Office Premises – To Rent, Purchase or Build to Suit? Tax Angle

22 April 2008

PRICEWATERHOUSECOOPERS

Taxation Services

0. To Rent, Purchase or Build to Suit? Tax implications. Introduction

The "Occupier's policy" - the choice between different options is primarily dictated by factors other than tax. Various trends can be spotted in Europe:

a. **An effort to optimise property portfolio by big corporates/utilities, overcome inefficient use of properties with substantial capital tied-up in non-core areas (example – Sale-Leaseback);**

b. **Optimise occupancy via adoption of more aggressive space standards - moving from static desks to flexible desk sharing – relocation;**

c. **Moving to PropCo/OpCo structures;**

d. **Potential ownership of premises for occupancy.**

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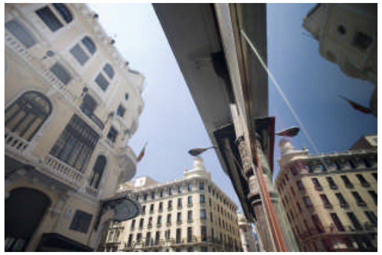

a. Example of RE re-structuring project.

1. Assessment of the status of real estate operations of a a big corporate

► Feasibility study and financial analysis of the various options available

► Strategies worked out:

- ► Consolidation to a single new purpose built headquarters complex
- ► Sale and short term lease back of a few key buildings, while new HQ being commissioned and built
- ► Programme of disposal for the remainder, as legal, ownership and other issues are worked through
- ► A management approach covering all technical aspects to real estate and project management issues

2. Structuring the optimization options and preparing the transaction. Implementation

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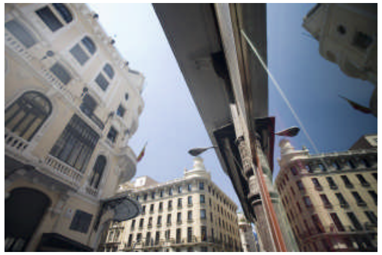

b. Example of a relocation project.

Challenge:

- Relocate without impacting continuity of service;
- Recruitment of significant numbers of new people to replace those who choose not to relocate;
- Adopt more aggressive space standards for office occupation;
- Introduce new ways of working.

- A major cultural shift for the organisation in terms of:
  - - moving from static desks to flexible desk sharing
  - - implementing improved approaches to storage and clear desk policies
  - - perceived loss of control of an individual's working environment
- Heavily reliant on new equipment, lead times and procurement, critical to programme
- Restricted by what is possible given the current building infrastructure
- Success reliant on good communication and buy-in from the staff

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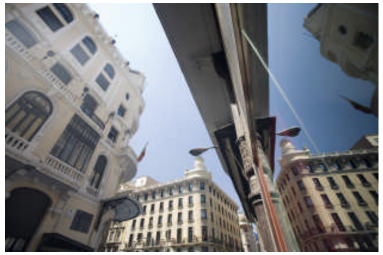

C. OpCo/PropCo structure. How it works

- A typical property rich group is often valued on a multiple of earnings basis, the multiple being determined by the industry sector.
- If an existing group had EBITDA of £100m and an industry multiple of 8, the enterprise value of the group would be £800m.
- Refinancing the group as separate operating and property investment security groups should allow the property sub-group to be valued on the underlying value in the property rather than on a multiple of earnings basis.
- ***Based on Propco borrowing debt at 85% loan to value against its property investments, this example group could borrow funds in excess of £1.1 billion against a business originally valued at £800m.***

	A Plc	**Propco**	**Opco**
EBITDA	100	65	35
Industry Multiple	8		5
Enterprise Value	800		175
Intra-group rental charge at 65% x EBITDA	65		
Yield	5%		
Enterprise Value			
Propco (yield basis)		**1300**	
Opco (multiple of earnings basis)			**175**
Total			**1475**

✓**Tax implications to consider :in Russia:**

- Transfer pricing with respect to sale
- Profits tax with respect to capital gains;
- VAT charged;
- Increased property tax base

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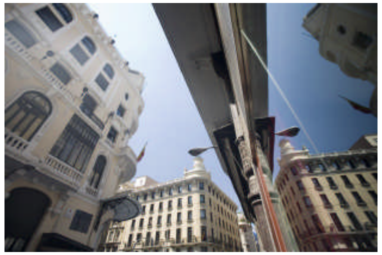


Tax implications often are a significant factor to be taken into account with respect to different options, in particular, if any restructuring is contemplated.

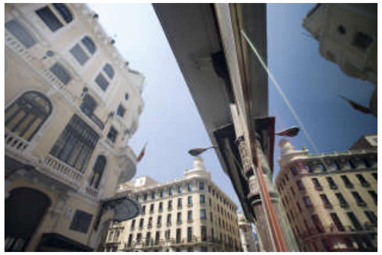
This presentation covers:

A. Key tax implications of a Rent Option

B. Key tax implications of Purchase of premises and Build to Suit option

C. Accounting issues

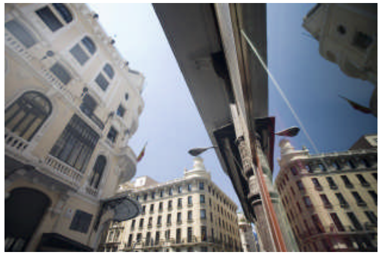
A. To Rent, Purchase or Build to Suit? Tax implications. Rent Option



Generally:

- **Rent charge is usually profits tax deductible;**
- **VAT on rent is usually recoverable (if the tenant is in VATable business)**
- **If not a “financial lease”, no property tax charge on the renter (although landlords tend to pass to tenants property tax charges through rents).**

A. To Rent, Purchase or Build to Suit? Tax implications. <u>Rent Option (continued)</u>



Complexities:

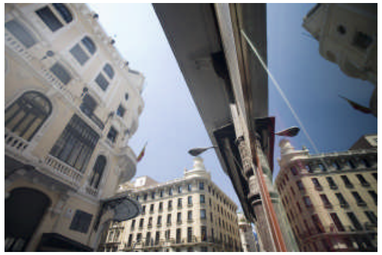
1. **Tax treatment of the costs that a tenant incurs in relation to fit-out of premises:**

   a. **Non-removable improvements – if not reimbursed by landlord:**
      i. **depreciation over the term of the lease but at the building depreciation rate; when leaving the building the non- depreciated amount is lost;**
      ii. **VAT risks when leaving the building?**
      iii. **tax authorities take the position that 10% depreciation premium does not apply.**

      Arrange for landlord to incur relevant costs and increase rent rate?

   b. **Separate fixed assets (cables, vide-control systems, etc.);**
   c. **Low value items;**
   d. **“repairs”.**

A. To Rent, Purchase or Build to Suit?
Tax implications. Rent Option (continued)



Complexities:

2. **Tax treatment of payments under preliminary rent agreement. Approaches in the market:**

   a. **Treat as refundable deposit and provide for higher rent charge (over the total lease period under a conservative approach)**

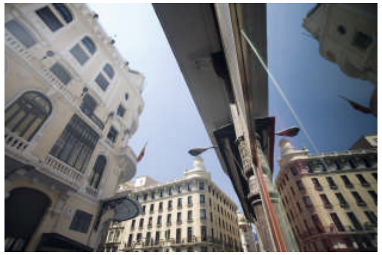
   b. **Provide that the lease agreement applies to prior periods covering the period of preliminary rent agreement.**

3. **Other:**

   a. **Transfer prices if related party arrangements/challenge of deductibility of rent charges;**

   b. **Potential VAT/profits tax risks if "variable" rent part is formulated as compensation of landlord's expenses.**

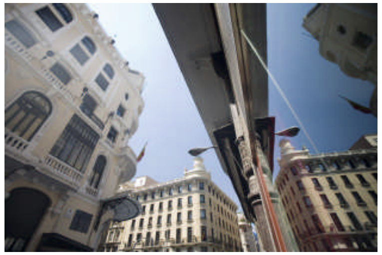
B. To Rent, Purchase or Build to Suit?
Tax implications. Purchase/Build to Suit Option



Generally:

- **Cost of the building deducted for profits tax purposes through:**
  - **10% depreciation premium;**
  - **Depreciation charge;**
- **Interest expenses generally deductible subject to thin capitalisation rules/statutory thresholds**
- **VAT on the building should generally be recoverable if business is VATable;**
- **Property tax charge.**

B. To Rent, Purchase or Build to Suit?
Tax implications. Purchase/Build to Suit Option (continued)



Complexities:

1. **Profits tax and VAT treatment of additional costs incurred under investment agreements with the City (transfer to the City part of premises, improvements to public assets, etc.)**

2. **VAT recovery:**

   a. **Generally to recover relevant VAT it is necessary to go to court;**

   b. **Three year period for claiming VAT;**

   c. **Financial costs associated with financing of gradual VAT offset;**

   d. **If you will be subletting any of the premises, need to consider VAT issues arising on lease of premises to accredited foreign legal entities.**

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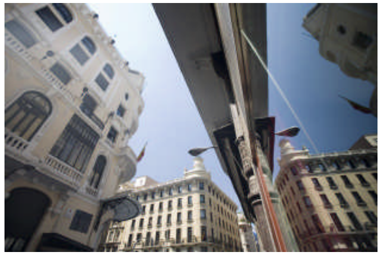
B. To Rent, Purchase or Build to Suit?
Tax implications. Purchase/Build to Suit Option (continued)

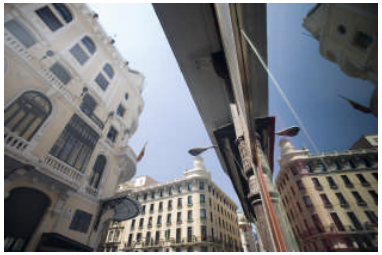


Complexities:

3. **Thin capitalisation rules hit the taxpayer particularly :**
    a. **In situations where the building was acquired via a share deal;**
    b. **where bank loans are guaranteed by foreign parent company.**

4. **Taxation of unrealised foreign exchange gains.**

B. To Rent, Purchase or Build to Suit?
Tax implications. Purchase/Build to Suit Option (continued)



Other considerations:

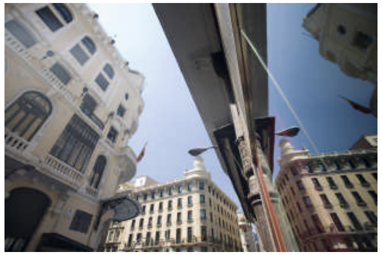
1. **Significant non cash expense in the form of depreciation/VAT offset – issue of utilisation of excess cash.**

2. **The balance sheet of the company may be burdened by significant debt.**

3. **In most cases sellers would offer a share deal rather than an asset deal which would trigger:**
   a. **Issue of how to integrate property into business – separate PropCo leasing to operating business? Merger of PropCo with OpCo?**
   b. **In case of separate PropCo, transfer pricing risks with respect to lease charges to own operating company, although on the other hand would potentially provide greater exit flexibility;**
   c. **Limited capacity to structure all debt in a tax efficient manner.**

4. **If an asset deal - more difficult exit (e.g. if need to move, need to sell or sublease property)**

C. To Rent, Purchase or Build to Suit? Accounting issues (IFRS)



Rent:

- **Building leased – operating lease – off balance sheet;**
- **Building leased – finance lease – on balance sheet;**
- **Land –potentially on balance sheet (IAS 40) – fair value/cost model**

Purchase:

- **Own use – IAS 16 – cost/revaluation model;**
- **Capital appreciation/rent out – IAS 40 - fair value/cost model**

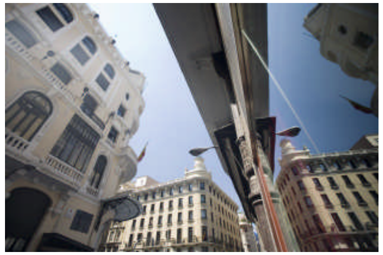
Build:

- **IAS 16 – cost/revaluation model – typically no revaluation of CIP;**
- **IASB discussing IAS 40/possibly to include constructed buildings as investment property.**

Deferred tax issues need to be considered.

Decision tree for categorising properties

(building or land or both)



Is the real estate held for sale during the ordinary activities? — yes → **IAS 2**

no ↓

Is it a construction contract for a third party? — yes → **IAS 11**

no ↓

Is there an intent to sell the real estate as its own or as part of a disposal group? — yes → **IFRS 5**

no ↓

Is the real estate used by the owner? (during ordinary activities?) — yes → **IAS 16**

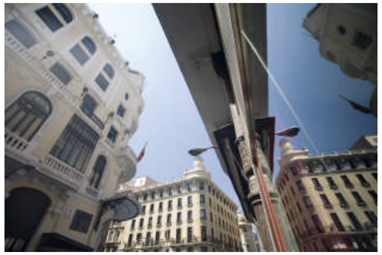
no ↓

Is it real estate in the phase of creation or development? — yes → **IAS 16**

no ↓

It is an Investment Property (held to earn rentals or for capital appreciation or both). → **IAS 40**

Important IFRSs for Real Estate

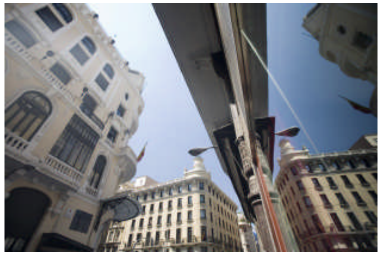


IAS 16	Property, Plant and Equipment
IAS 40	Investment Property
IAS 36	Impairment of Assets
IAS 17	Leases
IAS 41	Agriculture

IAS 2	Inventories
IAS 11	Construction Contracts

IAS 18	Revenue

IFRS 3	Business Combinations
IFRS 5	Non-current Assets Held for Sale and Discontinued Operations



Questions?

Thank you!

Marina Kharitidi, Senior Tax Manger, PwC
marina.kharitidi@ru.pwc.com
office telephone: + 7 (495) 967 6000