenant's perspective, this is usually a better answer so they might strongly prefer this option.
- From a landlord's perspective, while it might not necessarily be a better answer economically, as long as they are not out of pocket (timing of tax costs can be factored and compensated) it could be seen as an "accommodating" gesture since it makes the overall cost to the tenant less, which should help in negotiation of other commercial points.



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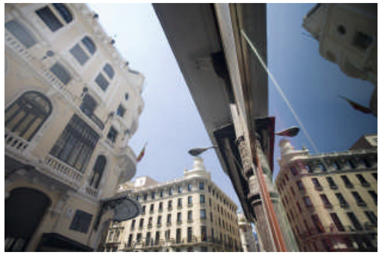

## Questions?

## Thank you!

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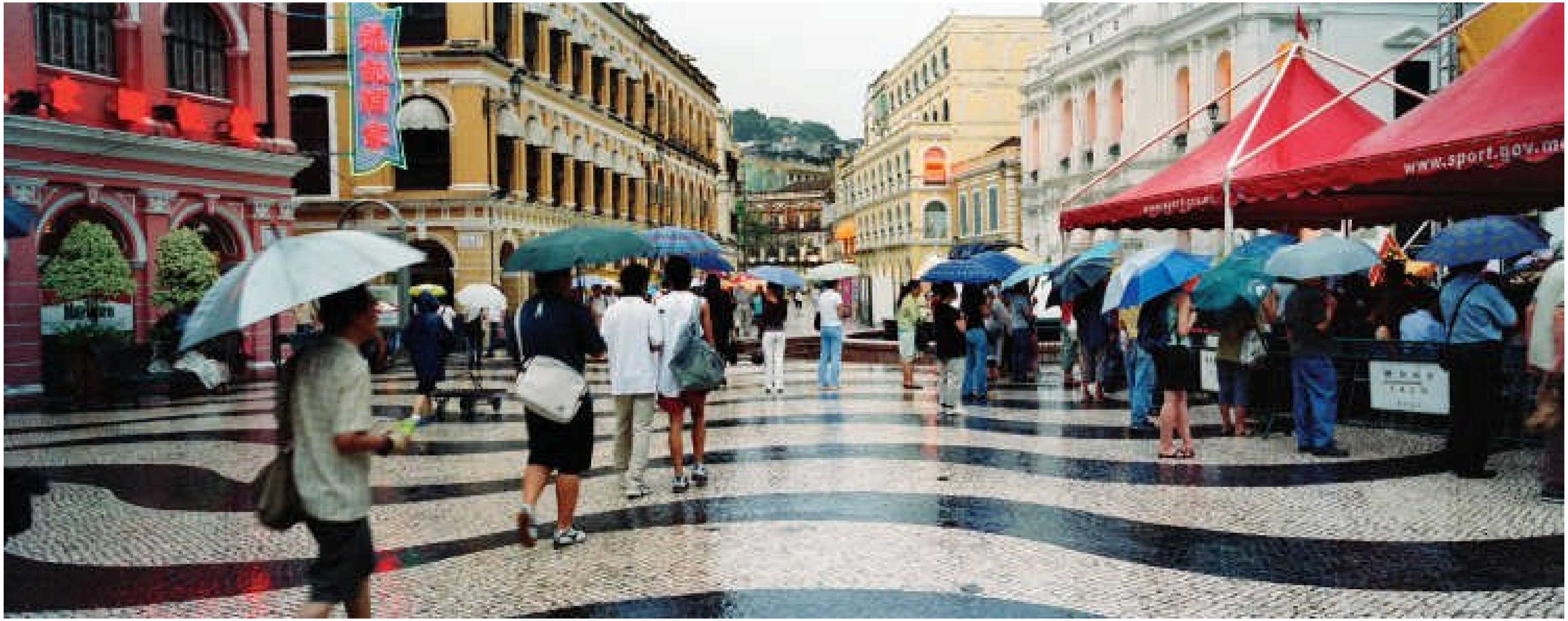

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