Legal **Alert**

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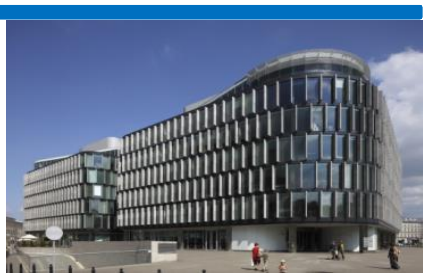
Banking, Finance & Restructuring Department
Tax & Accounting Department

Real estate lease as an alternative to financing



Szymon Gałkowski
Partner
Banking, Finance &
Restructuring Department
s.galkowski@kochanski.pl

Tomasz Zaleski
Partner
Tax & Accounting Department
t.zaleski@kochanski.pl

Klaudia Szymańska
Associate
Banking, Finance &
Restructuring Department
k.szymanska@kochanski.pl

Financial leases are growing in popularity as a tool for financing investments

Unlike loans, financial leases are an easier method of obtaining financing. For the most part leases continue to apply to vehicles and machinery, but should also be considered as a method of financing real estate, including buildings, land and perpetual usufruct title to land.

Operating vs. financial lease

Tax law distinguishes between two types of leases that differently determine which of the parties to the agreement may recognize lease payments as a tax deductible expense, in a part which represents the repayment of the initial value of fixed or intangible assets.

It is worth noting that with respect to buildings it is possible to structure a lease either as an operating or financial lease, according to the needs and financial standing of the lessee. As regards land and perpetual usufruct title, the legislator has put in place a special arrangement which has tax effects that are identical to those for a financial lease.

Operating lease – characteristics

Under an **operating lease**, a lessor discloses an asset in its accounting records by recognizing depreciation. **A lessee recognizes the entire rent paid by it as a tax deductible expense**. **An initial payment** is also recognized by the lessee as a tax deductible expense.

Total payments specified in the agreement, less VAT, must correspond at least to the initial value of the leased asset. Typically, an operating lease for buildings and structures is concluded for a term not shorter than 5 years. VAT is added to each lease payment as it matures.

For the purposes of the VAT Act, an operating lease is a service to which the base rate (currently 23%) applies. If at the end of the initial lease term the lessor transfers to the lessee the ownership of leased fixed assets, the value of these assets determined as **the purchase price specified in the sales agreement** (not necessarily the market value) represents income from the sales of the assets, save that if the price is lower than the hypothetical net value of the assets, income is determined at **the market value**.

Hypothetical net value is the initial value less:

a. depreciation, calculated using a coefficient of 3 – for fixed assets;

b. depreciation calculated using three times shorter depreciation periods – for intangible assets.

Financial lease – characteristics

The requirement related to the minimum contractual term does not apply to a financial lease. **The lessee recognizes a depreciation expense** under **a financial lease** that meets certain conditions laid down in tax regulations. The sum of lease payments stipulated in the agreement, less VAT, should correspond at least to the initial value of the leased asset and, where the lessor re-leases the asset, to the market value of the asset determined as at the date of the renewed lease. The lease payments consist of two portions, i.e. the principal and interest. **Only the interest portion may be recognized as tax deductible expenses**.

Under the VAT Act a financial lease is defined as a supply of goods. In the context of legislation, the civil law principle *superficies solo cedit* is reversed. As an example, in respect to the supply of developed land, to determine whether or not VAT is charged depends on the characteristics of the building or structure. Accordingly, where there is a supply of buildings and structures, VAT must be paid in full in advance on all lease payments upon the first installment as soon as the leased asset is accepted.

This arrangement is similar to a bank loan and the difference lies only in the ownership. Typically, real estate financial leases involve a preliminary agreement to sell the real estate at the end of the lease term at a **price agreed by the parties at their discretion**, even if such **price differs significantly from the market value. Unlike operating leases, the hypothetical net value reducing the lower limit of the price does not apply.**

In contrast to loans, a decision to opt for and to select the type of lease should be made after the customer's needs are analyzed. On the one hand, a lease can serve as a tool of tax optimization which facilitates e.g. to adjust the cost base to the expected future income, and to "make up" a tax loss. On the other hand, a leaseback can be an effective means of financial restructuring which allows funds to be raised and/or an improvement in liquidity, while enabling businesses to continue to use the asset.

Leasing may also prove to be a method of financing which is easier to obtain than a bank loan because the lessor retains ownership of the leased asset (including real estate) over the lease term. This is a safer option for the lessor.

Kochański Zięba Rapala i Partnerzy
Metropolitan, Pl. Piłsudskiego 1
00-078 Warszawa, Polska
Tel.: +48 22 326 9600
Fax: +48 22 326 9601
www.kochanski.pl

Operating lease – effects for the lessor

Income	**Expenses**
• lease payment • purchase price of the asset (purchase)	• depreciation of the value of the leased assets • net book value of the asset (purchase)

Operating lease – effects for the lessee

Income	**Expenses**
-	• payments made by the lessee under the agreement • purchase price of the asset (purchase)

Financial lease – effects for the lessor

Income	**Expenses**
• interest portion of the lease payment* • price of the asset (purchase option)	• expenses incurred in acquiring or manufacturing the leased asset, less any repayment of its value (purchase option)

*interest portion of the lease payment = lease payment – repayment amount of the initial value

Financial lease – effects for the lessee

Income	Expenses
-	• interest portion of the lease payment • depreciation • purchase price of the asset (purchase option)

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Lease of land and perpetual usufruct title to land

Since land and perpetual usufruct title to land are non-depreciable assets, they cannot be used under an operating lease. For these assets it is possible to conclude an agreement having the characteristics of a financial lease or rental. If the lease meets the following criteria:

- it is concluded for a fixed term;
- it applies to land and/or perpetual usufruct title to land (in the latter case, as of January 2013);
- the sum of lease payments stipulated in the agreement corresponds at least to the value of the assets which equals the expenses incurred in acquiring them;

the lessor's income and the lessee's tax deductible expenses do not include the payments stipulated in the agreement, incurred by the lessee in the initial term in connection with the use of the leased asset, in the part which represents the repayment of the value of these assets.

Tax consequences of lease of land and perpetual usufruct title to land after the expiry of the initial term are the same as those for a financial lease.

Leaseback

Leases can be used not only during the project implementation, but also in order to use available funds to enhance the company's liquidity.

Typically, a leaseback involves the sale of real estate to a leasing company with the concurrent conclusion of a lease, which allows for continued use of the real estate.

At the end of the lease term the real estate can be repurchased at a price fixed at the inception of the lease.

Operating lease vs. tenancy/tenancy with the right to collect profits

An operating lease should also be distinguished from a tenancy/ tenancy with the right to collect profits. With regards buildings, the advantages of operating leases essentially include tax preferences arising over the lease term (accelerated accumulated depreciation) as well as on purchase of the leased asset at the end of the lease (the asset may be purchased at a price lower than the market value but higher than the so-called hypothetical net value).

These differences should also be borne in mind since **leases which do not meet the conditions specified in tax regulations** for operating or financial leases incur **tax consequences identical to those incurred by tenancy/ tenancy with the right to collect profits**.

Operating lease converted into financial lease

A lessee under an operating lease can also change the type of lease. One of the terms of a financial lease is that the lessee should recognize depreciation. In such case, therefore, the current "operating" lessor should cease to recognize depreciation as soon as a financial lease is concluded.

There are good prospects for the development of real estate leasing in Poland. If you are interested in this form of financing, our Law Firm is more than happy to contact you with various leasing companies that we cooperate with.

If any of the issues addressed above raises your concerns or requires further clarification, the lawyers of Kochański Zięba Rapala & Partners are willing to assist you.

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