2012 Eastern Europe Real Estate Review
RUSSIA – MOSCOW

Accelerating success.
Representative Transactions in 2011

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<tr>
<th>Company</th>
<th>Transaction Description</th>
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<tr>
<td><em>Northwood Investors</em></td>
<td>Acquisition and financing of a 30,000 sq.m. office building located in La Défense</td>
</tr>
<tr>
<td><em>Sahaviriya Steel Group Plc</em></td>
<td>Acquisition of Tata Steel’s steelmaking plant located in Redcar, Teesside</td>
</tr>
<tr>
<td><em>Accession Fund Sicav</em></td>
<td>Refinancing of Accession Fund sub-portfolio of 9 office buildings and 1 logistics park located in Central and Eastern Europe</td>
</tr>
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<td><em>Poland, Czech Republic, Hungary, Romania</em></td>
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</tr>
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<td><em>Unibail-Rodamco</em></td>
<td>Acquisition of GTC’s 50% stake in the Galeria Mokotow shopping centre located in Warsaw</td>
</tr>
<tr>
<td><em>Panattoni Germany Management GmbH</em></td>
<td>Development and lease of a 16,000 sq.m. logistics centre located in Schwäbisch Gmünd, Germany</td>
</tr>
<tr>
<td><em>Tristan Capital Partners</em></td>
<td>Acquisition from VGP N.V. of an 80% stake in 6 industrial parks located in the Prague region</td>
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<td><em>Li &amp; Fung Limited</em></td>
<td>Approximately 500,000 square foot office lease for LF USA’s new US headquarters in the Empire State Building</td>
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<td><em>UFG Real Estate</em></td>
<td>Acquisition of two office buildings and one shopping centre located in Moscow</td>
</tr>
<tr>
<td><em>AIRE GmbH &amp; Co. KGaA</em></td>
<td>Sale of the 118,000 sq.m. APP logistics park located in Bratislava</td>
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</tbody>
</table>

Almaty  
Baku  
Barcelona  
Beijing  
Berlin  
Bratislava  
Brussels  
Bucharest  
Budapest  
Frankfurt  
Hong Kong  
Istanbul  
Kyiv  
London  
Madrid  
Moscow  
New York  
Paris  
Prague  
Shanghai  
St Petersburg  
Warsaw  

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EXECUTIVE SUMMARY

RECENT TRENDS

Economy: The economy continued to recover benefiting from stronger external demand. Construction sector activity picked up which also contributed to GDP growth. The undercurrent for economic growth in Russia remained the high prices it commanded for energy resources.

Investment: 2011 was a record year for Russia’s commercial real estate market as the total investment volume reached close to US$10 billion.

Industrial: The industrial property market experienced the most acute shortage of supply in Moscow and the Moscow Region. In 2011, the vacancy rate for Grade A properties declined to 1.2%. In St. Petersburg, net take-up exceeded new supply, which led to a further reduction in vacancy rates in St. Petersburg’s warehouse property market to 6.2% which led to an increase in rental rates.

Offices: In Moscow the office sector demonstrated a strong recovery due to lower levels of commissioned space and a surge in pent-up demand for office space. The combination of these factors resulted in lower vacancy rates across all Grades, as well as higher rental rates in existing business clusters. In St Petersburg, the vacancy rate increased to 14% by year-end.

Retail: The Moscow retail property market saw a recovery of demand in 2011, encouraging retailers to revive their development plans. Retail space that came online between 2009 and 2010 was filled. The limited number of shopping centres built in Moscow in 2011 led to an increase in competition to secure the best locations among retail operators. In St Petersburg, retail stock continued to grow in the market. In addition to the completion of new facilities, numerous “frozen” projects announced back in 2006 and 2007 have revisited development plans.

MARKET PROGNOSIS

Economy: Russia’s GDP forecast for 2012 was revised down from 4.4% in mid-2011 to 3.7% as of December 2011, in line with GDP revisions across Europe.

Investment: Investment volumes in 2012 will be dictated by the economic situation in Europe and the US. If the Eurozone crisis worsens, we expect a decline in real estate investment volumes this year. In all segments, assets are being consolidated in the hands of large holding companies such as Tashir Group of Companies, BIN Group, and 01 Properties, which seldom sell quality properties.

Industrial: High demand for warehouse space in Moscow coupled with low vacancy rates will drive local and foreign developers to bring new projects to market. In particular, MLP has resumed construction of Phase II of MLP Podolsk. Raven Russia has announced its intention to build 100,000 m$^2$ of space in 2012. Ghelamco Group commenced construction of Dmitrov Logistics Park, the company’s first project in Russia. In St Petersburg, an insufficient volumes of new supply and persistent levels of demand, is likely to cause rental rates to increase further.

Offices: Declining vacancy rates and increasing asking rental rates in Moscow’s established business districts will continue throughout 2012. In St Petersburg, 2012 take-up volumes are expected to reach 150,000 m$^2$ to 160,000 m$^2$. Due to a potential delay in new supply, vacancy rates may decrease slightly to 12-13%.

Retail: Demand for premises in Moscow’s major retail corridors will continue to increase, driven by the limited available space in the capital’s shopping centres. In St Petersburg, 25 projects are under construction with a GLA of 650,000 m$^2$ and a projected completion date between 2012 and 2014. Less successful retail projects will continue to renovate or revise their concept to remain competitive in cities such as Moscow, St. Petersburg, and Yekaterinburg.
Positive news from the world’s top-performing economies and from commodity markets helped bolster the Russian economy in 2011.

Domestic demand (both consumers and investors) maintained a certain level of stability despite the downturn in real disposable income (~1.4%).

Russia’s GDP forecast for 2012 was revised down from 4.4% in mid-2011 to 3.7% as of December 2011.

Recovery in the lending markets had a positive impact on consumption and, as a result, retail turnover increased by 5.4% in comparison to 2010. However, volatility in global commodity markets caused the lending market to become more conservative. The MosPrime interbank interest rate, a money market indicator, almost doubled in 2011.

In their best efforts to mitigate the consequences of the financial crisis, country leaders purchased toxic assets and liberalised the monetary policy. Such actions had a stabilising effect on corporate lending and promoted retail consumption.

Construction sector activity picked up which also contributed to GDP growth. The undercurrent for economic growth in Russia remained the high prices it commanded for energy resources.
**SUMMARY**

2011 was a record year for Russia’s commercial real estate market as the total investment volume reached close to US$10 billion.

Real estate investment transactions in the Moscow region corresponded to US$7.34 billion, almost twice as high as 2010’s investment total of US$3.94 billion.

The sale of The Ritz-Carlton hotel on Tverskaya Ul. was the largest transaction in the Moscow market. The value of the transaction was US$700 million; Verny Capital, a Kazakh private equity company, was the buyer. It was the second-largest real estate deal (historically) in the Moscow region, surpassed only by 01 Properties’ acquisition of the Horus Group’s property portfolio the year before for a total of US$850 million.

The most active buyers* were VTB Capital, Holding Centre trading house, the Gutseriev family, Boris Mints’ 01 Properties, and UFG Asset Management. Likewise, there were several American investors quite active in the Russian market including Hines, Heitman, and TPG Fund.

Vladislav Doronin’s Capital Group was the most active** seller in the Moscow market. VTB Bank, which sold its retail premises in DON-Stroy’s residential complexes, also stood out. Orco Property Group, a Luxembourg company, sold its main assets in Russia, namely an office building located on Radischevskaya Ul., a warehouse facility on Yaroslavskoye Shosse, and Otrada Club & Village residential project.

Of all the commercial real estate segments, the office property segment saw the greatest investment activity totaling US$3.12 billion. However, in 2011 office market transactions as a percentage of total market share transactions declined from 73% to 43%.

The most significant increase in the volume of investment deals was observed in the retail segment. Compared to 2011, retail investments grew twelve-fold to US$2.27 billion (29.6% of the total volume).

Investments in the hotel segment also soared to US$1.1 billion (a nine-fold increase). However, 60% of this increase was attributed to the sale of the Ritz-Carlton hotel for US$700 million.

The industrial sector was the only asset Grade to see a drop in transaction volumes, with only two major transactions concluded: the sale of Severnoye Domodedovo warehouse facility and Pushkino Logistics Park, in total worth US$690 million.

Investment volume by source of capital in 2011 can be broken down as follows: Foreign investors (23%), domestic investors (70%), and confidential transactions (7%).

Slightly less than 10% of the total transaction volume was accounted for by end-user companies who were mostly in the office segment, including the acquisition of premises in Western Gate BC by Federal Grid Company of Unified Energy System, and the purchase of Phase II of Legion II BC by Norilsk Nickel among others.

Transactions with end users in the build-to-suit format were also concluded in the warehouse segment.

A sale-leaseback deal was announced between VTB Leasing and Holding Centre for the Leipzig department store, a first for several years.

Following an improvement in the economic environment, and decreasing capitalisation rates in H1 2011, the trend reversed in H2 2011 but remained at levels below those at the end of 2010.
PROGNOSIS

Investment volumes in 2012 will be dictated by the economic situation in Europe and the US. If the Eurozone crisis worsens, we expect a decline in real estate investment volumes this year.

In addition to macroeconomic factors, the limited supply of quality properties will lead to a reduction in the total amount of real estate transactions. Many properties formerly available on the market have changed hands and will not be offered for sale in the short term.

The commissioning of new properties will face challenges due to restrictions on construction capacity within the Garden Ring.

In all segments, assets are being consolidated in the hands of large holding companies such as Tashir Group of Companies, BIN Group, and 01 Properties, which seldom sell quality properties.

This year, the retail segment will see the most significant reduction in the number and volume of transactions as the number of properties in this segment are smaller.

A number of major end-user transactions are expected in the office segment.

COMMERICAL REAL ESTATE TRANSACTIONS BREAKDOWN, 2011, MOSCOW
(INCLUDING INVESTMENT TRANSACTIONS AND TRANSACTIONS WITH END USERS), US$ MILLION

<table>
<thead>
<tr>
<th>Segment</th>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hotel</td>
<td>80.0</td>
<td>700.0</td>
<td>15.0</td>
<td>298.0</td>
<td>1,093.0</td>
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<tr>
<td>Warehouse</td>
<td>0</td>
<td>218.3</td>
<td>243.2</td>
<td>75.0</td>
<td></td>
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<tr>
<td>Office</td>
<td>170.0</td>
<td>855.8</td>
<td>926.8</td>
<td>1,170.9</td>
<td>3,123.5</td>
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<tr>
<td>Retail</td>
<td>566.0</td>
<td>606.0</td>
<td>865.6</td>
<td>227.0</td>
<td>2,264.6</td>
</tr>
<tr>
<td>Mixed-use</td>
<td>9.4</td>
<td>0</td>
<td>0</td>
<td>314.9</td>
<td>324.3</td>
</tr>
<tr>
<td>Total</td>
<td>825.4</td>
<td>2,380.1</td>
<td>2,050.6</td>
<td>2,085.8</td>
<td>7,341.9</td>
</tr>
</tbody>
</table>

Source: Colliers International
The industrial property market experienced the most acute shortage of supply in Moscow and the Moscow Region. In 2011, the vacancy rate for Grade A properties declined to 1.2%. This was due to the fact that the volume of new construction shrunk to almost half the volume of the past two years, while the take-up of quality warehouse space exceeded pre-crisis levels. Together, these factors were responsible for a record growth of industrial rental rates in 2011. Grade A industrial rents increased by 21% and Grade B industrial rents increased by 24%.

**SUPPLY**

In 2011, 400,000 m² of warehouse space was commissioned in the Moscow Region, which is comparable to the quantity that came on market in 2010. However, 2011’s new industrial supply levels are 1.5 to 2 times less than pre-crisis new supply levels.

The total stock of warehouse space in the Moscow region grew to 7.6 million m² in 2011.

**DEMAND**

Demand for warehouse space stabilised. Gross take-up amounted to approximately 1 million m², equal to 2010 levels. However, demand exceeded the volume of new construction by a factor of two making it challenging to secure quality space.

Logistics companies, retail operators, FMCG companies, and manufacturers drove demand. Together, these sectors accounted for 80% of the total number of requests in the warehouse market of Moscow and the Moscow region. In 2011, the share activity from logistics operators increased to 38% up from 15% in 2010.

The most sought-after premises in Moscow and the Moscow region, which accounted for 50% of the requests were for large blocks of space with an area greater than 5,000 m². The number of requests for space with an area over 10,000 m² was 1.7 times higher than in 2010. The lack of available space and warehouse property expansions fuelled this trend.

To adhere to stricter control over warehouse owners compliance with fire safety standards, requirements for quality warehouse facilities were more stringent in 2011.

**VACANCY/AVAILABILITY**

As demand exceeded new construction by a factor of two, vacancy rates declined in 2011. Vacancy rates in the Moscow region market for quality warehouse properties returned to their pre-crisis levels at 1.2%.

Low vacancy rates led to an increase in rental rates for warehouse premises in 2011; Grade A (21%) and Grade B (24%).

In 2011, rental rates for Grade A and Grade B properties reached US$135 m² / pa and US$120 m² /pa, respectively.

The trend to consider longer lease terms continued into 2011. In 2010, it was common to sign a five year lease agreement. 2011 saw the signing of lease agreements between seven to 10 years. Nonetheless, short-term lease agreements still prevailed in the Grade B segment.
In 2011, the regional markets saw an intensification of new industrial construction. Three new properties were under construction in Krasnodar, PNK’s Phase II is being built in Novosibirsk, and construction work on Phase II of Volzhsky Industrial Park is being carried out in Nizhny Novgorod.

Demand for industrial space in the regions was also healthy. In 2011, Kazan’s key warehouses facilities, Q Park and Biek Tau, were fully leased out, which led to a reduction in the city’s vacancy rate to 1%. A similar situation was observed in Yekaterinburg.

Demand for industrial space in Russia’s regions was dominated by federal companies and retail operators. Another notable trend was the growing demand for warehouse space from car and car parts manufacturers. This trend was especially pronounced in the markets of Kaluga, Togliatti, and St. Petersburg.

Lower rental rates were a key success factor driving demand in the regional warehouse market compared to Moscow and the Moscow region. Depending on the location, rental rates may vary from 10% to 20% lower than in Moscow. A second key success factor making the regions competitive was that the average term of lease agreements was only three to five years, shorter than in Moscow and the Moscow region.

High demand for warehouse space coupled with low vacancy rates will drive local and foreign developers to bring new projects to market. In particular, MLP has resumed construction of Phase II of MLP Podolsk. Raven Russia has announced its intention to build 100,000 m² of space in 2012. Ghelamco Group commenced construction of Dmitrov Logistics Park, the company’s first project in Russia.

As developers tend to commission large warehouse facilities in phases there will be few “speculative” projects with a simultaneously commissioned area of over 100,000 m² to enter the Moscow Region’s market in the next two years.

Despite higher volumes of new construction for industrial space, the vacancy rate is not expected to rise above 1.5%.

A shortage of commissioned space at existing warehouse facilities will drive a shift in demand toward warehouse properties under construction.

Taking into account the increase in new construction expected in 2012, rental rates are expected to remain stable for warehouse properties in Moscow and the Moscow region. In H1 2012, rental rates for large Grade A premises will stabilise at US$135 m² /pa to US$140 m² /pa. Industrial premises with areas of less than 5,000 m² may be leased out at a higher rate.

In 2012, the completion of 750,000 m² to 800,000 m² of new space is expected. Some of the new industrial space has already be sold, leased or is being developed as a build-to-suit project and will not enter the leasing market.
OFFICE MARKET

The office sector demonstrated a strong recovery due to lower levels of commissioned space and a surge in pent-up demand for office space. The combination of these factors resulted in lower vacancy rates across all Grades, as well as higher rental rates in existing business clusters.

SUPPLY

In 2011, 750,000 m² of office space was completed with Grade A business centres accounting for 37% and Grade B office properties accounting for 63%. The proportion of new construction and renovation equalled 70% and 30% respectively. The total office stock of Grade A and Grade B inventory reached 13.48 million m². New construction levels in 2011 were 15% lower than 2010 levels.

Improvements in the office market performance prompted developers to return to previously suspended projects. The first “unfrozen” office projects from 2010 were added to new supply in the market. Smaller properties came online first as they take less time to construct. The average GLA of a building commissioned in 2011 was 10,000 m² in the CBD and 11,000 m² in other submarkets. Larger projects, “unfrozen” after the crisis, will be actively commissioned between 2012 and 2013 with an increase in the average GLA to 11,000 m² in the central part of Moscow and 19,000 m² to 20,000 m² outside of the CBD.

Most Moscow-City sites are actively being developed again. Construction work resumed at SkyLight business centre and White Gardens complex. In addition, developers continued to purchase new sites to develop office projects. For example, O1 Properties bought the Evocom Plaza project on Oktyabrskaya Ul. in the summer of 2011, while in late 2011, it purchased the former Bolshevik factory building, for the purpose of renovating it into a Grade A business centre. In addition, in late 2011, Moscow-City Plot No. 15, previously designated for construction of Moscow City’s Mayor’s Office, was sold at auction.

DEMAND

Office demand in Moscow was driven by banks, financial organisations, IT and telecommunication, and mining and energy companies. These sectors accounted for over 60% of gross take-up. Due to instability in the international financial markets, Russian companies were mainly responsible for generating demand in Moscow’s office properties (74%) in contrast to international companies.

Consistent demand for Grade A and Grade B office properties has been witnessed since H2 2010. In 2011, about 1.9 million m² of quality office space was either leased or sold to end users, almost double the take-up of office space in 2010. Demand was fueled by the search for quality office space and low supply meeting the needs of end users.

In 2011, transactions (lease and sale) were split according to Grade A (26%) and Grade B (74%) space.

The greatest proportion of transactions was recorded in the CBD, representing 35% of the total amount of space leased in 2011. The share of transactions in the West part of Moscow increased from 9.5%, as of H1 2011, to 15% by year end. In the Southern part of Moscow, they increased from 9% to 12%. The volume of transactions in each of the other districts accounted for less than 10% of total take-up in the leasing market.

Net take-up in 2011 amounted to almost 400,000 m², which meant that companies expanded during relocation (so this is only 21% of all mkt activity).
VACANCY AND RENTAL RATES

A reduction in new supply and increased demand for office properties resulted in decreasing vacancy rates. In 2011, the breakdown of vacancy rates by Grade was: Grade A (15.8%) and Grade B (9.1%).

Vacancy rates increased in Moscow’s South-West and in Moscow-City due to the large amount of new office space that came online in these districts. Office projects such as Westpark, Leipzig Fashion House, and Ochakovo BC (70,000 m²) were built in the city’s South-West district located in the vicinity of the MKAD. In Moscow-City, the Imperia Tower (over 70,000 m²) was constructed.

Grade A weighted average asking rental rates exceeded US$800 m²/pa, which was 30% higher than at the beginning of the year. Grade B, weighted average rental rates varied between US$350 m²/pa to US$450 m²/pa due to fluctuations of the USD/RUB exchange rate. By the end of 2011, Grade B rental rates decreased by 3% compared to rents in 2010 (around US$400 m²/pa).

PROGNOSIS

Declining vacancy rates and increasing asking rental rates in Moscow’s established business districts will continue throughout 2012. At the same time, in other areas, the market is expected to stabilize.

Between 2012 and 2013, we could expect a reduction in new construction volumes between 0.5 and 0.7 million m²/pa.

700,000 m² of office space is expected to be completed in 2012. Most of the buildings are located outside the CBD.

Demand for office space will stay concentrated in the central part of the city, Leningradsky Prospekt area, as well as around Leninsky Prospekt and Tulskaya metro stations. Given a stable economic environment, we predict lower vacancy rates and higher rental rates. The rental rates for Grade A premises in 2012 in these districts will be in the US$900-1300 m²/pa level, while the rental rates for Grade B premises will range from US$650-900 m²/pa.

By the end of 2012, vacancy rates may drop to 3-4% for Grade B offices and 10% to 12% for Grade A premises.

In other Moscow districts, vacancy rates are expected to stabilize. Substantial new supply may push vacancy rates up to the 18-19% range for Grade A offices and 11-13% for Grade B premises. However, as new supply is absorbed, vacancy rates will gradually decline. As a result, average asking rental rates outside the established business districts will remain between US$500-600 m²/pa for Grade A and US$300-450 m²/pa for Grade B premises.
The retail property market continued to develop vigorously. Recovery of demand encouraged retailers to revive their development plans. Retail space that came online between 2009 and 2010 was filled. The limited number of shopping centres built in Moscow in 2011 led to an increase in competition to secure the best locations among retail operators. To strengthen their market positions, retailers focused on quality business development and expansion into new regional markets.

**SUPPLY**

In 2011, a historical low of newly constructed retail floor space was reported in the market as only five shopping centres were opened in Moscow, with a total GBA of 300,380 m\(^2\) (171,740 m\(^2\) GLA). 2011’s new retail supply figure was 50% lower than new supply in 2010 and 65% lower than new supply in 2009 (in terms of GLA).

The total stock of shopping centres in Moscow (GBA) was 6,100,310 m\(^2\) (3,074,410 m\(^2\) GLA), taking into account the Ramstore SC demolition on Yartsevskaya Ul.

Retail space provision in Moscow equalled 265 m\(^2\) per 1,000 residents, whereas in Eastern Europe, the average value of retail space per 1,000 residents was 350 m\(^2\), and reached between 600-800 m\(^2\) in some cities.

**DEMAND**

In 2011, international retailers opened stores in Moscow including American Eagle Outfitters, Victoria’s Secret, DKNY, and Banana Republic. A number of brands entered the Russian market in several cities at once, such as Desigual, Diesel and Dorothy Perkins.

Some international retailers, having already familiarised themselves with the Russian market, decided to abandon the franchising model and develop stores independently such as Hermes, Prada, Guess, Hugo Boss, Lee, Wrangler, Mango, New Yorker, Promod, S’Oliver, and ECCO.

Russian federal retail chains are also expanded in 2011. The highest growth was recorded in the food sector. In 2011, two major transactions were completed: DIXY purchased Victoria chain, while Alexandr Zanadvorov, owner of The Seventh Continent, purchased Mosmart chain. The Magnit chain added 1,254 stores in 2011, including 210 stores of the new drogery format.

Several new retail formats were rolled out in 2011 including the first electronic department store by Svyaznoy (Enter project). In addition to electronics, Enter will sell furniture, toys, household goods, jewellery. DIXY converted its stores to a convenience store format. O’S TIN focused on expanding its product mix to include children’s clothing and increasing store floor space to 1,000 m\(^2\) in its clothing stores. SPAR plans to develop hypermarkets (5,000 m\(^2\)) and test in Chelyabinsk.

**VACANCY AND RENTAL RATES**

Rental rates at the most successful shopping centres increased by 10-15% during 2011, while vacancy rates have declined by 1-3% seeing the return of the tenant “waiting-list.”

In less successful shopping centres, rates remained stable or increased by up to 5%. Developers were ready to accommodate tenants and, in some instances, grant them certain privileges such as partial finishing of premises, and preferred payment terms.
In 2011, positive trends were observed in the high street retail market. Rental rate increases did not exceed the inflation rate. Vacancy rates in Moscow’s major retail corridors remained low, amounting to 3-5%.

Despite rental rates in the central part of Moscow being among the highest in the world, international companies continued to open stores. In 2011, Jimmy Choo and Joseph stores opened in Stoleshnikov Pereulok and French brands Daum and Lalique opened an interior design store with an area of 170 m² at the corner of Nikolskaya Ulitsa and Tretyakovsky Proezd.

Public catering establishments show the greatest demand for street retail premises. For example, in 2011, Ginza opened more than 10 restaurants in Moscow. Large-format operators also continued their development. In 2012, Paulaner plans to open a restaurant located on the Garden Ring, with a total area of 1,600 m².

REGIONAL CITIES

An increase in tenant demand triggered development in the regional cities. In 2011, 39 shopping centres, with a total GBA of 1,685,800 m², were opened increasing the new supply of retail space in Russia (including Moscow) to 1,986,180 m².

LESS SUCCESSFUL RETAIL PROJECTS

Less successful retail projects will continue to renovate or revise their concept to remain competitive in cities such as Moscow, St. Petersburg, and Yekaterinburg.

In addition to improving quality of shopping centres, developers are venturing into new formats. In 2012, the opening of the first outlet centres in Moscow (Vnukovo Outlet Village, Outlet Village Belaya Dacha, Fashion House Moscow) has been announced. Developers are also paying more attention to formats such as Retail Parks and Life Style Centres.
HOTEL MARKET

OVERVIEW
Moderately positive trends in the hotel market in Moscow, forecast in late 2010, were confirmed by 2011 results. The occupancy levels of hotels in the 3-4-5 star segments have finally reached pre-crisis levels. Positive trends support our expectations that the hotel market will see further recovery.

SUPPLY
In 2011 hotel room stock in Moscow in the 3-4-5 star segments equaled 29,000 rooms, an increase of 4.1% from 2010. Hotel stock excluded hotels located close to the international airports of Sheremetyevo, Domodedovo and Vnukovo.

Eight new hotel properties, adding 1,111 rooms, were put into operation in 2011.

Only 57% of rooms planned to open in 2011 actually opened in the market. The opening dates for the Azimut Hotel (9 Varshavskoe Sh.) and the Mercure Arbat (6 Smolenskaya Sq.) have been rescheduled for 2012, whereas DoubleTree by Hilton Vnukovo has been rescheduled for 2013.

The share of hotels under international operators’ management has remained unchanged and accounts for one third of rooms in the 3-4-5 star segments.

International operators are represented in the top segment of Moscow’s accommodation facilities, where 75% of the available accommodations are under their control.

International operators still have a low penetration rate in the 3-star hotel segment: Only 4% of 3-star hotels are managed by international operators.

DEMAND
According to the Tourism Committee of Moscow, 3.99 million of foreign guests visited Moscow in 2010. During the first nine months of 2011 3.4 million foreign guests came to Moscow, which is 11.1% more than the same period in 2010.

According to Mosgorstat, at the end of H1 2011 the total number of accommodated visitors in Moscow was 2.17 million guests. By H1 2011 the growth rate exceeded pre-crisis level by 20% compared to H1 2010.

In terms of leisure and recreational tourism, Moscow is not as competitive as other tourist centres. Only every third foreign guest who visited the city declared the purpose of the trip as leisure and recreational tourism. The main purpose of travel remained business or professional activities, which accounted for more than 50% of accommodated visitors.

In 2011, occupancy level and ADR (average price per room) growth in the luxury hotel segment (+0.7% and +2.5% respectively) increased the RevPAR index. However the growth rate of RevPAR slowed down to 3.2% in 2011 in comparison to 2010 where the RevPAR index increased by 5.5% from 2009.
For the first time the RevPAR index in the luxury and upscale hotel segments demonstrated an increase since 2009. It can be explained by a 4.6% increase in ADR compared to the same period in 2010. The occupancy level has remained almost the same (+1% compared to 2010) for these segments.

The largest occupancy level (+10.1%) increase was reported in the midscale hotel segment. It resulted in a RevPAR increase of 9.8% compared to 2010. For the past three years the ADR index had been decreasing, but according to the results of 2011 the minimum decrease in ADR was 0.2%. The highest occupancy levels (83.3% to 89%) was observed in the summer months as well as in September.

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PROGNOSIS

In 2012 we expect a 3.6% increase in the supply of 3-4-5 star segment properties. Notably, all new hotel room supply will be managed by chain operators. The main share of new stock will be located in the centre of Moscow.

Despite an increase in the new supply of midscale hotels, there was an insufficient number of modern-standard hotels.

Moderate annual growth of new rooms on the market will maintain the balance of supply and demand for hotel space.

Moscow’s key hotel indicators signal that the hotel market continues to show signs of recovery and continued growth.

International hotel operators remained interested in developing new brands in Moscow as well as in developing different types of accommodation.

The education and training sector is expected to grow.

The implementation of the urban program for tourism development, to be rolled out over the next few years, will be essential to the growth of inbound and domestic tourism. This program will also play a factor in influencing the quality of development in the tourism industry in Moscow.
512 offices in 61 countries on 6 continents

- United States: 125
- Canada: 38
- Latin America: 18
- Asia Pacific: 214
- EMEA: 117

- $1.5 billion in annual revenue
- 978.6 million square feet under management
- Over 12,500 professionals

**KEY METRIC DEFINITIONS**

**Prime Headline Capital Value (derived):** This is a calculation of market value derived from the annual prime headline rent divided by the prime (net initial) yield.

**Prime Net Initial Yield:** The yield an investor is prepared to pay to buy a Grade A building, fully-let to high quality tenants at an open market rental value in a prime location. Lease terms should be commensurate with the market. As a calculation Net Initial Yield = first years’ net income/purchase price (prior to deducting fees and taxes).

**Prime Headline Rent:** Represents the top open-market tier of rent that could be expected for a unit of standard size commensurate with demand, of the highest quality and specification in the best location in the market at the survey date. This should reflect the level at which relevant transactions are being completed at the time but need not be exactly identical to any of them, particularly if deal flow is very limited or made up of unusual one-off deals. If there are no relevant transactions during the survey period, the quoted figure will be more hypothetical, based on expert opinion of market conditions, but the same criteria on building size and specification will apply.

**Prime Net Effective Rent:** Prime Net Effective Rent is the lowest rent payable, based on a calculation of the Prime Headline Rent, less the monetary equivalent of the highest of either the rent-free period or fit-out contribution available at the time of the survey date.

**Average Headline Rent:** Average Headline Rent represents the average open-market tier of rent that could be expected for a unit of standard size commensurate with demand, based on a blend of Grade A and B space across a range of locations in the market at the survey date.

**Total Competitive Stock:** Includes the gross leasable floor space in all A and B class buildings.

**Space Under Active Construction:** Represents the total amount of gross leasable floor space of properties where construction has commenced on a new development or in existing properties where a major refurbishment/renovation is ongoing at the survey date.

**Space Under Construction – Inactive:** Represents the total amount of gross leasable floor space of properties where construction had started/where a major refurbishment/renovation was ongoing, but activity has since stopped for a period of three months or longer.

**Vacant Space:** The total gross leasable floor space in existing properties that meet the Competitive Stock definition, which is physically vacant and being actively marketed at the survey date. Space should be available for immediate occupation.

**Take-up:** In our calculation of take-up, gross take-up accounts for all occupational market activity including renegotiations, renewals and sale-and-leasebacks. Net take-up includes new leases and pre-leases only, although it will often include relocations.
LEGAL OVERVIEW

BASIC FORMS OF TITLE

In Russian law, ownership consists of the unlimited rights of the owner to possess, use and dispose of property. However, there are other forms of title, such as the right of so-called “full economic jurisdiction” (“khозяйственное ведение”) and the right of operational management (“оперативное управление”), which are available only to state and municipal enterprises. These rights extend to the use, possession and disposal of the assets only within the scope of the business activity designated by the owner (the state) in the company’s founding documents and subject to mandatory provisions of law. For land, the primary forms of commercial land use are land leases and land ownership (freehold). Other forms of land use rights, such as the right of perpetual use of a land plot are available only to state enterprises, state-funded institutions and residences of former RF presidents which have historical heritage status. The right of lifetime inheritable possession of land plots was formerly provided by the state to individuals and can now be acquired only by inheritance of the respective rights. An easement is a form of title to a land plot owned by another person, consisting of the right to use the land for a specific limited purpose. Russian law does not allow for a trust in its Western meaning, i.e. a split between legal and beneficial ownership. Mortgage and fiduciary management (trust management) rights to a property are not treated as rights in rem in Russia. Title to the mortgaged property does not automatically pass to the mortgagor in the event of default, and a trustee is not recognised as the legal owner of the property.

ACQUISITION OF REAL ESTATE BY FOREIGNERS

Generally, foreigners may directly acquire real estate in Russia, with the exception of agricultural land and land plots together with property located on them in border areas and specially designated areas.

REGISTRATION SYSTEMS

To have legal effect, all rights to real estate and transactions giving rise to such rights (except leases with a fixed term of less than one year or an indefinite term) must be registered in the RF Consolidated State Register. The register is maintained by a specialised government agency and contains information regarding the owner of the property and encumbrances on it (registered leases, mortgages, trust management agreements, etc.). Upon written request and for a fee, any party may obtain an excerpt for a property containing basic information about the property and its encumbrances. Before registration, all land plots, buildings, structures, premises and unfinished buildings must undergo technical and cadastral registration in the State Cadastre of Real Estate. The cadastr is maintained by the Federal Cadastral Agency and contains technical and other information detailing the specific characteristics of the property. The agency is obliged to provide publicly available information in the cadastral to anyone upon request. Furthermore, it has recently become possible to apply for state registration of title by post, and it is also now possible to apply simultaneously for the registration of title with the register and cadastral registration with the cadastral. The law also provides for online access to information in the register and the cadastral. However, for the register at least, this option is not yet functional.

TRANSFER TAXES

VAT (18%) is payable on property acquisitions (other than land plots and apartments). The buyer can generally credit this VAT against the VAT liability on its own sales (refunds are provided for by law, but are problematic in practice). The transfer of shares in a Russian company that owns property is exempt from VAT. Both the sale of property or shares in a company owning the property may incur capital gains tax (20%) for a non-resident seller (unless such gain is exempt from taxation under an applicable double tax treaty). Property owners pay a property tax (established by law of RF constituents but not exceeding 2.2% of the average annual book value of the property), and land tax payable on freehold land is based on a number of regional coefficients.

LEASES

Leases are freely negotiable. Most provisions of law pertaining to lease agreements are optional and may be varied by the parties, but certain mandatory provisions must be adhered to. The most important restriction concerns the mandatory registration requirement for leases of property for a fixed term of more than 1 year. In order to be effective under Russian law, a lease agreement must contain a definitive description of the leased property and the amount of rental payments or a formula for their calculation.

PRIVATISATION CLAIMS

A claim arising out of a transfer of assets during privatisation would qualify as a claim for a declaration of the transaction as being null and void, being contrary to the law then in effect. The statute of limitations for a null and void transaction is three years, starting from the commencement of the execution of the relevant transaction.

NOTARIES AND NOTARIAL FEES

Generally, notarial certification of real estate transactions is not required. Notarial certification is mandatory only (i) when required by law (for example, transfer of shares in a Russian LLC, annuity contracts, spousal consents to the transfer of jointly owned real estate, mortgage consent to out-of-court foreclosure of mortgaged real estate), or (ii) if the parties agree on the necessity of such certification even if it is not required by law. The notarial fees for certification of real estate contracts may be a fixed amount or a certain percentage of a contract’s value. For example, notarial certification of transactions with a subject requiring appraisal, if notarisation is required by law (such as an annuity contract) costs 0.5% of the contract value, while notarial certification of contracts on the alienation of real estate costs 0.3% of the contract value when the contract is concluded with children, spouses, parents, or siblings, and 0.5 % of the contract value and higher (depending on the contract value) when the contract is concluded with other persons.

LANGUAGE

For the purposes of state registration and/or notarisation, real estate transactions must be executed in Russian. In practice, English is often used as a second and controlling language.

ARBITRATION

Any transaction involving Russian real estate property must be governed exclusively by Russian law. As regards the forum for dispute resolution, if a party to a dispute is foreign (an individual or a legal entity), and the subject matter of the dispute is (a) a real estate property located in Russia, or (b) the title to such property, or (c) challenging the records in the relevant property cadastre, such dispute shall be exclusively heard and resolved by a Russian state (arbitrazh) court at the location of such property. However, if both parties to the dispute are Russian,
but one of them is a Russian legal entity with foreign investment, the dispute would fall outside of the exclusive jurisdiction of Russian state (arbitrazh) courts and would be eligible for consideration and resolution by an international court of arbitration. In May 2011 the RF Constitutional Court expressed the position that disputes involving Russian real property can be heard in an arbitration court (whether international or domestic). The registration of title to Russian real estate on the basis of an arbitration award should be possible provided that the arbitration award is recognised in Russia. Russia is a party to the 1958 New York Arbitration Convention and generally foreign arbitration awards should be enforceable in Russia.

**Mortgage and Foreclosure**

There have been several important legislative amendments made to the RF laws on pledge (mortgage) throughout recent years. According to these amendments, the parties to a mortgage agreement may now agree an out-of-court foreclosure procedure at any time, rather than in the event of a default. The arrangement may also be incorporated directly into a mortgage agreement at the outset. In this case a notarised consent of the mortgagee for the out-of-court procedure is required. The mortgagee may take possession of the property (or sell it to a third party) at a price equal to the market value of such a property, which is determined in accordance with the RF laws on valuation activity, without having to foreclose via a public auction. Although these changes appear on the face of it to substantially simplify and expedite foreclosure, the practice of their application remains undeveloped and there are still certain exceptions in which out-of-court foreclosure is prohibited by law (for example, where the collateral is a cultural landmark, residential premises owned by individuals, or agricultural land).

Typically, when a land plot and/or a building on it is purchased, constructed or is being constructed using financing from a bank or a special-purpose loan, the land plot itself, together with all the building and structures on the said land plot, are considered to be mortgaged together. Such a mortgage arises by operation of law and is registered simultaneously with the registration of title to the respective real property.
RUSSIA – TAX SUMMARY

GENERAL PROVISIONS

In a view of economic recovery the Russian government is focused on the economic stabilisation and modernisation as well as integration with more developed economics. As part of this new transfer pricing regulation and consolidated tax reporting were introduced starting from 1 January 2012. Also starting from 2012 Russia has introduced compulsory IFRS reporting for public companies.

The current main focus of Russian fiscal policy development is systematisation of the existing incentives and exemptions and minimisation of opportunities for tax evasion, in particular:

- introduction of tax incentives for innovation and human capital development;
- revision of taxation rules for transactions with securities, financial instruments and debt;
- replacement of property tax with real estate tax charged on the fair value of assets;
- introduction of tax evasion prevention mechanisms.

Another focus of the Russian government is to simplify tax administration to help creating favorable investment environment for foreign investors.

At the same time the tax authorities are still applying a stronger approach to taxpayers for the purposes of sustaining tax yields for the Russian budget: increased attention is being paid to the nature of tax losses incurred by companies; there are increased challenges to tax planning schemes applying the substance over form approach to the transactions.

CORPORATE PROFITS TAX AND CAPITAL GAINS

The Russian corporate profits tax (CPT) rate remains one of the lowest in Europe - 20%. CPT is calculated on a net basis (income net of deductible expenses, if they are economically justified and properly supported via documentation).

There is no special capital gains tax in Russia. Capital gains received by Russian resident corporations from the sale of property or shares in property holding companies is subject to Russian corporate profits tax at a general rate of 20% except for the following.

Capital gains received by a Russian or foreign shareholder from the sale of shares in a Russian company owned for a period of five years or longer is subject to Russian corporate profits tax at a rate of 0%. 1

Where shares in a Russian company are sold by a foreign shareholder, any capital gain arising on such transaction will be subject to tax at 20% if more than 50% of the Russian company’s balance sheet is comprised of Russian real estate (RE) property. This tax can be reduced to zero under a number of double tax treaties (DTT) concluded by Russia with other countries. However, under some DTTs (e.g. with the UK) Russia has taxing rights for such capital gains.

Furthermore, changes were introduced to the existing DTT with Cyprus, Luxembourg and Switzerland so that zero rates on capital gains from the sale of shares in RE companies will no longer be applicable. In the case of Cyprus such amendments will enter into force after 4 years from the year of ratification of the Protocol by both parties and as for Luxembourg and Switzerland, the amendments will enter into force starting from the year following the year of ratification. Presently it is not clear when the mentioned Protocols should enter into force. DTTs between Russia and Germany, Austria, the Netherlands are still intact.

In the recent years structures involving real estate ownership via real estate investment funds (REIFs) have become widespread in Russia. An REIF’s profits are not subject to CPT until they are remitted to investors. Moreover, income of a foreign investor from participation in an REIF (intermediate income, income from unit redemption or sale) may be exempt from withholding tax in Russia under a number of DTTs.

In connection with the above it should be noted that recently signed Protocols to DTTs with Cyprus and Luxembourg introduce Russian withholding tax (20%) on income received from REIFs in the form of intermediary payments or as a result of sale or redemption of REIF units. In the case of Cyprus income from sale of units should become subject to tax only after 4 years from the year when the Protocol enters into force, similarly to transactions on sale of shares in Russian RE companies. Amendments introduced to Russia – Switzerland DTT also impose withholding tax of 20% on REIF units sale or redemption. Intermediary income payable by Russian REIFs to Swiss unitholders are qualified as dividends subject to withholding tax of 5 – 15%.

Similar changes may be introduced in future to other DTTs and incorporated in new DTTs based on the model DTT developed by the Russian government in 2010.

Tax Depreciation

Fixed assets and intellectual property with an initial value of over RUB 40,000 and a useful life of over one year can be depreciated for tax purposes.

A company may depreciate fixed assets over their useful economic life using the straight-line or reducing balance method. The useful economic life (determined by law) of RE assets is usually more than 30 years.

When a company starts depreciating a RE asset, it can elect to deduct a “depreciation premium” (a one-off capital allowance) in the amount of 10% of the depreciable asset’s value (30% for assets with useful lives between three and twenty years). Therefore, it is important that the value of an asset is properly allocated between the building and other assets (internal systems, lifts, etc.).

The standard tax depreciation allowance is then calculated on the basis of historical cost of the asset decreased by tax depreciation premium.

Russian statutory and IFRS accounting could be different from tax depreciation due to deviations between IFRS, statutory and tax accounting principles (e.g. interest costs are capitalized for accounting purposes but can be expensed for tax purposes).

Accounting depreciation is deducted from the Russian company’s accounting profits which directly impacts the profit distributable by the company through dividends. This may create a “cash trap” issue in a Russian subsidiary when not all cash generated by real estate can be distributed to shareholders through dividends. In this case, other ways of cash distribution, e.g. interest, management fees, upstream loan could be
Interest Expenses
Interest expenses are not capitalised into the initial value of fixed assets and should instead be deducted for Russian profits tax purposes on the last day of each reporting period or included in tax losses carried forward.

Interest expenses are deductible for Russian profits tax purposes provided that they are:

- economically justified and incurred in relation to revenue-generating activities;
- compliant with thin capitalisation rules;
- compliant with established arm’s length principles; and
- the transactions involved in financing structures have business purpose and are properly documented.

Under current arm’s length principles, interest should be deductible as long as the rate does not deviate by 20% from the average level of interest charged on loans issued under similar (comparable) terms in the same period.

From 1 January 2011 until 31 December 2012 either if comparable loans cannot be found or at taxpayer’s choice the maximum deductible interest on loans denominated in foreign currency is calculated as the refinancing rate of the Central Bank of Russia multiplied by 0.8 (currently, 6.4% based on a refinancing rate of 8% effective in January 2012).

The maximum deductible interest on loans denominated in Russian rubles is determined as refinancing rate of the Central Bank of Russia multiplied by 1.8 (i.e. 14.4% based on a refinancing rate effective in January 2012).

Additionally, financing transactions with Russian and foreign affiliated entities and offshore companies may be subject to new Russian transfer pricing regulations (see below).

Thin capitalisation rules apply when:

- a Russian company has an outstanding debt to a foreign company (FLE) which owns (either directly or indirectly) more than 20% of the Russian company’s share capital; or
- the above debt is instead owed to a Russian affiliate of the FLE; or
- a debt is guaranteed by an above FLE (or its Russian affiliate); and
- an unpaid loan amounts to more than three times the net assets of the Russian receiver of the debt (12.5 times for banks and leasing companies).

Interest found to be excessive under these rules is treated as a dividend, meaning that it will be non-deductible for profits tax purposes and subject to withholding tax at 15% (or a lower rate if a double tax treaty (DTT) is applicable).

The tendencies following from the recent Russian arbitration court practice evidence that the Russian tax authorities have started paying more attention to the financing structures involving foreign “sister” companies. Although such structures do not technically fall under the scope of Russian thin capitalization rules, the latter might still be applied if the tax authorities are able to prove that the actual creditor of a Russian debtor is a foreign shareholder, while the financing company is actually a mere “conduit” used for tax minimization purposes.

Tax Losses
Losses may be carried forward for 10 years. All tax losses (including carry forwards) can be deducted for tax purposes in actual amount. Losses from the sale of a RE asset are tax deductible in equal instalments over the remaining useful life of the asset.

Transfer pricing regulations
Starting from 2012 new rules on transfer pricing came into force, whereby under certain conditions, the transaction may be considered as controlled for tax purposes.

With respect to such transactions, the taxpayer has the responsibility to prepare documentation substantiating market rate of the prices applied in controlled transactions.

Under the new rules on transfer pricing the following transactions of RE companies are deemed to be controlled:

- Cross-border transactions:
  - Between related parties (regardless of the volume);
  - With a party that is resident of a “black-listed” offshore jurisdiction (minimum total volume of transactions with one party is RUB 60 mln);
- Domestic transactions between Russian entities:
  - Between related parties (starting from 2014 minimum total volume of transactions with one party is RUB 1 bln);
  - Between related parties if one party is subject to mineral extraction tax, corporate profits tax (CPT) at a 0%-rate or CPT exemption (minimum total volume of transactions with one party is RUB 60 mln);
  - Starting from 2014 – between related parties if one party is subject to special economic regime (minimum total volume of transactions with one party is RUB 60 mln) or special tax regime (minimum total volume of transactions with one party is RUB 100 mln).

Parties are considered related for transfer pricing legislation purposes if the relationship between these parties can influence the conditions and results of transactions between these parties, and/or, the economic results of their business activity.

A taxpayer is obliged to notify the tax authorities about controlled transaction not later than 20 May following the calendar year in which the transaction occurred.

For non-payment or incomplete payment of tax as a result of application of prices that deviate from the market level, the penalties are set at 40% of the unpaid tax. 3

New transfer pricing rules allow five methods which can be used by tax authorities during a tax audit to review the prices applied by a taxpayer:

1) Comparable uncontrolled price (CUP) method
2) Resale price method;
3) Cost plus method;
4) Transactional net margin method;
5) Profit split method.

CUP method has priority over other. Methods 2-5 may only be used if the method of comparable market prices is not applicable or if its application would not allow for a reasonable conclusion as to the compliance of actual prices with arm’s length prices.

Consolidated tax reporting
Starting from 2012 the Russian Tax Code permits filing of consolidated profits tax returns by consolidated groups of taxpayers (hereinafter – CGT) which is a voluntary association of profits tax payers based on the agreement on CGT establishment.

Profits tax is payable on the cumulative tax base of a CGT. Transactions within a CGT are not subject to transfer pricing rules.

Participants of a CGT must meet specific requirements, in particular, total aggregated amount of taxes payable should be above RUB10 bn, revenue above RUB 100 bn, value of assets above RUB 300 bn. Period of existence of a CGT may not be less than 2 years.

Only a Russian legal entity may be a CGT participant provided that it holds in other CGT participants or is owned by another CGT participant for not less than 90%, and is not in the process of reorganization / liquidation / insolvency procedure and its net assets exceed charter capital.

WITHHOLDING TAX
Russian source income, which is not attributable to a permanent establishment, such as rent, royalties, interest and dividends paid to a foreign legal entity, is subject to withholding tax.

There is no withholding tax on the repatriation of profits from a local Russian office (Branch or RO) to its head office.

Withholding taxes may be reduced or eliminated if the recipient is tax resident in a country operating a double tax treaty arrangement with Russia. In order to be eligible for DTT relief, the foreign recipient company must submit a tax certificate to the Russian income payer confirming it is resident in the treaty country.

If the appropriate documents have not been submitted by the recipient, the income payer must withhold tax. If tax is withheld even though treaty relief is available, a refund claim may be filed by the foreign recipient. This is, however, a time-consuming process and there is no certainty that a refund will be obtained.

Dividend Distributions
Under the Russian Tax Code, dividends paid by a Russian company to a Russian or a foreign company are subject to Russian withholding tax at source. This tax is to be withheld and transferred to the Russian budget by the Russian income payer.

The tax rate on any dividends distributed from a Russian company to its Russian parent is 9%.

However, the dividend income received by a Russian company from its Russian or foreign subsidiary may be taxed at 0% if certain criteria are met:

• the recipient of the dividends owns at least 50% of the charter capital of the distributor;
• the investment has been owned by the recipient for at least 365 days.

It should be noted, that the 0% rate is not applicable if the foreign subsidiaries of the Russian companies are situated in the offshore jurisdictions, per the list of the Russian Ministry of Finance. Currently such list includes, for example, Cyprus, British Virgin Islands, Lichtenstein.

Dividends distributed by Russian companies to foreign companies are taxed at a general rate of 15%, which can be reduced based on the provisions of an applicable DTT.

Other Income
 Interest, royalties and leasing income paid by a Russian company to a foreign company are subject to Russian withholding tax at a general rate of 20%. In some cases this rate can be reduced if applied to certain types of income (e.g. interest income from state bonds).

Withholding tax on the above payments can also be reduced based on the provisions of an applicable DTT.

VALUE ADDED TAX (VAT)
Output VAT
The standard VAT rate in Russia is 18%, payable to the budget on an accruals basis. The sale of residential RE property and land plots is not subject to Russian VAT. The sale of development services by developers organizing construction of residential properties under shared construction agreement is also exempt from VAT.

The sale and lease of commercial RE property is generally subject to VAT. However, the lease of property to foreign citizens or legal entities accredited in Russia is exempt from VAT if the foreign citizens are residents of/ foreign legal entities are incorporated in countries included in a list provided by the Government of the Russian Federation.

This is mandatory and the taxpayer must apply this exemption.

The sale of shares (as well as other securities, including units in REIFs) and equity interests in limited liability companies and the contribution of property in the form of an investment (i.e. into the charter capital of the company, into a simple partnership – joint activity arrangement – etc.) are exempt from VAT in Russia.

Input VAT (VAT-able Sales)
Input VAT (VAT on purchases and expenses) is recoverable if a number of requirements are met. The recoverability of input VAT does not depend on it having been paid to the supplier or on import.

Input VAT is not recoverable in respect of expenses or assets used in the manufacture or sale of products exempt from VAT, including expenses or assets incurred in non-production activities.

This VAT may be deducted for profits tax purposes (if incurred in an acquisition of current assets) or should be included in the initial value of fixed assets.

In certain circumstances input VAT recovery may be denied if the supplier has not paid over their output VAT.

Generally under current legislation, the taxpayer can offset VAT on capital construction assets (RE), before the taxpayer
has completed building the RE asset.

OTHER RELEVANT TAXES

Property Tax

Property tax is levied on property of Russian companies, REIFs and property of PEs of foreign companies situated in Russia, qualifying as fixed assets, which includes buildings, but does not include land and RE under construction. The maximum rate is currently 2.2% of the average net book value of fixed assets, but actual rates vary depending on the region in question.

Foreign legal entities with no PE in Russia are liable to pay Russian property tax only on RE assets located in Russia (on the basis of inventory value of such assets determined by Russian authorities).

Property tax constitutes a deductible expense for profits tax purposes.

RE assets of REIFs are also subject to property tax. The management company of REIF is obliged to pay property tax expensed by the assets of a REIF.

Land Tax

Land tax is a local tax payable on land which is owned by a company. The tax basis is the cadastral value of the land which is set by corresponding local land authorities on 1 January each year.

The tax rate depends on the specific purpose of the land. The maximum rates are 0.3% for land used for housing purposes and 1.5% for other types of land. However, specific rates are set up by the local authorities. This is a self-assessed liability and is payable in quarterly instalments.

Land tax is deductible for profits tax purposes.

Land plots constituting assets of REIFs are also subject to land tax. The management company of a REIF is obliged to pay land tax expensed by the assets of the REIF.

SPECIFIC REAL ESTATE ISSUES

Legal Structure

Due to the high tax burden on dividends and capital gains in Russia, RE project structures often involve foreign legal entities in jurisdictions with favourable tax regimes or Russian REIFs. At the same time, if the business grounds for having foreign legal entities in such structures are unclear, the tax authorities may charge additional taxes as if all entities in the structure were Russian.

Construction

In several cases Russian tax authorities are unwilling to allow tax deduction of certain construction-related expenses or offset of corresponding input VAT. This in particular relates to construction costs incurred before the official construction permit has been obtained or after the object has been commissioned.

It is also a common situation when a developer building residential or commercial RE in Russia is obliged to construct and transfer several RE objects to local authorities (e.g. engineering, transport or social infrastructure). The tax authorities tend to challenge tax deduction of construction costs and offset of input VAT relating to such objects. However, a draft law is currently under consideration in Russia, which may enable a developer to deduct such infrastructure costs for CPT purposes, if they have been incurred under agreements with municipal authorities.

Another common issue closely investigated by the tax authorities is commonly late recognition of income under long-term construction agreements by construction companies, whereas under Russian tax rules such income should be recognised evenly through the entire period of construction.

It should also be noted that the RF Supreme Arbitration Court Plenum has issued a Resolution of 11 July 2011 №54 concerning legal treatment of contracts regarding real estate to be constructed or acquired in future. According to the Resolution, when considering cases related to investment contracts in the sphere of real estate construction, the courts should apply the civil regulations on real estate sale and purchase agreements, construction contracts or joint activity (simple partnership).

Herewith, if not stated otherwise, the courts should treat agreements on investment into real estate construction (i.e. investment contracts, shared construction contracts) as sale and purchase agreements with regard to future real estate objects.

Moreover, according to the mentioned Resolution, initial registration of title to real estate constructed under an investment (or other) agreement may only be performed by the entity holding rights to the land plot under real estate.

The above approach may lead to tax treatment of operations under investment agreements similarly to sale and purchase agreements with regard to future real estate. In particular, in such a case receipt of funds from an investor would no longer be regarded as a tax-exempt investment contribution but would rather be treated as an advance payment (subject to VAT at the moment of receipt in case of commercial real estate).

It is not presently clear whether the tax authorities would attempt to apply the above Resolution in order to impose additional taxes on construction companies. Arbitration court practice should be constantly monitored in this regard.

In order to ensure tax efficiency of construction projects in Russia, proper documentation and justification of arguable expenses, and of the method of recognition of income, should be elaborated.

Financing

A Russian company can only distribute dividends if it generates sufficient profits in its statutory accounts. At the same time a company owning RE is likely to have a significant non-monetary depreciation expense, leading to low accounting profits. As a result, the company will be unable to distribute all of its available cash via dividends (“cash trap”).

This issue can be mitigated if equity finance is in part or in full substituted by debt financing.

At the same time tax deduction of interest expenses may be limited by general interest deductibility rules, as well as thin capitalisation rules (see “Interest expenses”). Therefore, accurate structuring of the intra-group financing structure is required in order to maximise the interest expense deduction for Russian project companies and minimise the tax burden arising upon profits distribution via interest (in particular Russian withholding tax on interest paid to non-residents).
Operation

Local legislation in most Russian regions provides substantial tax incentives (reduced profits tax, property tax and land tax rates) for companies investing in RE in the territory of the corresponding region. The tax effect from utilisation of such incentives may be significant.

In order to apply the regional tax incentives a project company should meet specific requirements stipulated by regional law and prepare proper documentation confirming its eligibility for the incentives.

Management

The management structure of a group involving Russian project companies may be connected with tax risks.

If foreign group companies are managed from the territory of Russia, this may lead to the loss of tax residence of these companies in jurisdictions of their incorporation and creation of a taxable permanent establishment status in Russia. As a result additional tax costs may arise for the group.

In order to minimise the above risks it is necessary to elaborate an effective management structure. This involves setting up appropriate contractual arrangements between the management company and project companies and elaborating a reasonable methodology for management fee determination.

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1. This applies to shares acquired by companies from 1 January 2011

2. Minimum total volume of transactions with one party for FY 2012 and for FY 2013 is RUB 3 bln and RUB 2 bln respectively.

3. For FY 2012 – 2013 penalty is not applicable. For FY 2014 – 2016 penalty is set at 20% of the unpaid tax.
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