The Changing Approach to Real Estate Transactions from a Tax Perspective

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Agenda

PART I – could we see some asset deals?

- Market before the current crisis & common deal structures
- How the market has changed, and why we might see some asset deals
- Pros and cons (from a tax perspective) of an asset deal when compared to a share deal

PART II – Some topical tax issues – responding to the crisis

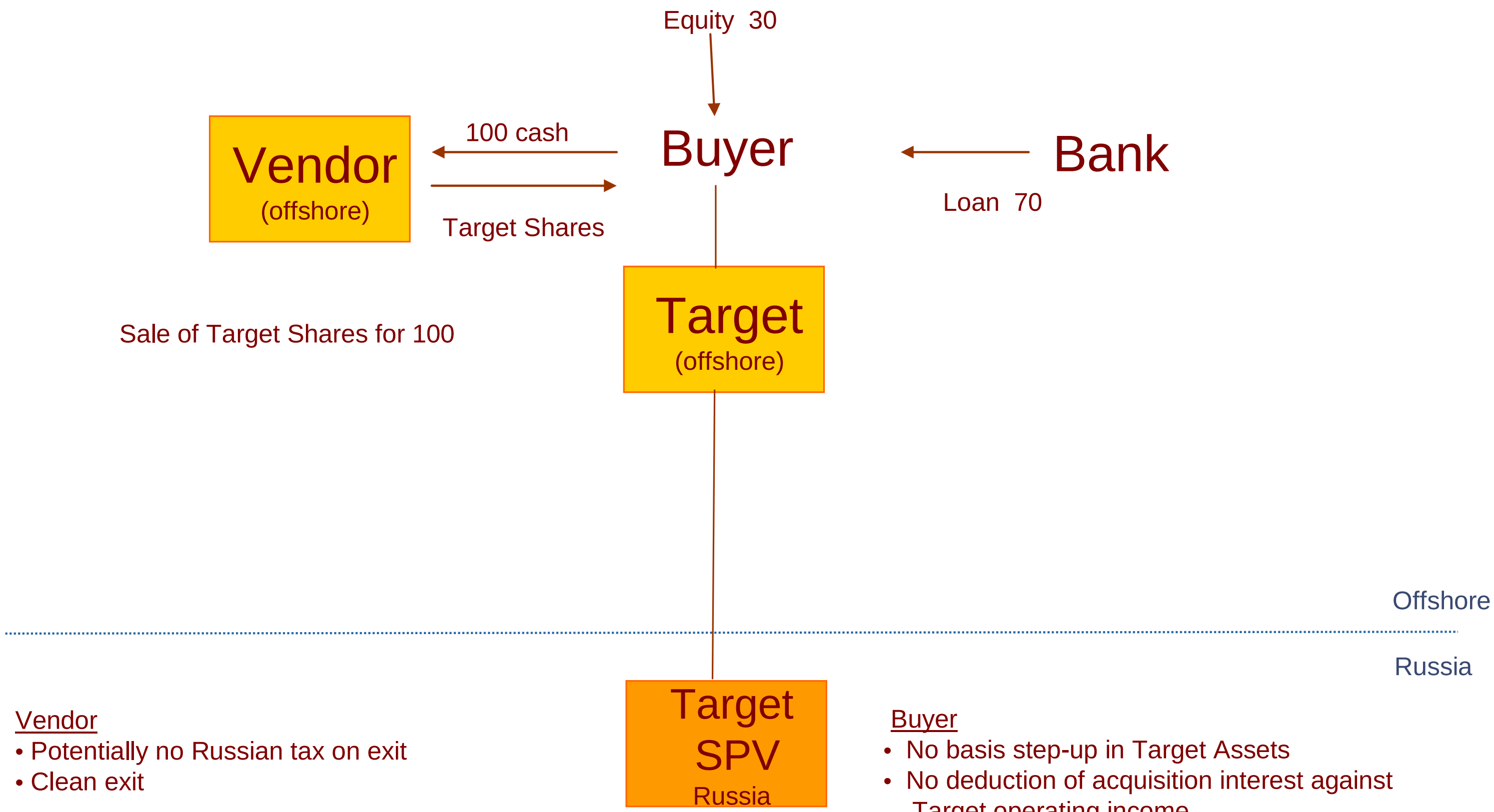
- Introduction of new anti-crisis tax legislation

What was the market like prior to the financial crisis?

- The real estate market was booming with plenty of developments being undertaken, insufficient supply of office and retail space, and many foreign players seeking to enter or expand investment in the market.
- Foreign lenders were embracing Russia, forcing Russian banks to be more competitive
- As a result, significant capital was flowing into Russia from foreign investors and lenders.
- This put pressure on both investors and lenders – need to accept vendor's terms or else risk losing the deal.

In summary, it was a sellers' market!

What were the common deal structures in the past?



<u>Vendor</u>

- Potentially no Russian tax on exit
- Clean exit

<u>Buyer</u>

- No basis step-up in Target Assets
- No deduction of acquisition interest against Target operating income
- Need higher level of due diligence on Target OpCo

- Share deal the norm – but brought with them additional tax risks for buyers:
  - Buying a company means buying its tax history – so very detailed tax due diligence of the target was critical to the deal.
  - Built in capital gains tax – sellers generally not willing to accept any responsibility/share costs
  - Potentially significant VAT recoverability risks – especially if developer used "questionable" suppliers during construction.
  - If the Vendor didn't have the "right" structure, they may have restructured internally before sale – in which case buyers often forced to assume risks for pre-deal restructuring (e.g. "quasi" asset deals).
  - It was very difficult to achieve debt-pushdown to tax efficiently finance the acquisition

Buyers often forced to accept tax inefficient structures and all of the tax risks!

How has the market changed?

- Lack of availability of both equity and debt financing accentuated by the mass exodus of western investment – deals virtually non-existent.
- Increased pressure on developers – many projects frozen or discussions around amendment of development plans – facing pressure from lenders to sell off assets/projects.
- General business growth forecasts slowed drastically, meaning vacancies are increasing and rents decreasing.
- There is a “flight to quality” – including structure - buyers are cherry picking and in a better position to dictate terms.

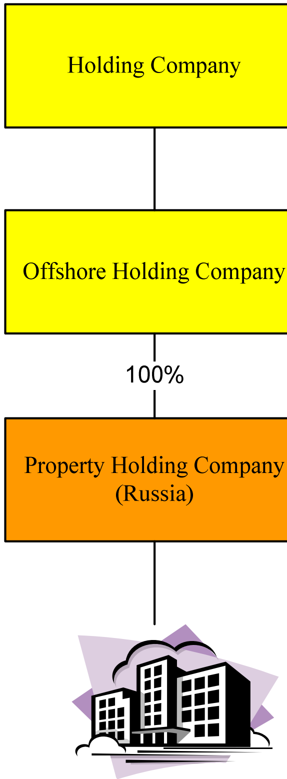
In summary, it’s now a buyer’s market!

➢ So why might we start to see some asset deals?

- Market appreciation has slowed/reversed – Vendors won't be sitting on such HUGE capital gains on exit!
- Profits tax rate has been lowered to 20%
- Distressed sales will happen:
  - Cash-strapped developers need to quickly generate cash.
  - Highly leveraged players breach loan covenants or default and banks take assets – have assets to sell;
- Financiers may want debt closer to the asset (at asset co level vs offshore shareholder).
- Buyers unlikely to freely accept all of the risks/cost of latent capital gains taxes any more – will be priced into the deal.
- If tax and other costs already priced in, might as well offer the option of an asset deal if it creates a more appealing structure for the buyer
- Depreciation of Rouble against US dollar and Euro creates even bigger problems….see following example

Example of rouble devaluation effect on thin cap risk in share deals

- Assume last year developer holds Russian real estate through the following structure:



Costs: US$ 100

Equity funding: US$ 25

Debt: US$ 75

Other assumptions for the following example:

- interest rate 15%
- Debt either guaranteed or provided by shareholders
- rental income $19 p.a.

Example of effect of rouble devaluation on thin cap risk

- The (simplified) balance sheet of the Property SPV pre-crisis would have been:

Rouble

Asset	2,500		
		Debt	1,875
		Equity	625

where 1US$ = 25 RUR

US Dollar

Asset	100		
		Debt	75
		Equity	25

- Tax P&L (simplified, converted to $$) pre rouble devaluation would have been:

Taxable Profit in Russian SPV (converted to $)

Rental income	19
Interest expense	(11.3)
Depreciation	(3.3)
Taxable income	4.4
Profits Tax (at last years rate, 24%)	(1.1)
Distributable profit	3.3

Cash Repatriation ($)

Interest:	11.3
Dividends	3.3
- Russian WHT on dividend (assuming 5%) r	(0.2)

Net cash repatriated (including interest)	14.4
Tax leakage	-1.3
Cash "trapped" in Russia*	3.3

* note: cash is only trapped from a dividend perspective - can still be used to repay debt

- Fast forward to 2009, assume an investor is offered the shares in the Russian company holding the real estate and the related debt for $100 (i.e. at Vendors cost), but now the rouble is at $1=35. This is what they acquire:

Rouble

Asset*	2,500		
		Debt	2,625
		Equity*	(125)

US Dollar

Asset	100		
		Debt	75
		Equity	25

where 1US$ = 35 RUR

***for illustrative purposes, ignoring accumulated dep'n and previous year results except debt revaluation**

- Since the company had foreign currency debt, the fall in the rouble has created a large loss on the balance sheet, thus effectively erasing equity.
- Since the entity is in a negative net equity position, unless the capital structure is changed, the thin cap rules could disallow all interest expense for tax purposes.

- Loss on loans will reduce profits tax temporarily, but if thin cap rules disallow interest deduction, the payments are also treated as dividends for Russian tax purposes, creating withholding tax obligation.

Taxable Profit in SPV (converted to $)

Rental income	19
Interest expense	(11.3)
disallowed interest	11.3
Depreciation	(2.3)
Taxable income before currency loss	16.7
currency loss	(21.4)
taxable income	(4.7)
Profits Tax @ 20%	n/a
Distributable Profits	n/a

where 1US$ = 35 RUR

Cash Repatriation ($)

Dividends	n/a
Interest	11.3
- Russian WHT on interest (assuming 15%)*	(1.7)

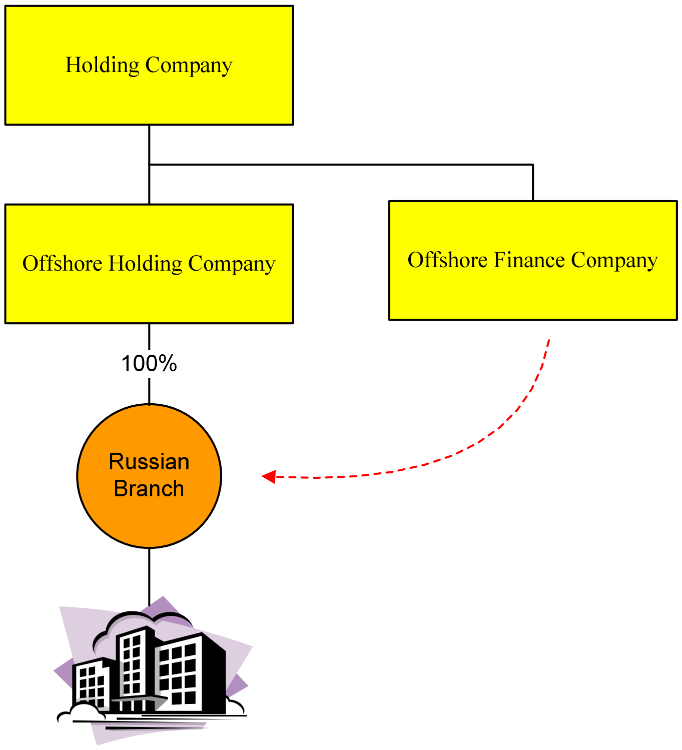
Net cash repatriated (interest net of tax)	9.6
Tax leakage	-1.7
Cash "trapped" in Russia**	7.7

* it is not clear what, if any, treaty relief is available for interest reclassified as dividends under thin cap rules. 15% is the maximum dividend rate without treaty

** note: cash is only trapped from a dividend perspective - can still be used to repay debt

- Accounting losses on the debt revaluation also further inhibits dividend distributions resulting in a higher “trapped cash” issue.

- Assume instead the investor undertakes an asset deal with the following acquisition structure:



Acquisition price: US$ 100

Equity funding: US$ 25

Debt: US$ 75

Other assumptions for the following example remain the same: interest rate 15%, rental income $19

- The (simplified) balance sheet of the Property Branch would now be:

Rouble

Asset	3,500		
		Debt	2,625
		Equity	875

where 1US$ = 35 RUR

US Dollar

Asset	100		
		Debt	75
		Equity	25

- The tax implications and cash repatriation would be:

Taxable Profit in SPV Russian Branch (converted to $)

Rental income	19
Interest expense	(11.3)
Depreciation	(3.3)
Taxable income	4.4
Profits Tax	(0.9)
Distributable profit	3.5

Cash Repatriation offshore ($)

Interest:	11.3
After Tax Branch Profits	3.5
- Russian WHT	n/a
Additional Cash in branch distribiuted	3.3
Net cash repatriated (including interest)	18.1
Tax leakage	-0.9
Cash "trapped" in Russia	0.0

➢ What does an asset deal mean from a Buyer's perspective:

Pros:

- More flexibility in structuring, since no requirement to purchase the vendors' existing structure.
- Ability to have debt financing at the asset level reduces tax leakage through deductions for interest.
- Step-up in the tax basis of asset – less tax risk on exit.
- If foreign buyer, ability to acquire in branch of foreign company, meaning lower tax drag and easier cash management.
- Not accepting historical corporate tax risks – less tax due diligence required.
- More certainty over "quality" of input VAT

Cons:

- Potentially higher property tax base (but costs may potentially be passed to tenants).
- VAT applicable on purchase and may need to be financed due to difficulty in getting cash refunds in practice (but conditions improving on this issue).
- If seller in a tax loss position, previously generated losses may be forfeited.
- More complicated to close (transfer of rights, registrations, etc.).

➢ What does an asset deal mean from a Seller's perspective:

Cons:

- May need to pay profits taxes on any rouble gains (which could be substantial depending on the deal).
- More complicated to close from a legal perspective (transfer of rights, re-registrations, etc.).
- Potentially left with cash rich shell companies from which the cash needs to be repatriated or re-invested – this will have additional tax implications.
- Left with VAT recoverability risk on development inputs

Pros:

- Tax cost may be minimised if there are existing tax losses in company against which to offset gains (e.g. losses on foreign currency loans, construction period interest expense, etc.).
- Less negotiation with purchasers over compensation for historical tax (and other) risks.
- May have intercompany loans in place making it easier to extract the cash tax efficiently
- Buyer has to pay full VAT on asset purchase, vs discounted purchase of receivable

An Asset Deal might not always be the right answer, but it is important to consider and run the numbers! You may find that in some cases even if Vendor doesn't want to pay tax, you can save money by compensating them!

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PART II: Recent Tax Development Affecting Real Estate investment structures

Finally, some good news about Russian tax:

Russian Profits Tax Rate Reduced to 20% (from 24%) as of 1 January 2009!

This actually makes the corporate tax rate in Russia very competitive….

Some more good news about Russian tax:

- Recovery of VAT on advances paid to suppliers
  - As of 1 January 2009, VAT on advances paid to suppliers can be recovered once the VAT is paid. This means that now tenants can recover VAT on advance rent payments. Creates additional room for negotiation with tenants.
  - Will require all appropriate documentation to be in place (e.g. invoices issued by suppliers).
- Amortization premium
  - From 1 January 2009, a Russian legal entity can immediately deduct 30% of the acquisition cost of some new fixed assets ("amortization premium").
  - However, since the useful life of most buildings is 30 years – it is unlikely that the increased premium will apply to real estate acquisitions or developments (but currently available 10% premium would still apply).

Is this potentially more good news?

- Amendment to interest deductibility threshold
  - Previously there was a choice to use a "comparables" method, or a so called "safe harbour" maximum rate;
  - From 1 September 2008 until 31 December 2009, the interest deductibility rules have changed. In particular, the "safe harbour" limits have increased:
    - 22% for foreign currency denominated loans (previously 15%);
    - 1.5 times the Central Bank of Russia refinancing rate for Rouble denominated loans (previously 1.1 times).
  - However, while under previous rules taxpayers had a choice, now the safe harbour method is only available if there are no comparables.
  - <u>This leaves uncertainty over the interpretation of what constitutes "comparable" debt obligations, and how the comparables method is to be applied = potentially additional headaches for taxpayers trying to apply the new rules!</u>

To wrap it up…..

- The market has moved from a seller's market to a buyer's market.
- As a result, there may be more options to consider in structuring the deal and more room for negotiations.
- It is important to consider both an asset deal and share deal and use cash-flow modelling to analyse which would be better from both parties perspective.
- The structure of the deal will have a direct impact on the approach to tax (as well as other) due diligence!
- Finally, given the fall in rouble coupled with the recent changes in interest deductibility rules, for those with existing investments it is imperative to review your debt structures to ensure compliance with both thin capitalisation rules as well as new interest deductibility thresholds.

Questions?


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