

Real Estate Business Breakfast

29 October 2008



Agenda/Contents

The global financial crisis and its impact on the Ukrainian RE Market

Recent legislative changes on land and construction issues

New NBU regulations on foreign loans and currency operations

Tax update on recent clarifications of the tax authorities that may affect RE projects

The global financial crisis and its impact on the Ukrainian real estate market



Agenda

The global financial crisis

Impact of the global financial crisis on the Ukrainian economy

Impact of the global financial crisis on the Ukrainian RE market

Forecast for the RE Market

The global financial crisis

- The global financial crisis has hit every national economy, without exception
- The global financial crisis has revealed the structural weaknesses of the global financial systems and unregulated global markets
- Over-abundance of debt is no longer available and the cost of borrowings has substantially increased
- Investors are becoming more conservative and withdrawing their investments from emerging markets
- Decline in the global demand for steel, oil as well as other commodities evidences the existence of a close link between the financial sector and the real economy on a global scale
- Various economic commentators are predicting a severe economic recession, drastic decrease in production and soaring unemployment others are more optimistic

Impact of the global financial crisis on the Ukrainian economy

- The global financial crisis will has/will affect the Ukrainian economy for the following reasons:
 - Ukrainian economy is export oriented and the market conditions in the global markets are worsening
 - Huge trade deficit – USD 12.5 bln for 8m 2008
 - Ukraine is heavily dependant on foreign borrowings, which by far constitute approximately 60% of GDP (85% - private borrowings)
 - Foreign investors are withdrawing their investments from the Ukrainian market
 - Political instability
 - The above challenges have prompted international rating agencies to downgrade Ukraine's credit rating from “stable” to “negative”
- **At the same time, no one is able to provide any reliable indications as to the duration, severity or spread of this impact!**

Impact of the global financial crisis on the Ukrainian RE Market

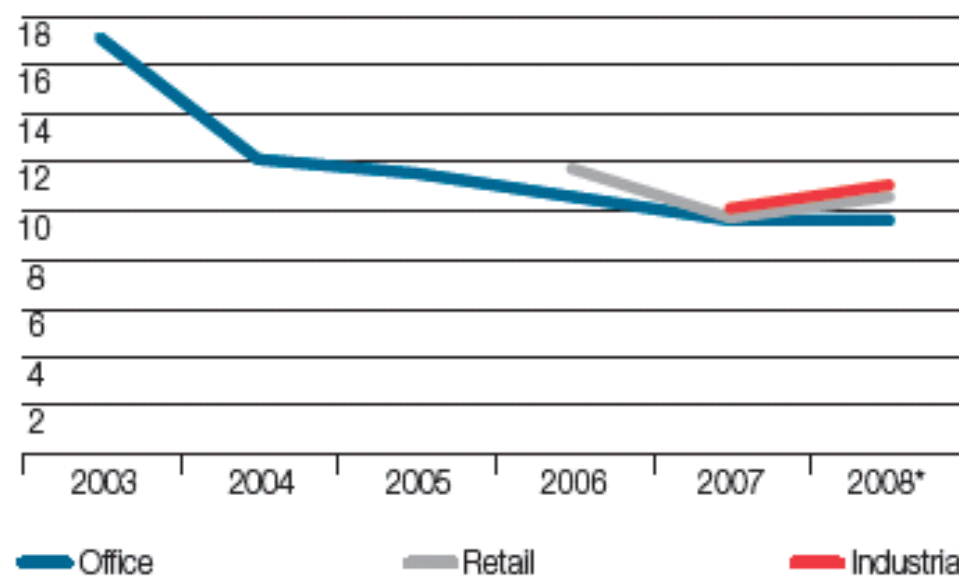
- As an illustration of this, the total output in the construction industry for 9m 2008 declined by 10.3% if compared with the same period last year
- The key factor of impact on the RE market lies in the increased cost of borrowings and lack of necessary liquidity
- Equity players should be able to negotiate better deals nowadays
- Inability of many developers to secure debt funding on favourable terms forces them either to:
 - Freeze existing projects in anticipation of better times; or
 - Look for potential buyers for their projects - there is a huge number of attractive projects on the market

Impact of the global financial crisis on the Ukrainian RE Market

- Drastic undersupply of commercial properties combined with the freeze of projects under development creates upward pressure on rents and transaction yields
- Residential market is experiencing significant difficulties with sales of apartments due to the tightened credit terms
- A large number of residential projects may be put on hold
- Developers are decreasing prices for residential apartments to stimulate sales

Prime Yields in Kyiv

2003-2008*, percent



* Forecast

Source: DTZ Research

Forecast for the RE Market

- Notwithstanding a noticeable decline in investor activity, many commentators foresee a new wave of M&As resulting in further market consolidation
- Preparation for Euro 2012 is likely to attract considerable investments into commercial construction and infrastructure development
- Severe deficit of quality properties combined with the freeze of projects under development would prevent prices from a significant downward correction
- The financial crisis would change the RE Market fundamentals: the role of debt funding, assessment of risks, securitization
- **Crisis is not only a time of challenges, but also opportunities!**

Recent legislative changes on land and construction issues

Adrian Opaits
Legal Senior Manager



Agenda

Land auctions

Land lease rights and servitudes

Zoning rules

Project development and construction permits

Contributions for development of social and engineering infrastructure

Commissioning procedure

Land auctions

- Companies and individuals that obtained the right to develop municipal land before 1 January 2008 may directly lease it by 14 October 2009
- The list of exceptions from mandatory land auctions was extended to:
 - Subsurface resources exploration
 - Location of diplomatic representations of foreign countries and international organizations
 - Construction and maintenance of infrastructure objects (roads, airports, pipelines, oil terminals and power stations)
 - Complex reconstruction of residential areas
- Procedure of preparing land plots for auctions was stipulated in detail in the Land Code

Land lease rights and servitudes

- Lease right for private land may be sold, pledged or contributed to the charter capital of companies for a period not exceeding 50 years
- Servitudes for private land may be pledged
- Transfer of servitudes to state/municipal land shall be done via auctions
- Lease rights and servitudes for state/municipal land may not be transferred to another person

New zoning rules

- Any person may apply to a local architecture department for information on the preferred and acceptable development categories of a certain land plot
- To start the development procedure, the land owner should file the intention of development with the local authorities, describing the future construction
- If this intention complies with the preferred or acceptable categories, the authorities should issue the input information for project development within two weeks
- If it does not comply, the applicant may still provide additional reasons for the planned construction. If the local authorities agree with the additional reasons, the town-planning survey should be developed and approved

Project development and construction permits

- The architect becomes responsible for the project's compliance with Ukrainian legislation and building norms
- The architecture project should be approved by the local architecture department and undergo a state inspection. No need to approve the project with the environmental, cultural, sanitary authorities or other local bodies
- If the project corresponds to the issued technical conditions, then the project is not subject to the approval of the utility supply companies
- The law now describes the procedure to obtain the permit for construction works (previously it was the order of Ministry of Construction)
- During the project development stage, the landowner may apply for a permit to conduct preparatory works (fencing the territory, temporary connections to utilities, preparing the roads, etc.)

Contributions for development of social and engineering infrastructure

- The law decreased the maximum social contributions for the development of social and engineering infrastructure. Overall, these contributions may not exceed:
 - for non-residential buildings – **10%** of construction value;
 - for residential buildings – **5%** of construction value.
- Precise amount of contribution will be defined in the shared participation agreement
- Local authorities shall not demand any other assets or services from the building owner, apart from the share participation
- If under the technical conditions, the developer is obliged to construct utilities objects or lines outside his plot, then these costs shall be considered his share participation

Commissioning procedure

- Commissioning procedure is shorter and unified (could we just say: Simplified commissioning procedure?); developer must only work with one authority - State Building Inspection
- After completing construction, the developer shall apply to the State Building Inspection to obtain the Certificate of Correspondence
- The State Building Inspection shall check the correspondence of the finished construction to the architecture project and building norms, and issue the Certificate of Correspondence within **10 business days**
- Developer may claim the refusal of the State Building Inspection to issue the Certificate in court

New NBU regulations on foreign loans and currency and payment operations

Olena Polyakova
Attorney



Agenda

NBU's current approach to foreign currency loans

NBU regulation of currency and payment operations

NBU's current approach to foreign loans

- Limitation on lending to borrowers without foreign currency revenue
- Lending without limitations in UAH and to borrowers who generate foreign currency revenues, as soon as the bank has sufficient resources to finance the loans
- At the same time, the following operations are considered to be violations of the law:
 - refinancing bad debts through loans;
 - unreasonable prolongation of loans; and
 - changing interest rates, so that they do not correspond to the NBU rate

NBU regulation of currency and payment operations

- Purchase and exchange of foreign currency for early fulfilment of contractual obligations is a violation of Ukrainian currency regulations
- Limitations on purchasing one foreign currency for another foreign, if the currencies belong to different groups of the NBU classifier (limitation does not apply to import operations)
- 5% margin for deviations between sale and purchase currency exchange rates

Tax update

Svetlana Bilyk
Tax Senior Manager



Agenda

Debt funding after the abolishment of interest rate caps for long term loans from non-residents

Contribution of immovable property to share capital by an individual

VAT treatment of corporate mergers

Increased focus on business purpose

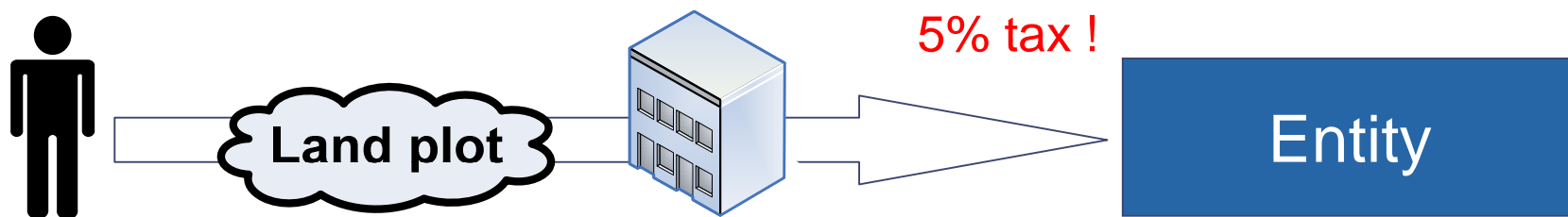
Update on the status of the Ukraine-Cyprus treaty

Debt funding after the abolishment of interest rate caps for long term loans from non-residents

- The NBU has abolished interest rate caps for loans from non-residents with a maturity period of over one year. For loans with a maturity period of less than one year the maximum interest rate has been increased from 9.8% to 11%.
- Debt funding from offshore is commonly utilized by many developers as it allows to benefit from interest deductions and manage cash position efficiently.
- The more debt can be “pushed down” to the asset level, the better.
- **BE CAREFUL!** High interest rates on related party loans may be challenged by the tax authorities on the grounds of:
 - Domestic transfer pricing rules; and
 - Treaty provisions (withholding tax relief applies only to the arm’s length part of interest payments).

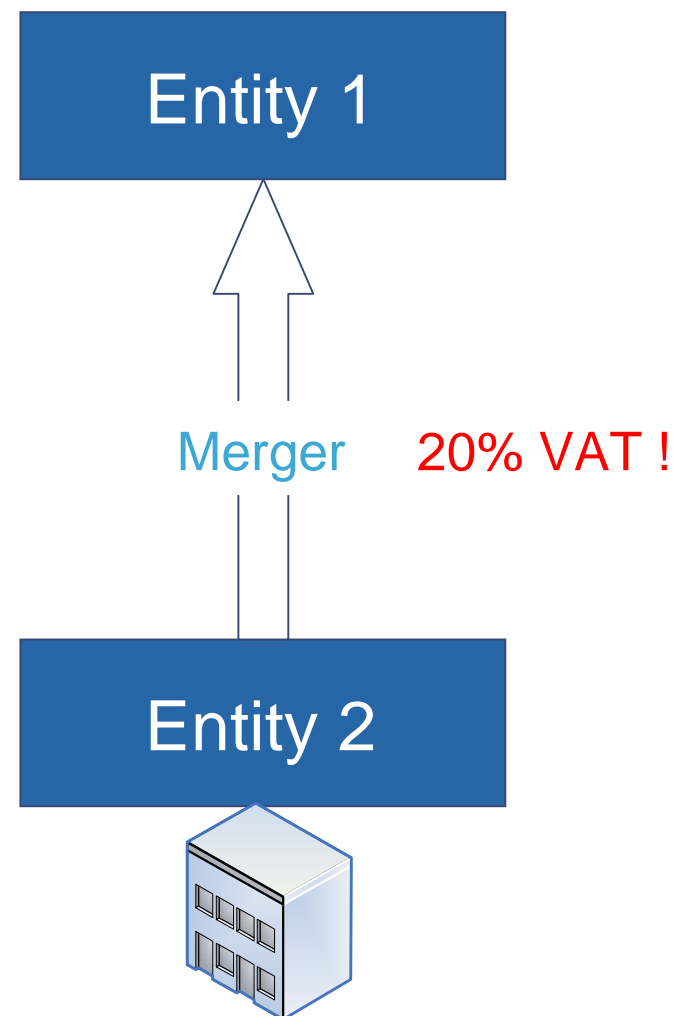
Contribution of immovable property to share capital: Change of a favourable treatment

- The tax authorities issued a letter (No. 2251/Б/17-0714 dated 13 February 2008) in which they treated an individual's contribution of an immovable property to share capital of a legal entity as an exchange of such property for corporate rights.
- According to the tax authorities, the entity issuing shares to the individual in return for the contribution must act as a tax agent and withhold personal income tax at 5% (lower rate may apply in certain cases).
- Failure to fulfil the tax agent functions may result in harsh penalties – 200% of tax underpaid.
- We opine that the line of argumentation used by the tax authorities lacks a legal basis. Taxpayers should be prepared to dispute tax assessment through court.



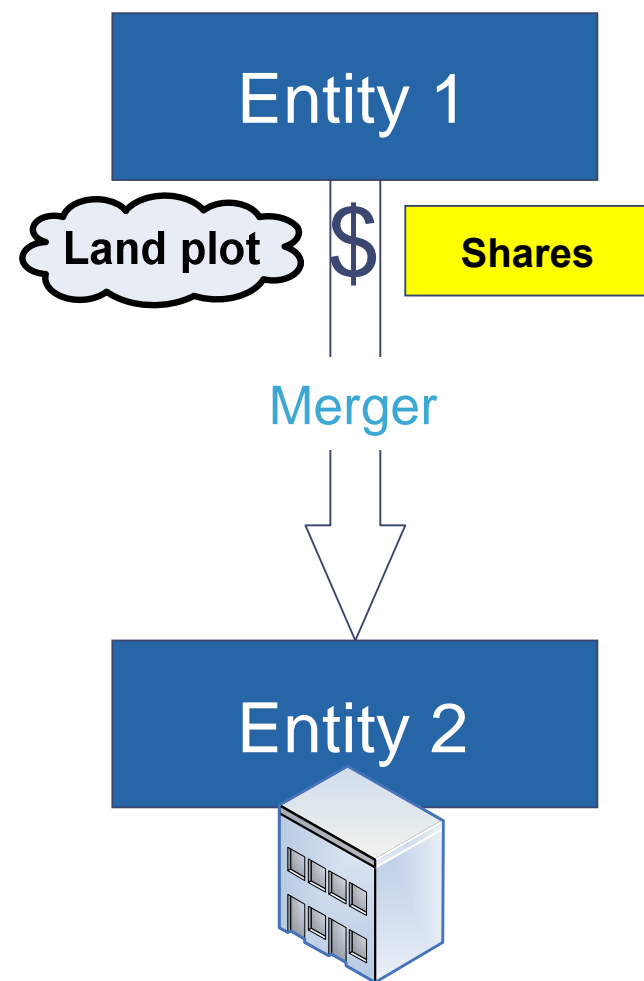
VAT treatment of corporate mergers: Is there a supply?

- The tax authorities have recently issued a letter (No. 6484/7/16-1517-07 dated 1 April 2008) in which they claim that the transfer of assets in the course of a merger should be subject to VAT.
- The position of the tax authorities is based on a requirement of the VAT Law to recognise the deemed supply of goods, in respect of which VAT credit was claimed, if they are subsequently used in supplies that are exempt / outside the scope of VAT.
- We opine that a corporate merger is not considered as a “supply” from both tax and legal perspectives.
- Taxpayers may need to dispute the VAT implications of corporate mergers in the court.



VAT treatment of corporate mergers: Possible option to eliminate risks

- AT exposure may be eliminated if a transfer of assets in the course of a merger is limited to those that are not subject to VAT (e.g. land, shares, cash).



Increased focus on business purpose: Changing perception

- The courts (especially the Supreme Court of Ukraine) have started to pay more attention to the underlying business purpose of a taxpayer's conduct.
- The courts and the tax authorities look at the overall picture rather than simply the data contained in a tax return.
- The mere intention to obtain a tax benefit is insufficient to qualify as a business purpose.
- The courts assess the behaviors of taxpayers on a case-by-case basis and rule on the existence of a business purpose.
- The business purpose concept is not clearly defined in Ukrainian legislation and thus is open to interpretations.
- Artificial arrangements that are driven purely by tax reasons are apparently at high risk!

Increased focus on business purpose: What does it mean for you?

- Tax and legal structures must be driven by sound business reasons.
- Tax and legal structures must have appropriate substance (e.g. employees, required infrastructure).
- Robust documentation and strong economic justification must be put in place to substantiate business transactions.
- You must be prepared to defend the desired tax treatment in the court.

Update on the status of the Ukraine - Cyprus double tax treaty

- On 19 September 2008 the Committee on Foreign Affairs approved and thus recommended that the Parliament adopt the law denouncing the effective USSR-Cyprus double tax treaty (honoured by Ukraine).
- In May 2008 the Parliament did not support the recommendation of the Committee on Foreign Affairs to denounce the treaty.
- Currently, there appears to be no consensus between the major political parties and parliamentary re-elections are likely to be held soon.
- Under the current circumstances, the denunciation of the existing treaty with Cyprus and / or promulgation of the new treaty seems to be unlikely in the nearest future.
- The Cabinet of Ministers intends to include Cyprus into the “black list of offshore jurisdictions”. This would restrict tax deduction of payments to Cyprus (e.g. royalties, interest) only to 85% of total costs.
- Further developments need to be closely monitored!

Thank you.