



Real Estate Accounting Guide 2022

March 2022



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Foreword

Dear Readers,

We are more than pleased to announce that the seventh edition of the Real Estate Accounting Guide has just been released.

It offers both key theoretical considerations and real-life examples illustrating issues specific to the industry, which pose a challenge to the majority of the accounting functions of RE companies across Central Europe.

We truly believe that our publication will facilitate the assessment of risks associated with your real estate transactions. We also hope that the Guide will make it easier for you to close future reporting periods not only faster but also more efficiently, in addition to ensuring that the information contained in your financial statements and reports is reliable and comparable, in line with the highest market standards.

The accounting part of our publication has been prepared based on the International Financial Reporting Standards (IFRSs). We also examine some important tax issues typical for the real estate industry, with a focus on four countries, namely Poland, the Czech Republic, Romania and Hungary, in addition to exploring the topic of valuation.

The seventh edition of the Guide presents the core IFRS requirements which affect the reporting process at real-estate companies. It offers a glimpse into changes in tax regulations applicable to the sector as well.

We believe that you will find our publication particularly useful and will appreciate all your comments and suggestions which could help us suit future editions of the Guide to your needs and expectations to the greatest extent possible.

Enjoy your reading!

Ewelina Dufrat
Director, Audit & Assurance, Real Estate Sector

Part 1

Accounting of real estate investment

Introduction

The accounting part of the guide will focus on selected topics related to recognition, measurement, derecognition and disclosures specific to real estate companies. The structure of the guide corresponds to particular stages of life of an investment property: from construction or acquisition through the operating phase until disposal. This publication covers accounting principles set out in the IFRS Accounting Standards. In addition, at the end of the accounting part of the guide, we will highlight key differences between the IFRS Accounting Standards and local Generally Accepted Accounting Principles that are applicable in selected Central European countries.

This publication will specifically cover the provisions of IAS 16, IAS 23, IAS 36, IAS 37, IAS 40, IFRS 3, IFRS 5, IFRS 13 and IFRS 16 that are particularly relevant to real-estate companies.

The guidance in this publication is derived from Deloitte's iGAAP on DART publication as at January 31st, 2022. as listed in the Bibliography on page 96.

[The Deloitte Accounting Research Tool](#) is a comprehensive online library of accounting and financial disclosures literature. iGAAP on DART allows access to the full IFRS Accounting Standards, linking to and from: Deloitte's authoritative, up-to-date, iGAAP manuals which provide guidance for reporting under IFRS Standards; and Model financial statements for entities reporting under IFRS Accounting Standards.

In addition, our Beyond the numbers volume of iGAAP provides guidance on disclosure requirements and recommendations which businesses must consider in light of the broader environmental, social and governance matters which can significantly drive the value of an entity.

To apply for a subscription to DART, click [here](#) to start the application process and select the iGAAP package. For more information about DART, including pricing of the subscription packages, click [here](#).

All practical examples cited in this publication use CU (meaning Currency Unit) as a currency.

1. Investment property – definition

Investment property is defined in IAS 40 as follows. [[IAS 40:5](#)]

"Investment property is property (land or a building – or part of a building – or both) held (by the owner or by the lessee as a right-of-use asset) to earn rentals or for capital appreciation or both, rather than for:

- use in the production or supply of goods or services or for administrative purposes; or
- sale in the ordinary course of business."

Included in this definition [[IAS 40:8](#)]:

- land held for long-term capital appreciation, and not for short-term sale in the ordinary course of business;
- land held for a currently undetermined future use. If an entity has not decided whether land will be used for owner-occupation or for short-term sale in the ordinary course of business, it should be regarded as held for capital appreciation;
- a building owned by the entity (or a right-of-use asset relating to a building held by an entity) and leased out under operating lease(s);
- a vacant building that is being held to be leased out under an operating lease (or leases); and
- property that is being constructed or developed for future use as investment property.

Not included in this definition [[IAS 40:9](#)]:

- property that is being held for sale in the ordinary course of business, or that is under construction or development for such sale (within the scope of IAS 2). This means that properties acquired specifically for the purpose of subsequent disposal in the near future, or for development and resale, are excluded from the scope of IAS 40;
- owner-occupied property; and
- property leased to another entity under a finance lease.

Typical examples of investment properties include shopping centres, warehouses and office buildings held for rental income and capital appreciation.

1.1. Property leased to other group members

The conclusion on classification of the property may be different in the consolidated financial statements and individual financial statements of the group member entity.

If an entity owns a property that is leased to, and occupied by, another group member (e.g. a parent or another subsidiary), the property is not recognised as an investment property in the consolidated financial statements because it will be treated as owner-occupied from the perspective of the group. However, from an individual-entity perspective, the property is treated as an investment property if it meets the definition in [IAS 40:5](#). [[IAS 40:15](#)]



2. Acquisition of investment property

The first stage in accounting for an acquisition is to determine whether a transaction or other event is a business combination, which requires that the assets acquired and liabilities assumed constitute a business. [IFRS 3:3] The transaction or event should be analysed by applying the definition of a business combination, and the detailed guidance set out in paragraphs B5 to B12D of the Standard.

2.1. Identifying a business combination

IFRS 3 defines business combination as a transaction or other event in which an acquirer obtains control of one or more businesses. Under IFRS 3, a business is defined as an integrated

set of activities and assets that is capable of being conducted and managed for the purpose of providing goods or services to customers, generating investment income (such as dividends or interest) or generating other income from ordinary activities.

A business consists of inputs, and processes applied to those inputs, that have the ability to contribute to the creation of outputs. The three elements of a business are defined as follows.

[IFRS 3:B7]

Input

- Any economic resource that creates outputs, or has the ability to contribute to the creation of outputs, when one or more processes are applied to it.
- Examples include non-current assets (including intangible assets or rights to use non-current assets), intellectual property, the ability to obtain access to necessary materials or rights and employees.

Process

- Any system, standard, protocol, convention or rule that, when applied to an input or inputs, creates outputs or has the ability to contribute to the creation of outputs.
- Examples include strategic management processes, operational processes and resource management processes. These processes typically are documented, but the intellectual capacity of an organised workforce having the necessary skills and experience following rules and conventions may provide the necessary processes that are capable of being applied to inputs to create outputs.
- Accounting, billing, payroll and other administrative systems typically are not processes used to create outputs.

Output

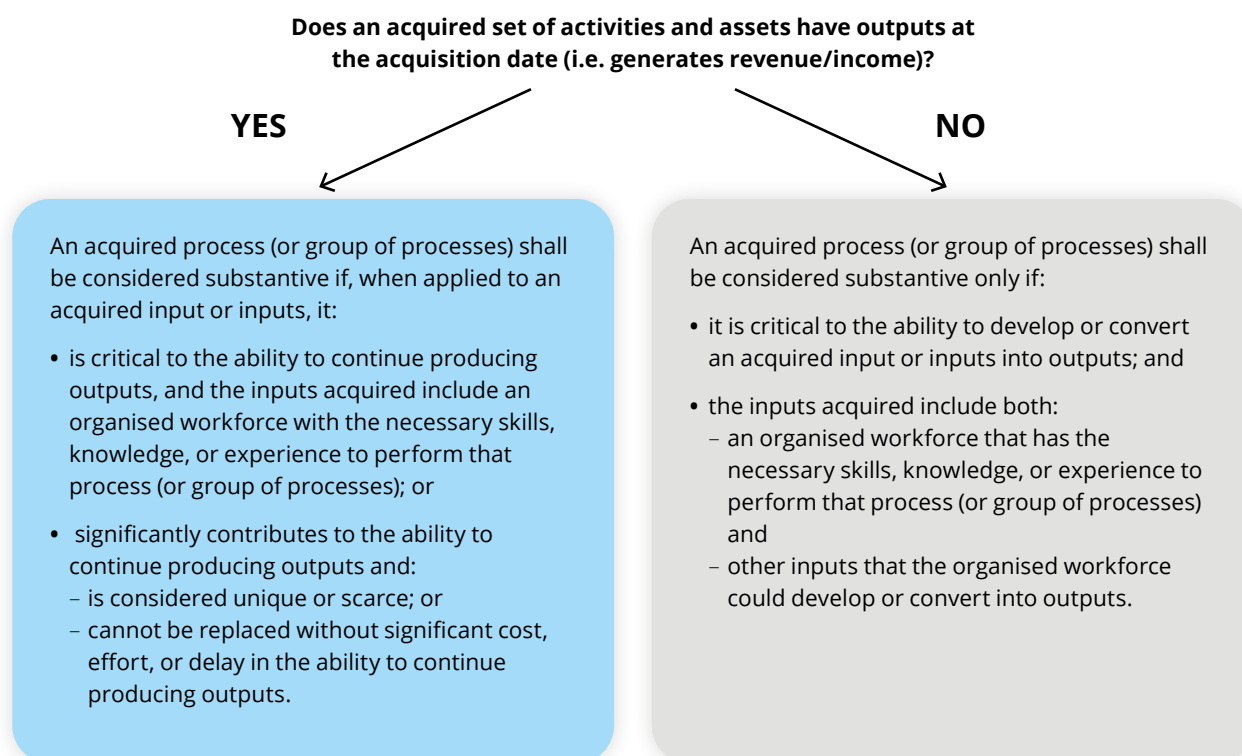
- The result of inputs and processes applied to those inputs that provide goods or services to customers (in the meaning of IFRS 15), generate investment income (such as dividends or interest) or generate other income from ordinary activities (e.g. lease rentals).

To be a business, an integrated set of activities and assets must include at a minimum, an input and a substantive process that together significantly contribute to the ability to create output. However, outputs are not required for an integrated set of activities and assets to qualify as a business. An example of an acquired set of activities and assets that does not have outputs at the acquisition date is an early-stage entity that has not yet started to generate revenue. If an acquired set of activities and assets was generating revenue at the acquisition date, it is considered to have outputs even if subsequently it will no longer generate revenue from customers (for example, because it will be integrated into the entity's operations). [[IFRS 3:B12A](#)]



2.1.1. Assessing whether an acquired process is substantive

IFRS 3 assesses whether an acquired process is substantive on the basis of whether or not the acquired set of activities.



Generally, when an acquired set of activities and assets does not include outputs, more persuasive evidence is required that the set constitutes a business because the existence of outputs already provides some evidence that the acquired set of activities and assets is a business. [\[IFRS 3:BC21M\]](#)

IFRS 3 includes the following observations relating to the assessment of whether an acquired process is substantive, in the context of acquired sets of activities and assets with or without outputs.

- An acquired contract is an input and not a substantive process. A contract that provides a continuing revenue stream (e.g. a lease contract) is not itself a process. Nevertheless, an acquired contract, for example a contract for

outsourced property management or outsourced asset management, may give access to an organised workforce.

- Difficulties in replacing an acquired organised workforce may indicate that the acquired organised workforce performs a process that is critical to the ability to create outputs.
- A process (or group of processes) is not critical if, for example, it is ancillary or minor within the context of all the processes required to create outputs.

2.2. Concentration test

IFRS 3 has an optional, simplified approach for assessing whether an entity has acquired a business or assets. **Under this optional concentration test (which an entity can elect to apply on a transaction-by-transaction**

basis), if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets, then an entity can conclude that the acquisition is not a business combination. [\[IFRS 3:B7A\(a\)\]](#)
The acquisition would instead be accounted for as an asset acquisition (see 3.1).

If the concentration test is not met (i.e. substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets), this does not necessarily mean that the transaction is a business combination. In order to conclude whether the transaction is an asset acquisition or a business combination,

the entity must assess if the acquired set of activities and assets includes, at a minimum, an input and a substantive process by applying [IFRS 3:B8 to B12D](#).

An entity that has performed the concentration test and concluded that the acquired set of activities and

assets is not a business may disregard the outcome of the concentration test and instead perform the detailed assessment required by [IFRS 3:B8 to B12D](#) to determine whether the transaction is a business combination. [\[IFRS 3:BC21X\]](#)

CONCENTRATION TEST

Is substantially all of the fair value of the gross assets acquired concentrated in a single identifiable asset or group of similar assets?

YES

Test is met

= it is NOT a business

IFRS 3.B7A(a),

Yet, the outcome of the test may be disregarded and a detailed assessment may be further performed as required by [IFRS 3:B8 to B12D](#).

NO

Test is NOT met

= it has not been concluded yet whether it is a business or not

Detailed assessment has to be further performed as required by [IFRS 3:B8 to B12D](#).

As explained in [IFRS 3:BC21U](#), the International Accounting Standards Board ("the Board") designed the concentration test with the aim of making it easy to understand and, in some straightforward cases, simple to operate and less costly than applying the detailed assessment otherwise required by [IFRS 3:B8 to B12D](#).

As a result, the concentration test focuses on a single identifiable asset or a single group of similar identifiable assets.

The Board does not expect entities to carry out detailed calculations to apply the test, because detailed calculations would defeat the purpose of the test, which is to permit a simplified assessment.

In theory, in some circumstances, the concentration test may result in a "false positive", i.e. identifying a transaction as an asset acquisition when a detailed assessment would identify it as a business combination. The Board was aware of

this possibility when it introduced the concentration test in IFRS 3 and designed the test to minimise the risk that a false positive would deprive users of financial statements of useful information.

[\[IFRS3:BC21Z\]](#)

The test which is set out in [IFRS 3:B7B](#) can be broken down in three steps as set out below.



2.3. Example A—acquisition of real estate

Scenario 1

BACKGROUND

An entity purchases a portfolio of 10 single-family homes that each has an in-place lease. The fair value of the consideration paid is equal to the aggregate fair value of the 10 single-family homes acquired. Each single-family home includes land, building and property improvements. Each home has a different floor area and interior design. The 10 single-family homes are located in the same area, and the classes of customers (e.g. the tenants) are similar. There is no significant difference between the risks associated with operating in the real estate market of the homes acquired. No employees, other assets, processes or other activities are transferred.

APPLICATION OF REQUIREMENTS

The purchaser elects to apply the optional concentration test set out in paragraph B7B and concludes that:

- each single-family home is considered a single identifiable asset in accordance with paragraph B7B for the following reasons:
 - the building and property improvements are attached to the land and cannot be removed without incurring significant cost; and
 - the building and the in-place lease are considered a single identifiable asset, because they would be recognised and measured as a single identifiable asset in a business combination (see paragraph B42);
- the group of 10 single-family homes is a group of similar identifiable assets because the assets (all single-family homes) are similar in nature and the risks associated with managing and creating outputs are not significantly different. This is because the types of homes and classes of customers are not significantly different;
- consequently, substantially all of the fair value of the gross assets acquired is concentrated in a group of similar identifiable assets.

The purchaser therefore concludes that the acquired set of activities and assets is not a business.

Scenario 2

BACKGROUND

Assume the same facts as in Scenario 1, except that the purchaser also purchases a multi-tenant corporate office park with six 10-storey office buildings that are fully leased. The additional set of activities and assets acquired includes the land, buildings, leases and contracts for outsourced cleaning, security and maintenance. No employees, other assets, other processes or other activities are transferred. The aggregate fair value associated with the office park is similar to the aggregate fair value associated with the 10 single-family homes. The processes performed through the contracts for outsourced cleaning and security are ancillary or minor within the context of all the processes required to create outputs.

APPLICATION OF REQUIREMENTS

The purchaser elects to apply the optional concentration test set out in paragraph B7B and concludes that the single-family homes and the office park are not similar identifiable assets, because the single-family homes and the office park differ significantly in the risks associated with operating the assets, obtaining tenants and managing tenants. In particular, the scale of operations and risks associated with the two classes of customers are significantly different. Consequently, the fair value of the gross assets acquired is not substantially all concentrated in a group of similar identifiable assets, because the fair value of the office park is similar to the aggregate fair value of the 10 single-family homes. Thus the purchaser assesses whether the set of activities and assets meets the minimum requirements to be considered a business in accordance with paragraphs B8–B12D.

The set of activities and assets has outputs because it generates revenue through the in-place leases. Consequently, the purchaser applies the criteria in paragraph B12C to determine whether any processes

acquired are substantive.

The purchaser concludes that the criterion in paragraph B12C(a) is not met because:

- the set does not include an organised workforce; and
- the processes performed by the outsourced cleaning, security and maintenance personnel (the only processes acquired) are ancillary or minor within the context of all the processes required to create outputs (see paragraph B12D(c)) and, therefore, are not critical to the ability to continue producing outputs.

After considering the only processes acquired – those performed by the outsourced cleaning, security and maintenance personnel – the purchaser also concludes that the criteria in paragraph B12C(b) are not met. Either of the following reasons justifies that conclusion:

- the processes do not significantly contribute to the ability to continue producing outputs;
- the processes are readily accessible in the marketplace, meaning they are not unique or scarce. In addition, they could be replaced without significant cost, effort, or delay in the ability to continue producing outputs.

Because none of the criteria in paragraph B12C are met, the purchaser concludes that the acquired set of activities and assets is not a business.

Scenario 3

BACKGROUND

Assume the same facts as in Scenario 2, except that the acquired set of activities and assets also includes the employees responsible for leasing, tenant management, and managing and supervising all operational processes.

APPLICATION OF REQUIREMENTS

The purchaser elects not to apply the optional concentration test set out in paragraph B7B and therefore assesses whether the set meets the minimum

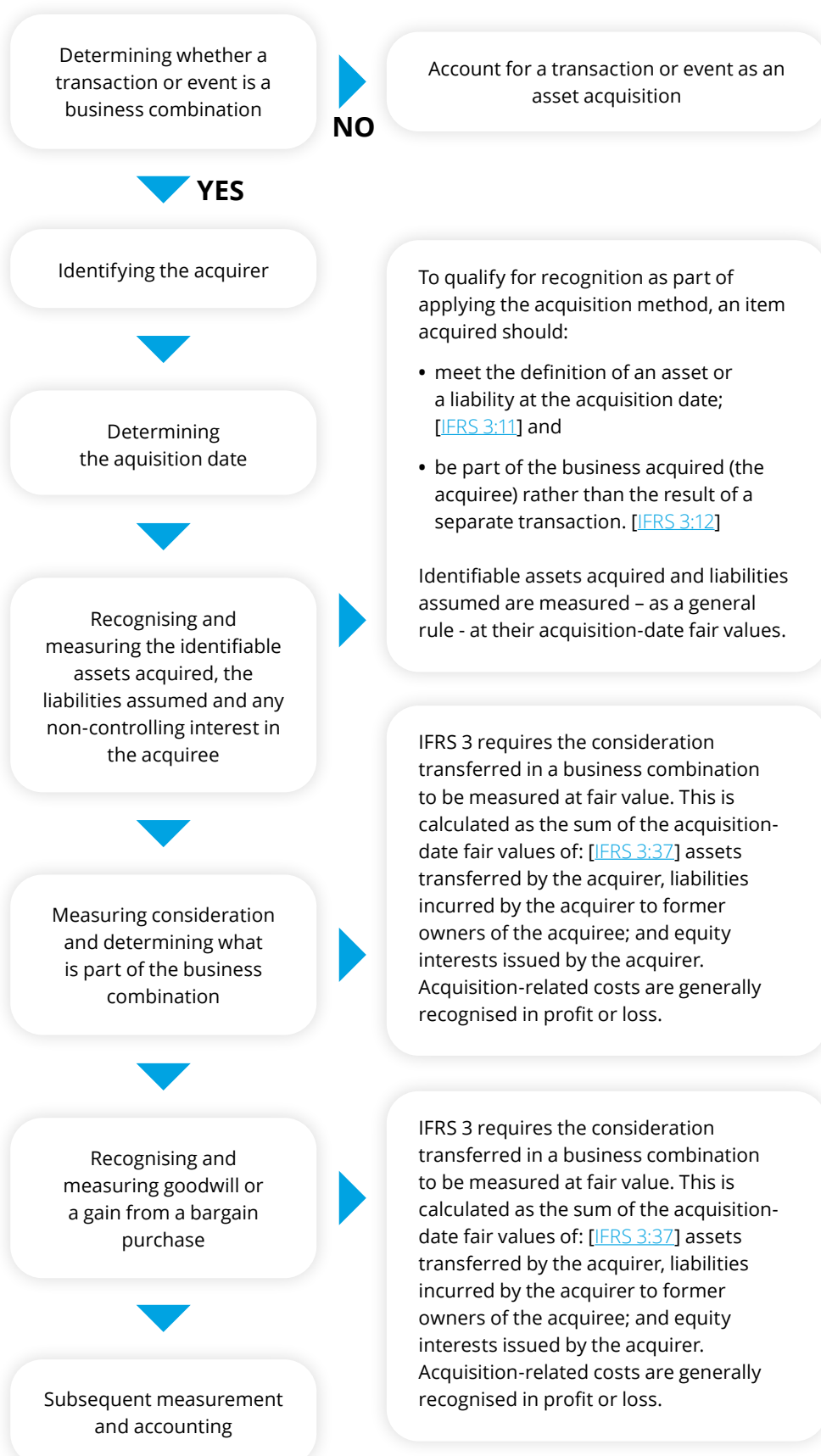
requirements to be considered a business in accordance with paragraphs B8–B12D.

The acquired set of activities and assets has outputs because it generates revenue through the in-place leases. Consequently, the purchaser applies the criteria in paragraph B12C.

The purchaser concludes that the criterion in paragraph B12C(a) is met because the set includes an organised workforce with the necessary skills, knowledge or experience to perform processes (i.e. leasing, tenant management, and managing and supervising the operational processes) that are substantive because they are critical to the ability to continue producing outputs when applied to the acquired inputs (i.e. the land, buildings and in-place leases). Furthermore, the purchaser concludes that the criterion in paragraph B8 is met because those substantive processes and inputs together significantly contribute to the ability to create output. Consequently, the purchaser concludes that the acquired set of activities and assets is a business.

2.4. The acquisition method of accounting

IFRS 3 requires that all business combinations be accounted for by applying the acquisition method. [IFRS 3:4] Taking all the requirements of the Standard into account, there are seven distinct steps to be considered, which are summarised in the chart.



Accounting principles underlying asset acquisition are set out in section 3.1.

2.4.1. Key differences between accounting for business combination and asset acquisition

The accounting impact on acquisition date and post-acquisition between an asset acquisition and a business combination are vastly different. The table summarises the key differences.

Area	Business combination	Acquiring a group of assets
Goodwill	Potentially results in goodwill or gain in a bargain purchase	Does not give rise to goodwill or gain on a bargain purchase
Deferred tax	Give rise to deferred tax at initial recognition of assets and liabilities due to fair value adjustments	Does not give rise to deferred tax
Valuation of assets and liabilities	Assets acquired and liabilities assumed are initially measured at their respective fair values based on market participants' perspective	Assets and liabilities are assigned carrying amounts by allocating consideration paid to individual assets and liabilities based on their fair value
Contingent liabilities	Special requirements for contingent liabilities	IAS 37 applies for contingent liabilities (not recognised)
Transaction costs	Transaction costs are expensed to profit or loss	Directly attributable transaction costs are capitalised as part of cost of assets

2.5. Impairment testing of goodwill which arises as a result of a deferred tax liability recognised in a business combination

IAS 36:75

In a business combination, a deferred tax liability may be recognised for temporary differences arising from the initial recognition of assets.^[IAS 12:22(a)] The recognition of this deferred tax liability increases the goodwill recognised which is subject to impairment testing.

Consistent with [IAS 36:50\(b\)](#), which requires the use of pre-tax cash flows when determining value in use, generally a deferred tax liability is not included in the carrying amount of the CGU. However, when the recognition of a deferred tax liability results in an increase in goodwill, excluding the deferred tax liability from the carrying amount of the CGU (or group of CGUs) to which goodwill has been allocated will result in an impairment loss at the acquisition date despite the absence of a decline in future cash flows. This does not appear reasonable. Therefore, to the extent that goodwill has been increased because of the recognition of a deferred tax liability in the purchase price allocation,

it is acceptable to include the related deferred tax liability in the determination of the carrying amount of the CGU (or group of CGUs).

Subsequently, if the recoverable amount reflects value in use, the carrying amount of the CGU (or group of CGUs) is adjusted for any remaining deferred tax liability at the impairment test date which resulted in an increase in goodwill (i.e. noting that the deferred tax liability recognised at the acquisition date may have fully or partially reversed).

3. Measurement of investment property at acquisition or during construction

3.1. General principles

An owned investment property should be recognised as an asset when: [\[IAS 40:16\]](#)

- it is probable that the future economic benefits that are associated with the investment property will flow to the entity; and
- the cost of the investment property can be measured reliably.

An owned investment property shall be measured initially at its cost. Transaction costs shall be included in the initial measurement. [\[IAS 40:20\]](#)

Start-up costs are not included unless they are necessary to bring the asset to the condition required for its intended operation. Abnormal costs, and operating losses incurred before the property reaches its required level of occupancy, are excluded from the cost of the investment property. [\[IAS 40:23\]](#)

An investment property held by a lessee as

a right-of-use asset should be measured initially at its cost in accordance with IFRS 16.

3.2. Elements of cost

3.2.1. Component of cost of an acquired asset

The cost of a purchased investment property comprises its purchase price and any directly attributable expenditure. Directly attributable expenditure includes, for example, professional fees for legal services, property transfer taxes and other transaction costs. [\[IAS 40:21\]](#)

Example of expenditure to be capitalised as part of the cost of an investment property

Entity R acquires a building for CU95 million in March 20X1 as an investment property. In June 20X1, Entity R refurbishes entirely the building at a cost of CU5 million to bring it to the condition required by the rental market. Entity R will pay an estate

agent two months' rent if the agent locates a lessee. In December 20X1, Entity R (the lessor) finally rents the property under an operating lease to Entity S (the lessee). When it buys the building, Entity R should recognise the purchase price as the initial cost of the building under IAS 40.

The refurbishment costs are necessary to bring the property to a condition suitable for renting out and, therefore, these costs should also be included in the initial cost of the building.

The estate agent's fees are not part of the initial cost of the building but they are considered to be "initial direct costs incurred in negotiating and arranging an operating lease" under IFRS 16 (see 7.2.). They are, therefore, capitalised as part of the leased building. When the cost model is used, the expenditure should be depreciated over the lease term. When the fair value model is used, the costs should be capitalised and will, therefore, result in a smaller revaluation gain (or larger revaluation loss) when the building is next remeasured to fair value.

3.2.2. Components of cost for a self-constructed asset

IAS 40 does not deal specifically with the recognition of the cost of a self-constructed investment property. Over the period of construction, the costs of construction will be capitalised as part of the cost of the investment property under construction in accordance with the general principle for recognition. Paragraphs 16 to 22 of IAS 16 provide guidance as to what is appropriately included within such costs. If the entity does not construct similar assets for sale (which is the case for majority of real estate companies), only those elements of costs described in [IAS 16:16](#) can be incorporated in the cost of a self-constructed asset. Accordingly, costs which can be included are:

- direct materials;
- direct labour costs; and
- unavoidable costs that are directly attributable to the construction activity (i.e. costs that would have been avoided if the asset had not been constructed).

This concept of 'directly attributable' costs is different from the concepts applied in the measurement of costs of conversion in IAS 2. The latter include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Such systematic allocation of fixed overheads is not appropriate under IAS 16, because IAS 16 looks to capitalise only directly attributable costs.

The Standard gives no further guidance on how to determine which costs should be viewed as 'directly attributable'. Costs that are directly incremental as a result of the construction of a specific asset would generally be eligible, if they relate to bringing the asset to working condition.

The capitalisation of borrowing costs is considered in accordance with the general requirements of IAS 23 (see 3.3.).

If an entity follows the fair value model in accounting for its investment property (see 4.2.), provided that the fair value of the property under construction can be

measured reliably, the costs capitalised during the course of construction do not affect the carrying amount of the investment property under construction, which is remeasured to fair value at the end of each reporting period. Therefore, any costs capitalised during the reporting period simply reduce the amount recognised in profit or loss for any gain (or increase the amount recognised for any loss) arising on remeasurement to fair value at the end of the reporting period. Although the amount reported in the statement of financial position is not affected, it is important to capitalise construction costs when appropriate, because this may affect the classification of amounts in the statement of comprehensive income (e.g. any gain on remeasurement may be overstated and property expenses overstated by the same amount).

3.2.2.1. Depreciation of leasehold land during the construction of an investment property – investment property measured using the cost model

When an entity constructs a building on leasehold land that is classified as an investment property measured using the cost model, the depreciation of the leasehold land right-of-use asset during the construction period should be incorporated in the cost of the building under construction. The depreciation of the right-of-use asset for the leasehold land is an expenditure that is directly attributable to the construction of the building, and incorporation of such depreciation in the cost of building while under construction is consistent with the principles of IAS 16.

Example of termination payments by a lessor to a lessee

Company A owns an office building that it leases to Company B. The lease is classified as an operating lease in accordance with IFRS 16. Company A would like to convert the office building into a block of flats, believing that this will attract significantly higher rental income. First, however, Company A must terminate the lease

contract with Company B. Company A applies the cost model as its accounting policy for the measurement of its investment property subsequent to initial recognition.

[IAS 16:16\(b\)](#) states that the cost of an item includes "any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management". [IAS 16:7](#) requires that the cost of an item be recognised as an asset if "it is probable that future economic benefits associated with the item will flow to the entity" and if "the cost of the item can be measured reliably".

Therefore, if Company A's cost of terminating Company B's operating lease meets the recognition criteria in [IAS 16:7](#), Company A should capitalise this cost because it is a directly attributable cost of enabling operation of the asset in the manner intended by management.

Company A should also consider whether there is an indicator of impairment and whether any further impairment testing should be performed to ensure that the building is not recognised at a carrying amount higher than its recoverable amount as a result of capitalising the lease termination costs.

3.2.3. Deferred payments

The cost of an investment property for which payment is deferred is the cash price equivalent of the deferred payments. The difference between the cash price equivalent recognised at initial measurement, and the total payments made, is recognised as an interest expense over the period of credit, i.e. the period from the point of receipt of the property until the point of settlement of the related liability. [IAS 40:24]

There is no definition of 'cash price equivalent' in IAS 40. It is presumably intended to equate to the present value of the deferred payment but might also encompass a cash price offered by the vendor as an alternative to the deferred payment terms.

Example of payment for an asset deferred beyond 'normal credit terms'

The commercial property market in a particular city is very slow. As an inducement to potential purchasers, a seller of commercial property in that city advertises a property for sale at 'no interest for the first three years after purchase, market rate of interest thereafter'. Other property sellers in the city are making similar offers. A buyer purchases a property on those terms. [IAS 16:23](#) requires imputation of interest if payment for an item of property is deferred beyond 'normal credit terms'. In this circumstance, the three-year interest-free period does not represent normal credit terms.

The intention of [IAS 16:23](#) is to ensure that the asset is recognised at its current cash sale price; the 'normal credit terms' requirement is intended to recognise that settlement of cash purchases often takes a few days, weeks, or even months (depending on the industry and national laws), and imputation of interest is not required in those circumstances. However, particularly for a large item such as a property, the cash sale price would be significantly lower if cash payment is made up-front rather than deferred for three years. If the deferral period is greater than what can be considered normal credit terms, the imputed interest element should be recognised.

3.2.4. Cessation of capitalisation

Recognition of costs in the carrying amount of an investment property ceases when the item is in the location and condition necessary for it to be capable of operating in the manner intended by management. Therefore, costs incurred in using or redeploying an item are not included in the carrying amount of that item. [[IAS 16:20](#)]

In the case of a self-constructed asset, a policy decision should be made and applied consistently as to what event or activity characterises the point at which an asset's physical construction/installation is complete (i.e. when the item is in the location and condition necessary for it to

be capable of operating in the manner intended by management), so that all costs incurred after that point are identified and expensed.

When there is delay in achieving final physical completion, costs arising during the period of delay are likely to fall into the category of abnormal costs and so be expensed as incurred. Borrowing costs incurred during such a period of delay will not qualify for capitalisation under IAS 23, which requires that capitalisation should cease when active development is suspended (see 3.3.3.2).

Regulatory consents (e.g. health and safety clearance) are sometimes required before an asset may be used legally. Cost capitalisation will not necessarily continue until such consents are in place. Management will normally seek to ensure that such consents are in place very close to the time-frame for physical completion and testing, and that they do not delay the commencement of operations. Avoidable delays in obtaining consents which prevent the start of operations should be seen as abnormal and similar in effect to an industrial dispute, with the result that capitalisation should cease.

The words 'capable of operating in the manner intended by management' in IAS 16 cannot be used to justify ongoing capitalisation of costs (and postponement of depreciation) once the asset has actually been brought into use just because the asset does not live up to management's original intentions. This may, however, constitute an impairment indicator under IAS 36.

Example of capitalisation of costs incurred between the completion of a building and the date of approval for occupation

On 20 September 20X0, Company A completed the construction of a shopping centre. By law, the local health and safety authority must approve the offices for occupation before any activity can commence. This approval can be requested only when the building is physically

complete, and it takes on average three months to obtain such approval.

The health and safety authority issued the approval for occupation on 20 December 20X0. In the three months from 20 September 20X0, Company A incurred CU10 of building management costs (e.g. utility and security expenses) and interest expenses. (The building is identified as a qualifying asset under IAS 23.)

The costs incurred by Company A between 20 September 20X0 (when the building was physically completed) and 20 December 20X0 (when the approval for occupation was issued) should be included in the initial cost of the building.

The management costs incurred are considered "directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management" ([IAS 16:16\(b\)](#)). In addition, obtaining the approval for occupation is considered to be an activity "necessary to prepare the qualifying asset for its intended use or sale" ([IAS 23:25](#)); therefore, Company A should continue to capitalise borrowing costs until the approval is obtained.

However, any abnormal amounts of wasted resources incurred in obtaining that approval should not be capitalised ([IAS 16:22](#)). For example, if the approval for occupation had taken longer than the customary three-month period from the completion of construction, due to avoidable delays caused by Company A failing to provide the required information to the health and safety authority, Company A could include in the original cost of the building only those costs incurred during the time usually required to obtain the approval for occupation. (In the circumstances under consideration, this was three months.)

If the delays were due to a slow response from the health and safety authority (without cause by Company A), the capitalisation period would be extended.

3.3. Borrowing costs

3.3.1. Core principle and scope

The core principle of IAS 23 is that borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset form part of the cost of that asset. Other borrowing costs are recognised as an expense. [IAS 23:1]

A qualifying asset is defined as an asset that necessarily takes a substantial period of time to prepare for its intended use or sale.

[IAS 23:5]

IAS 23 does not provide any guidance on what constitutes a 'substantial period of time'. The specific facts and circumstances should be considered in each case. For example, it is likely that a period of 12 months or more might be considered 'substantial'. It may be reasonably expected that in most cases investment property under construction will meet the definition of a qualifying asset.

IAS 23:4 provides an optional exemption from the requirement to capitalise borrowing costs for qualifying assets that are measured at fair value (which would include investment property under construction if an entity follows the fair value model for investment property). Therefore, entities can choose, as a matter of accounting policy, whether to capitalise borrowing costs in respect of such assets. When relevant to an understanding of the financial statements, that accounting policy should be disclosed.

The exemption for assets measured at fair value in IAS 23:4 recognises that the measurement of such assets is not affected by the amount of borrowing costs incurred during their construction or production period.

3.3.2. Borrowing costs – definition

Borrowing costs are defined as interest and other costs that an entity incurs in connection with the borrowing of funds.

[IAS 23:5]

Borrowing costs may include: [IAS 23:6]

- interest expense calculated using the effective interest method as described in IFRS 9;
- interest in respect of liabilities recognised in accordance with IFRS 16; and
- exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

Refinancing gains and losses do not qualify as part of borrowing costs that are eligible for capitalisation under IAS 23. IFRS 9 is clear that 'refinancing' gains and losses should be recognised in profit or loss when they arise. Refinancing gains and losses may arise, for example, on early repayment or a substantial modification of the terms of borrowings.

The borrowing costs that are eligible for capitalisation are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. [IAS 23:10]

3.3.2.1. Specific borrowing costs

When funds are borrowed specifically for the purpose of acquiring or constructing a qualifying asset, the amount of borrowing costs eligible for capitalisation is the actual borrowing costs incurred on those funds during the period. [IAS 23:12]

The financing arrangements may result in the specific borrowings being drawn down prior to some or all of the funds being utilised to finance the qualifying asset. In such circumstances, any investment income earned on the temporary investment of the funds, pending their

expenditure on the qualifying asset, should be deducted from the actual borrowing costs incurred to arrive at the borrowing costs eligible for capitalisation. [IAS 23:13]

3.3.2.2. General borrowing costs

General borrowings are all borrowings of the entity that are outstanding during the period but excluding borrowings made specifically for the purpose of obtaining a qualifying asset until substantially all the activities necessary to prepare that asset for its intended use or sale are complete. [IAS 23:14]

When a qualifying asset is funded from a pool of general borrowings, IAS 23:14 requires that the amount of the borrowing costs to be capitalised should be determined by applying an appropriate capitalisation rate to the expenditure on the qualifying asset.

The capitalisation rate is calculated as follows: [IAS 23:14]

$$\frac{\text{Total general borrowing costs for the period (i.e. excluding specific borrowings)}}{\text{Weighted average total general borrowings (i.e. excluding specific borrowings)}}$$

In the calculation of borrowing costs to be capitalised, the amount of expenditure on a qualifying asset should consist only of payments of cash, transfers of other assets or the assumption of interest-bearing liabilities, and should be reduced by any pre-sale deposits, progress payments or grants received in connection with the qualifying asset. The average carrying amount of the asset during a period, including borrowing costs previously capitalised, is normally a reasonable approximation of the expenditures to which the capitalisation rate is applied in that period. [IAS 23:18]

When funds are borrowed generally, interest income earned on excess funds should not be offset against the interest cost in determining the appropriate capitalisation rate, nor in determining the limit on capitalisation by reference to the amount of borrowing costs incurred during the period.

3.3.3. Period of capitalisation

3.3.3.1. Commencement of capitalisation

[IAS 23:17](#) states that borrowing costs should be capitalised from the commencement date, which is the date when the following three conditions are first met:

- expenditures for the asset are being incurred;
- borrowing costs are being incurred;
- activities necessary to prepare the asset for its intended use or sale are being undertaken.

The term 'activities' in this context is interpreted as having a broad meaning and should include all steps necessary to prepare the asset for its intended use. Such activities include initial technical and administrative work, such as activities associated with obtaining permits, prior to the commencement of the physical construction of the asset. [[IAS 23:19](#)]

The mere holding of an asset, however, without any associated development activities, does not entitle an entity to capitalise related borrowing costs. A typical example is the holding of land banks that are not undergoing activities necessary to prepare them for their intended use. Capitalisation of borrowing costs should only commence when such activities are being undertaken as part of a specific development plan to change an asset's condition. [[IAS 23:19](#)]

3.3.3.2. Suspension of capitalisation

Capitalisation of borrowing costs should generally continue as long as the three conditions listed at 3.3.3.1. are met. If, however, the entity suspends activities related to development for an extended period, capitalisation of borrowing costs should also cease until such time as activities are resumed. [[IAS 23:20](#)]

Such interruptions in development may occur, for example, due to cash flow difficulties or a desire to hold back development while the market is in depression, in which case the borrowing

costs incurred during the period of suspension are not considered to be a necessary cost of development and therefore cannot be capitalised. On the other hand, temporary delays that are necessary or expected in the process of preparing an asset for its intended use, or which result from a natural delay such as adverse weather conditions that are common to the location, do not require the suspension of capitalisation. [[IAS 23:21](#)]

3.3.3.3. Cessation of capitalisation

In accordance with [IAS 23:22](#), capitalisation should cease when substantially all of the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

An asset is normally ready for its intended use or sale when the physical construction of the asset is complete, even when routine administrative work is continuing. If minor modifications, such as the decoration of a property to the purchaser's specification, are all that are still outstanding, this indicates that substantially all the activities are complete. [[IAS 23:23](#)]

Capitalisation will therefore generally cease when the physical construction of an asset is complete, because at that stage the asset will be substantially ready for its intended use, notwithstanding that further time might be necessary to complete routine administrative work, market the asset or, in the case of an investment property, find a tenant.

Example of investment property subject to lessee fit-out

When a lessor completes a property subject to fit-out and transfers it to the lessee, who then carries out further work to bring the property to the condition necessary for its intended use, from the perspective of the lessor the property is available for its intended use at the time the lessee takes possession. This is the commencement date of the lease (as defined in IFRS 16). It is also the date at which the lessor ceases capitalisation of borrowing costs (unless there is a delay between the lessor completing work and

the lessee taking possession, in which case capitalisation will cease at the earlier date).

Example of cessation of capitalisation of borrowing costs on land

Entity A acquires and develops a piece of land and thereafter constructs a building on that land. Both the land and the building meet the definition of a qualifying asset and general borrowings are used to fund expenditures on both assets.

The land will not be available for alternative use during construction of the building. To determine when to cease capitalisation of borrowing costs for the land, Entity A should consider the intended use of the land. The land and building could be used for owner-occupation (property, plant and equipment), for rent or capital appreciation (investment property) or for sale (inventory). The intended use of the land is not simply the construction of a building, but the subsequent use of the land and building for one of these three purposes.

If the land is not capable of being used for its intended purpose while construction continues on the building then, applying [IAS 23:24](#), Entity A should consider the land and building together to assess when to cease capitalisation of borrowing costs on the land. In the circumstances described above, the land would not be ready for its intended use or sale until substantially all the activities necessary to prepare both the land and building for that intended use are complete.

3.4. Subsequent costs

Appropriate application of the recognition principle set out at 3.1 results in: [[IAS 40:18 & 19](#)]

- the immediate expensing of the costs of the day-to-day servicing of a property (e.g. the costs of labour, consumables and minor parts used for repairs and maintenance); and
- costs incurred to replace parts of the original property being recognised in the investment property if they meet the recognition criteria.

When the costs of replacement parts are capitalised, the carrying amounts of the replaced parts are derecognised.

[\[IAS 40:19\]](#)

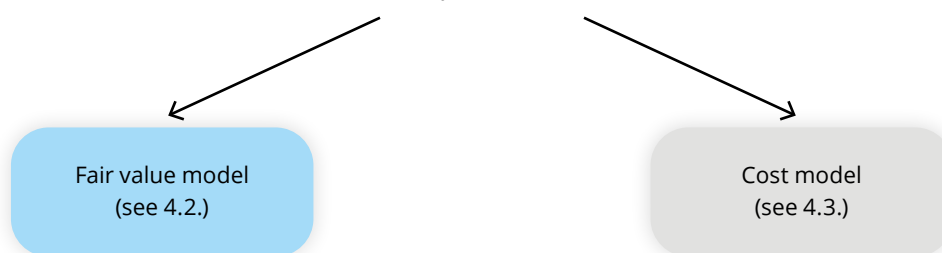
If the entity has been using the cost model (see 4.3.) to measure its investment property, but the replaced part was not being depreciated separately, and the carrying amount of the replaced part cannot be determined, the cost of the replacement may be used as an indication of what the cost of the replaced part would have been at acquisition. [\[IAS 40:68\]](#)

When the fair value model is being used (see 4.2.), the carrying amount of the investment property may already reflect the deterioration in value of the replaced part. In other cases it may be difficult to discern how much fair value should be reduced for the part being replaced. An alternative to reducing fair value for the replaced part, when it is not practical to do so, is to include the cost of the replacement in the carrying amount of the investment property, and then to reassess the fair value of the property (i.e. in the same way as would be required for additions not involving replacement). [\[IAS 40:68\]](#)



4. Measurement of investment property after acquisition or construction (valuation models)

For measurement after initial recognition of investment property i.e. after its acquisition or construction, IAS 40 allows an entity to choose between two valuation models:



Having decided on its policy, an entity should apply that model to all of its investment property. [[IAS 40:30](#)]

If an entity adopts the cost model, it must still measure the fair value of all of its investment property for disclosure purposes, except in exceptional circumstances when the fair value cannot be reliably measured (see 4.2.4.).

4.1.1. Right-of-use assets that meet the definition of investment property

If a lessee applies the fair value model in IAS 40 to its investment property, it is also required to apply that fair value model to right-of-use assets that meet the definition of investment property. [[IFRS 16:34](#)]

A lessee is required to account for right-of-use assets that meet the definition of investment property in a manner consistent with its policy for owned investment property – i.e. using either the

cost model and disclosing fair value, or using the fair value model. [[IFRS 16:BC178](#)]

4.1.2. Change in accounting policy for investment property

Once a policy has been adopted, any change will be considered a voluntary change in accounting policy which, under IAS 8, is permitted only if it will result in financial statements providing reliable and more relevant information. **IAS 40 notes that it is highly unlikely that a change from the fair value model to the cost**

model will result in a more relevant presentation.

[IAS 40:31]

4.2. Fair value model

4.2.1. Fair value model – general principles

After initial recognition, an entity that chooses the fair value model measures all of its investment property at fair value, except when the requirements of [IAS 40:53](#) apply (inability to determine fair value reliably – see 4.2.4.). [[IAS 40:33](#)]

Fair value is defined as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See IFRS 13 Fair Value Measurement.)”.

[IAS 40:5]

When measuring the fair value of investment property, an entity should ensure that the fair value reflects, among other things, rental income from current leases and other assumptions that market participants would use when pricing the investment property under current market conditions. [[IAS 40:40](#)]

When a lessee uses the fair value model to measure an investment property that is held as a right-of-use asset, it is required to measure the right-of-use asset (and not the underlying property) at fair value (see 4.2.7.). [[IAS 40:40A](#)]

Assets or liabilities recognizes elsewhere in the financial statements (e.g. prepaid or accrued operating lease income) should not be double-counted in determining the carrying amount of investment property under the fair value model. For example, if

the lifts and air-conditioning system in a property are considered an integral part of the building, they are generally included in the fair value of the investment property and are not recognized as separate assets. Similarly, if an office is leased on a furnished basis, and the rental income relates to the furnished office, the fair value of the office generally includes the fair value of the furniture, and the furniture is, therefore, not recognized as a separate asset.

[IAS 40:50]

The fair value of investment property held by a lessee as a right-of-use asset reflects expected cash flows, including variable lease payments that are expected to become payable. Accordingly, if a valuation obtained for a property is net of all payments expected to be made, any recognized lease liability must be added back to arrive at the carrying amount of the investment property using the fair value model. [[IAS 40:50\(d\)](#)]

Example of remeasurement of investment property: transaction costs incurred on acquisition

Entity A acquires an investment property (in an orderly transaction with a third-party market participant) immediately before the end of its reporting period for CU100 million. It incurs additional costs in the form of legal and other professional fees of CU2 million at the time of initial recognition, which are directly attributable to the acquisition of the property. These transaction costs are included in the initial measurement of the investment property in accordance with [IAS 40:21](#) (see 4.1). Therefore, the investment property is initially recognized at CU102 million.

Entity A measures its investment property using IAS 40's fair value model. At the end of the reporting period, the fair value of the investment property is unchanged from the price paid by Entity A of CU100 million.

Under IFRS 13, the fair value of the investment property should be measured at the reporting date at the amount that would be received at that date from the sale of the property in an orderly

transaction in Entity A's principal (or most advantageous) market. If the property were to be sold, costs might be incurred by Entity A (as the seller) or by the purchaser as part of the transaction. However, under [IFRS 13:25](#), any transaction costs that would be incurred by Entity A if the property were sold should not be deducted from the fair value of the property. Likewise, costs that would be incurred by a purchaser (e.g. those similar to the legal and other professional fees capitalised by Entity A) would not be received by Entity A on sale of the investment property. Consequently, these costs do not affect the investment property's fair value as defined by IFRS 13.

Accordingly, the property should be measured at the reporting date at CU100 million. The difference between this amount and the carrying amount of CU102 million should be recognized as a fair value adjustment in profit or loss in accordance with [IAS 40:35](#) (see 4.2.6).

This example demonstrates that when an investment property is acquired immediately before the end of a reporting period, such that its fair value is unlikely to change between the date of acquisition and the end of the accounting period, it is likely that a downward revaluation will be recognized in profit or loss that is equal and opposite to the capitalised acquisition costs, if any.

4.2.3. Use of independent valuers

Entities are encouraged (but not required) to use, as the basis for measuring fair value, a valuation by an independent valuer “who holds a recognised and relevant professional qualification and has recent experience in the location and category of the investment property being valued”.

[IAS 40:32]

[Paragraphs B55](#) and [B56](#) of the Basis for Conclusions on IAS 40 explain that it is for the preparers of financial statements to decide, in consultation with auditors, whether an entity has sufficient internal resources to determine reliable fair values.

4.2.4. Inability to measure fair value reliably

There is a rebuttable presumption that the fair value of an investment property can be measured reliably on a continuing basis. But in exceptional cases, when an investment property is first acquired (or when an existing property first becomes an investment property after a change of use), there may be clear evidence that the fair value of the property is not reliably measurable on a continuing basis. This arises when, and only when, the market for comparable properties is inactive (e.g. there are few recent transactions, price quotations are not current, or observed transaction prices indicate that the seller was forced to sell) and alternative reliable measurements of fair value (e.g. based on discounted cash flows) are not available. [\[IAS 40:53\]](#)

Note that the exception under [IAS 40:53](#) is available only when the investment property is first recognised as such. If an investment property has previously been measured at fair value, it should continue to be measured at fair value until disposal (or until it otherwise ceases to be an investment property, for example because it becomes owner-occupied). This is the case even if comparable market transactions become less frequent or market prices become less readily available. [\[IAS 40:55\]](#)

When, in the circumstances described above, it is not possible for an entity that uses the fair value model to measure the fair value of a particular property (other than an investment property under construction) reliably on initial recognition, that investment property is measured using the cost model under IAS 16 or IFRS 16. [\[IAS 40:53\]](#) In accounting for the property under IAS 16 or IFRS 16, the entity is required to assume that the residual value of the property is zero. The entity continues to apply IAS 16 or IFRS 16 until the disposal of the property. [\[IAS 40:53\]](#) Special rules apply for investment properties under construction – see 4.2.5.

When an entity is compelled, for the reasons set out in [IAS 40:53](#), to measure a particular investment property using the cost model under IAS 16 (see 4.3.) or IFRS 16, it continues to measure all of its other investment property at fair value. [\[IAS 40:54\]](#)

An economic downturn may increase the volatility of prices in real estate markets and restrict the level of comparator transactions against which to assess value. This may increase uncertainty around reported investment property fair value compared to 'normal' market conditions. For this reason, third-party valuers may include valuation uncertainty paragraphs in their reports in order to draw the reader's attention to the financial backdrop against which the valuations have been assessed. Generally, this type of uncertainty paragraph may not caveat the valuation opinion provided, but it may make reference to major upheaval in the financial sector, reduced liquidity in the market place and restricted availability of debt and similar factors, and may state that these factors have caused increased uncertainty in respect of current real estate prices. The rebuttable presumption in [IAS 40:53](#) that the fair value of an investment property can be determined reliably on a continuing basis does not apply to such situations.

4.2.5. Investment property in the course of construction

If an entity determines that the fair value of an investment property under construction is not reliably measurable but expects the fair value to be reliably measurable when construction is complete, the entity measures the investment property under construction at cost until the earlier of the fair value becoming reliably measurable or construction being completed. [\[IAS 40:53\]](#)

Once the entity is able to measure reliably the fair value of the investment property under construction, that property should be measured at fair value. Once construction is complete, it is presumed that fair value can be measured reliably.

4.2.6. Changes in fair value

Changes in the fair value of investment property are recognised in profit or loss in the period during which they arise. [\[IAS 40:35\]](#)

4.2.7. Fair value of investment property held under a lease

When a lessee uses the fair value model to measure an investment property that is held as a right-of-use asset, it is required to measure the right-of-use asset (rather than the underlying property) at fair value. [\[IAS 40:40A\]](#)

When lease payments are at market rates, the fair value of an investment property held by a lessee as a right-of-use asset at acquisition, net of all expected lease payments (including those relating to recognised lease liabilities), should be zero. Accordingly, remeasuring a right-of-use asset from cost in accordance with IFRS 16 to fair value in accordance with [IAS 40:33](#) (taking into account the requirements in [IAS 40:50](#) – see 4.2.1) should not give rise to any initial gain or loss, unless fair value is measured at different times. This could occur when an election to apply the fair value model is made after initial recognition. [\[IAS 40:41\]](#)

The requirements in [IAS 40:40A](#), [IAS 40:41](#) and [IAS 40:50\(d\)](#) are intended to specify that the fair value of a right-of-use asset to which the fair value model of IAS 40 is applied should be determined in the context of the lease contract from which the asset arises.

This means that when the fair value model is applied, the carrying amount of a right-of-use asset is the fair value of the lease contract grossed up by the amount of the recognized lease liability (measured applying IFRS 16). This can be measured as:

- the present value of the expected rentals that could be received from a third-party sub-lease of the property (at market rates, at the measurement date); less
- the present value of all rentals (fixed and all variable) expected to be paid under the head lease; plus

- the recognized head lease liability measured in accordance with [IFRS 16:26 to 28](#).

For example, consider a five-year lease contract which includes fixed annual payments of CU100 and expected annual variable payments based on usage of CU30. Ignoring the effect of discounting, the right-of-use asset and the lease liability recognised on the commencement date are both CU500 (i.e. the present value of the fixed lease payments). Assuming that at the commencement date the lease contract reflects market rate, on that date the carrying amount of the right-of-use asset applying the fair value model may be measured as:

- the presented value of the expected cash inflows of CU650; less

- the expected cash outflows of CU650; plus
- the recognised lease liability of CU500.

Hence, the carrying amount of the right-of-use asset under the fair value model is CU500 and is equal to the carrying amount of the right-of-use asset determined under IFRS 16 at the commencement date – i.e. consistent with [IAS 40:41](#), there is no initial gain or loss on remeasurement of the right-of-use asset from cost under IFRS 16 to fair value under IAS 40.

4.3. Cost model

[IAS 40:5](#) defines cost as

“the amount of cash or cash equivalents paid

or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognizes in accordance with the specific requirements of other IFRS's...”.

After initial recognition, an entity that chooses the cost model should measure investment property as follows: [\[IAS 40:56\]](#)

In accordance with IFRS 5 if it meets the criteria to be classified as held for sale (or is included in a disposal group that is classified as held for sale) (see 8.5.).

In accordance with IFRS 16 if it is held by a lessee as a right-of-use asset and is not held for sale in accordance with IFRS 5.

In all other cases, in accordance with the requirements in IAS 16 for the cost model (see 4.3.).

4.3.1. Cost model under IAS 16

When the cost model is selected, after recognition an item of investment property is carried at cost less any accumulated depreciation and any accumulated impairment losses. [\[IAS 16:30\]](#)

When the cost model is used, the cost of the asset normally remains unchanged until it is derecognised. The treatment of subsequent costs is considered at 3.4.

4.3.2. Depreciation

4.3.2.1. Requirement to depreciate items of investment property measured at cost model

If an item of investment property has a limited useful economic life (in general,

all items of investment property except for a land), then its cost is reduced to its estimated residual value by the systematic allocation of depreciation over the asset's useful economic life. [\[IAS 16:50\]](#)

The depreciation charge for investment property for each period should be recognised in profit or loss. [\[IAS 16:48\]](#)

Depreciation, as defined in [IAS 16:6](#), is the systematic allocation of the depreciable amount of an asset (i.e. the cost of

the asset less its residual value) over its useful life.

In order to comply with the requirements of IAS 16 relating to depreciation, it is necessary to identify:

- the parts (components) of each item of investment property measured under cost model that are to be depreciated separately (see 4.3.2.2.);
- the cost of each separately depreciable component (see 4.3.2.2.);
- the estimated residual value of each separately depreciable component (see 4.3.2.3.);

- the length of time during which each separately depreciable component will be commercially useful to the entity (see 4.3.2.4.); and
- the most appropriate depreciation method for each separately depreciable component.

4.3.2.2. Each significant component to be depreciated separately

In accordance with IAS 16 each part of an investment property measured using a cost model with a cost that is significant in relation to the total cost of the item should be depreciated separately. [IAS 16:43]

When an investment property is first recognised, the Standard requires that the entity should allocate the amount initially recognised between the item's significant parts (i.e. those separately identifiable components of the item with a cost that is significant to the total cost of the item). Each significant part is required to be depreciated separately. [IAS 16:44]

Once the individually significant parts have been identified, the remaining parts that are not individually significant are grouped together. Although the entity may have varying expectations as to the useful lives and pattern of consumption of the benefits of these remaining components, because they are not individually significant, IAS 16 allows that they can be depreciated as a group, provided that the depreciation rate and method selected result in a faithful representation of the pattern of consumption of benefits. [IAS 16:46]

IAS 16 gives a further example of circumstances in which cost may need to be allocated to significant parts of an asset. If an entity acquires a property subject to an operating lease in which it is the lessor, it may be appropriate to depreciate separately amounts reflected in the cost of the item that are attributable to favourable or unfavourable lease terms relative to market terms (see 4.4.2.2.1.). [IAS 16:44]

4.3.2.2.1. Component accounting for in-place leases

[IAS 16:44]

If an entity acquires an investment

property with operating leases already in place, the amount paid for the property will reflect the effect of those in-place leases (above and below market rentals, direct costs associated with obtaining new tenants etc.). IAS 16:44 states that, in the circumstances described, "it may be appropriate to depreciate separately amounts reflected in the cost [of the property] that are attributable to favourable or unfavourable lease terms relative to market terms". If, for example, an entity determines, through the exercise of judgement, that the components of cost attributable to favourable or unfavourable lease terms are significant, those components should be depreciated separately. This will result in a higher (if the lease terms are favourable) or lower (if they are unfavourable) total depreciation charge over the period for which the in-place lease terms apply (see below for a numerical example).

However, IAS 16 is silent with respect to other amounts related to the value of in-place leases that may be reflected in the cost of the property. Therefore, whether an entity recognises such amounts as separate components for depreciation purposes is an accounting policy choice to be applied consistently for all similar transactions.

4.3.2.2.2. Example of component accounting for in-place leases

For example, Entity A acquires a building for CU200,000. The building has an existing tenant with a remaining lease term of five years. The rentals from that in-place lease

are unfavourable when compared with the current market. If Entity A had been able to secure vacant possession, it would have been willing to pay CU240,000 for the building.

Entity A applies the cost model for investment property under IAS 40 (i.e. Entity A measures the property in accordance with IAS 16's cost model). The remaining useful life of the building is estimated to be 20 years, with nil estimated residual value.

Entity A should identify two separate components reflected in the price paid for the building – a 'gross cost' of CU240,000 offset by the component attributable to the unfavourable lease of CU40,000 (which is determined to be significant in relation to the total cost). The former is depreciated over 20 years, the latter over five years. The annual depreciation charges recognised over the life of the building are therefore as follows.

In this example, the component approach results in a lower total depreciation charge over the period for which the in-place lease terms apply.

	Year 1-5	Year 6-20
Depreciation on 'gross cost'	12,000	12,000
Depreciation on unfavourable lease component	(8,000)	-
Net charge	4,000	12,000

Assuming no change to the building's useful life or residual value.

4.3.2.3. Residual value

IAS 16 defines residual value as the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

[IAS 16:6]

The definition focuses on the amount that could currently be obtained on disposal of the asset, rather than the amount that is

expected to be obtained at the end of the asset's useful life.

In practice, the residual value of an asset is often insignificant and, therefore, is immaterial in the calculation of the depreciable amount. However, when the residual value is significant, then it will directly affect the depreciation recognised over the life of the asset.

The residual value of an asset is required to be reviewed at least at each financial year end. [IAS 16:51] If the revised estimate differs significantly from previous estimates of residual value, the effect is accounted for prospectively as a change in estimate, in accordance with the requirements of IAS 8. [IAS 16:51]

If the revised estimate of residual value is equal to or greater than the asset's carrying amount, whether due to inflation or otherwise, then the asset's depreciation

charge is zero unless and until its residual value subsequently decreases to an amount below the asset's carrying amount.

[IAS 16:54]

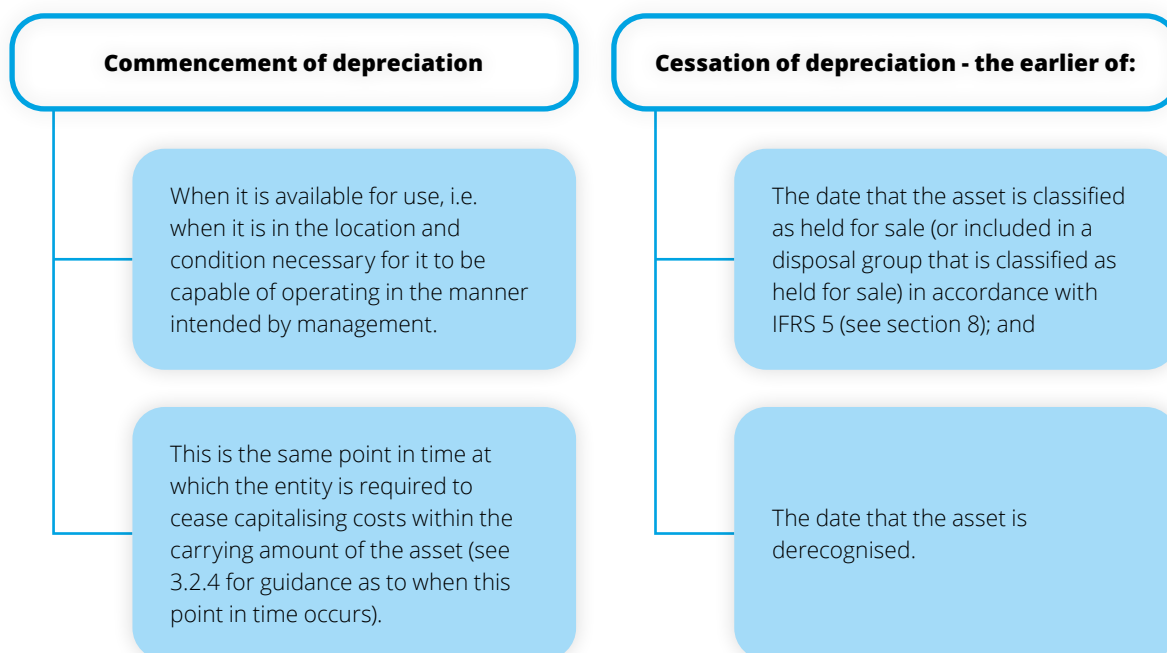
4.3.2.4. Definition of useful life

In the context of investment property, 'useful life' would mean the period over which an asset is expected to be available for use by an entity.

[IAS 16:6]

4.3.2.5. Period of depreciation

IAS 16 provides specific guidelines for the commencement and cessation of depreciation:



Therefore, depreciation of an asset does not cease when an asset becomes idle or is retired from active use unless the asset is fully depreciated. This may however trigger the recognition of an impairment loss which will result in the reduction of the carrying amount of the asset to its estimated recoverable amount.

4.3.2.6. Change in estimate of useful life

IAS 16 requires that the estimate of the useful life of an investment property measured under cost model should be reviewed at least at the end of each financial year. If expectations differ from previous estimates, the change is

accounted for as a change in accounting estimate in accordance with IAS 8.

[IAS 16:51]

A significant reduction in the estimated useful life of an asset may indicate that the asset has been impaired because the amount that the entity expects to generate

from the use of the asset may have been reduced below its carrying amount (see [IAS 36:12\(f\)](#)). In such circumstances, a detailed impairment test should be performed and, if necessary, an impairment loss recognised to reduce the carrying amount of the asset to its recoverable amount. The recoverable amount is then depreciated over the revised estimate of the useful life of the asset.

4.3.2.7. Depreciation of freehold land and freehold buildings

Freehold land held as investment property does not have a limited useful life and, therefore, should not be depreciated.

If freehold land is purchased together with freehold buildings, it is necessary to allocate the purchase consideration between the value of the land and that of the buildings. It is because buildings have limited useful economic lives and are no different from other depreciable assets. IAS 16 emphasises that an increase in the value of the land on which a building stands does not affect the determination of the useful life of the building. [[IAS 16:58](#)]

4.3.3. Impairment: general requirements for the identification of an impairment loss

An entity should refer to the requirements of IAS 36 to determine whether an item of investment property measured at cost model is impaired. IAS 36 explains how an entity reviews the carrying amount of its assets, how it determines the recoverable amount of an asset, and when it recognises or reverses an impairment loss. [[IAS 16:63](#)]

4.4. Example disclosures for investment properties measured at fair value model – IAS 40 and IFRS 13

Below are presented example disclosures required for investment properties measured at fair value model by the provisions of IAS 40.75, IAS 40.76 and IFRS 13.93.

IAS 40.75(a)

Note 1: Investment property – accounting policy adopted

Investment properties are properties held to earn rentals and/or for capital appreciation (including property under construction for such purposes). Investment properties are measured initially at cost, including transaction costs. Subsequent to initial recognition, investment properties are measured at fair value. All of the Group's property interests held under operating leases to earn rentals or for capital appreciation purposes are accounted for as investment properties and are measured using the fair value model. Gains and losses arising from changes in the fair value of investment properties are included in profit or loss in the period in which they arise in the line other gain and losses.

An investment property is derecognised upon disposal or when the investment property is permanently withdrawn from use and no future economic benefits are expected from the disposal. Any gain or loss arising on derecognition of the property (calculated as the difference between the net disposal proceeds and the carrying amount of the asset) is included in profit or loss in the period in which the property is derecognised.

IFRS 13.93(g),
IFRS 13.IE65

Note 2: Fair value measurements and valuation processes

Some of the Group's assets and liabilities are measured at fair value for financial reporting purposes. The board of directors of the Company has set up a valuation committee, which is headed up by the Chief Financial Officer, to determine the appropriate valuation techniques and inputs for fair value measurements.

In estimating the fair value of an asset or a liability, the Group uses market-observable data to the extent it is available. Where Level 1 inputs are not available, the Group engages third-party qualified valuers to perform the valuation. The valuation committee works closely with the qualified external valuers to establish the appropriate valuation techniques and inputs to the model. The Chief Financial Officer reports the valuation committee's findings to the board of directors every quarter to explain the cause of fluctuations in the fair value of the assets and liabilities.

Information about the valuation techniques and inputs used in determining the fair value of various assets and liabilities are disclosed in the note 3 (investment properties) and note Y (financial instruments).

IAS 40.76,
IAS 40.75(f),
IAS 40.75(h)

Note 3: Investment property

	31/12/21	31/12/20
	CU'000	CU'000
Fair value		
Completed investment properties	4,968	4,941
	Year ended 31/12/21	Year ended 31/12/20
	CU'000	CU'000
Balance at the beginning of year	4,941	4,500
Additions	10	202
Acquisitions through business combinations		-
Other acquisitions[describe]		
Disposals	-	(58)
Transferred from property, plant and equipment	-	-
Other transfers	-	-
property reclassified as held for sale	-	-
Gain/(loss) on property revaluation	30	297
Effect of foreign currency exchange differences	(13)	-
Other changes	-	-
Balance at the end of year	4,968	4,941
Unrealised gain on property revaluation included in profit or loss (included in other gains and losses) (see note X)	30	297

All of the Group's investment property is held under freehold interests.

The Group did not have any investment properties in a course of construction on 31 December 2021 or 31 December 2020.

The Group has pledged all of its investment property to secure general banking facilities granted to the Group.

The property rental income earned by the Group from its investment property, all of which is leased out under operating leases, amounted to CU 12.3 million (2020: CU 11.8 million). Direct operating expenses arising on the investment property, all of which generated rental income in the year, amounted to CU 8.2 million (2020: CU 7.9 million).

The Group has entered into a contract for the maintenance of its investment property for the next five years, which will give rise to an annual charge of CU 0.3 million.

IAS 40.75(e)
IFRS 13.91(a),
93(d),
IFRS 13.93(a),(b)

Note 3.1 Fair value measurement of the Group's investment properties

The fair value of the Group's investment property as at 31 December 2021 and 31 December 2020 has been arrived at on the basis of a valuation carried out on the respective dates by Messrs R & P Trent, independent valuers not related to the Group. Messrs R & P Trent are members of the Institute of Valuers of A Land, and they have appropriate qualifications and recent experience in the valuation of properties in the relevant locations. The fair value was determined based on the market comparable approach that reflects recent transaction prices for similar properties and capitalisation of net income method, where the market rentals of all lettable units of the properties are assessed by reference to the rentals achieved in the lettable units as well as other lettings of similar properties in the neighbourhood. The capitalisation rate adopted is made by reference to the yield rates observed by the valuers for similar properties in the locality and adjusted based on the valuers' knowledge of the factors specific to the respective properties.

There has been no change to the valuation technique during the year.

In estimating the fair value of the properties, the highest and best use of the properties is their current use.

	Level 2	Level 3	Fair value as at 31/12/21
	CU'000	CU'000	CU'000
Commercial units located in A Land – BB City	-	1,020	1,020
Office units located in A Land – CC City	-	1,984	1,984
Residential units located in A Land – DD City	1,964	-	1,964
Total			4,968

	Level 2	Level 3	Fair value as at 31/12/20
	CU'000	CU'000	CU'000
Commercial units located in A Land – BB City	-	1,123	1,123
Office units located in A Land – CC City	-	1,964	202
Residential units located in A Land – DD City	1,854	-	1,854
Total			4,941

For the residential units located in DD City, A Land, the fair value was derived using the market-comparable approach based on recent market prices without any significant adjustments being made to the market observable data.

For investment properties categorised into Level 3 of the fair value hierarchy, the following information is relevant:

IFRS 13.93(d), IFRS 13.93(h)(i), IFRS 13.93(c), IFRS 13.93(e)(iv)	Valuation technique(s)	Signific unobservable input(s)	Sensitivity
Office units located in A Land – CC City	Income Capitalisation Approach	Capitalisation rate, taking into account the capitalisation of rental income potential, nature of the property, and prevailing market condition, of x% - x% (2020: x% - x%).	A slight increase in the capitalisation rate used would result in a significant decrease in fair value, and vice versa.
		Monthly market rent, taking into account the differences in location, and individual factors, such as frontage and size, between the comparables and the property, at an average of CU[X] (2020: CU[X]) per sqm per month.	A significant increase in the market rent used would result in a significant increase in fair value, and vice versa.
Commercial units located in A Land – BB City Residential units located in A Land – DD City	Income Capitalisation Approach	Capitalisation rate, taking into account the capitalisation of rental income potential, nature of the property, and prevailing market condition, of x% - x% (2020: x% - x%).	A slight increase in the capitalisation rate used would result in a significant decrease in fair value, and vice versa.
		Monthly market rent, taking into account the differences in location, and individual factors, such as frontage and size, between the comparables and the property, at an average of CU[X] (2020: CU[X]) per sqm per month.	A significant increase in the market rent used would result in a significant increase in fair value, and vice versa.

There were no transfers between Levels 1 and 2 during the year. There were no transfers into or out of Level 3 during the year.

COMMENTARY:IFRS 13.97
IFRS 13.95**Fair value hierarchy**

The categorisation of fair value measurements into the different levels of the fair value hierarchy depends on the degree to which the inputs to the fair value measurements are observable and the significance of the inputs to the fair value measurement. It is additionally worth noting the following points:

- The classification into the three-level hierarchy is not an accounting policy choice. For land and buildings, given their unique nature, it is extremely rare that the fair value measurement would be identified as a Level 1 measurement. Whether the fair value measurement in its entirety should be classified into Level 2 or Level 3 would depend on the extent to which the inputs and assumptions used in arriving at the fair value are observable. In many situations where valuation techniques (with significant unobservable inputs) are used in estimating the fair value of the real estate properties, the fair value measurement as a whole would be classified as Level 3.
- The level within which the fair value measurement is categorised bears no relation to the quality of the valuation. For example, the fact that a real estate property is classified as a Level 3 fair value measurement does not mean that the property valuation is not reliable – it merely indicates that significant unobservable inputs have been used and significant judgement was required in arriving at the fair value.

Fair value disclosures for investment properties measured using the cost model

For investment properties that are measured using the cost model, IAS 40.79(e) requires the fair value of the properties to be disclosed in the notes to the financial statements. In such a case, the fair value of the properties (for disclosure purpose) should be measured in accordance with IFRS 13. In addition, IFRS 13.97 requires the following disclosures:

- The level in which fair value measurement is categorised (i.e. Level 1, 2 or 3).
- When the fair value measurement is categorised within Level 2 or Level 3, a description of the valuation technique(s) and the inputs used in the fair value measurement.
- The highest and best use of the properties (if different from their current use) and the reasons why the properties are being used in a manner that is different from their highest and best use.

Transfers between the different levels of the fair value hierarchy

Where there had been a transfer between the different levels of the fair value hierarchy, the Group should disclose the reasons for the transfer and the Group's policy for determining when transfers between levels are deemed to have occurred (for example, at the beginning or end of the reporting period or at the date of the event that caused the transfer).

5. Lease income

5.1. Recognition of lease income – general

Lease payments from operating leases should be recognised as income on a straight-line basis unless another systematic basis is more representative of the pattern in which benefit from the use of the underlying asset is diminished.

[IFRS 16:81]

5.1.1. Operating lease – variable lease payments

IFRS 16:8 requires lease payments under an operating lease to be recognised as income on a straight-line basis over the lease term, unless another systematic basis is more representative of the pattern in which benefit from the use of the underlying asset is diminished. The question arises as to whether variable lease payments in an operating lease should be estimated at the inception date and recognised on a straight-line basis over the lease term.

IFRS 16:70 specifies that, for finance leases, the lease payments included in the measurement of the net investment in a lease at commencement date include variable lease payments that depend on an index or a rate. Other variable payments (e.g. those linked to future performance or use of an underlying asset) are excluded from the measurement of the net investment and are instead recognised as income when they arise. The treatment adopted for variable lease payments under operating leases should be consistent with these requirements.

Therefore, variable lease payments under operating leases, including increases or decreases to lease payments as a result of changes in an index or a rate after the commencement date, should not be estimated and included in the total lease payments to be recognised on a straight-line basis over the lease term. Instead, they should be recognised in profit or loss in the period in which they are earned.

In July 2006, in the context of IAS 17, the IFRIC (now the IFRS Interpretations Committee) considered whether an estimate of contingent rents payable (receivable) under an operating lease should be included in the total lease payments (lease income) to be recognised on a straight-line basis over the lease term. The IFRIC noted that, although the Standard is unclear on this issue, this has not, in general, led to contingent rents being included in the amount to be recognised on a straight-line basis over the lease term. Accordingly, the IFRIC decided not to add this issue to its agenda. This conclusion is equally valid under IFRS 16.

5.1.2. Operating lease – lease payments increased by fixed annual percentage

IFRS 16:81

Some contracts provide for annual payments in an operating lease to increase by a fixed annual percentage over the life of the lease. It is sometimes suggested that, if such increases are intended to compensate for expected annual inflation over the lease

period, it may be acceptable to recognise the increases in each accounting period as they arise.

However, such a treatment would not be appropriate. The lease payments should be recognised on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

This was confirmed by the IFRIC (now the IFRS Interpretations Committee) in the November 2005 IFRIC Update in the context of IAS 17. This conclusion is equally valid under IFRS 16.

5.1.3. Changes in operating lease payments

5.1.3.1. Accounting for changes in operating lease payments that are not a lease modification

[IFRS 16:81](#)

The following circumstances do not result in a lease modification:

- a change in consideration for an operating lease as a result of the

application of the original terms and conditions of the lease;

- a deferral of payments that is accompanied by a proportional increase in lease payments in later periods, such that the overall effect is that the consideration in the operating lease is unchanged.

When there is a change in the consideration for a lease that is not a lease modification, the [Educational material on the application of IFRS 16 Leases](#) published by the IFRS Foundation on 10 April 2020 indicates that such a change generally results in recognition of a variable lease payment. Accordingly, in the case of a reduction in the consideration for an operating lease that is not a lease modification, the lessor recognises the effect of the reduction in the period when it is earned (see 5.1.1. for a discussion on timing of recognition).

5.1.3.2. Example of accounting for changes in operating lease payments that are not a lease modification

For example, Entity A is the lessor of an

operating lease which, at the beginning of 20X3, has a remaining lease term of five years with annual lease payments of CU100,000 due at the end of each year. The original terms and conditions of the lease specify that the lessee will be released from its obligation to pay rent for a specified year if an earthquake greater than a specified magnitude occurs in the area where the leased asset is located and results in the leased asset not being available for use. Such earthquakes do occur in the area, but infrequently and unpredictably. Accordingly, the lease includes negative variable lease payments to be recognised in the period earned. At the beginning of 20X3, an earthquake occurs which triggers the clause such that the lease payment for 20X3 is waived. This concession does not constitute a lease modification because the change in consideration is part of the original terms and conditions of the lease. Instead, the change in lease payments is accounted for as a variable lease payment.

Year	Original annual rent payments	Revised annual rent payments	Operating lease income (original)	Operating lease income (revised)
	CU	CU	CU	CU
20X3	100,000	-	100,000	-
20X4	100,000	100,000	100,000	100,000
20X5	100,000	100,000	100,000	100,000
20X6	100,000	100,000	100,000	100,000
20X7	100,000	100,000	100,000	100,000
Total	500,000	400,000	500,000	400,000

Because there is a change in the consideration for the lease which is not a lease modification, the reduction in lease payments in 20X3 is accounted for as a negative variable lease income in 20X3, i.e. in the period it is earned. Accordingly in 20X3, operating lease income is reduced from CU100,000 to CUnil.

5.1.3.3. Example of accounting for changes in timing of operating lease payments

[IFRS 16:81](#)

Entity B is the lessor of an operating lease which, at the beginning of 20X3, has a remaining lease term of five years with annual lease payments of CU100,000 due

at the end of each year. At the beginning of 20X3, Entity B grants a rent concession to its lessee whereby the lease payments for 20X3 to 20X5 are partially reallocated to 20X6 and 20X7 as illustrated in the table below.

Year	Original annual rent payments	Revised annual rent payments	Operating lease income (original)	Operating lease income (revised)
	CU	CU	CU	CU
20X3	100,000	30,000	100,000	100,000
20X4	100,000	50,000	100,000	100,000
20X5	100,000	90,000	100,000	100,000
20X6	100,000	130,000	100,000	100,000
20X7	100,000	200,000	100,000	100,000
Total	500,000	500,000	500,000	500,000

If the rent concession is granted because of an existing clause in the lease (i.e. the rent concession is not a modification to the lease), the operating lease income in each year from 20X3 to 20X7 continues to be CU100,000. This is because the effect of the time value of money is not taken into account in determining operating lease income, and [IFRS 16:81](#) requires lease income to be recognised on a straight-line basis.

Note that in this case, the accounting outcome is the same if the change in lease payments is a lease modification rather than the result of a contractual clause in the contract. This is because the application of [IFRS 16:87](#) (which addresses modifications of operating leases) requires the revised lease payments to be recognised over the lease term. As a result, operating lease income of CU100,000 per year for each of the five remaining years of

the lease term would also be recognised if the rent concession represents a lease modification.

5.1.3.4. Example of accounting for deferrals of operating lease payments with a time-value-of-money payment increase

[IFRS 16:81](#)

Lessor C is a lessor in an operating lease arrangement which ends on 31 December 20X2, under which Lessee D is required to pay rent of CU100 per month at the beginning of each month.

On 30 May 20X1, Lessor C grants Lessee D a rent concession (not part of the original terms and conditions of the lease), such that rent of CU100 for June 20X1 is deferred and is receivable in its entirety in December 20X2 in addition to the rent of CU100 per month receivable in respect of December 20X2.

As part of the rent concession, Lessor C adds a fixed amount of CU5 which is also payable in December 20X2. This amount can be considered as reasonable compensation for the deferral of payment, based on the credit risk of Lessee D at the time the rent concession is offered.

Therefore, in December 20X2, the amount receivable will be:

	CU
Deferred rent	100
Additional fixed amount	5
Rent for the fixed month	100
Total	205

As indicated at 5.1.3.1, a deferral of operating lease payments that is accompanied by a proportional increase in lease payments in later periods, such that the overall effect is that the consideration in the operating lease is unchanged, does not result in a lease modification as defined in IFRS 16. IFRS 16 does not address how to recognise the additional amount due as part of a lease concession that is neither a lease modification nor a consequence of the original terms and conditions of the lease contract. Accordingly, Lessor C establishes an appropriate accounting policy to account for this additional amount.

One acceptable approach is to account for it as interest paid in compensation for the deferral of the rent (i.e. as compensation for financing), recognised separately from the lease payment for the use of the asset. Following this approach, in this example, the difference of CU5 between the nominal value of the deferred rent payment due in December 20X2 (CU105) and the original amount which was payable in June 20X1 (CU100) is not recognised as additional operating lease income, but as interest income for the period over which the financing is provided. Lessor C should therefore recognise operating lease income of CU100 in June 20X1 and a corresponding receivable of CU100 which is accreted using the effective interest method to CU105 by December 20X2 giving rise to interest income over this period.

Another acceptable approach is to view the additional amount as an implied variable amount which becomes fixed when the concession is granted. Following this approach, in this example, Lessor C should recognise the total revised lease payments of CU1,905 ($CU100 \times 19 \text{ months} + CU5$) on a straight line basis, or another systematic basis, over the remaining lease term (19 months from 1 June 20X1 to 31 December 20X2).

Other approaches may also be acceptable.

5.2. Costs incurred in earning lease income

Costs incurred in earning the lease income,

including depreciation, are recognised as an expense. [IFRS 16:82]

5.3. COVID 19-related rent concessions

5.3.1. Background

Since the onset of the COVID-19 pandemic, the number of rent concessions granted has increased significantly. There is currently diversity in the methods used to account for rent concessions affecting operating leases on the lessor's side.

Some lessors treat this forgiveness as a lease modification and therefore apply paragraph 87 of IFRS 16, which requires accounting for modification as a new lease from the effective date of the modification. This treatment leads to an effective allocation of the loss resulting from the rent concession over the remainder of the lease term.

Other lessors, however, apply instead the derecognition requirements of IFRS 9 to their lease receivables in these circumstances, resulting in the recognition of an immediate loss equal to the receivable's carrying amount in the period when the concession is granted. Both methods are discussed in more detail at 5.3.2. and 5.3.3.

5.3.2. Treatment as lease modification under IFRS 16

In accordance with paragraph 87 of IFRS 16, the contract modification shall be accounted for as a new lease from the effective date of the modification.

Considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease, the granted concession is spread over the remaining term of the contract, reducing future lease payments.

Applying paragraph 81 of IFRS 16, lease payments from operating leases shall be recognised as income on a straight-line basis (except if another basis is more representative). This generally represents the pattern in which benefit from the use of the underlying asset is diminished. Therefore, the effect of a rent concession

will be spread over the remaining lease term, reducing future lease income.

Applying this method is supported by definition of a lease modification in IFRS 16.

Appendix A of IFRS 16 defines a lease modification as a change in the scope of a lease or the consideration for a lease, that was not part of the original terms and conditions of the lease.

A decision to forego past lease payments (not required by law or foreseen in the contract) meets this definition.

5.3.3. Derecognition of the operating lease receivable according to IFRS 9

Regarding lessors' lease receivables, paragraph 3.2.3 of IFRS 9 requires derecognition of a financial asset when the contractual rights to the cash flows from this financial asset expire. According to paragraph 3.2.12 of IFRS 9, on derecognition of a financial asset, the difference between the carrying amount (measured at the date of derecognition) and the consideration received shall be recognised in profit or loss.

Under this accounting treatment, the concession would be recognised as a loss in the income statement, with a corresponding reduction to the lease receivable in the period during which the reduction is contractually agreed. The lessor will continue to recognise the unchanged amount of lease income over the lease term.

This method is supported by the fact that, while in accordance with paragraph 2.1(b) of IFRS 9 rights and obligations under leases to which IFRS 16 applies are in general excluded from the application scope of IFRS 9, subsection (i) of this paragraph states that operating lease receivables are subject to derecognition

and impairment requirements of IFRS 9.

In addition, the IASB's educational guidance "IFRS 16 and COVID-19", released on 10 April 2020, includes a section highlighting the application of the requirements of IFRS 9 as follows:

"If a change in lease payments results in the extinguishment of a part of a lessee's obligation specified in the contract (for example, a lessee is legally released from its obligation to make specifically identified payments), the lessee would consider whether the requirements for derecognition of a part of the lease liability are met applying paragraph

3.3.1 of IFRS 9 Financial Instruments."



6. Lease incentives

6.1. Lease incentives - general

Lease incentives are defined as "payments made by a lessor to a lessee associated with a lease, or the reimbursement or assumption by a lessor of costs of a lessee".

[\[IFRS 16:Appendix A\]](#)

Such incentives may take the form, for example, of an up-front cash payment to the lessee or a reimbursement or assumption by the lessor of costs of the lessee (e.g. relocation costs and costs associated with a pre-existing lease commitment of the lessee).

Such payments are offset against lease payments made by the lessee to

the lessor. When any incentives are paid to the lessee, even if they are not part of the formal lease agreement, they should be offset against lease payments.

Another form of lease incentives directly impacting cash flows from rent are rent concessions and rent-free periods.

6.2. Reimbursement linked to leasehold improvements

A lessor may agree to make payments to a lessee linked to work or improvements to the leased asset that are organised and paid for by the lessee. These payments should be accounted for as lease incentives if they meet the definition in IFRS 16, i.e. they are "the reimbursement or assumption by a lessor of costs of a lessee". If it is determined that the reimbursement is a payment for work carried out for the benefit of the lessor, such payment does not meet the definition of lease incentive and is accounted for applying other applicable Standards.

Since IFRS 16 provides no further guidance on what constitutes "the reimbursement or assumption by a lessor of costs of a lessee", judgement should be exercised to evaluate the nature of the leasehold improvements in respect of whether they represent an asset of the lessee or the lessor. For example, the reimbursement of an expenditure that does not relate solely to the lessee's use of the property but enhances the value of the property generally, and for which the lessor will receive benefit beyond the term of the lease, is not a lease incentive. Instead, that reimbursement is a cost incurred by the lessee on behalf of the lessor. In such cases, both the expenditure and the reimbursement should be accounted for under the Standard(s) applicable to the transaction.

6.3. Example of rent-free period

Company T, an owner of a shopping gallery, signed lease agreement with tenant Y, offering the following conditions:

Monthly rent	CU 400
Lease commencement	1 July 20X1
Lease end	30 June 20X6
Rent-free period	1 July 20X1 - 30 September 20X1

The total rent due during the lease duration amounts to CU 22,800 (CU 400 x 57 months), giving the effective monthly rent of CU 380 (CU 22,800/60 months).

Year	Annual rent payments	Operating lease income (straight-lined)	Cumulative difference
	CU	CU	CU
20X1	1,200	2,280	(1,080)
20X2	4,800	4,560	(840)
20X3	4,800	4,560	(600)
20X4	4,800	4,560	(360)
20X5	4,800	4,560	(120)
20X6	2,400	2,280	-
Total	22,800	22,800	-

At the end of each year, Company T will recognise lease incentive asset in the amount shown in the 'Cumulative difference' column.

Example of cost of relocation

Company X signed a lease agreement to rent office space to Company G. The duration of the lease is 10 years from 1 January 20X0. Company X agreed to cover relocation costs of CU 1,200 for Company G. The monthly rent rate is CU 200. The effective monthly rent rate after deduction of relocation cost amounts to CU 190. The relocation costs covered by Company X should be accounted for as a lease-incentive asset in the balance sheet when incurred. Starting from the lease commencement date, CU 120 should be debited to lease income each year.

7. Initial direct costs incurred in obtaining an operating lease

7.1. Initial direct costs – definition

Initial direct costs are defined as the "incremental costs of obtaining a lease that would not have been incurred if the lease had not been obtained, except for such costs incurred by a manufacturer or dealer lessor in connection with a finance lease".

[\[IFRS 16:Appendix A\]](#)

In the context of identifying initial direct costs, the key question is whether the costs under consideration would have been incurred irrespective of whether the lease was obtained. If the answer is 'yes', then the costs are not initial direct costs.

Therefore, for example, the salaries of permanent staff employed to negotiate and arrange new leases are not initial direct costs, because these will be incurred irrespective of whether or not the lease is obtained. In contrast, 'signing commissions' paid to employees when a specific lease is finalised, or commissions for signed lease contracts paid to agents who introduced the lessee, will qualify as initial direct costs and should be included in the initial measurement of the net investment in the lease.

Other costs frequently identified as initial direct costs are legal and other professional fees associated with the arrangement and negotiation of a lease, although these should be carefully scrutinised to ensure that they are genuinely incremental (i.e. that they do not include, for example, any 'retainer' element or fees of a more general nature).

7.2. Initial direct costs – accounting principles

Generally, according to IFRS 16.83, a lessor shall add initial direct costs incurred in obtaining an operating lease to the carrying amount of the underlying asset and recognise those costs as an expense ("amortize") over the lease term on the same basis as the lease income. In our view, such approach is appropriate if cost method is used for investment property. When the fair value model is used, the costs should be also capitalised but instead of amortization they will result in a smaller revaluation gain (or larger revaluation loss) when investment property is next remeasured to fair value.

Example of expenditure to be capitalised as part of the cost of an investment property

[IAS 40:20](#)

Entity R acquires a building for CU95 million in March 20X1 as an investment property. In June 20X1, Entity R entirely refurbishes the building at a cost of CU5

million to bring it to the condition required by the rental market. Entity R will pay an estate agent two months' rent if the agent finds a lessee. In December 20X1, Entity R (the lessor) finally rents the property under an operating lease to Entity S (the lessee).

When it buys the building, Entity R should recognise the purchase price as the initial cost of the building under IAS 40. The refurbishment costs are necessary to bring the property to a condition suitable for renting out and these costs should therefore also be included in the initial cost of the building.

The estate agent's fees are not part of the initial cost of the building but they are considered to be "initial direct costs incurred in negotiating and arranging an operating lease" under IFRS 16. They are, therefore, capitalised as part of the leased building. When the cost model is used, the expenditure should be depreciated over the lease term. When the fair value model is used, the costs should be capitalised and will therefore result in a smaller revaluation gain (or larger revaluation loss) when the building is next remeasured to fair value.



8. Accounting for disposals

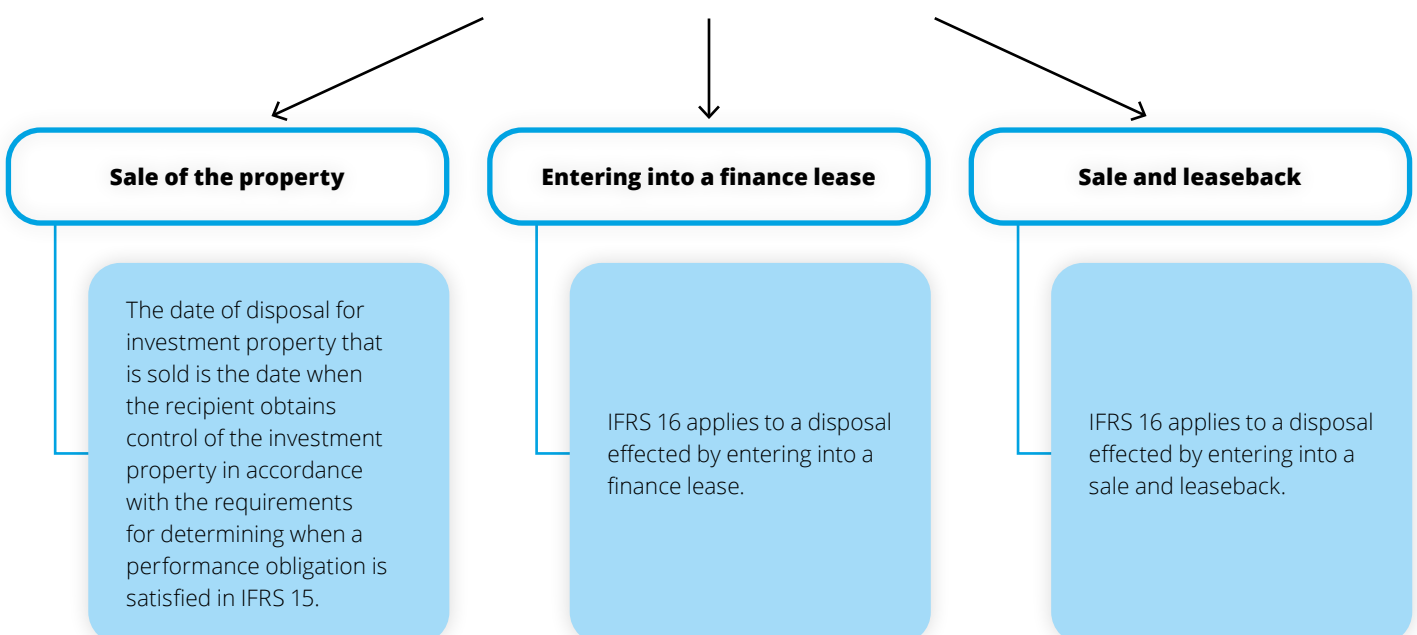
8.1. Disposals

An investment property is derecognised (i.e. removed from the statement of

financial position) on disposal or when it is permanently withdrawn from use and no future economic benefits are expected

from its disposal. [[IAS 40:66](#)]

The disposal of an investment property may occur through:



The gain or loss on the retirement or disposal of an investment property is calculated as the difference between the net disposal proceeds and the carrying amount of the property and is recognised in profit or loss in the period of the retirement or disposal. This is subject to the requirements of IFRS 16 in the case of a sale and leaseback transaction. [IAS 40:69]

The amount of consideration to be included in the gain or loss arising from derecognition of an investment property is determined in accordance with requirements for determining the transaction price in IFRS 15:47 to 72. Subsequent changes to the estimated amount of the consideration included in the gain or loss should be accounted for in accordance with the requirements for changes in the transaction price in IFRS 15. [IAS 40:70]

When any liabilities are retained relating to the property after its disposal, IAS 37 or other relevant Standards are applied to those liabilities. [IAS 40:71]

8.1.1. Rental guarantees

To encourage potential buyers, real estate sellers often offer rental guarantees when negotiating the terms of transactions. Typically, the seller underwrites a certain level of building occupancy for a certain period of time. If it turns out that the new owner will not be able to find tenants for the property, the previous owner undertakes to cover the relevant rent and/or service charge costs. Another common approach is to put in place a guarantee assuring the level of rents, against which the seller undertakes to provide compensation for rent concessions and rent-free periods given to tenants.

In our view, such guarantees should be treated as a variable consideration in a sale transaction and accounted for accordingly in line with the requirements of IFRS 15:50 to 54.

Example of rental guarantees

Company G decides to dispose of an office building to Company B. The parties agree

that the transaction price will be CU 1 million. The carrying value of the asset at the disposal date was CU 680 thousand. The seller provides the buyer with a three-year rental guarantee assuring 95% occupancy level and offering compensation for any lease incentives that need to be incurred to attract new tenants. At the transaction date, the seller estimates that as a result of the guarantee, it will have to pay CU 100 thousand to the buyer within three years of completing the transaction and this payment is highly probable. The amount of CU 100 represents variable consideration. When carrying out the transaction, the buyer paid full transaction price of CU 1 million to the seller.

Putting the discounting to one side, the transaction should be accounted for as follows:

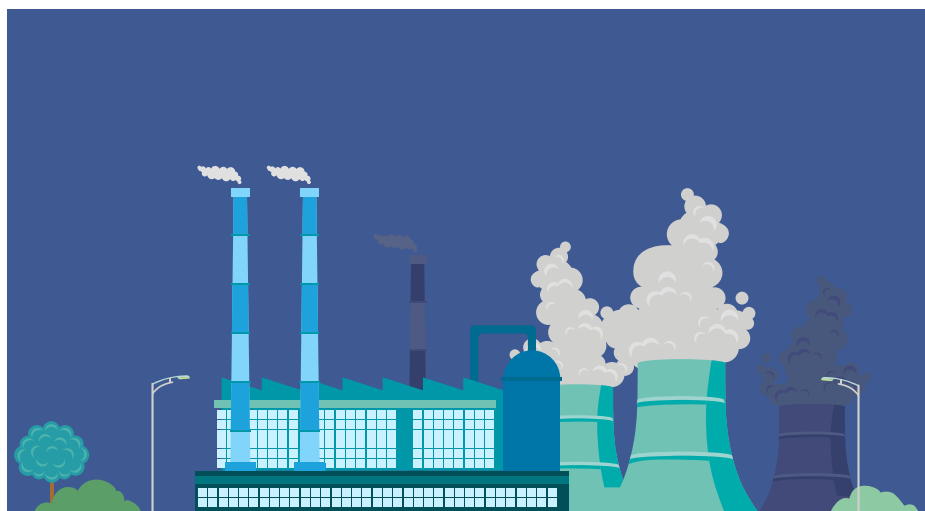
Receivables	DT:	CU 1 M
Investment property commencement	CT:	CU 680 K
Rental guarantee liability	CT:	CU 100 K
Profit on disposal of property:	CT:	CU 220 K

8.2. Investment properties under fair value model excluded from the scope of measurement requirements of IFRS 5

It must be highlighted that investment properties accounted for in accordance with the fair value model in IAS 40 are

excluded from the scope of measurement requirements of IFRS 5. The exclusions relate only to the measurement requirements of IFRS 5 – the classification and presentation requirements of IFRS 5 apply to such investment properties. However, investment properties accounted for in accordance with the cost model in IAS 40, fall within the scope of both the measurement as well as classification and presentation requirements of IFRS 5.

Investment properties can be held for sale (or for distribution) either as individual assets or as a part of a disposal group.



8.3. Assets that are to be sold – general requirements

The overall principle of IFRS 5 is that a non-current asset (or disposal group) should be classified as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. [IFRS 5:6] The Standard specifies certain requirements and conditions that must be met for this to be the case.

The two general requirements for a non-current asset (or disposal group) to be classified as held for sale are that: [IFRS 5:7]

The asset (or disposal group) must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (or disposal groups); and

The implementation guidance accompanying IFRS 5 states that a non-current asset (or disposal group) is available for immediate sale if an entity currently has the intention and ability to transfer the asset (or disposal group) to a buyer in its present condition.

When an asset is still in the course of construction, and significant activities will need to be performed before it can be transferred, it is unlikely that it could be regarded as available for immediate sale.

Assets that are being used are not precluded from classification as held for sale if they meet the criteria set out in IFRS 5:7. This will be the case, for example, when an entity continues to operate an asset while actively marketing it.

The sale must be highly probable.

IFRS 5 defines 'highly probable' as meaning "[s]ignificantly more likely than probable", where 'probable' means "[m]ore likely than not" [IFRS 5:Appendix A]

A number of specific conditions must be satisfied for the sale of a non-current asset (or disposal group) to qualify as highly probable [IFRS 5:8]:

- a) the appropriate level of management must be committed to a plan to sell the asset (or disposal group);
- b) an active programme to locate a buyer and complete the plan must have been initiated;
- c) the asset (or disposal group) must be actively marketed for sale at a price that is reasonable in relation to its current fair value; and
- d) except as discussed below, the sale should be expected to qualify for recognition as a completed sale within one year from the date of classification, and actions required to complete the plan should indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

IFRS 5:9 notes that, on occasion, events or circumstances may extend the period to complete the sale beyond one year. Provided that the delay is caused by events or circumstances beyond the entity's control and there is sufficient evidence that the entity remains committed to its plan to sell the asset (or disposal group), such an extension does not preclude an asset (or a disposal group) from being classified as held for sale.

A firm purchase commitment is an agreement with an unrelated party, binding on both parties and usually legally enforceable, that (a) specifies all significant terms, including the price and timing of the transactions, and (b) includes a disincentive for non-performance that is sufficiently large to make performance highly probable. [IFRS 5:Appendix A]

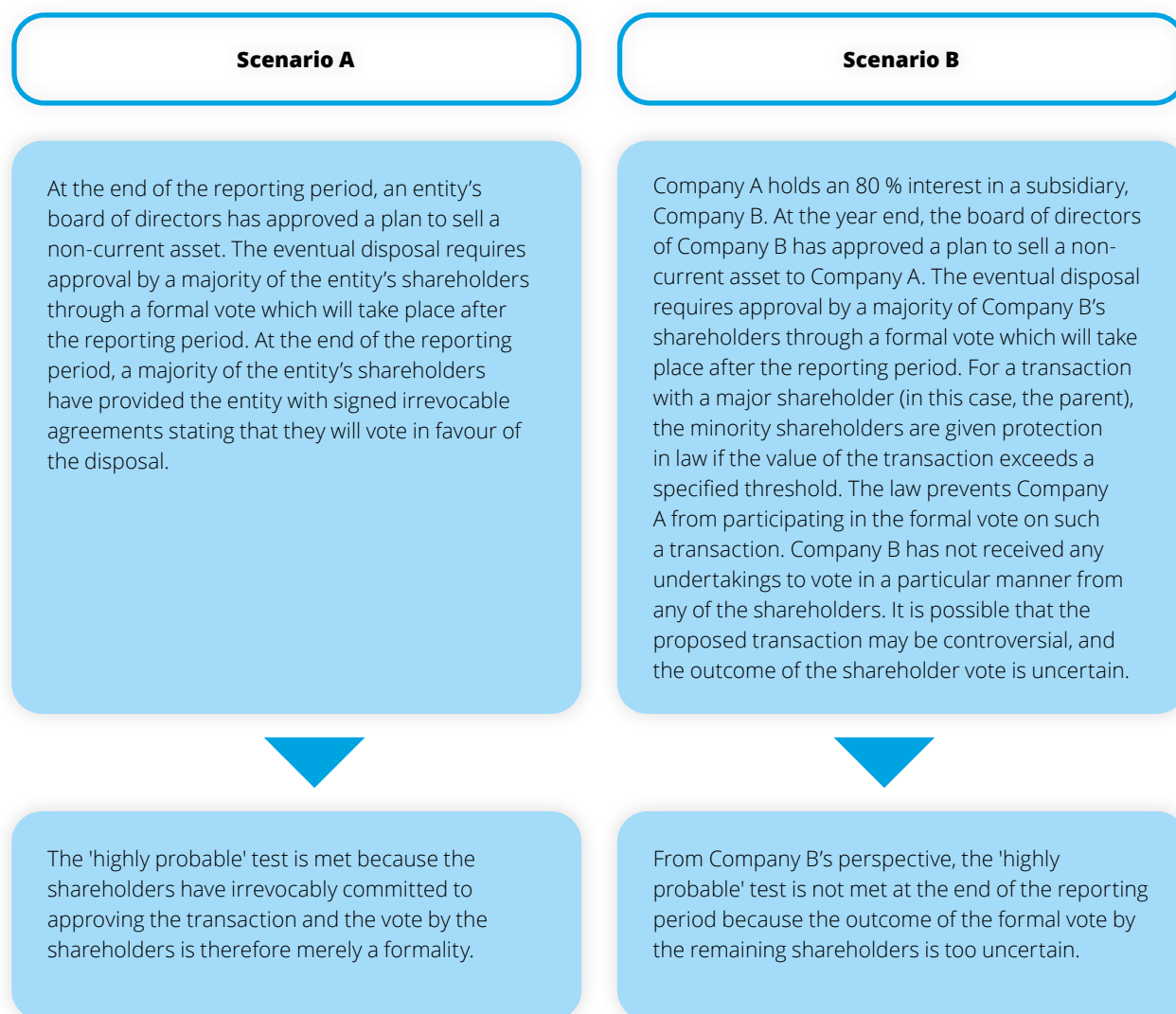
8.3.1. Example of availability for immediate sale

Entity X intends to sell an office building. Entity X does not intend to transfer the property to a buyer until it has completed

refurbishment to increase the property's sales value. This delay in the timing of the transfer of the property demonstrates that the property is not available for immediate sale. The criterion in [IFRS 5:7](#) will not be

met until the refurbishment is completed.

8.3.2. Examples of plan of sale requiring shareholder approval



8.3.3. Completion of sale expected within one year – exceptions

An entity is committed to a plan to sell a non-current asset and classifies the asset as held for sale at that date.

- During the initial one-year period, the market conditions that existed at the date the asset was classified initially as held for sale deteriorate. As a result, the asset is not sold by the end of that period. During that period, the entity actively solicited but did not receive any reasonable offers to purchase the asset and, in response,

reduced the price. The asset continues to be actively marketed at a price that is reasonable given the change in market conditions, and the criteria in [IFRS 5:7](#) & [8](#) are therefore met. In that situation, the conditions in [IFRS 5:B1\(c\)](#) for an exception to the one-year requirement in [IFRS 5:8](#) would be met. At the end of the initial one-year period, the asset would continue to be classified as held for sale.

- During the following one-year period, market conditions deteriorate further, and the asset is not sold by the end of

that period. The entity believes that the market conditions will improve and has not further reduced the price of the asset. The asset continues to be held for sale, but at a price in excess of its current fair value. In that situation, the absence of a price reduction demonstrates that the asset is not available for immediate sale as required by [IFRS 5:7](#). In addition, [IFRS 5:8](#) also requires an asset to be marketed at a price that is reasonable in relation to its current fair value. Therefore, the conditions in

[IFRS 5:B1\(c\)](#) for an exception to the one-year requirement in [IFRS 5:8](#) would not be met. The asset would be reclassified as held and used in accordance with [IFRS 5:26](#).

8.4. Held for sale criteria met after the reporting period

If the held for sale criteria are not met until after the reporting period, non-current assets (or disposal groups) should not be classified as held for sale. Instead, the disclosures required by [IFRS 5:41\(a\)](#), [\(b\)](#) and [\(d\)](#) should be provided. [[IFRS 5:12](#)].

8.5. Measurement at the lower of carrying amount and fair value less costs to sell

When non-current assets and disposal groups are classified as held for sale, they are required to be measured at the lower of their carrying amount and fair value less costs to sell. [[IFRS 5:15](#)]

The comparison of carrying amount and fair value less costs to sell is carried out on the date the non-current asset (or disposal group) is first classified as held for sale, and then again at each subsequent reporting date while it continues to meet the held-for-sale criteria.

Note that it is necessary to consider the requirements of IFRS 5 in this regard,

not only for items meeting the criteria as held for sale at the end of the reporting period, but also for 'in-period' disposals, including assets sold during the reporting period that were not classified as held for sale at the previous reporting date.

8.6. Individual assets held for sale

As described at 8.2., investment properties valued at fair value, are outside the scope of IFRS 5's measurement requirements. When classified as held for sale, such investment properties continue to be measured in accordance with IAS 40, although the presentation and disclosure requirements of IFRS 5 apply.

8.7. Recognition of deferred tax for a single asset in a corporate wrapper [IAS 12:38](#)

In many jurisdictions, it is common for an investment property to be held within a corporate structure that holds only one material asset, the investment property itself. When the parent disposes of the property, it will dispose of it within that corporate shell because, in many cases, this will shield the parent entity from adverse tax consequences.

[IAS 12:11](#) requires temporary differences in the consolidated financial statements to be determined by comparing the carrying amounts of assets and liabilities

in the consolidated financial statements with the appropriate tax base. These amounts are sometimes referred to as 'inside basis differences'. In the case of an asset or a liability of a subsidiary that files separate tax returns, the tax base is the amount that will be taxable or deductible on the recovery (settlement) of the asset (liability) in the tax returns of the subsidiary.

In addition, [IAS 12:38](#) requires the determination of the temporary difference related to the shares held by the parent in the subsidiary by comparing the parent's share of the net assets of the subsidiary in the consolidated financial statements, including the carrying amount of goodwill, with the tax base of the shares for the purposes of the parent's tax returns. This amount is sometimes referred to as an 'outside basis difference'. IAS 12 includes no exception to these requirements for single-asset subsidiaries and, consequently, both components of deferred tax are required to be recognised in consolidated financial statements (subject to the requirements of [IAS 12:39](#) and [44](#) limiting the recognition of outside basis differences, and the general recognition criteria in IAS 12 for any deferred tax assets) even if the parent expects to sell an investment property within a corporate shell.



9. IFRS Accounting Standards versus local Generally Accepted Accounting Principles

The table below highlights key differences in the main accounting principles described in chapters 1-8 between IFRS Accounting Standards and Generally Accepted Accounting Principles applicable in particular Central European countries.

No	Question	IFRS Accounting Standards	Estonia	Latvia	Lithuania
1a	Is there "investment property" in local GAAP and if it is material it is presented in a separate line in the balance sheet?	Yes	Yes	No, treated as PPE	Yes
1b	If there is no "investment property" in local GAAP, does local GAAP allow to use IAS 40 in local GAAP (i.e. only IAS 40 can be used, and not all other IAS/IFRS)?	N/a	N/a	Yes	N/a
1c	If IAS 40 can be used in local GAAP, can it be used in full including e.g. selection of cost model or fair value model with changes in fair value in profit or loss under fair value model?	N/a	N/a	Yes	N/a
2	Available models for subsequent measurement of investment property (also if under local GAAP investment property is not distinguishable and is treated as PPE)	Cost model or fair value model	Cost model or fair value model	Cost model or revaluation model	Cost model or fair value model
3	Under fair value model (or revaluation model), the change in fair value (gain or loss) is recognized in	Gains and losses in profit or loss	Gains and losses in profit or loss	Gains in equity and losses in profit or loss with exceptions similar to ones described in IAS16.39-40	Gains and losses in profit or loss
4	Fair value under fair value model (or revaluation model) has to be assessed	At the end of each reporting period	At the end of each reporting period	With sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period	At the end of each reporting period
5	Measurement of investment property under construction at fair value (also if under local GAAP investment property is not distinguishable and is treated as PPE and measured under revaluation model)	Possible when fair value of investment property under construction becomes reliably measurable	Possible when fair value of investment property under construction becomes reliably measurable	Possible when fair value of investment property under construction becomes reliably measurable	Possible when fair value of investment property under construction becomes reliably measurable
6	Lease payments from operating leases are generally recognised as income on a straight-line basis (which also means that the impact of lease incentives granted to lessors is straight-lined as well)	Yes	Yes	Yes	Yes, but it is also acceptable that a rent discount is recognized during the period for which it was agreed
7	Capitalization of borrowing costs during construction of investment property (also if under local GAAP investment property is not distinguishable and is treated as PPE)	Required but if investment property under construction is measured under fair value model - optional	Optional	Optional	Not permitted

No	Question	Poland	Czech Republic	Slovakia	Hungary
1a	Is there "investment property" in local GAAP and if it is material it is presented in a separate line in the balance sheet?	Yes	No, treated as PPE	No, treated as PPE	No, treated as PPE
1b	If there is no "investment property" in local GAAP, does local GAAP allow to use IAS 40 in local GAAP (i.e. only IAS 40 can be used, and not all other IAS/IFRS)?	N/a	No	No	No
1c	If IAS 40 can be used in local GAAP, can it be used in full including e.g. selection of cost model or fair value model with changes in fair value in profit or loss under fair value model?	N/a	N/a	N/a	N/a
2	Available models for subsequent measurement of investment property (also if under local GAAP investment property is not distinguishable and is treated as PPE)	Cost model or fair value model	Cost model only	Cost model only	Cost model or fair value model
3	Under fair value model (or revaluation model), the change in fair value (gain or loss) is recognized in	Gains and losses in profit or loss	N/a	N/a	Gains and losses in equity
4	Fair value under fair value model (or revaluation model) has to be assessed	At the end of each reporting period	N/a	N/a	At the end of each reporting period
5	Measurement of investment property under construction at fair value (also if under local GAAP investment property is not distinguishable and is treated as PPE and measured under revaluation model)	Not possible	N/a	N/a	Not possible
6	Lease payments from operating leases are generally recognised as income on a straight-line basis (which also means that the impact of lease incentives granted to lessor is straight-lined as well)	Yes	Yes	Yes	Yes
7	Capitalization of borrowing costs during construction of investment property (also if under local GAAP investment property is not distinguishable and is treated as PPE)	Required	Optional	Required	Optional

No	Question	Bulgaria	Romania	Slovenia	Croatia
1a	Is there "investment property" in local GAAP and if it is material it is presented in a separate line in the balance sheet?	Yes	Yes, but is presented as a separate line only for medium to big entities with total assets bigger than 3.5 MEUR and turnover bigger than 7 MEUR	Yes	Yes
1b	If there is no "investment property" in local GAAP, does local GAAP allow to use IAS 40 in local GAAP (i.e. only IAS 40 can be used, and not all other IAS/IFRS)?	N/a	N/a	N/a	N/a
1c	If IAS 40 can be used in local GAAP, can it be used in full including e.g. selection of cost model or fair value model with changes in fair value in profit or loss under fair value model?	N/a	N/a	N/a	N/a
2	Available models for subsequent measurement of investment property (also if under local GAAP investment property is not distinguishable and is treated as PPE)	Cost model or fair value model	Cost model or fair value model, with the observation that also under fair value model entities compute annual depreciation	Cost model or fair value model	Cost model or fair value model
3	Under fair value model (or revaluation model), the change in fair value (gain or loss) is recognized in	Gains and losses in profit or loss	Gains in equity and losses in profit or loss with exceptions similar to ones described in IAS16.39-40	Gains and losses in profit or loss	Gains and losses in profit or loss
4	Fair value under fair value model (or revaluation model) has to be assessed	With sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the reporting period	With sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period	At the end of each reporting period	At the end of each reporting period
5	Measurement of investment property under construction at fair value (also if under local GAAP investment property is not distinguishable and is treated as PPE and measured under revaluation model)	Not possible	Not possible	Possible when fair value of investment property under construction becomes reliably measurable	Possible when fair value of investment property under construction becomes reliably measurable
6	Lease payments from operating leases are generally recognised as income on a straight-line basis (which also means that the impact of lease incentives granted to lessors is straight-lined as well)	No, income is recognized on a straight-line basis but lease incentives are expensed in profit and loss when incurred	Yes	Yes	Yes
7	Capitalization of borrowing costs during construction of investment property (also if under local GAAP investment property is not distinguishable and is treated as PPE)	Not permitted	Required	Required	Required but if investment property under construction is measured under fair value model - optional

No	Question	Serbia	Bosnia & Herzegovina	Moldova	Albania
1a	Is there "investment property" in local GAAP and if it is material it is presented in a separate line in the balance sheet?	Yes	Yes	Yes	Yes
1b	If there is no "investment property" in local GAAP, does local GAAP allow to use IAS 40 in local GAAP (i.e. only IAS 40 can be used, and not all other IAS/IFRS)?	N/a	N/a	N/a	N/a
1c	If IAS 40 can be used in local GAAP, can it be used in full including e.g. selection of cost model or fair value model with changes in fair value in profit or loss under fair value model?	N/a	N/a	N/a	N/a
2	Available models for subsequent measurement of investment property (also if under local GAAP investment property is not distinguishable and is treated as PPE)	Cost model or fair value model	Cost model or fair value model	Cost model or fair value model	Cost model or fair value model
3	Under fair value model (or revaluation model), the change in fair value (gain or loss) is recognized in	Gains and losses in profit or loss	Gains and losses in profit or loss	Gains and losses in profit or loss	Gains and losses in profit or loss
4	Fair value under fair value model (or revaluation model) has to be assessed	At the end of each reporting period	At the end of each reporting period	At the end of each reporting period	At the end of each reporting period
5	Measurement of investment property under construction at fair value (also if under local GAAP investment property is not distinguishable and is treated as PPE and measured under revaluation model)	Possible when fair value of investment property under construction becomes reliably measurable	Possible when fair value of investment property under construction becomes reliably measurable	Possible when fair value of investment property under construction becomes reliably measurable	Possible when fair value of investment property under construction becomes reliably measurable
6	Lease payments from operating leases are generally recognised as income on a straight-line basis (which also means that the impact of lease incentives granted to lessor is straight-lined as well)	Yes	Yes	Not specified	Yes
7	Capitalization of borrowing costs during construction of investment property (also if under local GAAP investment property is not distinguishable and is treated as PPE)	Required but if investment property under construction is measured under fair value model - optional	Required but if investment property under construction is measured under fair value model - optional	Not specified	Not permitted

Kosovo - There is no local GAAP, entities apply IFRS Accounting Standards

Part 2

Valuation of real estate

Introduction

The purpose of this part of the guide is to present the specifics of property appraisal for financial reporting purposes. The section covers the legal basis for appraisals, the real estate valuation methodology as well as the main points when verifying a valuation report prepared for inclusion in financial statements, with some practical examples. In addition, we highlight the recent changes introduced to the International Valuation Standards and RICS Red Book Global Standards regarding the issues related to sustainability and ESG due to its increasing development. At the end of this chapter, we summarise the impact of COVID-19 on the real estate market and valuations. Although, the publication refers to Polish acts and standards, these take international standards into consideration. Whereas the definition of the Market Value stated in the Polish Act constitutes a unified definition of Market Value and complies with the definitions used in other international valuation standards.

Real estate measurement -the appraiser's perspective

The following legal acts provide the legal basis for an appraisal in Poland:

- The Act on Real Property Management of 21 August 1997, henceforth: "ARPM", (consolidated text: Journal of Laws of 2016, items 2147, 2260; of 2017, items 624, 820, 1509, 1529, 1566, 1595);
- Regulation of the Council of Ministers of 21 September 2004 on real estate appraisal and preparation of valuation reports, henceforth: "Regulation" (Journal of Laws no. 207, item 2109 as amended).

The above-mentioned ARPM includes the unified definition of Market Value which complies with the definitions used in other international valuation standards.

Additionally, the Polish Federation of Appraisers' Associations has published the National Appraisal Principles (henceforth: "Appraisal Principles"), including among others National Basic Appraisal Standards

(henceforth: NBAS) and National Special Appraisal Standards (henceforth: NSAS). The solutions adopted in the Appraisal Principles take international experience into account, including the European Group of Valuers' Association TEGOVA and the International Valuation Standards Council (IVSC).

The Appraisal Principles do not provide a legal basis for real estate valuation in Poland (except for the Standard on Appraisal for collateral purposes). They provide proceeding principles that comply with best practices. From the financial reporting perspective, the NSAS entitled "Appraisal of Titles to Real Estate, Property and Equipment for Reporting Purposes" is of particular importance, as it is dedicated to valuation for reporting purposes both in line with the Accounting Act and IAS. The updated standard includes requirements regarding fair value presentation, introduced by IFRS 13, presenting them as good practices to be applied also for PAS reporting purposes.

The standard to a large extent implements the terminology used in **IFRS 13**, with a view to ensuring the consistency of valuation reports with financial reporting requirements. At the same time, for compliance purposes, appraisers apply methods that are convergent with an entity's accounting policies, in particular the consistency principle.

Definitions introduced by IFRS 13 set out and name those procedures that should be applied in reports for these purposes. Solid arguments supporting assumptions arising from market analyses or sensitivity analyses of estimates should for some time have been using as good practice.

Pursuant to Article 152 of ARPM, **approaches to real estate valuation include the comparison approach, the income approach, the cost approach and the mixed approach.** An appropriate approach is selected by an appraiser pursuant to Article 154 of ARPM. Pursuant to Article 156 of ARPM, a valuation report

prepared by an appraiser is a formal document certifying the valuation of a given property.

Real estate valuation methods and techniques included in the above approaches, as well as the form of a valuation report, are defined in the Regulation.

Real estate valuation for financial reporting purposes is addressed by International Financial Reporting Standards, mainly by IAS 40, and by IFRS 13.

1. Appraiser and valuation report

Section 1 of Chapter 5 of ARPM defines the profession of a property appraiser, to be performed by an individual holding valid real estate valuation certificate.

The key task of an appraiser involves determining the value of a property, as well as that of plant and equipment permanently attached to the property, in the form of a valuation report.

Additionally, an appraiser may prepare analyses and studies, regarding among other subjects the real estate market and any related advisory support; the effectiveness and development of real estate investments; the financial effects of the adoption or modification of local spatial plans; determining real estate values for individual investors; the valuation of investment properties classified as such by accounting regulations; and the valuation of real properties as fixed assets under the Accounting Act.

A valuation report is a document reserved for an appraiser. It is prepared in writing and constitutes an author's opinion on the value of a given property.

According to the Regulation, a valuation report must include the following components:

- valuation subject and scope;
- valuation purpose;
- the formal basis of valuation and the source of data regarding the valued property;

- data material for the calculation of the real estate value;
- a description of the condition of the valued property;
- a description of the planning information of the property;
- real estate market analysis and characteristics regarding the purpose and method of valuation;
- indication of the type of the estimated value, selected valuation approach, method and technique; and
- a presentation and justification of calculations of the property value and the valuation outcome.

Additionally, an appraiser shall include appropriate clauses indicating specific circumstances of the particular property valuation.

2. Basis of real estate valuation for financial reporting purposes

As a company asset, real estate usually makes a significant balance sheet item, and as such may have a bearing on the assessment of the company's standing. In accordance with financial reporting requirements (whether IFRS or PAS), depending on the adopted model, the value of assets, including investment property, cannot be lower than the higher of two figures: its recoverable amount, calculated as fair value less costs to sell, or the value in use of an asset or CGU. Consequently, fair value becomes crucial for measuring investment property or inventories (which include real estate under construction or completed, recognised in a developer's accounting records at cost, for which fair value is frequently calculated for impairment-testing purposes).

Fair value of a property is often treated as an equivalent of its market value. The fair value concept, however, is somewhat broader and includes the replacement value. Therefore, **the statement that the market value can be considered the fair value is true, although in certain cases fair value is not the same as the market value.** This is because the replacement value (the depreciated

replacement cost) can be considered the fair value, albeit it does not meet the market value definition. In practice, the replacement value is seldom considered the fair value equivalent of investment property or property under construction with a view to sell apartments classified in financial statements as inventories. This is because in the course of measurement, the cost approach does not consider actual market transactions (supply and demand), referring only to the depreciated construction cost, at least in the case of buildings located on a plot of land. Financial reporting allows accepting the outcome of such calculation as fair value for specific types of real estate, lacking appropriate market transactions or leases, which disallows reference to market parameters for calculation purposes. A positive outcome of the break-even point test, which confirms the economic reason to maintain an asset by an entity and its usefulness for its business operations, is an additional condition that allows the use of the depreciated replacement cost in valuation.

Consequently, in order to confirm the fair value of a property, an entity should analyse valuation reports that depart from the fair value definition, although they are often taken to be fair value-based. In particular, an entity should focus on all reports that define non-market value, such as investment value/worth or valuations reflecting an actual or anticipated market constraint, and forced sales. Due to specific assumptions, the value calculation resembles a scenario analysis (optimistic or pessimistic compared to typical market conditions); its result does therefore not meet the fair value definition.

Fair value estimates for financial reporting purposes should at the same time comply with the principles arising directly from the following accounting principles and procedures: accrual, matching, going concern, prudence, materiality, consistency/comparability and individual measurement.

When preparing a valuation report for financial reporting purposes, an

appraiser shall therefore refer to general principles, without ignoring the specifics of an accounting standard used by the client (PAS, IAS, US GAAP or other accounting principles) and the industry specifics. The issue of the

valuer's responsibility in providing financial reporting valuations was also addressed in the updated RICS Valuation Global Standards, effective from 31 January 2022. This includes engagement and valuation reporting, full details of the accounting standards to be adopted in the valuation, and to include the full definition of the basis of value including reference to the basis of value definition (e.g. IFRS 13 or FRS 102, etc.) along with details of the accounting standard body whose definition has been applied.

The principle of consistency and comparability of valuation outcome period to period is another vital element of the valuation process.

An appraiser performing regular valuation of investment property should therefore analyse prior reports in order to ensure consistency of valuation methodology. This is unless indications occur that support a change in the valuation approach, such as modification to a spatial plan that allows the adoption of another valuation method or other assumptions.

3. Real estate valuation: approach and methodology

The real estate valuation process performed by an appraiser consists of the following steps:

1. Confirming the subject, purpose and date of valuation;
2. Verifying documents that certify the legal and actual status of the property, i.e. current copies of the land and mortgage register, maps derived from the land register, notarial deeds confirming land purchase;
3. Depending on the type of property being valued, verifying documents related to various operating aspects of the property, among other technical inspections, information regarding terms of binding leases, environmental decisions, decisions made by maintenance officers etc.;
4. Carrying out a property inspection to identify issues that do not arise directly from the reviewed documents regarding the property;
5. Analysing planning documentation regarding the property (a local spatial plan, land development decision, analysis of spatial development directions and conditions) to verify whether the current use of the property complies with its intended use and is "the highest and the best";
6. Identifying any actual and potential amounts receivable and payable in relation to the current condition of the property.

Pursuant to ARPM, real estate valuation is based on one of the following four approaches: comparison, income, cost or mixed. The Regulation precisely defines real estate valuation methods and techniques under each approach (see the table below).

Selection of an appropriate approach and method to estimate the real estate value is the key element of the valuation process.

	Comparison approach	Income approach	Cost approach	Mixed approach
Method	<ul style="list-style-type: none"> Comparing pairs Average price adjustment Statistical analysis of the market 	<ul style="list-style-type: none"> Investment Profit 	<ul style="list-style-type: none"> Reconstruction costs Replacement costs 	<ul style="list-style-type: none"> Residual Liquidation costs Land-related ratios
Techniques	<ul style="list-style-type: none"> N/A 	<ul style="list-style-type: none"> Direct capitalisation Discounted cash flow (DCF) 	<ul style="list-style-type: none"> Detailed Integrated components Ratio 	<ul style="list-style-type: none"> N/A
Parameters	<ul style="list-style-type: none"> Transaction prices Real estate characteristics 	<ul style="list-style-type: none"> Market rent rates Vacant space (market) Real estate costs Capitalisation rate Discount rate Terms a of leases 	<ul style="list-style-type: none"> Comparison approach parameters for undeveloped land valuation purposes Building and structure replacement costs 	<ul style="list-style-type: none"> Parameters used in the comparison, income based and cost approach

3.1. Comparison approach

This approach denotes determining the property value based on transaction prices of similar properties, adjusted by characteristics of the property undergoing valuation. The most frequently used methods under this approach include comparing pairs and average price adjustment. When using the comparison approach, an appraiser is obliged to present a set of transactions on properties similar to the one undergoing valuation (comparing pairs: at least three transactions; average price adjustment: 10+ transactions). The value of real estate is determined based on adjustments arising from differences between the characteristics of the property undergoing valuation and those of similar properties. This approach is applied mostly to the measurement of undeveloped land and residential property as both markets offer access to a large number of transactions. Additionally, the land and

residential property markets include groups of homogenous properties that share a number of features, which makes comparison easier: for example, land for single-family houses or three-room flats.

3.2. Income approach

Under the income approach, real estate is measured when the actual or potential rental or non-rental income (for example, a one-off lease of shared space in a mall for marketing purposes) generated by the property can be determined. The property value determined under the income approach includes both land and buildings located thereon.

The income approach includes two methods:

- investment method, for measurement of properties that generate income from rent that can be determined through an analysis of local market rent rates (for example: office buildings, trade malls, warehouses, service premises);

- profit method, for measurement of properties that generate income corresponding to the owner's share in the income generated from operations carried out in the valued property (e.g. hotels, fuel stations etc).

The direct capitalisation or discounted cash flow technique may be applied to each of the above methods.

Under the direct capitalisation method, a real estate value is calculated as the fixed annual income generated by the property divided by its capitalisation rate. The capitalisation rate is determined through analysis of the investment market and is calculated as a ratio of the annual income generated by that property to its transaction price. When using the discounted cash flow method, the property value is determined as the total value of the discounted cash flows generated by the property added to its residual value.

Valuation techniques under the income approach

Technique/parameters	Direct capitalisation	DCF
Gross Rental Income	Rental or non-rental income determined based on binding leases, market data or historical data.	
Cost	Costs related to the maintenance and operation of a real estate, re-commercialisation of space, loss of income due to vacancies, etc.	
Net Operating Income	Fixed annual income.	Variable future income (cash flows) – usually looking five to ten years ahead.
Discount Rate	Not applicable.	Discount rate reflects the risk related to cash flows generated by real estate, converting future cash flows into a present value.
Capitalisation Rate	A capitalisation rate determined based on market analysis of the investment.	
Value	Fixed annual income to capitalisation rate.	The total of discounted cash flows and discounted residual value, calculated as the annual income for the last projection period divided by the capitalisation rate.

The income approach utilises the discount rate and capitalisation rate. The difference between these rates is as follows:

- the discount rate originates from the capital market and quantifies the risk related to cash flows generated by real estate in relation to alternative capital-market investments. Its principle component is the risk-free rate for a given country, calculated based on the return

rate on treasury securities (bonds); other components reflect the risk relating to the property itself and its surroundings;

- the capitalisation rate is calculated based on transactions involving similar properties, concluded on the investment market.

Possible relationships between the above rates are described in the following table.

Discount rate / capitalisation rate

Relationship	Comment
Discount rate > Capitalisation rate	During a market boom, when the number of transactions on the investment market rapidly increases, capitalisation rates fall fast. For the valuation of commercial facilities, discount rates applied to rental income shall be higher than the market capitalisation rates.
Discount rate < Capitalisation rate	During a market slump, when the number of transactions on the investment market rapidly falls, capitalisation rates increase (as the value of real estate decreases). In the case of the valuation of commercial facilities with long-term leases concluded, the discount rates applied to stable rental income are lower than the market capitalisation rates (as operating risk is lower than transaction risk).

3.3. Cost approach

The cost approach is applied to measure the replacement costs of buildings and structures treated as a component of a plot of land. Two methods are used under each approach: the reconstruction cost method, and the replacement cost method.

Under the reconstruction cost method, an appraiser estimates the cost of reconstructing the property using the same technologies and materials as those originally used to construct it and reduces them by estimated costs of wear and tear.

Under the replacement cost method, the appraiser determines the cost of replacing the property components with facilities bearing similar characteristics but applying current technologies and materials.

The cost approach is applied to the measurement of construction materials in cases where there are no or few market transactions involving similar properties, or when a property cannot generate any income.

3.4. Mixed approach

The mixed approach is applied when a combination of the above approaches is required to determine the real estate value. This approach includes the residual value and liquidation value method.

The residual value method is used when construction works are to be carried out at a property, in order to construct or redevelop a facility. In such case, the property value is the difference between its value after the completion of the work and the costs of carrying out the work.

The liquidation method is used to value

land with facilities intended for demolition. In such cases, the land is appraised as undeveloped land, using the comparison method, and its estimated value is reduced by costs related to the demolition of the facilities located on it.

The following table presents approaches and methods applicable to the valuation of particular property. The selection of an appropriate methodology does not depend solely on the type and function of the property to be measured, and includes the purpose of the valuation, the technical condition of the property, the availability of market data and other factors.

4. Property valuation verification

A valuation report may determine different types of real estate value.

When verifying whether the value arising from a valuation report may be classified as fair value of a given property for disclosure in financial statements, an entity should focus on the following aspects:

- the subject of the valuation;
- the purpose, scope and date of the valuation;
- methodology;
- valuation assumptions;
- valuation conditions and any related restrictions;
- the property value.

4.1. Subject of the valuation

The first step on the way to preparing a valuation report involves defining the subject of the valuation. If the amount estimated in such a report is to be used as fair value of a property in financial

statements, the subject of the valuation as determined in the valuation report should be easily correlated with an appropriate item in the register of property, plant and equipment.

4.2 Purpose, scope and date of the valuation

An appraiser is obliged to determine the purpose, scope and date of the valuation in the initial section of the valuation report. These data alone may indicate that the analysed valuation report should not be used for financial-reporting purposes. The purpose, scope and date of the valuation should be verified in the first place. Below we provide an example of incorrect practice, involving the use of financial statements with reference to a valuation report intended for other purposes.

**Example 1
Using a valuation report
for financial reporting purposes**

Company X received a valuation report regarding undeveloped land from an appraiser. The estimated value was to be used as a fair value estimate in the financial statements of the company prepared as at 31.12.20X6. The appraiser indicated the purpose, scope and date of the valuation in the following manner:

**Selected sections of the valuation
report (incorrect)****The forced sale valuation.**

Scope of the valuation: The valuation includes defining the value for the purpose of forced sale of ownership title to an undeveloped plot of land.

Valuation date: 31.12.20X3

Company X should notice that the value estimated in the received report refers to forced sale and therefore does not meet the market/fair value definition. Additionally, the valuation was performed three years prior to the financial statements date; therefore, the estimated value is out of date. The purpose, scope and date of the valuation as determined in the received report disallow its use as

fair value as at 31.12.20X6. Consequently, its further verification is useless. The company should obtain a new valuation report prepared by an appraiser, determining the valuation purpose, scope and date in the following manner:

Selected sections of the valuation report (correct)

Valuation purpose: The valuation was prepared for the financial reporting purpose.

Scope of the valuation: The valuation includes defining the fair value of ownership title to an undeveloped plot of land.

Valuation date: 31.12.20X6

4.3 Methodology

An appraiser should correctly select a valuation approach and method depending on its subject. If the value determined in a valuation report is to be used for

financial-reporting purposes, an entity should verify whether the methodology underlying the report is correct. The following table presents examples of the incorrect selection of real estate valuation methodology.

Examples of the incorrect selection of real property valuation methodology

Real estate type	Incorrect methodology	Comment	Correct methodology
Undeveloped land Description: no binding local spatial plan or development decision.	<ul style="list-style-type: none"> Mixed approach / residual method Assumed construction of a commercial facility 	No legal or spatial conditions to construct a commercial facility, which disallows the use of the mixed approach to fair value measurement.	<ul style="list-style-type: none"> Comparison approach Analysis of transactions of similar undeveloped plots of land
Industrial facility Description: intended for demolition.	<ul style="list-style-type: none"> Income approach Facility commercialisation assumed 	The assumption to commercialise the building intended for demolition is non-viable.	<ul style="list-style-type: none"> Mixed approach Assumed liquidation costs and comparison approach of the undeveloped land
Office building Description: A class building, fully leased.	<ul style="list-style-type: none"> Comparison approach 	The commercialised A class office building should be valued using the income approach as it generates rental income.	<ul style="list-style-type: none"> Income approach
Single-family house Description: A residential building leased as a residence of an ambassador.	<ul style="list-style-type: none"> Income approach 	Although the building is leased, it has a residential purpose. A large number of transactions regarding single-family houses allow the application of the comparison approach, which better reflects the fair value. The income approach would make sense had the building been adjusted to commercial use, e.g. as an office.	<ul style="list-style-type: none"> Comparison approach Analyse transactions on single-family houses Possibly include cash flows related to a binding lease, if concluded for a definite period

The above examples do not cover all possible ways of using incorrect valuation methodologies for fair value estimation purposes. In order to check whether a given methodology is correct, an entity has to determine both the function and the type of the property undergoing a valuation and its current highest and best use.

4.4. Valuation assumptions

Once the correct valuation method has been selected, an entity can continue with the verification of the valuation assumptions. An entity should also pay attention to other parameters, depending on the approach and method adopted. The two examples below illustrate the most common errors identified when analysing valuation assumptions under the comparison and income approach.

Example 2

Property valuation assumptions part 1

Subject of the valuation

Undeveloped land of 100 ha intended for industrial development, location A, valuation as at 31.12.20X6

Methodology

Comparison approach, comparing pairs: assumptions in the valuation report.

Assumptions

The appraiser presented transactions regarding similar properties in order to estimate the market value of the industrial plot as at 31.12.20X6. The following table presents selected aspects of the above property that undermine the correctness of the selected basis.

The above example does not cover all possible ways of using the incorrect transactions for comparison valuation purposes. Valuation of developed plots of land requires a focus on additional parameters, such as their function, size or the technical condition of the facility. Please note that appraisers do not always indicate the purpose of a given plot of land when describing similar property. In such cases, they need verification based on publicly available local spatial development plans.

Transaction date	Transaction subject	Location	Purpose	Size	Comment
31.12.20X2	Undeveloped land	Location A	Industrial	75 ha	The comparative transaction date should be as close as possible to the valuation date. Due to small price fluctuations in a given market segment, transactions concluded within approx. 24 months of the valuation date can be used.
30.10.20X6	Plot of land with a warehouse building	Location A	Industrial	80 ha	An undeveloped plot of land should be compared to other undeveloped plots for valuation purposes. Comparing it to a developed plot of land may result in determining a value inconsistent with market quotations.
23.11.20X6	Undeveloped land	Location B	Production	90 ha	Location is of key importance for the property and affects its value. It is therefore crucial that plots of land treated as the benchmark are located within the local market or within comparable parallel markets.
24.12.20X6	Undeveloped land	Location A	Residential	110 ha	Comparative transactions should regard property with the same or similar purpose as the one subject to valuation. Comparing residential property to industrial property is incorrect.
28.12.20X6	Undeveloped land	Location A	Production	0.05 ha	Property used for comparison approach purposes should not differ too much in terms of size from the one subject to valuation.

Example 3

Property valuation assumptions part 2

Subject of the valuation

A plot of land with C class office facility located at C, valuation as at 31.12.20X6

Methodology

Income approach, investment method, direct capitalisation technique

Assumptions

The following table presents an incorrect selection of assumptions underlying valuation under the income approach along with methods of their verification.

Parameter	Assumption	Comment
Market rent rate	EUR 25/sq. m per month	<ul style="list-style-type: none"> The assumed rent rate is equal to those applied in the best office locations. The appraiser should have determined a rate appropriate for the location and standard of the facility. Verification of the correctness of the market rent rate applied for valuation purposes should be based on the analysis of the following documents: <ul style="list-style-type: none"> a lease of office space in the facility undergoing valuation; leases of office space in similar facilities; market reports for the office space sector, published by commercial agencies, including Cushman & Wakefield, CBRE, Colliers, Jones Lang Lasalle, or Savills; analysis of generally available office space lease offers published on the internet.
Market vacancy rate	5%	<ul style="list-style-type: none"> The appraiser should determine the vacancy rate based on the current occupation rate of the space available for lease in the facility undergoing the valuation. Additionally, the assumed market vacancy rate should be verified by the data published in reports prepared by the above commercial agencies.
Capitalisation rate	4.50%	<ul style="list-style-type: none"> The capitalisation rate for the facility undergoing valuation should be based on data derived from the investment market. In Poland, capitalisation-rate information is mostly available only for the prime properties. The 4.50% rate is the one applicable to the highest-quality office properties in Warsaw. When valuing facilities that offer a lower standard and less prestigious location, an entity should therefore verify whether the capitalisation rate adopted is sufficiently higher than the capitalisation rates for the prime locations in a given sector.

4.5. Property value

Even a correctly selected methodology and assumptions do not guarantee the correct valuation figure is presented in a valuation report. Incorrect figures may result from calculation errors or the adoption of market parameters that do not reflect current market prices. Therefore, comparing the value presented in a valuation report to available transaction prices is of key importance, in particular for a valuation based on the income approach.

The resultant figure may be deemed acceptable if it fits within the range of the latest observed transaction prices in a given segment, provided the methodology and assumptions underlying the valuation are correct.

5. Impact of ESG on valuation

It has been recognised that matters related to sustainability and Environmental, Social and Governance (ESG) factors have increased in importance in the view of the public and the market. This is resulting in an increasing need to quantify these factors in the valuation process. Valuation organisations (including IVSC and RICS) have addressed some of the issues involved in their updated valuation standards. According to RICS Valuation – Global Standards, effective from 31 January 2022, valuers should consider any sustainability and ESG factors that could affect the valuation as well as collecting and recording relevant appropriate data. While the proposed changes provide continuity and address recognised challenges, this is still an area of development and ongoing evolution.

6. Impact of COVID-19 on the real estate market and valuations

In March 2020, COVID-19 was declared a “Global Pandemic” by the World Health Organization. Since then, the situation relating to COVID-19 has changed regularly, with new regulatory and market requirements that have affected economies and real estate markets as well as real estate valuations. This applies to restriction of information, absence of relevant and sufficient market evidence, the ability to inspect properties and valuation assumptions. Reaction to the COVID-19

outbreak may differ between markets.

The sectors most affected by COVID -19 were hospitality and retail (shopping centres in particular). Investors' appetite for getting involved in such sectors declined. The office market is undergoing changes due to the remote working practices that continue in most organisations, meaning that some tenants / investors adopted wait-and-see or time-buying strategies.

The impact of the pandemic has been reflected in valuations mainly through the yields decompressing by approximately 25 bps to 100 bps depending on the sector and asset type. It is also apparent in rent reductions, particularly in the case of shopping centres, extended void periods, or higher reserve for bad debts. In sectors that have been most impacted by COVID-19 and face uncertain outcomes, it might be necessary to consider involving the material valuation uncertainty declaration. In such a case, the valuation is reported as being subject to ‘**material valuation uncertainty**’. This declaration does not mean that the valuation cannot be relied upon. It is included to ensure transparency and to provide further insight as to the market context under which the valuation opinion was prepared.

Part 3

Tax issues in real estate market

Introduction

The tax section of this guide focuses on those selected topics that are essential for investors to fully consider and address before making any investment in Central Europe's real-estate market.

The structure of this section therefore corresponds to the specific stages of an investment property's life: from construction or acquisition, through the operating phase to its ultimate disposal, including the distribution of profits.

The publication also covers tax regulations effective as of January 2022, and highlights the tax benefits and tax burdens connected with operating in Central Europe's real-estate market.

We trust that this comprehensive guide to real-estate taxation in Central Europe will prove valuable to your business objectives and encourage you to contact us should you have any further questions on the issues it covers.

1. Poland

Real-estate investment process

As a rule, the typical real-estate investment process can be divided into three stages:

- the construction or acquisition phase;
- the operational phase; and
- the exit phase.

Each of these stages is associated with different tax issues. The chapter presents selected tax issues that are typical for a given investment stage, along with examples presenting how to proceed in the event of their occurrence.

1.1. Acquisition or construction phase

In the case of an investment acquisition from an unrelated entity, the basic problem faced by investors is the choice of the form in which the acquisition is going to take place: i.e. asset deal (transfer of the ownership of assets and liabilities) vs share deal (transfer of the company's shares/stocks). When making a decision, an investor must take into account the

implications of direct and indirect taxes, the scope of tax succession (tax losses, deferred tax, depreciation) and also decide on a given financing structure. The list below shows the main advantages and disadvantages of different acquisition options from the buyer's perspective.

Asset deal (the buyer's perspective)

Advantages:

- Potential for entering real estate into the tax books at the market-purchase price.
- Potential for using VAT taxation of the real-estate property acquisition (under certain conditions) and the right to deduct VAT on purchases ensures the neutrality of the transaction.
- Potential for performing only limited due diligence.
- No tax liability for the seller's tax arrears if the assets do not constitute an enterprise / organised part of the enterprise (OPE). If otherwise, there

is potential for limiting the liability of the buyer by obtaining from the seller certificates of tax arrears (up to the amount of tax arrears presented thereof).

- Potential for obtaining a VAT refund within 25 days and for excluding the joint and several liability when applying the split-payment mechanism to the payment of the property purchase price.

Disadvantages:

- The need to precisely determine the tax implications involved in the scope of indirect taxes (VAT or CLAT) in advance. In many cases it is recommended to obtain a joint individual interpretation (joint tax ruling) confirming the tax consequences of the transaction for the seller and the buyer jointly.
- The need to precisely define the subject of the transaction for the purposes of CIT and real estate tax (RET).
- Verification of the subject of the

transaction as to whether it qualifies as a sale of real estate / enterprise or an OPE, which significantly changes the tax consequences of the transaction.

- Verification of whether the seller's bank account is included on so-called White List of VAT taxpayers, enabling them to secure tax-deductibility of the real estate property acquisition and to cut off the joint and several liability with the seller for the unsettled VAT on the transaction. If the seller's bank account is not white-listed, the purchaser may avoid the aforementioned sanctions by submitting a special notification (via the ZAW-NR form) to the head of the tax office responsible for the purchaser or by making a payment under the VAT split payment mechanism.

Share deal (the buyer's perspective)

Advantages:

- Under certain conditions, the ability to settle the tax losses of the acquired company. (In this respect, the buyer may be required to analyse whether the acquisition of a loss-making company qualifies as a reportable tax scheme, since the acquisition of such a company may fulfil the generic hallmark set out in the MDR provisions, especially if the amount of tax losses is significant. Please note that generic hallmark must be met jointly with the main tax benefit test to qualify for reportable tax scheme).
- Potential for negotiating a price reduction through unrealised profits (latent capital gain).
- No need to analyse the qualification of the transaction as an enterprise / OPE (i.e. unlike in an asset deal, there is no risk of potential reclassification of the transaction by the tax authorities).
- An individual tax ruling (as confirmation of the nature of the transaction for tax purposes) is not necessary.

Disadvantages:

- Continuation of tax settlements (the tax history) of the acquired company, which makes it necessary to conduct a detailed

tax due diligence process before the purchase.

- As the buyer is taking over the target company together with all its liabilities, more extensive indemnities and warranties are to be secured in the Sale and Purchase Agreement (SPA) than in the case of an asset acquisition.
- 1% tax on civil law transactions (CLAT) on the fair market value of the shares / stocks purchased.
- No potential for updating the property's value to its market value.
- Refinancing the investment may entail certain tax consequences, in particular the tax realisation of foreign exchange differences, restrictions resulting from the so-called debt financing costs limitation (the earnings stripping rules), withholding tax (WHT) and CLAT.
- The real-estate company being a subject of such a transaction (whose shares are sold) might be obliged to collect and tax on the income (i.e. to act as a tax remitter) earned by the seller from the sale of shares. Additional safeguards to be taken by the buyer as of January 2021 include:
 - The buyer should verify the calculation of the seller's taxable income earned from the sale of shares in a real-estate company and the taxes resulting from the transaction, and secure this issue in the SPA by adding the appropriate warranties.

Limitation aiming at restricting debt push down benefits

In recent years, tax law in Poland has been subject to numerous changes affecting new real-estate investments, company reorganisations and their financing structures. In particular, the debt push down mechanism is effectively not available under Polish CIT rules. It is therefore not possible to classify as tax costs the costs of financing granted for the acquisition of a company's shares, if as a result of post-transaction activities (e.g. a merger of companies) they were to be settled against the operating income of the acquired company.

Additional limitation of deducting financing costs in capital transactions

In addition, beginning from 2022, the taxpayer is obliged to exclude from the tax costs any debt-financing costs obtained from a related entity, in the part in which they were allocated directly or indirectly to capital transactions. These might include the acquisition of shares in a company or all rights and obligations in a partnership, increases in the share capital, the purchase of shares for redemption (buy-back of shares) or making additional payments.

Summary

Recent developments in Polish tax law have substantially affected the tax environment and could have a major impact on the acquisition structure of a real-estate investment.

In order to determine which type of transaction will be most favourable for the investor from a tax point of view, a potential buyer should carefully examine the deferred tax items of the company to be acquired, such as, inter alia, the tax value of the property in the seller's books, unrealised exchange-rate differences on the loans and the company's accumulated tax losses, by which it may potentially be possible to reduce the company's income in the future. Each transaction requires a case-by case approach and pre-acquisition analysis of the tax consequences they may entail.

The occurrence of factors such as a higher tax value than the market value of the property, a high level of accumulated tax losses, the occurrence of negative unrealised exchange-rate differences and the lack of significant tax risks may make a share deal transaction a favourable solution. On the other hand, significant tax risks identified in the pre-acquisition due diligence phase, CLAT being a non-recoverable cost of the shares acquisition versus deductible VAT and new regulations on shifting the obligation to settle tax on the sale of shares in real-estate companies to the real-estate company being acquired may be arguments for choosing an asset deal instead.

1.1.1. Selection of acquisition structure

Several holding vehicles are available to a foreign buyer and the tax structuring of the real-estate investment acquisition should be carefully analysed beforehand.

Local holding company

Given the limitation on tax-deductibility of interest incurred within debt push-down structures introduced as of January 2018, arrangements that use a Polish tax resident company acquiring the financing to purchase the shares, followed by a merger with the target, are no longer tax efficient due to the restrictions on debt push-down benefits. Additionally, the new tax regime in force as of January 2022 for holding companies being Polish tax residents gaining full tax exemption on the disposal of shares (many other conditions would also have to be met), would not apply to the disposal of shares in a real estate-rich company.

Foreign holding company

The foreign buyer may choose to make the acquisition itself. Non-residents are not subject to tax in Poland on gains on the disposal of shares in a Polish company (unless a so-called 'real estate-rich company clause' in a relevant tax treaty or provided in the Polish CIT Act applies). The real estate-rich company clause is gradually being introduced to the tax treaties with countries that have served so far as the holding jurisdictions for real-estate investments in Poland (e.g. The Polish President signed the Act of 14 October 2021 on the ratification of the amending protocol to the DTC with the Netherlands on 23 November 2021. A real estate-rich company clause provided for in the protocol introduces taxation of gains derived by a Dutch tax resident from sale (or other disposal) of shares in a company (or comparable interests) if, at any time during the 365 days preceding the disposal, these shares derived more than 75% of their value directly or indirectly from immovable property located in Poland (indirect shareholding should also be considered in this context).

1.1.2. Acquisition funding

A buyer needs to decide whether an acquisition

will be funded with debt or with equity.

1.1.2.1. Debt financing in share deal acquisitions

The principal advantage of debt financing is the potential tax-deductibility of interest (see the section below on 'Deductibility of interest'). This is because, unlike interest distribution, the payment of a dividend does not reduce the tax base of the Polish entity paying the dividend.

Until the end of 2017, a typical scheme used debt push-down structure. As of 1 January 2018, an amendment was introduced that denies tax deductions for interest on bank facilities and loans if the interest reduces income associated with the acquired company's business continuity, in particular due to a merger and the transformation of its legal form. Due to these limitations introduced on the tax-deductibility of interest incurred within such structures and the new distinction between types of revenues (capital vs. other source of revenues), these scenarios are no longer available.

CLAT is levied on loans (from non-shareholders) at a rate of 0.5% but can be mitigated if properly structured.

Loans from banks or financial institutions are CLAT-exempt. Shareholder loans granted to companies are CLAT-exempt. Loans granted by partners to partnerships generally are subject to 0.5% CLAT.

Additional payments to a company's equity and cash injections to increase the share capital are subject to CLAT at 0.5%. Share premium is not subject to CLAT.

Deductibility of interest

Interest incurred to earn revenue is normally tax-deductible when paid/compounded to the loan principal within the respective source of revenue. Interest on a loan granted for shares acquisition is as of January 2018 classified within the capital source of revenue. It therefore cannot be deducted from the revenues belonging to other source (i.e. from operational business activity source of revenue).

When the financing is granted to a Polish company, Polish earnings-stripping rules should be observed. As of January 2022, the amount of debt-financing costs exceeding 30% of tax EBITDA or PLN 3 million is not tax-deductible (details in section 3.1.4.).

1.1.2.2. Equity financing

Any establishment (or increase) of the share capital in the Polish company is subject to 0.5% CLAT in Poland (share premium is not subject to CLAT). Dividend payments from a Polish company may be exempt from WHT if the conditions of the EU Parent-Subsidiary Directive are met. Dividends are not deductible for Polish tax purposes.

Although equity offers less flexibility should the parent subsequently wish to recover the funds it has injected, in certain circumstances the use of equity may be more appropriate than debt, e.g.:

- the funding company prefers not to recognise taxable revenue arising from interest;
- the borrower is generating low EBITDA;
- the notional interest deduction is being used to the maximum level; and
- where the borrower is loss-making, in which case it may not be possible to deduct all the cost of interest for tax purposes.

1.2. Development of the real-estate investment by the investor

In cases when the investor develops the real-estate property, it can be difficult to correctly classify the real-estate investment for tax purposes.

1.2.1. Real-estate properties built for sale

In the case of real-estate properties built for sale, costs are recognised on a general basis. As a rule, when considering the revenue from the sale of these real-estate properties, they should be recognised as costs in the tax year in which the revenue from their sale is earned.

However, there are still many contradictory interpretations regarding when to classify expenses related to the construction of buildings for sale as tax costs. The most complex issue is the definition of indirect costs and whether they are related to the construction in question or to the company's operations in general. It happens that in some cases the tax authorities define expenses closely related to the construction process as indirect costs, recognised at the time they are incurred. This approach is obviously too restrictive. By recognising costs on a one-off basis and generating a tax loss in the particular years of investment execution, a taxpayer will be able to settle at most 50% of the accumulated tax loss in the year of obtaining revenue from the sale of the real-estate property. (Alternatively there is the possibility of a one-off reduction of the taxpayer's taxable base by an amount of tax loss up to PLN 5 million, which in the case of a large real-estate investment project may be still insufficient).

In the case of a single project carried out by a special purpose vehicle, as is typical in the real-estate business, this may lead to the inability to utilise a significant part of the tax losses. Additional doubts arise in the case of financial costs. While the general rule of recognising the interest as tax costs at the time of its payment is not questioned in the case of real-estate properties being constructed for sale, the tax authorities issue tax rulings allowing taxpayers to defer the moment of recognising financial costs (in particular interest, commissions, loan-related fees etc.) and recognise them in the tax year in which the taxpayer obtains revenue from the sale of the real-estate property.

In order to avoid possible problems, it is important to indicate clearly and formally in the cost documentation (agreements, invoices, internal documentation) the direct relation of the cost to the construction process. At the same time, it is possible to indicate a group of indirect costs which, as a rule, will have to be of a nature other than those directly related to revenue. An example of such a cost is the property tax on the land or the perpetual usufruct fee

on the land on which the real investment for sale is developed.

EXAMPLE 1

Scenario: A Sp. z o.o. is an entity that carries out development activity. The company deals with the construction of flats and commercial premises in residential buildings for sale. The financing for the investments carried out by the company is provided by the payment made by purchasers. Pursuant to Polish law, A Sp. z o.o. is required to enter into an agreement to maintain an open trust bank account to which buyers will make payments for the purchase of flats. In the case of an open trust account, the bank transfers the funds paid by the purchasers to A Sp. z o.o. upon confirmation that a given stage of development has been completed.

Question: If the development agreement obliges the purchasers to make periodic payments to the open housing trust account in accordance with the payment schedule, which correspond to the advancement of the housing project, should the developer recognise such payments as taxable revenue at the time when they are transferred to the developer's account by the bank maintaining the open trust account?

Answer: Payments made by the purchasers of apartments to the open trust account, and then transferred by the bank operating this account to the account of the developer upon confirmation of completion of a given stage of development of the project, do not constitute taxable revenue of the developer at the time of receipt. Under the Polish law, revenue does not include amounts collected or accrued towards goods and services to be delivered in subsequent reporting periods. Such payments made by purchasers are of the nature of an advance and are therefore not treated as a definitive benefit for the developer.

EXAMPLE 2

Scenario: C Sp. z o.o. begins to develop a residential project. It intends to conclude reservation agreements with prospective purchasers, under which it will reserve apartments for clients for the period specified in the agreement, subject to payment of a reservation fee. The reservation fee will be refundable to the customer's bank account if the development agreement is not executed. If a development agreement is executed, the reservation fee will be credited towards the sale price of the residential apartment.

Question: Does receipt of the reservation fee constitute taxable revenue for the developer?

Answer: The reservation fee as a returnable benefit will not constitute taxable revenue for the residential property developer. If the reservation fee is offset against the sales price, the general rules regarding the moment of generating taxable revenue will apply.

EXAMPLE 3

Scenario: E Sp. z o.o. is about to complete a residential project. It intends to begin delivering apartments to buyers on the basis of a hand-over protocol. The signing of the protocol is the moment at which the buyer receives the keys to the apartment. The notarial deeds transferring the ownership right to the apartments to the buyers may only be signed several months after the handover of the apartments.

Question: Is the moment of actual delivery of the apartment to the buyer, by handing over the keys and confirming such delivery by signing the hand-over protocol, the moment when the developer should recognize the taxable revenue?

Answer: Signing the hand-over protocol and handing over the keys to the apartments do not result in transferring to the buyer the right of ownership to the apartment. Only the conclusion of an agreement on the transfer of ownership of the premises in the form of a notarial deed results in an effective transfer to the buyer of the ownership right to the property.

EXAMPLE 4

Scenario: D Sp. z o.o. carries out real-estate development activity. The company is currently implementing a residential development project for sale. As a result, it incurs several costs while executing its investment, including general administration costs, related salaries, and the costs of bookkeeping services and renting office premises.

Question: Should these costs incurred during the investment period continue to be recognised on an ongoing basis?

Answer: Yes. These costs are of a general, permanent nature and are related to ensuring the continuity of the company's operations. They have no direct connection with the given real-estate investment and therefore should be classified as indirect costs deductible on the date they are incurred.

Example 5

Scenario: E Sp. z o.o. carries out real-estate development activity. The company is currently implementing three residential projects for sale. Consequently, it incurs advertising and marketing expenses during the investment period.

Question: When should advertising and marketing expenses be recognised for tax purposes?

Answer: The qualification of advertising and marketing expenses will depend on the nature of the specific cost. In a case when they are related to advertisements in the press, billboards, brochures and leaflets etc. concerning a particular investment, then the company should be able to prove their direct relation to income from the sale of apartments in this investment (as they are aimed at attracting people to buy apartments in this particular residential investment) and recognise them at the moment of earning revenue from the sale in the extent that is proportional to the cost of their development. On the other hand, if the company incurs expenses that cannot be attributed to a particular residential investment but constitute advertising of the company itself (e.g. advertising gadgets with the company's logo) one may also

consider recognising these as indirect costs that are deductible on the date they are incurred.

EXAMPLE 6 - Construction of a building for sale

Scenario: Development company A Sp. z o.o. has built a complex of single-family houses which it plans to sell.

Question: How should the company qualify the costs incurred by the construction of houses intended for sale?

Answer: In the case of a developer, revenue will arise once the houses are sold. The costs associated with a particular house should be recognised when the company earns revenue from its sale. However, allocating costs to particular houses in this situation is not straightforward. As a rule, the costs incurred for the construction of an entire housing complex should be allocated to the particular houses according to a set proportion (e.g. based on their area or their value).

1.2.2. Real-estate properties built for own use (as long-term investment/ fixed asset)

The capitalisation of a wide range of expenses relating to the cost of one's own real-estate properties has not raised major doubts over the years. However, for several years it has been possible to observe contradictory trends, indicating the recognition of certain categories of cost on the date of incurrence, not through depreciation. This applies in particular to expenditures related to the transfer of road infrastructure to the municipality and technical infrastructure (e.g. network connections) to municipal enterprises. (The tax authorities take a position that allows for a one-off inclusion of this type of expenditure in tax costs on the date it is incurred).

EXAMPLE 7 - Building a real-estate property for rent

Scenario: Company B has built a shopping mall in which it will lease premises to

tenants. The construction of the mall and its subsequent rental is its sole business. In the course of the construction, the company incurred various categories of costs, such as general management costs including accounting services. It also received a loan in foreign currency for the construction of the shopping centre and the car park located next to it, purchased the land for the construction of the shopping centre, paid the real estate tax on the land on which the investment was carried out and used the services of a construction company to which it commissioned the construction works.

Question: How should the company segregate the construction costs after completion, and which of the above costs will determine the initial value of the shopping mall?

Answer: When making the cost segregation, the company should carefully analyse all incurred costs and allocate them appropriately to determine the initial value of the building and its accompanying structures.

First of all, the costs of real-estate tax should not be considered as an element determining the initial tax value of the building, but as a tax-deductible cost at the moment of being incurred. The initial tax value of the building also does not include the cost of land acquisition, which will only be a cost at the time of disposal of the property.

The company will include in the initial tax value the cost of interest on the loan paid before the fixed asset was put into use and will adjust the initial tax value by using any realised exchange-rate differences. Costs that arise on repayment of financing after the fixed asset has been put into use will be recognised for tax purposes in accordance with general rules.

Costs of general management, such as costs of accounting services or those of remunerating members of the management board will not increase the initial tax value of the building and accompanying structures, but instead will be tax costs according to general rules.

Expenditures for the services of the construction company shall be qualified as the cost of building and accompanying structures' construction. However, additionally within these costs, part of the expenditures shall be allocated proportionally to the building and part to the structures (e.g. car park, pavements, internal roads). Determining the value of the developed structures at the cost-segregation stage of the investment process significantly helps to determine the real-estate tax base applicable later on.

1.2.3. Real estate tax (property tax) vs. moment of completion of construction works

One other issue that may raise doubts in connection with the construction of buildings for own use is the moment at which the real-estate tax obligation arises.

In the case of newly constructed buildings, the property tax obligation arises on 1 January of the year following that in which the construction has been completed, or in which use of the structure or of the building or its parts has commenced before its final completion. In the view of the tax authorities, as well as the courts, this moment should be determined as the day of completion of the construction (e.g. on the basis of annotation in the construction logbook) and not on the basis of the date of the later permit for the use of the building. In such cases, it is necessary to verify the date of actual completion of the construction works. The actual completion of construction at the beginning of the year allows the moment of tax obligation to be postponed until 1 January of the year following that in which construction was completed.

EXAMPLE 8 - Completion of construction at the end of the year and property tax

Scenario: The company completed the construction of an office property in mid-December 2020. In turn, the occupancy permit was issued on 10 January 2021.

Question: Will the property tax liability arise in 2020?

Answer: Although the company only received the occupancy permit in 2021, the completion of the construction took place in 2020. When the circumstance upon which the tax obligation depends is the existence of a building, the tax obligation arises on 1 January of the year following the year in which the construction was completed or in which its occupancy began. In this case, the taxable event will be the actual completion of the construction. However, if the actual completion of construction did not occur until early January, the property-tax obligation would not arise until 1 January 2022. For the purposes of the emergence of the real-estate tax obligation, the relevant date is the moment at which the earlier of the events occurs, i.e. completion of construction or commencement of use (which, as a factual state, does not have to be the same as the date of obtaining the occupancy permit).

1.3. Operation and commercialisation phase, leasing of the real-estate property

During this phase, real-estate companies mostly earn their revenues from the rental of property (or other contracts of a similar nature) and incur costs that are mainly related to the real-estate property and its rental, including tax depreciation, financing costs and the cost of ensuring the lease of the property.

Pursuant to the Polish tax law, the income of the real-estate company is subject to taxation of 19% (or 9%) CIT rate.

Recent years have brought important tax changes relating to the real-estate sector, which are having an impact both on operating activities of real-estate companies and on the entire business environment.

We list below the applicable general tax rules and the most important modifications affecting the real-estate business, also taking into account the most recent tax amendments introduced by the so-called Polish Deal.

1.3.1. General taxation rules

1.3.1.1. Tenant acquisition costs

At the commercialisation stage of the real-estate investment, the costs of acquiring and attracting tenants are incurred both in the form of remuneration for a real-estate broker and incentives for tenants in the form of a cash bonus paid at the conclusion of a lease agreement (the so-called lease incentives). In some cases, property owners also offer tenants rent rebates or even rent-free periods.

EXAMPLE 9 - New tenant acquisition costs – real estate broker commission

Scenario: Company ALFA intends to acquire a major tenant (an anchor tenant) for the office building it constructed in January 2020. For this purpose, ALFA has engaged a real-estate broker in and agreement to seek tenants. Thanks to the efforts of the broker, a lease agreement was signed with a tenant for a period of five years. The company paid the broker a fee for the service of finding the tenant.

Question: Will the remuneration paid to the real-estate broker be a tax-deductible cost?

Answer: The tax authorities do not question the tax deductibility of any remuneration paid to the real-estate broker for finding a new tenant, since this is an expense incurred to earn revenue in the form of rent paid by the new tenant. The only doubt relates to the moment of recognising the cost for tax purposes. The position of the tax authorities in this regard has changed over time. Currently, the prevailing approach is that this cost, as a cost other than one directly connected to revenue, may be recognised as a tax cost on a one-off basis on the date on which it is incurred. However, according to the tax authorities' approach, this cost may be also recognised as a tax cost by spreading it proportionally over the duration of the lease agreement, if the taxpayer uses this approach for accounting purposes. This position results from the definition of the day on which the cost was incurred as the day on which the expense was entered in the books (booked).

EXAMPLE 10 - Costs of acquiring a new lessee - bonus for the lessee for concluding a lease agreement

Scenario: ALFA has concluded a lease agreement with a retail chain to which it has leased a large-format shop in its newly-constructed shopping centre. In order to attract a key tenant, it paid them a lump sum bonus for concluding the lease agreement for a period of five years.

Question: Can the remuneration paid as a bonus for concluding the lease agreement be a tax-deductible cost for ALFA Company?

Answer: The tax authorities do not question the possibility of recognising as a tax cost an expense in the form of a bonus for a new tenant for concluding a long-term lease agreement, since this is a cost incurred to earn revenue in the form of rent from the lease to be paid by the tenant. The only doubts concern the moment of recognising the cost for tax purposes. There is no uniform approach that tax authorities take as to whether such a cost may be recognised on a one-off basis or should be recognised over the term of the lease agreement.

The tax authorities take the position that it is necessary to identify the day on which the cost is incurred, understood as the day on which the cost is booked in the company's books. If the company recognises the expense in the books as a one-off cost, then the cost should be recognised for tax purposes also in the full amount on a one-off basis. However, if the company accounts for the cost in the books during the term of the lease agreement, it should do the same for tax purposes. However, in line with the recent interpretation presented in the jurisprudence, the moment of recognising the cost of the bonus for the lessee for accounting purposes should not determine the moment of its recognition for tax purposes. This means that the cost of the bonus for the lessee may be subject to recognition for tax purposes once - on the date of incurring the expense (i.e. on the date of entering the invoice in any account in the company's books, even if for

accounting purposes the company would settle it over time).

EXAMPLE 11 - Acquiring a new tenant - rent-free period

Scenario: ALFA has agreed a five-year contract with a new tenant, who due to the conclusion of a long-term lease agreement was granted a rent-free period for the first six months. However, during this period the tenant is obliged to pay the costs of utilities and service charges.

Question: What corporate income-tax consequences will the granting of a rent-free period to a new tenant have for ALFA?

Answer: According to the tax authorities' approach, the period of the lease agreement for which no rent is charged should not be considered in isolation from the remaining term of the lease agreement. In the case in question, the real estate is not given to the lessee for use free of charge because, from the perspective of the entire term of the lease, the use is of a chargeable nature. What is more, even during the rent-free period, the lessees remain obliged to pay a service charge as well as utility charges. It is crucial that the landlord can justify that the total rent payable for the entire lease period does not differ from the market rent.

1.3.1.2. Tax depreciation in real-estate company

As a rule, the standard tax depreciation rate for buildings, including commercial property, is set at 2.5% of the capitalized costs per annum. An annual rate of 4.5% applies to structures. Higher rates may also apply to other specific categories of fixed assets. It may be possible to disaggregate other specific fixed assets from the building (e.g. sprinklers, air-conditioning etc.) which may be depreciated with higher depreciation rates (e.g. 10%).

However, in some cases limitations concerning tax-deductibility of depreciation are applicable.

Starting from 1 January 2022, according to the recently adopted amendments,

real-estate companies (as defined in point 3.2.1) have been entitled to include in their tax-deductible costs write-offs for the consumption of fixed assets (depreciation write-offs) in the amount not higher than the depreciation write-offs for the consumption of fixed assets made in accordance with the accounting provisions.

In practice, this means that:

- if for accounting purposes a taxpayer recognises real-estate property as a fixed asset and depreciates it, they are entitled to include depreciation write-offs in their tax result (as a tax-deductible cost). However, in that case the fixed asset must be presented in a historical value; in practice this means that the taxpayers' tax result will be decreased by the depreciation write-off cost, but depreciation write-offs will at the same time decrease the financial result and consequently dividend capacity; or
- if for accounting purposes a taxpayer recognises real-estate property as an investment property, it will not be entitled to make depreciation write-offs (neither for accounting nor for tax purposes); in practice it means that the taxpayers' tax result will not be decreased by depreciation write-off's cost. At the same time, however, this cost will not decrease the financial result, and in consequence its dividend capacity will be higher than in the case indicated above. Nevertheless the taxpayer will be able to recognise the undepreciated value of the property upon its disposal.

Moreover, starting from 1 January 2022, residential buildings (e.g. including investment in PRS, student houses etc.) have not been depreciable for tax purposes. The taxpayer is now only entitled to recognise costs incurred in the acquisition of this asset upon its disposal. Until 31 December 2022, only for residential buildings acquired/developed by 31 December 2021 will it be possible to recognise tax depreciation in line with the previous regulations.

1.3.1.3. Minimum CIT from commercial real estate (RE CIT)

Buildings (or their parts) that are rented or leased are taxed under a specific, dedicated tax regime.

There are some exceptions, but taxation generally involves buildings which are the property or in the joint ownership of the taxpayer, are wholly or in part for use under a rental, lease or other agreement of a similar nature and are located in the territory of Poland.

The tax base is the initial tax value of all the taxpayer's rented buildings minus PLN 10 million (around EUR 2,175,000). RE CIT should be paid monthly at the rate of 0.035% of the tax base (i.e. 0.42% per year). RE CIT can be deducted from the declared CIT liability (and may be deducted from monthly CIT advances), meaning the taxpayers are entitled to deduct the monthly RE CIT from monthly CIT advances.

It is possible to apply for a refund of RE CIT where it exceeds an entity's final CIT liability or when the entity has incurred tax losses due to transactions conducted on an arm's length basis. However, the tax authority would then need to review certain information to verify the CIT liability of the taxpayer (i.e. perform a form of 'tax audit') before RE CIT is refunded.

As part of the COVID measures, RE CIT has been suspended as from March 2020 to the end of the epidemic status in Poland.

1.3.1.4. Thin capitalisation (earnings stripping rules)

During the operating phase of real-estate investment, financing costs (e.g. in the form of interest on loans) for constructed or acquired real estate are still being incurred. In this case, it is possible that limitations on the recognition of interest as a tax-deductible cost, resulting from the so-called 'thin capitalisation', may apply.

As of January 2018, debt-financing costs affected by the earnings stripping rules have encompassed all costs related to obtaining financial resources from other entities (both from related and unrelated

parties). The limitation includes any kind of debt-financing costs (e.g. interest, commission, fees, bonuses, and the interest part of the lease instalment).

Starting from 1 January 2022, the new limitation of tax-deductibility of the debt financing costs in the Polish CIT Act was amended in such a way that the taxpayer may now include as tax-deductible costs either:

- the surplus of debt-financing costs within the limit set by the value of 30% of the tax EBITDA obtained in the fiscal year; or alternatively
- the safe harbour, i.e. the limit of PLN 3 million.

There will therefore be no basis for combining both limits and applying them simultaneously.

Debt-financing costs disallowed in a given tax year may be utilised within the following five years within the applicable tax-deductibility limit.

1.3.1.5. Distribution of profits from a real-estate company to a shareholder

1.3.1.5.1. Dividends

Dividends paid by a Polish resident company to another resident company generally are not subject to withholding tax. Dividends paid to a resident individual are subject to withholding tax at 19%.

Dividends paid to a non-resident are subject to withholding tax at 19%, unless the rate is reduced under a tax treaty or the dividends qualify for an exemption under the EU Parent-Subsidiary Directive provided the dividend is not related to a transaction (or a set of transactions) undertaken to benefit from a tax exemption and that does not reflect economic reality.

1.3.1.5.2. Interest

Interest paid to a resident company is not subject to withholding tax.

Interest paid to a non-resident company is subject to 20% withholding tax, unless the rate is reduced under a tax treaty or the EU

Interest and Royalties Directive, provided the interest is not related to a transaction (or a set of transactions) undertaken to benefit from a tax exemption and that does not reflect economic reality. An exemption based on the Directive may be available only if the recipient is the beneficial owner of the interest.

The recent amendments in the Polish CIT Act in force as of January 2022 include the new 'beneficial owner' definition, according to which it should be understood to be an entity that:

- receives payments for its own benefit, decides on its own on its use and bears the economic risk of losing this payment (or part thereof);
- is not an intermediary nor a representative, trustee or any other entity obliged to transfer the received payment (or part thereof) to another entity;
- conducts genuine business activity in the country of its residence – i.e. it receives payment relating to the business operations performed.

In assessing whether the recipient of payments performs genuine business activities, the nature and scale of its business should be taken into account.

Due care to be exercised by WHT remitter

Due care requirement exists under the Polish CIT Act requiring a WHT remitter to execute due care considering the nature and scale of business activity in verifying and documenting whether their payment-recipient status entitles them to benefit from WHT exemption/reduced rate. The threshold required is not clearly specified, although some general guidelines provided by the Ministry of Finance were issued suggesting this would depend on the characteristics of the payment recipient and the amounts paid.

1.3.1.5.3. New WHT collection rules

The collect and refund withholding tax regime regarding payments exceeding PLN 2 million per annum (to an individual recipient of payments) came into force

on 1 January 2022. The excess over that amount will be subject to a standard 19% (dividend)/20% (interest/royalties) WHT rate.

The pay and refund regime shall be applicable only to passive payments (dividends, interest, royalties) made only to related, non-Polish entities. The regime will therefore not cover service payments (advisory fees) and other payments made to non-related suppliers.

Under new rules, the payer acting as a WHT remitter must withhold tax at the standard rate on the surplus over PLN 2 million at the time of payment, unless the payer either:

- provides tax authorities with a statement that a withholding tax exemption or reduced rate is applicable; or
- obtains advance tax opinion from the tax authorities that an exemption based on the EU directives or exemption (reduced tax rate) on the basis of double tax treaty provisions may be applied.

Where tax is withheld but the payment qualifies for an exemption or reduced rate, a refund subsequently may be requested from the tax authorities (within a period of up to six months).

1.3.2. Ongoing CIT taxation

1.3.2.1. New definition of the real-estate company

The definition of a real-estate company was introduced to Polish CIT Act as of January 2021. For a company to be considered a 'real-estate company', it must meet the following conditions:

- as at the last day of the year preceding the tax year, at least 50% of the balance sheet value of assets, directly or indirectly, was the balance sheet value of real estate (property) located in Poland or rights to such properties;
- the balance sheet value of these properties exceeded PLN 10 million or the equivalent of this amount, determined according to the average exchange rate of foreign currencies, announced by the National Bank

of Poland, on the last business day preceding the last day of the tax year preceding the tax year;

- in the year preceding the tax year, tax revenues from rental, sublet, lease, sub-lease, leasing and other contracts of a similar nature or from the transfer of ownership, the subject of which are real estate or rights to real estate, and from shares in other real-estate companies, constituted at least 60% of the total tax revenues.

The introduction and application of the real-estate company rules impose new obligations on this category of companies, i.e.:

- the tax remittance obligations are shifted to the real-estate companies on share deal transactions, i.e. in the case of alienation of more than 5% of shares (or rights of a similar kind) in a real-estate company by a foreign entity, the real-estate company is obliged to settle the income tax advance payment on the realised income from the transaction on behalf of the seller;
- providing the head of the tax administration with information about the real-estate entity's partners or shareholders (whereas partners and shareholders holding at least 5% in real-estate companies will be required to report on the shares held in these companies);
- appointing a tax representative, provided such real-estate companies have no seat or place of management in the EU or in an EEA Member State.

1.3.2.2. Shifted income

Starting from 1 January 2022, following amendments to the Polish CIT Act, a new tax is being levied on taxpayers (tax residents in Poland) due to the so-called 'shifted income'.

This tax would amount to 19% of certain qualifying expenses, including, in particular, debt financing and management costs, if the sum of such expenses from the shifted-income catalogue constitutes at least 3% of the sum of all tax costs incurred in a given tax year by the Polish taxpayer. The shifted income is deemed to be certain

costs incurred directly or indirectly for a related entity provided that:

- the actual income tax paid by this related entity for the year in which it obtained the receivable, in the state of their seat, management, registration or location, is 25% lower than the amount of income tax that would be due from it if the income of this entity was taxed with 19% Polish standard tax rate (i.e. 14.25% CIT or lower), whereby the tax actually paid is understood to be tax that is not refundable or deductible in any form, including for the benefit of another entity; and
- these costs:
 - are classified in any form as tax-deductible costs, are deducted from the income, tax base or tax of that related entity, or
 - are paid by this related entity in the form of dividends or other revenues from participation in the profits of legal persons for the year in which it received the payment
 - constituted at least 50% of the value of revenues obtained by this entity, determined in accordance with the provisions on income tax or accounting.

The amendment assumes that the above taxation rules will not apply if the indicated costs are incurred for the benefit of a related entity, subject to taxation on all its income in a Member State of the European Union (EU) or in a country belonging to the European Economic Area (EEA) and conducting significant actual business activity in that country.

1.3.2.3. Tax-deductibility of certain expenses on intangible services

Starting from 1 January 2022, the legislator decided to repeal the provision, pursuant to which taxpayers are currently obliged to limit the tax-deductibility of their intangible expenses incurred for the benefit of related parties. An appropriate mechanism considering the limitation of the above-mentioned costs has been included in the computation structure of the new tax (the so-called minimum CIT). For more details on minimum CIT taxation, please see below.

1.3.2.4. Minimum CIT taxation

From 1 January 2022, a new income tax (the so-called minimum CIT) has been payable by corporate taxpayers provided that such entities:

- report losses from the sources of income other than capital gains; or
- report the share of income in their revenues (other than capital gains), amounting to 1% or less.

The rate of the minimum income tax is set at 10%.

The taxable base would be calculated as the sum of:

- 4% of the value of revenues from sources other than capital gains;
- costs of debt financing incurred on behalf of related entities, exceeding 30% of the so-called tax EBITDA;
- deferred income tax related to the disclosure of certain intangible fixed assets, resulting in an increase in gross profit or a decrease in gross loss; and
- the value of costs regarding purchasing of some services and intangible rights in the part exceeding 5% of tax EBITDA plus PLN 3 million.

The amount of the minimum income tax due will be deductible from CIT, calculated according to general rules for three consecutive tax years after the given tax year in which the tax was paid.

The new provisions provide for some exclusions from the above taxation. In particular, minimum CIT will not apply to taxpayers beginning economic activities, in the year when operations commence and in the next two tax years.

1.3.2.5. Transfer pricing

According to Polish law, Polish taxpayers are required to prepare and maintain transfer pricing (TP) documentation that justifies the pricing, as well as contracting parties and their roles in the relevant transaction.

The main rules regarding TP documentation (comprising a three-tiered

TP documentation structure with different scope content – ‘Local File’, ‘Master File’ and ‘Country-By-Country Reporting’) are as follows:

- capital relations threshold at the level of 25%, personal connection (e.g. same persons on management also trigger TP relation);
- the obligation to prepare TP documentation applies only to transactions exceeding PLN 10m (for goods and financial transactions) or PLN 2m (for other transactions, including inter alia services), depending on the type of transaction, i.e. irrespective of the level of revenues or costs incurred by a taxpayer;
- the new safe harbours for loans meeting specific criteria and low value-added services are introduced, the application of which exempts the taxpayer from the obligatory benchmarking requirements;
- the materiality threshold for the Master File is PLN 200 million of the consolidated revenues;
- the Master File will be allowed to be prepared in English, also by other group entity (translation will only be required at the request of the tax authorities);
- the deadlines for the preparation of the Local File and Master File with related statements is extended to the end of the ninth and twelfth month after the end of the given tax year, respectively;
- the taxpayers are obliged to submit a new electronic TP-R form instead of CIT-TP/PIT-TP forms within nine months after the end of the tax year; and
- the tax authorities are entitled to re-characterise or even disregard a related party transaction if they consider that unrelated entities would not enter into such a transaction or would carry out a different transaction.

Under the new TP rules, the management board is obliged to file the sworn statement that prices within the managed entity are of an arm's length nature. In consequence, management may be held personally responsible if there is a breach of TP regulations.

As from 1 January 2022, some amendments have been implemented to the TP regulations. In particular, they will cover the following factors:

- an extension of the deadline for the preparation of local TP documentation – this deadline is now to expire by the end of the tenth month after the end of the tax year;
- an extension of the deadline for submitting TP information, to the end of the eleventh month after the end of the tax year;
- the elimination of the statement of the preparation of TP documentation as a separate document and transferring it, in the amended wording, to the TP information; and
- an extension of the deadline for submitting, at the request of the tax authorities, local TP documentation from seven to fourteen days.

1.3.3. Selected compliance requirements applicable to real-estate companies and major taxpayers

1.3.3.1. Notification on shareholders of the real-estate company

According to the CIT changes which came into force as from 1 January 2021, a real-estate company and taxpayers holding directly or indirectly at least 5% of shares (or an interest of a similar nature) in such a company are obliged to notify tax authorities about entities holding directly or indirectly such an interest. (They should also report the number of shares held directly or indirectly in the real-estate company).

The above entities are obliged to provide information for the fiscal or financial year, by the end of the third month after the end of the tax/ financial year. The information should reflect the data as of the last day of the tax/financial year.

1.3.3.2. Obligation to prepare a tax strategy and publish the information on the execution of the tax strategy

Under new CIT provisions applicable as from 1 January 2021, taxpayers whose

revenues earned in the tax year exceeded the equivalent of EUR 50 million in a tax year (converted into PLN according to the average EUR exchange rate announced by the National Bank of Poland on the last working day of the calendar year preceding the year of making individual data of taxable persons public) and tax capital groups are obliged to prepare and publish information on the execution of their tax strategy.

In this case, taxpayers should prepare and disclose information on, inter alia:

- their approach to processes and procedures on managing obligations arising from tax regulations and ensuring their proper execution;
- the number of submitted reports on tax schemes (MDR), separately for each tax;
- transactions with related entities, the value of which exceeds 5% of the asset's balance-sheet total;
- restructuring activities planned or undertaken by the taxpayer;
- submitted applications for a tax ruling.

The above listing is not exhaustive and the report itself is to be prepared considering the nature, type and size of the business.

Information classified as trade, industrial, professional or production-process secrets is excluded from the disclosure obligation.

The initial report on the tax strategy executed in 2020 was to be prepared and published by the end of 2021. The next report, which will cover the period of 2021, should be presented by the end of 2022.

1.3.3.3. Obligation to report on payment practice in accordance with the provisions on payment gridlocks

The provisions on payment gridlocks impose on tax capital groups, and on CIT taxpayers who exceeded the equivalent EUR 50 million in revenues in the previous tax year, the requirement to submit reports in a given year to the Minister of Economic Development and Technology on the payment practice (i.e. on the payments dates applied for commercial transaction).

The reports shall be submitted by the above entities by 31 January of each following year.

1.3.3.4. Recent tax amendments to restructurings

CIT regulations as in force from 2021 limit the taxpayer's right to deduct an incurred tax loss in the case of certain restructuring activities (mergers, in-kind contribution of an enterprise or organised part of an enterprise, the contribution of funds followed by purchase of an enterprise or organized part of an enterprise), if as a result of such reorganisation:

- there is a change to the core business activity conducted by the taxpayer; or
- at least 25% of the shares are held by an entity/entities which, as at the last day of the tax year in which the taxable person incurred the loss, did not have such shares.

Also, new provisions in force from 2022 make maintaining the tax neutrality of a reorganisation very challenging, as only the 'first' in a chain share-for-share exchange, spin-off or merger can be tax neutral.

1.3.3.5. RET

Polish RET is a local tax levied on the ownership of real-estate property and is payable annually to local authorities. Precise RET rates depend on the municipality in which the property is located.

RET tax base is:

- for land – the area and classification indicated in the Register of Lands and Buildings;
- for buildings – the so-called 'usable area' which should generally be measured on the inner side of walls and on each floor of the building; and
- for structures – the initial (gross) tax value of the structure, which is not decreased with its tax-depreciation for CIT purposes.

RET compliance is made on annual basis, i.e. the RET return is filed annually upon acquisition or by 31 January each year.

1.4. Exit from Investment

In the event that an investment is terminated and the investor wishes to sell the real-estate property, the key issue to be resolved is the choice of the form of disposal. As with acquisitions, the vendor can sell the property itself (an asset deal) or the company owning the real-estate property (a share deal). For the vendor the main considerations in this context are the income tax implications, indirect taxes (VAT, CLAT) as well as the possibility of an effective profit transfer and the extent of liability for tax obligations.

The share deal from the seller's perspective:

Advantages:

- No VAT taxation, and the burden of civil law transaction tax (CLAT) lies with the acquirer.
- Easier distribution of profits to the parent company.
- No need to liquidate the company.
- No liability of the shareholder for tax arrears of the sold company under tax regulations.

Disadvantages:

- 19% capital gains tax is payable on the disposal of shares. (In the case of foreign entities, there is also the possibility of taxation only abroad, depending on the provisions of the relevant double-tax treaty, i.e. whether a real-estate clause applies).
- The possibility for the buyer to negotiate a reduction of the price by unrealised profits (latent capital gain).
- Contractual regulation of the economic burden of responsibility for the tax arrears of the sold company. (The economic seller may share this burden with the buyer, if the parties so agree in the sale agreement).

Asset deal from the seller's perspective:

Advantages:

- Where there is no doubt that the subject of the transaction is an asset and not a company or its organised part, it should be less time-consuming to conduct an asset deal (as it is possible to skip the full due-diligence stage of the company).

Disadvantages:

- 19% taxation of profit on the sale of real estate. The tax base is the difference between the revenue from the transaction and the tax value of the property in the seller's books.
- It is necessary to precisely determine the implications in terms of indirect taxes (VAT or CLAT), sometimes with the necessity for a prior joint tax ruling that secures the tax treatment of the transaction.
- Verification of the subject of the transaction in terms of its proper qualification as a sale of real estate / enterprise or an organised part of the enterprise (OPE), which significantly changes the tax consequences of the transaction.
- The need to take additional measures to distribute profits to the parent company (e.g. liquidation of the company, redemption of shares).
- The need to consider the tax consequences related to the repayment of a loan/bank facility financing the acquisition/construction of the real estate being sold.
- Verification of the seller's total revenues obtained in the year of the sale of the property with regard to the possible obligation to prepare a tax strategy – the sale of real estate property may result in exceeding the threshold of EUR 50 million in a tax year.
- The need to analyse whether profit distribution to a non-resident entity by a seller may qualify as a tax-planning scheme. Such distribution, in addition to being subject to WHT, may trigger

obligations under the MDR rules, in particular, if the income earned by the non-resident exceeds a certain limit (i.e. PLN 25 million).

From a tax perspective, each transaction requires an individual examination of the possible tax consequences to assess which disposal scenario will be most favourable. The tax consequences of the transaction are an additional negotiating aspect between buyer and seller and may affect the final price of the property.

1.4.1. VAT classification

Depending on the period that has elapsed since the real-estate property was first occupied, the sale of buildings/structures may be either subject to VAT or exempt from VAT. Polish VAT regulations allowed resigning from the VAT exemption and opting for VAT taxation of a real-estate transaction in the form of submitting an appropriate statement to the head of the tax office competent for the buyer before the real-estate delivery date. However, under a recently introduced provision, transaction parties may also opt for VAT taxation of deliveries of buildings, structures, or their parts in the form of a statement included directly in the sale agreement that has the form of notarial deed.

In specific cases, it is possible only to tax or only to exempt the sale from VAT.

The parties to the transaction should also consider applying jointly in advance for a tax ruling regarding the appropriate classification of the transaction for VAT purposes.

1.4.2. Disposal of shares in real-estate companies/ changes in double tax treaties

In the case of disposal of shares in a real-estate company by a foreign entity from a country for which the double tax treaty concluded with Poland provides for a so-called real-estate clause (as well as in the case of sale of shares by Polish companies), the income determined based on the difference in price between the acquisition cost and the sale of shares will be subject to taxation in Poland and is qualified into the capital source of income.

Nevertheless, as from 1 January 2021, the method of collection of the tax on exit has changed.

Where a non-resident sells shares or similar interests that comprise at least 5% of the voting rights/interests in a company qualifying as a real-estate company under the Polish CIT Act (see the definition in section: 3.2.1.), the company whose shares are being sold is required to remit the tax and settle the capital gains tax payable on the transaction on behalf of the seller.

From a transactional perspective, the mechanism must be properly documented and will result in the following obligations for the participants of the transaction:

- **A real-estate company will be obliged to settle CIT resulting from the sale of its shares**
 - the real-estate company would be obliged to transfer an advance payment for CIT equal to 19% of the taxable basis (the taxable revenue reduced by tax-deductible expenses, if any) to the competent tax office, by the 20th day of the month following the one in which a taxable gain has occurred;
 - if the transaction amount is unknown to the company (including tax-deductible expenses to be recognised by the seller/s), the tax amount is determined as 19% of the fair value of the sold company's shares.
- The seller's or sellers' obligation
 - the seller/s is/are obliged to provide information regarding the sold company and the amount of the advance CIT payment regarding the transaction prior to the deadline indicated above. The real-estate company is obliged to inform the seller of the amount of the advance tax paid (on CIT-ISN form); as a result:
 - the taxpayer of capital gains tax would still be the seller/s, but a real-estate company (as the tax remitter) would be liable for the collection and payment of CIT to the tax office; furthermore
 - the seller should file the CIT-8 return for the year in which the disposal took place.

EXAMPLE 14 - The sale of shares in a Polish real-estate company by a shareholder from Luxembourg

Scenario: A Luxembourg S.a r.l. intends to sell its shares in a Polish SPV of which it is the sole shareholder. The Polish company's main asset is an office building which is fully leased to tenants.

Question: Will the transaction be taxed in Poland?

Answer: As the current double taxation treaty between Poland and Luxembourg contains a so-called real estate clause, the disposal of shares in the Polish company will be taxed in Poland.

2. The Czech Republic

2.1. Development Phase

2.1.1. Acquisition of the investment

In the case of an investment acquisition, the choice of the form of the acquisition is crucial on the investor's side. The transaction might be realised as an asset deal (a direct acquisition of property) or as a share deal (the acquisition of the company owning property) or as business deal (the so-called transfer of going concern). To identify the most efficient solution, the investor should take into account a wide range of tax implications such as income taxation (Corporate Income Tax ('CIT')), indirect taxation (Value Added Tax ('VAT')), transfer taxation (Real Estate Transfer Tax ('RETT')), the scope of potential tax-base succession elements (tax losses, deferred tax, depreciation costs) and the consequences of financing.

2.1.1.1. Asset deal transaction

From the buyer's perspective, an asset deal, i.e. the direct acquisition of a real-estate asset, provides the possibility of

reflecting the acquisition price of the real-estate asset in tax books and thus apply the tax depreciation from that price. Also, the interest from financing the acquisition might be treated as tax deductible and therefore might decrease the tax base of the buyer. Moreover the tax arrears of the seller are not transferred to the buyer (compared to the share deal).

However, when the capital gain from the sale of a real-estate asset is subject to taxation at the level of the seller, the corporate income tax being paid by seller (income minus tax net value) might be transferred to the buyer in form of an increased purchase price. Moreover, there is 4% RETT from 'fair market value' of real estate or purchase price, the higher of which is to be paid by the buyer.

From the VAT perspective, the asset can be sold by the seller as taxable (subject to VAT of 21%) or VAT exempt. Generally, VAT exemption without the right to VAT deduction applies to a sale of land other

than building land. If there is a construction located on the land the exemption of the land may be derived from the VAT treatment of the construction. The VAT exemption could be usually applied if the building is 'older' than five years. Nevertheless, the seller may decide that this transaction will be taxable with the consent of the buyer. If the option to tax is used, the obligatory local reverse charge applies if the buyer is a VAT payer (i.e. the buyer is obliged to self-assess output VAT and claim related input VAT at the same time in its VAT return if it has the full right to deduct input VAT).

The buyer should be able to claim VAT deduction if the asset is to be used for its taxable economic activities and the general conditions for the right to VAT deduction are met. In other cases there is no right to VAT deduction, or VAT can be claimed only in a partial amount.

2.1.1.2. Share deal transaction

As opposed to an asset deal, a share deal

might be a tax-neutral transaction for the buyer as well as for the seller. It should be noted that in this type of transaction a detailed due diligence process of the company prior to the purchase in terms of its historical tax settlements will be necessary.

Capital gain from the sale of shares (the difference between the selling price and the acquisition price of the shares) in a Czech subsidiary is generally subject to corporate income tax (19%) in the Czech Republic if the Czech participation exemption is not applied or the relevant double tax treaty does not state otherwise.

Based on the Czech participation exemption, the capital gain might be tax exempt if the parent company holds at least 10% of shares in the subsidiary for an uninterrupted period of at least 12 months, provided both companies have proper legal forms and both companies are EU tax residents.

Moreover, the sale of shares is not subject to RETT. Share-deal transactions when the place of supply is in the Czech Republic are in general VAT exempt. The seller is not allowed to claim input VAT from the costs directly relating to the sale of shares. From the seller's perspective, it is also important to consider whether the VAT-exempt share deal could influence their VAT coefficient (which might negatively impact the amount of recoverable VAT).

As the share deal is a transaction which might be fully tax neutral, the share deal might be cheaper than the asset deal. However, the price being paid for shares cannot be reflected in the tax values of real-estate assets, i.e. the tax values remain unchanged. In this respect, the buyer might often have the option of negotiating a price reduction should a case of unrealised profits occur (latent capital gain).

Moreover, the interest for the acquisition of shares should be treated as tax non-deductible at the level of the buyer of shares if the debt push down mechanism is not used, which might enable a reduction in the company's operating income by

financing costs (i.e. mainly interest) related to the acquisition of its shares.

There is also a limitation on the utilisation of tax losses when there is a substantial change in ownership (the 'same activity' test).

2.1.1.3. Business deal

From the seller's perspective, the transfer of a business (so called transfer of going concern / TOGC) is outside the scope of VAT, and no VAT will be charged by the transferor. To assess a transaction as being outside the scope of VAT, the conditions for TOGC must be fully fulfilled (i.e. the business must be transferred as a whole, including all assets and related liabilities, and it must be able to continue its economic activity going forward, etc.). It is always necessary to precisely evaluate all aspects of the transaction.

2.1.2. Property development by the investor

Generally, all the costs related to development, as well as the costs of demolishing an existing building in order to erect a new investment building, should be recorded under the account 'Acquisition of New Assets' until the new buildings/land are put into use. The development costs will become part of the tax value of the investor's real-estate assets, and will get to the tax base in form of tax depreciation or as tax value costs in the case of such buildings/land being sold.

The interest related to the acquisition of the building or related to financing of construction costs might be also included into the acquisition price of the real-estate asset until the asset is put into use. The interest related to the acquisition price of land should be recorded directly to the costs, and these should not be capitalised into the acquisition price of the assets.

When the development services are purchased from related parties, the general transfer pricing rules must be fulfilled (i.e. under the arm's-length principle, with documentation and the ability to prove the provision of services).

Simultaneously, there is a group of costs of a character not directly related to construction (indirect costs). An example of such costs will be general administrative and operational costs, including sales / administration / accounting, property tax related to the land on which the investment is carried out etc. These costs should be booked directly to the expenses. An individual approach should be taken to, among others, marketing or advertising expenses during the investment phase.

VAT from costs related to development can be deducted (if the general conditions for VAT deduction are met) if the costs are directly and demonstrably related to the VAT payer's taxable economic activities (or planned taxable activities).

With respect to the development costs linked to both the economic and non-economic activities, only a partial ratio can be applied, calculating VAT deduction in an amount that is proportionate to the extent of their use for economic activities.

It is also necessary to distinguish whether the costs related to economic activities are used for VAT-exempt or taxable supplies, or both. The full input VAT deduction can be claimed only from development costs related to taxable supplies. The pro-rata coefficient has to be applied to costs relating to both – VAT-exempt and taxable supplies. No VAT deduction is possible on costs related only to VAT-exempt (without an entitlement to deduct VAT) supplies.

Development costs resulting in the creation of fixed assets are subject to VAT adjustment rules. It has to be monitored during the adjustment period (five or ten years) if there is a change in the partial, pro-rata ratio or purpose of uses of these fixed assets. The VAT payer is obliged to return VAT if such a situation arises and the VAT deducted should be lower. The VAT payer has the right to claim VAT back in a case where the VAT deduction should be higher.

2.2. Operating and commercialisation phase

During the operational phase, the profit

(income minus tax costs) is subject to a CIT rate of 19%. Most common costs which arise during this phase are tax depreciations, financing costs and costs ensuring the lease of the real estate, such as brokerage costs or lease incentives. Among the most common lease incentives are tenant's remuneration, rent-free period and fit-out costs.

2.2.1. Real-estate tax depreciation

The building might be tax depreciated either for 30 (buildings for living in, such as flats) or 50 (hotels, shopping malls, administrative buildings etc.) years, depending on the purpose of the building. There are two possible options for depreciating – linear and digressive. As the method of tax depreciation cannot be changed during the life of the property, it is therefore recommended to consider the advantages and disadvantages of both methods before choosing. The accounting depreciation of buildings should reflect the actual use of buildings: there are no other rules. It is possible to use the component-depreciation method for accounting purposes.

According to Czech law, land cannot be depreciated for both tax and accounting purposes.

2.2.2. Interest costs

In general, interest costs might be treated as tax deductible in cases where they are used for achieving, securing and maintaining taxable revenue. However, some of the interest costs are treated as non-tax deductible, including interest from loans relating to the acquisition of shares or the interest derived entirely or mainly from the debtor's profit.

The tax deductibility of other interest costs on the loans is further limited by the following rules – the thin capitalisation rule and the ATAD rules.

The thin capitalisation rule applies to financial expenses from loans provided between related parties, when the equity/loan ratio of the recipient of the loan exceeds 4:1. Financial expenses (interest, bank guarantee, fee for the intermediation

of a loan etc.), which exceed this ratio, are treated as a non-tax deductible cost. The thin capitalisation rule also applies to so called 'back-to-back loans'.

As a result of the Anti Tax Avoidance Directive, new rules limiting the tax deductibility of financing costs have applied from 1 January 2020. As the thin capitalisation rules remain in force, there are two sets of rules limiting the tax deductibility of the interest.

This new rule should be applied on the net financing costs, i.e. the difference between financing expenses and financing revenues, provided both by the related and third parties (e.g. banks). (In contrast, the thin capitalisation rule limits only the interest related to a loan between related parties.)

The net financing costs are compared to the de minimis value of CZK 80 million or 30% of tax EBITDA. Any interest exceeding the limit should be treated as non-tax deductible, and might be unlimitedly carried forward to future tax periods. No carry forward is allowed for legal successor companies.

2.2.3. Brokerage fee and tenant's remuneration for the lease agreement sign off (lease incentives)

Generally, the brokerage fee and tenant's remuneration might be treated as tax deductible if they are incurred in achieving, securing and maintaining taxable revenue.

Nevertheless, it is always necessary to individually assess every contract and the actual substance of the remuneration provided, which affects not only the tax deductibility of such costs but also the booking of such a transaction (one-off cost or accrued).

From the VAT point of view it is necessary to recognise the purpose of remuneration. This must be always individually assessed. Based on the purpose, the remuneration might be considered as a provision of the service, discount or not subject to VAT at all.

2.2.4. Rent-free periods

Generally, the rent-free periods should be taken into account when the revenues / costs from rent are booked and should be accrued properly.

2.2.5. Fit-outs costs

Generally, the fit-out costs should increase the purchase price of the building or be booked as technical improvement for the tenant if such fit-outs costs are not actual repairs.

When the lease contract is terminated, the fit-outs costs paid by the tenant should be settled with the owner of the building or the premises should be restored to their previous condition. If not, the non-monetary income comes to the owner of the building and should be subject to taxation.

The VAT deduction can be claimed only on fit-outs costs linked to an economic activity as further described below. In case of the settlement of the fit-outs being paid by the tenant to the building owner, it can be subject to VAT of 21% or adjustment of original deduct VAT.

2.2.6 VAT – partial and pro-rata ratio

Real-estate investors, owners or operators might be required to calculate a VAT co-efficient, which basically determines their position regarding the recoverability of input VAT. The following transactions might result in an obligation to calculate VAT coefficients: e.g. VAT exempt rents, the provision of financing services or holding structures.

The VAT from operating and other costs can be deducted (if the general conditions for VAT deduction are met) if the costs are directly and demonstrably linked to the VAT payer's taxable economic activities (e.g. the taxable lease of immovable property).

With respect to the costs linked to economic and non-economic activities alike, only a partial ratio can be applied, calculating the tax deduction in a proportionate amount that corresponds to the extent they are used for economic activities.

It is also necessary to distinguish whether the costs relate to VAT-exempt or taxable supplies, or both. The full VAT deduction can be claimed only from the costs relating to taxable supplies. The pro-rata coefficient has to be applied to costs relating to both VAT-exempt and taxable supplies (e.g. management fees, legal and tax advisory or other overhead costs). In case the incurred costs are related only to VAT exempt transactions (without an entitlement to deduct VAT), then it is not possible to claim any VAT in this respect.

Provided that the incurred costs are fully re-invoiced to tenants, then it could be considered whether it is possible to claim full VAT and not to apply the pro-rata coefficient on these costs.

2.3. Exit from the investment

In the case of the completion of an investment and an intention to sell the property, as in the development phase the main consideration for the investor is the form of the exit to be taken from the investment. In such a case, the seller may sell the actual property (in an asset deal transaction) or sell the company owning the property (a share deal transaction). Again, the tax implications are main factors for consideration.

2.3.1. Profit distribution

Generally, the profit distribution might be tax exempt if: the parent company holds at least 10% of the shares in the subsidiary for an uninterrupted period of at least 12 months; both companies have proper legal forms; and both companies are EU tax residents. The exemption might be also applied when the dividends are distributed to the third-party countries with which the Czech Republic has concluded a double tax treaty and the receiving company is subject to tax in a home-country with an income tax rate similar to that of the Czech Republic of at least 12%.

2.3.2. Exit taxation

Effective from the taxable period that started on 1 January 2020, an amendment to the CIT Act introduced a tax on the relocation of assets without a change of ownership (i.e. exit tax).

The relocation of assets/functions from the Czech Republic should be subject to taxation of 19% if the assets are being sold. Payment of such exit tax might be deferred over five years based on the taxpayer's request. Please note, that this may have very limited impact on real-estate companies.

2.3.3. Asset deal

Generally, a capital gain from the direct sale of the assets (difference between revenues from the sale and tax-book value of the asset) is subject to corporate income tax at 19% in the Czech Republic. RETT is paid by the buyer.

If the sale of assets (e.g. the sale of immovable property) is VAT exempt without an entitlement to deduct VAT, the seller might be required to return part or the entire amount of the VAT originally claimed on the purchase of real estate (or its technical improvement). After 10 years, no obligation to return part of the previously claimed VAT exists in respect of non-current assets (or their technical improvement).

2.3.4. Share deal

A capital gain from the sale of shares (the difference between the selling price and the acquisition price of the shares) in a Czech subsidiary is generally subject to corporate income tax (19%) in the Czech Republic if the Czech participation exemption is not applied or if a relevant double tax treaty does not state otherwise (please see above). No RETT or VAT should be applied. The seller is not allowed to claim input VAT from the costs directly relating to the sale of shares. From the seller's perspective, it is also important to consider whether the VAT-exempt share deal could influence their VAT coefficient (which might negatively impact the amount of recoverable VAT).

2.3.5. Business deal

The transfer of a business is outside the scope of VAT, so the transferor is not obliged to pay output VAT from the enterprise deal (the so-called transfer of going concern / TOGC). To assess a transaction as being outside the scope of

VAT, the conditions for TOGC must be fully fulfilled (e.g. the business is transferred as a whole with all assets and related liabilities, and the business must be able to continue with its economic activity going forward, etc.). It is always necessary to precisely evaluate all aspects of the transaction.

2.4. Czech real estate: tax key points

2.4.1. Asset deal versus share and business deal

The share deal is the most common form when acquiring real-estate assets. When the shares are acquired, the following issues should be considered:

- reviewing the tax value of the property, especially if the proper documentation is available;
- considering latent capital gains tax as a potential discount on the purchase price;
- the financing and tax deductibility of the interest and potential debt-push down merger;
- deferred tax which might have an impact on the future tax base of the company;
- restriction of input VAT deduction from costs directly related to the share deal; and
- impact on the VAT coefficient due to related investment financing and the sale of shares.

3. Romania

3.1. Acquisition and development phase

3.1.1. Acquisition and land development – legal matters

Under Romanian law, the purchase of ownership rights over real-estate property is established on the basis of sale purchase agreements concluded in a notarised form, which is required for validity purposes.

In order to develop and operate a project, other real rights to the land might be required, including superficies rights, the right of easement, right of usage, or right of usufruct.

In relation to the sale of agricultural lands located outside city limits, the law provides that this can be performed only with the observance of the legal pre-emption rights established in favour of the co-owners, the immediate family, the owners of agricultural improvements over the land, the lessees, the owners or lessees of the neighbouring plots of land, young farmers, neighbouring

State institutions in the field of agricultural research, persons living in the respective territorial and administrative division (town) and in neighbouring ones, and the State, through the State Property Agency (in this order, under equal price and conditions).

Should the pre-emptors not exercise their pre-emption right, preference is then given to natural persons who:

- had lived in Romania for five years prior to the sale,
- had carried out agricultural activities and were registered with Romanian fiscal authorities within the same period,

or to companies which:

- had had their headquarters or secondary headquarters in Romania for five years and carried out agricultural activities in Romania for a minimum of 75% of their income for the previous five years, with the main shareholder being situated in Romania for at least five years. If none

of the potential purchasers fulfils this criteria, then the sale may be freely performed to any purchaser.

Further, with respect to the sale of certain categories of agricultural lands located outside city limits, it is necessary to obtain specific permits issued by the Ministry of National Defence and the Ministry of Culture. Additionally, if the land had been affected by agricultural or forestry activities, as well as industrial, economical or military activities that may impact the quality of the soil, the obtaining of a soil-quality certificate is mandatory prior to any sale. The sale of agricultural lands without observing the above-mentioned procedures may trigger the annulment of the sale agreement.

Note should also be made that, for agricultural lands, if they are sold within a period of eight years following their acquisition, the seller must pay a tax of 80% of the difference between the sale price and the purchase price at its acquisition date.

3.1.2. Types of real estate rights

The superficies right, which is the most frequent right to which developers resort when an ownership transfer is not performed, includes: (i) the right to own or build a construction on the property owned by a distinct person; (ii) the ownership right to the building; and (iii) the right to use the land pertaining to the building. According to the Romanian Civil Code, the superficies right may be established for a maximum of 99 years, with the possibility of prolonging it.

Pursuant to Romanian law, usufruct rights may be established on property belonging to another owner. The usufructuary (i.e. the holder of the usufruct right) has the right to use and enjoy the property belonging to a third party, including the right to receive profits from the income generated by the property. The usufruct right is a real-estate right of limited duration. Hence, if established in favour of an individual, it may have a duration equal to the lifetime of the usufructuary. If established in favour of a legal person it may have a duration of a maximum of 30 years.

For the purpose of ensuring the connection of utilities to a property, easement rights may be also established. Such rights represent, in fact, a limitation of the ownership right. The right of way is the most common right of easement established by land owners, and it represents the right of the land owner (or the owner of the construction erected on the land), lacking access to a public road, to have access to a neighbouring property which has access to a public road. Note should be made that in order for such rights to be validly constituted, urbanism certificates should be obtained by the parties to the agreement. Easement rights may be established also for the benefit of public-utility operators.

The law requires that the agreements on the basis of which real-estate rights are established are formalised in a notarised form. Furthermore, all such rights should be registered with the relevant land books in order to ensure third parties are aware of them.

3.1.3. Registry system

Real-estate properties and related rights are registered in the relevant land books held by the public authorities. Land books are opened for each immovable asset (land or, respectively, land and building) regardless of the identity of the owner.

Local offices for Cadaster and Land Registration are located in each county of Romania. All public registrations carried out within the above-mentioned structures are further centralised under the supervision of the National Agency for Cadaster and Land Registration.

Proof of ownership (or a related real-estate right) may currently be performed by way of notarised transfer deeds. However, the Civil Code provides that the proof of ownership right to real-estate assets will be made by the excerpt from the land book as of the date when the cadastral works for each local municipality are finalised. Hence, once the cadastral works are finalised, the registration with the land book shall become a condition for the valid transfer of the title over real-estate assets (save for in the case of certain limited exceptions provided by law).

The registration is also relevant for secured creditors (e.g. financing banks), in the sense that the registration date ensures the priority ranking against other creditors. Furthermore, land-book registration offers special protection to the good-faith registered owners against third-party claims against the title, after a certain period of time (five years during which the acquirer may prove its good faith).

3.1.4. Limitations over the acquisition of the real estate

The legal regime regarding the acquisition of real-estate assets by foreign investors differs depending on:

- the type of real-estate assets in question (land or buildings); and
- whether the foreigners are nationals of EU member states or non-EU member states.

While there are no restrictions relating to the acquisition of buildings by foreign entities and individuals, the following should be noted with respect to the acquisition of land:

- Nationals of EU member states (both companies and individuals) and stateless persons domiciled in EU member states may acquire:
 - land under the same conditions as those provided by law for Romanian nationals, for the purpose of setting up secondary offices or secondary residence in Romania, starting from 1 January 2012; and
 - agricultural land and forestry land under the same conditions provided by law for Romanian nationals starting from 1 January 2012.
- Nationals of non-EU member states (both companies and individuals) and stateless persons domiciled in non-EU member states:
 - may acquire the ownership right over land in Romania under the terms set by the applicable international treaties, on the basis of reciprocity.
 - However, conditions for the acquisition of land may not be more favourable for such companies or individuals than for nationals of EU member states.

3.1.5. Right to build

Under Romanian law, the right to build is granted only to owners, as well as to holders of real-estate related rights (except for special licenses granted to oil and natural gas operators).

The owner of land located within the perimeter of archaeological sites, as defined by Government Ordinance no. 43/2000, must observe specific regulations concerning restrictions for the protection and recovery of the archaeological heritage.

In cases when archaeological works are required in a specific area, any other activities shall be suspended until the termination of archaeological investigation, as evidenced by a certificate indicating archaeological completion.

3.1.6. Planning and developing real estate

Strategic planning and zoning in Romania are governed by the provisions of:

- Government Decision no. 525/1996 approving the general urbanism regulation;
- Law on territorial planning and urbanism no. 350/2001 and the related Implementation Norms (approved by Order no. 233/2016); and
- The Administrative Code of Romania, approved through Emergency Government Ordinance no. 57/2019.

Typical legislative and governmental controls relating to strategic planning and zoning are performed as follows:

- For the preparation and approval of strategic planning documentation ed, plans are prepared (at public authority level) for national territory, certain zones and for counties.
- For the preparation and approval of zoning documentation, the law defines (i) the General Urbanism Plan; (ii) the Zoning Urbanism Plan; (iii) the Detailed Urbanism Plan.
- The implementation of and compliance with the strategic planning and zoning regulations are typically ensured by local representatives of the Romanian State Inspectorate in Constructions and the Chief Architect institution.

Furthermore, specific legislative and governmental controls are applicable for ensuring the strategic planning and zoning of certain areas / objectives of public interest such as highways, national roads, bridges, railways, environmental protected areas, historical monuments etc.

3.1.7. Construction permissions

The first step in the process to permit construction is the issuance of the urbanism certificate, which presents the building parameters, restrictions, limitations and/or specific requirements to be observed in respect to the development on a specific plot of land.

Of the restrictions or special requirements typically applicable to construction development in Romania, the following should be highlighted:

- Specific restrictions deriving from zoning regulations – e.g. permitted and prohibited use of the plot of land and building parameters.
- Restrictions deriving from the specific location of the plot – e.g. vicinity of special types of facilities / infrastructure such as historic monuments, archaeological sites, special protection areas, military units, airports, utilities networks etc.
- General building restrictions / prohibitions on plots qualified as green areas, forests or arable lands.
- Specific height regime and other requirements deriving from the location of buildings near air traffic corridors.
- Specific requirements for neighbours' approvals in cases where new constructions are developed adjacent next to or near neighbouring buildings for which protective intervention measures are necessary.
- When buildings are developed with a purpose different than that of the neighbouring building; for change of purpose of premises in the existing buildings.

The construction permission procedure therefore entails the following main steps:

- The issue of an urbanism certificate.
- If required under the urbanism certificate, the preparation and approval of an urbanism plan (either a zoning urbanism plan – PUZ, or a detailed urbanism plan - PUD).
- The issue of all prerequisite approvals requested under the urbanism certificate (fire permit approval, approval issued in connection with environmental protection, approvals referring to the connection of various utilities etc.).
- The issue of the building permit.

In addition to the above, a complex technical project (that must be endorsed

by specialist verifiers) stands as basis for the building permit.

Once the building permit has been obtained, the investor is requested to provide the City Hall and the State Inspectorate in Constructions with a written notice certifying the certain date when the execution works effectively start. Commencement of works must occur within the deadline specified in the building permit, which may be of a maximum of 24 months. Once commencement is officially announced, the execution works must be performed within a certain limited period of time specified in the permit, which may be subsequently prolonged if certain conditions are met.

During the performance of construction works, the State Inspectorate in Constructions and other special local authorities/bodies are entitled to verify if the works are being commenced / performed in compliance with the building permit.

Completion of works is marked by the execution of a reception protocol with the participation of the local City Hall's representatives and (in certain cases provided by law) of the representatives of the firefighting authorities and State Inspectorate in Constructions.

3.2. Acquisition of land – tax matters

Depending on the route chosen (asset deal or share deal), under the acquisition phase several implications should be considered when determining the most efficient solution from a tax point of view. These include, but are not limited to the possibility of taking over the tax losses carried forward, depreciation costs, the deductibility of borrowing costs with respect to financing the transaction, potential VAT liabilities and more.

3.2.1. Asset deal

Following the acquisition of a real-estate property, the acquisition cost will become the new tax value of the asset, based on which the acquirer should start to compute the related tax depreciation. The acquirer

should split and book separately any real-estate property including both building and land, as different depreciation regimes and property taxes apply.

The VAT treatment depends on the status of the building (new or old) or land (building or non-building). For VAT purposes, buildings remain new by the 31st December of the year following the one of their reception.

For new buildings and building land, the sale will be subject to VAT as follows:

- VAT at the standard 19% rate will be charged by the seller directly on the invoice, if the buyer is not VAT registered in Romania. The person liable for VAT in this case is the seller, who needs to declare and pay such VAT to the state budget by the 25th of the month following the reporting period in which the sale takes place.
- No VAT will be charged on the invoice, if the buyer is VAT registered in Romania. In this case, the person liable for VAT will be the buyer, under the VAT reverse charge mechanism (nil cash flow impact).

Old buildings and non-building land are VAT exempt without credit. This means that no VAT will be charged on the sale, but part of the input VAT related to the construction/ purchase of the building or land may become a cost, as it cannot be deducted and adjustment will be necessary. The VAT adjustment period for immovable property is for 20 years.

There is an option to apply VAT to the sale of old buildings and non-building land as well. This is done by submitting a special notification to the tax authorities (with the format of the notification provided by the law). The notification can be submitted anytime within the five-years statute of limitations and has retroactive effect.

The asset deal may qualify in some cases as a transfer of business as going concern ('TOGC') if the assets transferred constitute an independent economic activity subsequent to the transfer. TOGC falls outside the VAT scope, and the buyer

is seen as the successor of the seller in respect of the assets transferred. In this case, the 20-year VAT-adjustment period for real estate will continue to run, the reference date being that on which the seller acquired the assets, not the date of transfer to the buyer.

3.2.2. Share deal

A detailed due-diligence exercise of the company is recommended prior to the purchase, in terms of historical tax settlements. The potential buyer should look carefully at the purchasing company's tax value of the property as well as the deferred tax calculation (i.e. unrealised exchange differences and the accumulated tax losses of the company), which will possibly reduce the company's future income.

Attention should be also given to the financing costs booked at the level of the operating company through debt-push down mechanisms.

Tax implications at the level of the holding company acquiring the shares should also be analysed carefully, considering provisions from the current Anti-Tax Avoidance Directive and the the proposed Directive that is expected to enter into force on 1 January 2024.

From a VAT perspective, the buyer will take over all the historical rights and obligations of the purchased company. Whereas the standard statute of limitations is of five years, for real-estate property a 20-year adjustment period should be observed in case activities not giving rise to VAT deduction right were performed or will be performed after acquisition.

For asset deals and share deals, if a transaction is carried out between related parties, transfer pricing rules should be observed.

3.2.3. Property development by the investor

3.2.3.1. Tax implications triggered by the applicability of the microenterprise regime

Romanian tax law provides that entities having revenues of less than EUR 1,000,000 at the end of the tax year should apply the microenterprise regime, starting the following year. The tax is computed by applying 3% (for entities with no employees) or 1% (for companies with at least one full-time employee) to the revenues obtained (except for certain types of income specifically excluded by the law from the taxable base). Starting with the quarter in which the company exceeds the EUR 1,000,000 threshold, it is obliged to register to and apply the corporate income tax (CIT) regime.

As an alternative, companies with at least RON 45,000 in share capital and at least two employees may opt to apply the CIT regime.

Given the revenue earned during the development phase, in practice most real-estate companies qualify as microenterprises, as they do not meet the threshold of EUR 1,000,000.

Applying the microenterprise regime may raise the following tax implications:

- Financing costs are not allowed for deduction – under the microenterprise regime, the developer will not be able to deduct the borrowing costs booked, as per the legislative provisions applicable.
- No tax losses are allowed to be carried forward – any tax losses incurred during the period in which the company is registered as a microenterprise will be lost. If the company was registered as a CIT payer and became a microenterprise due to the non-fulfilment of the conditions required, any tax losses carried forward from previous years will be allowed for deduction, starting with the moment when it reverts to the CIT system. These will be allowed for deduction within the timeframe of seven years (including the period during which the company was a microenterprise).

3.2.3.2. Special VAT-exemption regime for small companies

Newly set-up companies may apply the VAT exemption regime for small companies if

they estimate an annual turnover under the VAT exemption threshold of EUR 88,500 and they do not opt for VAT registration.

If the company becomes VAT registered later on, i.e. when the exemption threshold is exceeded, it will be able to adjust VAT on the real estate acquired/developed for 1/20 for each year of the remaining adjustment period as long as the real estate is used for taxable activities.

By opting for VAT registration before incurring investment costs, the company will be able to deduct the input AT it incurs with the investment. The VAT deduction for the investment is allowed in the investment period regardless of the activities (whether taxable or exempt) to which the investment goods are allocated in the operating phase.

3.2.3.3. Tax incentives for employees operating in the building sector

On 1 January 2019, several tax incentives were introduced for a period of 10 years for companies operating in the construction sector. Income tax and social health contribution exemption, together with a reduction of 3.75% for social insurance contribution, apply for eligible employees operating in the construction sector. The employer will be responsible in assessing the eligibility conditions for applying the tax facilities and monitor them during the implementation process.

3.3. Operating and commercialisation phase

3.3.1. Legal matters related to the operational stage

3.3.1.1. Leases of business premises: Applicable laws

The general framework applicable to lease agreements is regulated by the Civil Code, and specific provisions govern the residential leases and the land leases. Residential leases are also governed by EGO no. 40/1999 on residential tenant protection. Specific provisions may apply in a case where the premises are located within an industrial park (qualified as such according to the law).

Apart from the mandatory legal requirements, other exceptions to the parties' entitlement to freely negotiate lease agreements may apply, for example, if the premises are subject to bank financing (where minimum lease terms imposed by the bank must be observed) or if the building was developed under EU financing. In this latter case, for a certain period of time, lease agreements must take into account the fact that the project has to meet certain parameters undertaken upon the granting of the EU financing (such as granting microenterprises several facilities in terms of lower rents).

Types

Although not expressly regulated by law, the market standard includes two main types of leases, namely: (i) Triple Net Leases (although, in Romania, capital repairs are born by the landlord); and (ii) Non-Triple Net Leases.

Typical provisions

Typical provisions should refer to:

- **Length of lease term**

The terms of a lease may vary as follows:

- three to five years (and occasionally seven to ten years) in the case of regular tenants;
- 10 to 20 years in the case of anchor tenants of retail projects.

- **Frequency of rent payments**

Rent is typically paid in advance. Rent payments are made either monthly or quarterly (the latter payment mechanism being applicable in the case of anchor/ large scale leases).

- **Payment of guarantees at the start of the lease**

The tenant may provide the landlord with the following guarantees that secure its obligations:

- a letter of bank guarantee (preferably irrevocable, unconditional and at first demand);
- a cash deposit.

If applicable, the above should be accompanied by a parent company guarantee or a corporate guarantee.

- **Indexation of rent**

As a rule, the base rent is indexed

annually based on either MUICP or HICP. In some cases, the parties may agree to apply fixed base rents applicable during certain periods of time. The turnover rent mechanism is also frequently encountered in the case of retail projects. This means the tenant pays the higher amount between a certain base rent and turnover rent calculated by reference to an agreed percentage of the tenant's annual turnover.

- **Insurance of the premises**

Typically, the tenant contracts and maintains insurance for: (i) the tenant's fit-out works; (ii) content, equipment, assets, furniture and other personal properties in the premises; and (iii) civil liability insurance covering third parties and/or its employees and/or any other third parties, including the tenant's liability towards the landlord.

Typically, the insured risks include: fires, storms, blizzards, floods, earthquakes, lightning, explosions, rebellions, riots, deliberate damage, explosions and overflowing of water tanks, devices or pipes and other risks or insurances requested by the landlord (provided they exclude excesses and limitations imposed by insurers).

The landlord is responsible for (i) property insurance for the building (including landlord's installations and equipment) and (ii) insurance against property-owners' and third-party liability in respect of the common areas.

The insurance taken by the landlord does not cover the assets located within the premises which are not under the landlord's ownership.

- **Execution of fit-out works within the premises**

As a general rule, for any works entailing the issuance of a building permit, the building permit is issued in the landlord's name. This means only minor/temporary works can be performed independently by the tenant without the landlord's prior approval or acknowledgement. Even anchor tenants are usually under imposed contractual prohibitions that

prevent them from performing certain works/alterations in the premises, such as those which:

- affect the structure of the building;
- affect the external appearance of the premises or of the building;
- impact on the heating, air-conditioning, ventilation or other systems of the building;
- would reduce the leasable area of the premises; and
- obstruct the windows, doors or any areas of natural light.

• Service charge

Paid in advance on a monthly basis, the service charge is an estimated amount multiplied by the gross leased area, that is set for the first calendar year starting with the handover date to cover the services provided by the landlord according to the lease agreement. (Such services may include, but are not limited to: repair, renewal, decoration, cleaning, maintenance and lighting of the common areas of the building, cleaning the outside external glass façade, snow and ice clearance, providing the operation of heating, air conditioning and ventilation systems within the common areas, heating, cooling and ventilation of the tenant's premises, security and protection 24 hours/365 days etc.).

• Termination of the lease

A lease agreement can be terminated either: (i) unilaterally (break options) as per the contractual provisions; (ii) for default; or (iii) in a case of force majeure. Typical default events included in lease agreements that can trigger termination include a:

- delay in payment of rent or service charge;
- breach of the permitted use of the premises;
- breach of the tenant's obligations regarding the security instruments to be made available by the tenant; and
- breach by the tenant of its obligations regarding the works/alterations permitted within the premises.

If a lease is concluded for an unlimited duration, it can be unilaterally terminated by either party subject to serving a

prior written notice a reasonable time in advance.

3.4. Tax matters relating to the operational stage

Under the operating and commercialisation phase of a development, tax implications may arise in relation to:

- potential incentives (fit-outs) granted by the lessor when concluding or renegotiating an operational leasing contract;
- tax depreciation of the immovable property;
- deductibility of financing costs; and
- withholding tax for interest / dividends / management services paid to a non-resident.

3.4.1. Lease incentives granted to tenants

Romanian law allows the real-estate owner the right to grant certain incentives when negotiating or renegotiating a leasing agreement. These may include paying a cash amount in advance to the tenant, rent free periods or the reimbursement for part of the tenant's costs (e.g. a contribution to the fit-out works undertaken by the tenant).

Accounting-wise, the aggregate cost in relation to lease incentives granted to tenants should be deferred over the leasing period and recognised as a reduction of the lease income, usually on a straight-line basis.

From a VAT perspective, the lease incentives (fit-out contributions or rent-free periods) may be subject to VAT or out of the scope of VAT.

Aspects (to be analysed on a case-by-case basis) such as when incentives were granted, contractual terms and the status of the tenants determine the treatment of the incentives. During VAT audits, the subject of lease incentives is highly scrutinised by tax inspectors, often resulting in additional VAT liabilities.

3.5. Key aspects during the disposal stage

3.5.1. Legal matters related to the structuring / stages of a transaction

3.5.1.1. Types of structure

Various legal structures such as asset deals, share deals, forward purchase mechanisms or transfer of on-going concern (business transfer agreements) are used for the acquisition and/or development of real-estate property in Romania.

A detailed legal, tax, technical, environmental and commercial due-diligence exercise of the asset/company prior to the completion of the transaction is recommended. It has become market practice within the early stages of a transaction for a preliminary agreement to be concluded, such as a letter of intent, memorandum of understanding, term sheet with the purpose of securing the exclusivity period, the key commercial terms of the transaction, the timeline, and the due diligence terms.

When concluding binding preliminary sale-purchase agreements, in case one of the parties refuses to conclude the final agreement, the other party is entitled to ask the court of law to rule that the SPA should be replaced. The relevant claim has to be filed with the court no later than six months after the date the final agreement should have been concluded. In addition, in a case where a down payment was made on the basis of the preliminary sale-purchase agreement the promissory purchaser benefits from a legal mortgage over the property which has to be registered with the land book.

The time taken to complete a real-estate deal ranges from a couple of weeks to considerably longer, depending on the intended structure. The asset-based operations are the elements likely to be concluded in a shorter period, as a one-time operation, while share deals require, in principle, at least two stages, namely signing and closing, once the precedent conditions have been fulfilled.

Cases in which the consent or consultation of third parties (including public authorities) is required will take longer. The Ministry of Culture, the Ministry of Agriculture and Rural Development, Environmental Protection Agencies and the Competition Council are some of the authorities whose consultation/approval may be required for the purpose of finalising a real-estate transaction. The impact on timing may vary depending on which authorities are needed to be involved in the approval of the transaction. Hence, when structuring a share deal which involves change of control, if certain parameters are exceeded, the Competition Council's clearance is required.

Share deals will require registration of the transfer with the Trade Register, while asset deals will require notarisation by a public notary of the transfer deed, as a prerequisite for the valid transfer of land. Upon signing the sale and purchase agreement in a real-estate transaction, the public notary sends the documentation and the registration application to the Land Book Office in order for the transfer of the ownership right to be further registered in the relevant land book. Once the updated land book excerpt is issued, the new owner of the real estate undertakes to register its ownership title with the local fiscal authorities.

3.5.1.2. Applicable costs in case of asset deals

The notary fee is calculated by reference to a set of official evaluations (the public notary grid). If the purchase price is higher than the values in the grid, the fees are calculated by reference to the purchase price; otherwise, the calculation is made based on the official values. For transactions that do not exceed a threshold of RON 15,000, the notary fee is 2.2% of the value of the transaction. The notary fee for a transaction of a higher value shall be calculated as a fixed fee for each threshold plus an additional percentage applied to the value of the transaction exceeding that threshold (e.g. a fixed fee of RON 5,080 [approx. EUR 1,130] shall be applicable for a transaction value exceeding RON 600,001 plus an additional

0.44% of the transaction value exceeding this threshold).

It is customary for the buyer to also pay the land book registration and notary fees, although the parties may agree to share these costs.

3.5.1.3. Representations and warranties in real-estate transactions

The Civil Code regulates only two types of warranties (applicable in case of an asset deal): the warranty against eviction (i.e. total or partial loss of title); and hidden flaws in the real estate. The seller's liability against eviction and flaws is regulated in detail by law and can be limited or extended (to the extent permitted by the Civil Code).

Since the legal regime of other representations and warranties is not clearly defined under Romanian law, the remedies available to the buyer are generally the ones regulated under the contract, which can be further settled in court or in arbitration. Generally, the seller gives representations:

- validity of title;
- lack of litigation;
- state of the asset;
- disclosure of due-diligence information;
- potential litigation regarding the real estate;
- technical situation of the asset (including equipment), environmental obligations, fiscal and land book registration;
- validity of its corporate approvals;
- sufficiency of funds; and
- lack of any state of insolvency or similar.

3.5.1.4. Limitation of liability

The representations and guarantees granted by the seller may be subject to disclosure of information to the purchaser.

Furthermore, the Civil Code allows the parties to negotiate and establish limitations of the seller's liability with respect to the eviction and/or the hidden defects which may affect the real-estate asset subject to the transaction.

Nevertheless, according to Romanian law, there are certain limits within which the parties may regulate the liability of the seller. Namely, the liability of the seller may not be limited for matters which were known by the seller or which the seller should have known upon performing the sale of such asset, but were not disclosed to the purchaser.

3.6. Tax matters related to the structuring / stages of a transaction

3.6.1. VAT treatment of most common real-estate transactions

- lease of real estate – VAT exempt without credit, with an option to tax by submitting a notification to the tax authorities;
- sale of real estate to a buyer who is VAT registered in Romania – comments under point 1.1. are applicable, local simplification measures being applicable where the supply is taxable by law or option;
- sale of real estate to a non VAT-registered buyer – the new buildings and buildable land are taxable, subject to standard 19% VAT rate. In addition, old buildings and non-building land for which an option to tax is exercised are subject to standard 19% VAT rate.

In the specific case of the supply of houses to natural persons, the reduced 5% VAT rate is applicable under certain conditions (depending on the price and surface area).

3.6.2. Tax value and real-estate tax depreciation

Romanian tax legislation defines the tax value of a real-estate property as being the acquisition cost, production cost or the market value for real estate received free of charge or contributed. The tax value also includes any accounting revaluations performed according to the law.

Where revaluations result in a decrease of value below the acquisition cost/production cost/market value, tax depreciation should be computed considering the acquisition cost/production costs/market value. Any revaluation reserves, deducted for CIT purposes by

way of depreciation or expenses with the sale/write-off of the respective asset should be taxed simultaneously, when computing the CIT.

Under Romanian tax law, accounting depreciation expenses are non-deductible but allowed for tax deduction, in accordance with the law provisions. Land is a non-depreciable asset from a tax perspective.

3.6.3. Debt financing investments costs

New rules on the limitation of deductibility of interest and other costs economically equivalent to interest were introduced in FY 2018 as a result of implementing the EU Directive 1164/2016 – Anti-Tax Avoidance Directive (ATAD).

Briefly, such costs are deductible within the limit of EUR 1 million + 30% of the base computation.

The base computation (EBITDA) represents the difference between income and expenses booked as per the accounting rules, out of which the non-taxable income are subtracted, and the corporate income tax expenses, exceeding borrowing costs and tax depreciation amounts are added back. The exceeding borrowing costs represent the difference between the borrowing costs (e.g. interest, foreign exchange expenses etc.) and other economically equivalent income.

If the base computation is negative or zero, the borrowing costs exceeding the EUR 1 million threshold are non-deductible in the respective tax period, with the possibility of reporting them without time constraint over the next tax years. Interest and net foreign exchange losses carried forward from previous periods are subject to the same rules that started on 1 January 2018.

Additionally, close attention should be also paid to the purpose of the financing agreement, as the general deductibility rule according to which expenses are deductible if incurred for business purpose should be also met in order to benefit of interest deduction.

3.6.4. Management services

The deductibility of management services and the related input VAT is closely scrutinised during tax audits performed in Romania. As a rule, expenses are deductible for CIT purposes if incurred for business purposes. The related input VAT is also deductible as long it is incurred for business purposes and the beneficiary holds a correct invoice.

Going further, management, consulting, assistance and other services rendered by a non-resident entity are non-deductible for CIT purposes if there is no legal instrument for exchanging information between the two states and the transactions in question are considered artificial, having no economic purpose.

The Tax Code contains specific provisions regarding the tax treatment of certain expenses that might be incurred by companies that are part of a group. In this respect, the costs incurred with services provided by affiliated entities, such as administration, consultancy, management, control or similar functions, can be deducted only by the parent company, if their legal base is only the legal connection between the affiliated entities. Therefore, all the costs that have the nature of shareholder costs are non-deductible for CIT purposes at the level of the local companies.

No other specific rules or guidelines are provided for claiming the deductibility for service expenses.

In practice, close attention should be given to the documents available for proving that such services have been rendered and their economic benefit.

3.6.5. Tax on property

Under Romanian tax legislation, specific taxes due to local budgets are in place for real-estate properties.

Building tax – this tax is set according to the purpose for which the building is used: residential, non-residential or mixed. The tax rate is applied to the taxable value of the building, and ranges from 0.08% to

0.2% for residential buildings and from 0.2% to 1.3% for non-residential buildings, and local tax authorities may establish higher rates, by applying a maximum 50% increase.

Legal entities should evaluate buildings for local tax purposes every three years; otherwise the tax authorities are entitled to increase the tax rate to 5%.

Land tax – this is computed considering certain criteria such as number of square metres, the value per square metre, the status of the locality where the land is located, the land category etc.

The property taxes are computed and due for the entire tax year, and are payable by the real-estate owner as at 31 December of the previous year. The payments are due in two instalments, on 31 March and 30 September.

3.6.6. Fiscal consolidation for the companies within a group

Since 2021, companies have been able to opt to apply the consolidation of the CIT results provided that certain conditions are met (e.g. members are related parties and are subject to the CIT regime, that members have the same fiscal year etc.). In this respect, companies from the same group are allowed to aggregate their tax results. On the one hand, this lightens the tax-reporting burden at the group level. On the other, it allows the group to reduce its total cost with the taxes paid, as it is possible for the current tax losses of some of the member companies to be offset by the profits of the others.

Each member of the fiscal group should individually compute its tax on the profit due. Afterwards, the results should be consolidated and a single tax return should be filled-in and submitted to the tax authorities.

Another relevant aspect is that any tax losses registered before joining the group cannot be used at a consolidated level. Also, in relation to the transfer-pricing file, the transactions between the group members still have to be analysed and included in the file.

3.7. Exit from the investment

Asset deal

For CIT taxpayers, any profits derived from the sale of real-estate properties should be included in the taxpayer's taxable base and taxed with 16% CIT, unless offset by tax losses carried forward at company level. Revaluation reserves booked and not taxed up to the moment of sale will become subject to taxation in a similar way to revenues.

For microenterprises, any income obtained from the sale of real-estate properties is subject to 1% or 3% tax (depending on whether or not the seller company has at least one full-time employee).

According to the Tax Procedure Code, in order to transfer the ownership for buildings, the owners of the assets should present tax certificates attesting the settlement of all tax liabilities that are owed to the local budget. In lack of such certifying document, the sale and purchase agreement signed may become null and void.

From a VAT perspective, the rules detailed under point 1.1 apply. Special consideration should be given to VAT adjustment rules for real estate in cases where the supply of real estate is VAT exempt.

Depending on the assets transferred and the conditions of the transfer, the sale may benefit from the 'no supply rule' for TOGC.

Share deal

Under a share deal transaction, any capital gains derived by Romanian legal entities and non-resident companies from the sale of shares held in a Romanian company are generally subject to 16% CIT. Tax exemption may apply if the seller holds a minimum 10% of the shares in the Romanian entity, for a minimum uninterrupted period of one year. No VAT should arise on the sale of shares.

Tax exemption may also apply under the provisions of the double tax treaties concluded between Romania and the beneficiary country of residence. In this respect, the non-resident should provide a

valid tax-residency certificate.

For tax compliance purposes, even if no tax is due in Romania, there is an obligation for the non-resident seller to register and file nil tax returns, either directly or by appointing a tax agent.

Both asset deals and share deals performed between related parties, should observe the transfer pricing rules and the price should be set at market value, in accordance with the arm's length principle.

3.8. Romanian real estate: key points

3.8.1. Restitution claims initiated on the basis of the Romanian special restitution laws

After 1989, the Romanian State approved several legislative measures for compensating individuals and companies expropriated abusively during the communist regime.

This legislation entitled the expropriated persons to request restitution in accordance with special administrative proceedings. Moreover, according to this special restitution legislation, alienation of the immovable assets (land or buildings) for which such proceedings (administrative or judicial) were initiated is prohibited until completion thereof, subject to absolute nullity of the transfer deeds.

Therefore, purchasers of real-estate assets in Romania should carry out certain verifications with the public authorities in order to confirm whether the asset subject to the envisaged transaction is affected by such special restitution claims. Such checks should be completed prior to concluding the transaction documents.

3.8.2. Debt financing investments costs

New rules on the limitation of deductibility of interest and other costs economically equivalent to interest were introduced in 2018 as a result of implementing the EU Directive 1164/2016: the Anti-Tax Avoidance Directive (ATAD).

Briefly, such costs are deductible within the limit of EUR 1 million + 30% of the base computation.

The base computation (EBITDA) represents the difference between income and expenses booked as per the accounting rules, out of which the non-taxable income is subtracted, and the corporate income tax expenses, exceeding borrowing costs and tax-depreciation amounts are added back. The exceeding borrowing costs represent the difference between the borrowing costs and interest and other economically equivalent income.

If the base computation is negative or zero, the exceeding borrowing costs that exceed the EUR 1 million threshold are non-deductible in the respective tax period, with the possibility of reporting them without time constraint over the next tax years. Since 1 January 2018, interest and net foreign exchange losses carried forward from previous periods have been subject to the same rules.

3.8.3. Lease incentives granted to tenants

The Romanian law allows the real estate owner the right to grant certain incentives when negotiating or renegotiating a leasing agreement. These may include paying a cash amount in advance to the tenant, rent free periods or the reimbursement for part of the tenant's costs (e.g., contribution to the fit-out works undertaken by the tenant).

Accounting wise, the aggregate cost in relation to lease incentives granted to tenants should be deferred over the leasing period and recognized as a reduction of the lease income, on a straight-line basis, unless another systematic basis is representative of the timing of the asset's lease benefit.

From a VAT perspective, the lease incentives (fit-out contributions or rent-free periods) may be subject to VAT or out of the VAT scope depending on several aspects such as status of the tenant or contractual arrangements.

3.8.4. Tax implications triggered by the applicability of the microenterprise regime

Romanian tax law provides that entities with revenues of less than EUR 1 million

at the end of the tax year should apply the microenterprise regime as from the following year. Then, tax is computed by applying 3% (for entities with no employees) or 1% (for companies having at least one employee) to the revenues received (except for certain types of income specifically excluded by the law from the taxable base). A company is obliged to register and apply the corporate income tax regime starting with the quarter in which it exceeds the threshold of EUR 1 million.

Alternatively, companies with share capital of at least EUR 45,000 and at least two employees may opt to apply the CIT regime.

Given the revenue they earn, during the development phase, most real-estate companies effectively become microenterprises, as they do not meet the threshold of EUR 1 million.

The applicability of the microenterprise regime may raise the following tax implications:

- Financing costs are not allowed for deduction – under the microenterprise regime, the developer will not be able to deduct the borrowing costs booked, as per the legislative provisions applicable.
- No tax losses are allowed to be carried forward – any tax losses incurred during the period in which the company is registered as a microenterprise will be lost. If the company was registered as a CIT payer and became a microenterprise due to the non-fulfilment of the conditions required, any tax losses carried forward from previous years will be allowed for deduction starting with the moment when it reverts to the CIT system. These will be allowed for deduction within the timeframe of seven years (including the period in which the company was a microenterprise).

4. Hungary

A typical real estate investment process can be divided into three phases: acquisition of a particular investment; operating and commercialisation; and the exit stage. Each of these investment steps involves specific Hungarian tax issues. Below we present the key points to consider with regard to the tax liabilities arising in connection with a real-estate investment.

4.1. Development phase

4.1.1. Acquisition of the investment

In the case of a real-estate property acquisition, the choice of the form in which the acquisition will take place is crucial in terms of tax consequences. The property may be acquired either as an asset (asset deal transaction) or through the acquisition of the shares of the company owning the property (share deal transaction). In order to achieve an efficient solution, the investor in Hungary must take into account a wide range of tax implications: i.e. income taxation (Corporate Income Tax ('CIT'));

indirect taxation (Value Added Tax ('VAT')); taxation of the real property acquisition (Real Estate Transfer Tax ('RETT')); deferred tax assets (tax losses, FX related tax deferral, depreciation, development reserves, etc.); and the consequences of the particular way chosen to finance the real-estate investment.

4.1.2. Asset deal transaction

In the case of an asset deal, the acquired real-estate property can be recognised at a new value in the books of the acquirer, reflecting the value of the real-estate property at the time of the transaction. In the case of an asset deal, the potential tax losses relating to the real property will remain with the seller (i.e. they cannot be acquired and utilised by the acquirer), unless the asset deal qualifies as a preferential asset transfer in which case the tax losses attributable to the real property would be transferred to the acquirer.

One of the main tax considerations at

the time of a real property acquisition relates to the RETT liability payable by the acquirer. As a general rule, the tax liability is calculated at 4% of the fair market value of the real property acquired up to a HUF 1 billion threshold, and a 2% rate should be applicable on the part of the fair market value which exceeds this threshold (RETT is capped at HUF 200 million per real property i.e. land registry plot). However, preferential tax rates and tax-exemption titles are available in several cases, such as, inter alia, in the case of related party transactions (if certain conditions are met) or in the case of an acquisition for the purpose of developing residential properties (within four years).

VAT implications upon the acquisition of a real property should also be carefully analysed. As a general rule, the sale of certain categories of real properties, and also the leasing out of real properties, are to be considered as VAT-exempt transactions. However, taxpayers are entitled to opt for the taxable treatment of

such activities. In a case where the seller opts for taxable treatment, the acquisition of the real property will be subject to VAT. The reverse charge mechanism should apply in the case of the sale of undeveloped land (which does not qualify as a building plot) and properties which are built-in if more than two years have elapsed from the issuance of the licence relating to them. In the case of the reverse charge mechanism, the VAT does not need to be financed, as the same entity would be obliged to pay the VAT as is entitled to deduct the input VAT. Nevertheless, the acquirer of the real estate should also decide whether it intends to opt for the taxable treatment in respect of its potential real-estate leasing activity and/or in respect of the future sale of the real property. Input VAT can only be deducted in respect of those acquisitions (goods and services) which serve the taxable activities of the acquirer, so in many cases it is recommended to opt for the taxable treatment of business activities relating to real estate.

4.1.3. Share deal transaction

Real properties owned by the acquired company cannot be revaluated to fair market value on the basis of the change in the ownership of the company, and the utilisation of the available tax losses may also be restricted. (However, in most cases they can be utilised subsequent to the acquisition assuming that the company's activity remains unaltered.) Prior to the acquisition of a real-estate holding company, it may be recommended to perform a proper due diligence process in order to identify potential historical tax elements such as potential tax risks from previous tax years and deferred tax assets (e.g. tax losses, FX-related tax deferrals, depreciation, development reserves etc.).

The acquisition of the shares of a real-estate holding company should be subject to RETT as per the general rules. An actual RETT payment liability arises when the acquirer (alone or with related parties) has acquired at least 75% of the shares. RETT is calculated on the market value of the underlying properties. A company should qualify as a real-estate holding company

for RETT purposes if more than 75% of the company's adjusted assets consist of real properties located in Hungary or if it holds at least 75% of the shares of a real-estate holding company.

Regarding VAT, in general the share deals should fall outside the scope of the VAT legislation (i.e. no VAT consequences are triggered in this case), provided that certain conditions are met.

Acquisitions are often financed from intra-group loans which are to be repaid from the operation of the target entity. In recent years, however, debt-push-down acquisition structures have been placed under strict scrutiny by the tax authorities, which has basically eliminated such mechanisms from the Hungarian market unless they are well supported by business reasons that are not related to tax.

In order to decide on whether to acquire a real property through an asset deal or a share deal, an investor should carefully analyse all financial and tax aspects of the real property and its owner company.

4.2. Development

At the development stage, the main consideration in terms of tax implications should be the classification of the costs related to the development process. Costs and expenses incurred during the course of the real-estate development phase may be capitalised as assets, increasing the book value of the real property developed. Consequently, in the case of fixed assets, such costs and expenses may be depreciated for tax purposes as part of the gross value of the asset, for example including interest expenses incurred in connection with loan liabilities relating to the real property development. Costs and expenses which should not be capitalised in the value of the assets should be considered as deductible or non-deductible expenses for CIT purposes. Given the above, the costs and expenses incurred during the development phase should be carefully analysed on an item-by-item basis in accordance with Hungarian accounting and tax legislation.

If a certain cost or expense should not be capitalised but should be deductible for CIT purposes (administrative fees, advisory fees, etc.), then it should decrease the accounting profit and thus the CIT base of the investor. Without any potential revenue in the real-property development phase, this should generally result in the generation of tax losses which can be carried forward and offset the positive CIT bases of the subsequent tax years during the operating phase or in the tax year of the exit. As a limitation rule, tax losses can be carried forward for five years from the year of their generation and can offset the positive CIT base up to 50% of the CIT base of the given tax year.

The tax treatment of the fit-out costs of rented property should also be carefully analysed from CIT and VAT perspectives. The fit-out costs (depending on the actual circumstances) may be capitalised by the landlord (on the book value of the real property) or by the tenant (as investments made in respect of real properties they use but do not own). Furthermore, the related VAT consequences (e.g. when the fit-outs are left in the real property by the tenant at the end of the leasing period) should also be assessed properly. Construction and installation works in respect of which the taxpayer opted for the taxable treatment should be generally subject to the reverse-charge mechanism, meaning that the VAT does not need to be financed if the company has full deduction rights in respect of the input VAT on its acquisitions.

4.3. The operating and commercialisation phase, leasing of the real property

4.3.1. General tax aspects

The leasing fees received from tenants are part of the accounting income of the landlord company. The starting point for computing the CIT base is the accounting income, which is then adjusted in accordance with the provisions of the CIT rules. The CIT base is taxed at a rate of 9% (the lowest CIT rate in Europe). Real properties recognised as a fixed asset can be depreciated for CIT purposes over their useful lifetime. Generally, a 2% rate

is applied in respect of long-lasting real properties. However, a 5% depreciation rate can be applied in the case of leased properties. If the property is only partially leased then the applicable depreciation rate should be determined proportionally. Furthermore, residual value for accounting purposes should not be taken into account during the calculation of the CIT depreciation. As a special rule, a 3% depreciation rate can be applied in the case of real properties classified within the accommodation and restaurant sectors. If a company depreciates its fixed assets on the basis of the different components of the real properties under IFRS Accounting Standards rules, for CIT purposes, depreciation can be taken into account in respect of those components as well. Under certain conditions tax depreciation may also be recognised for investment properties which are measured in the fair value model under IFRS rules, even though they cannot be depreciated for accounting purposes under IFRS Accounting Standards.

Furthermore, as the leasing fees should be accounted for as net sales revenues, they should increase the Local Business Tax (LBT) base as well. The LBT base is the net sales revenue less certain items (such as the cost of mediated services, cost of goods sold (COGS), cost of raw materials, cost of subcontractors, etc.). The LBT is imposed by the local municipalities and its rate varies between the different municipalities (up to the statutory maximum of 2%). The cost of mediated services (e.g. utility and other services purchased and re-charged to tenants) is defined more strictly in the LBT legislation than in the accounting rules, as the costs of mediated services accounted in the books of a taxpayer should meet several formal and substantial criteria in order to qualify as cost of mediated services for LBT purposes as well.

Companies, excluding micro- and small enterprises, should also be subject to innovation contribution (0.3 %) assessed on the same base as the LBT.

As a general rule, the leasing of real properties should be considered as a VAT-

exempt activity, unless the taxpayer opts for taxable treatment. Although opting for taxable treatment should trigger VAT payment and related reporting liabilities, as a general rule the input VAT can only be deductible if it relates to an acquisition (goods or services) serving the taxable business activities of the taxpayer.

4.3.2. Discounts

In many cases, landlords provide discounts to their tenants in respect of factors including the first months of the leasing period. The VAT base of the leasing fee may be decreased by the amount of the discount if the discount is provided for promotional purposes and is included in the invoice or, in the case of a subsequent discount, the original invoice is corrected. The discount should be available to any independent party, i.e. each potential lessee under the same terms. If the discount does not meet the above condition, the tax base and the VAT amount should be calculated on the total amount of the leasing fee.

4.3.3. Periodic settlement

The periodic leasing fee should be subject to special tax point date rules for VAT purposes. The exact date of the supply as per the VAT legislation may vary depending on the payment due date and the invoice date (as opposed to the settlement period). Therefore, the tax point date depends on various factors and it should be determined carefully to ensure that the invoice indicates the tax point date properly. To safeguard the VAT deduction right of the tenants, the invoice should contain the correct tax point date.

4.3.4. Real-time invoice reporting

As per recent changes in Hungarian VAT legislation, taxpayers are required to provide information to the tax authority on all invoices exceeding a minimum threshold VAT content issued by an invoicing program. The data should be submitted to the tax authority in a predefined format, which will generate a unique identification code. Taxpayers are required to comply with the real-time invoice reporting obligation in order to avoid potential default penalties.

4.3.5. Property taxes

In addition to LBT, Hungarian municipalities are entitled to impose land and building taxes on the lands and buildings located in their territories. The base of the land and building taxes is, according to the decision of the given municipality, either the net floor area (which is the most common approach) or the fair market value of the land/building. As in the case of LBT, the rate of these taxes may vary up to statutory upper limits. As these taxes are imposed on the owners (as of 1 January of the given tax year) of the buildings/lands, they are generally recharged to the tenants (if any) as an ancillary element of the leasing fees. Their VAT treatment is therefore dependent upon the treatment of the leasing fees.

4.3.6. Financing aspects

As of 1 January 2019, new interest limitation rules have been implemented in Hungarian tax legislation (and the previous thin capitalisation rules had been abolished) in accordance with the provisions of the ATAD. As a general rule, the net financing costs of a taxpayer should be considered as deductible up to 30% of its EBITDA or EUR 3 million (whichever is the higher), but the deduction may exceed these thresholds if the taxpayer has a deferred capacity of interest deduction from the previous tax years. Special rules apply to companies that are part of a consolidated group for financial-reporting purposes. This may have an impact on the financing strategy of the investors who intend to fund their project with a large amount of loan financing, especially in the real-estate development phase when investors generally do not derive significant revenues.

4.3.7. Tax incentives

Hungarian companies may be entitled to apply several tax incentives set out in the CIT legislation (i.e. tax incentive related to the support of popular team sports, development tax allowance for certain investments, etc.).

Hungarian tax legislation recently introduced an energy-efficiency tax incentive, which may have an impact on the real estate sector as well. Based on the rules of this tax incentive, companies may

be eligible for a tax allowance in connection with investments or renovations aiming to increase energy efficiency, i.e. to reduce energy consumption. The amount of the tax incentive should be calculated on the basis of the costs which can be taken into account for this purpose and the specific aid intensity rate of the region where the investment is carried out. The tax incentive is capped at EUR 15 million. The tax incentive can be used over a period of six tax years but cannot exceed 70% of the CIT payable for any given tax year when the taxpayer intends to apply the tax incentive. Nevertheless, as this is a new element of the tax legislation, the practice of the authorities should be closely monitored.

Municipalities are also entitled to provide tax allowances for certain investments carried out in their territory. This may vary from municipality to municipality and the local decree should be consulted for the details.

4.4. Exit from the investment

When the investment is complete and there is an appetite to sell the property, the main consideration for the investor is the form of the exit from the investment. In such a case, the seller may either sell the property itself (in an asset deal transaction) or sell the company owning the property (a share deal transaction).

4.4.1. Asset deal

Asset deals are generally preferred by buyers on the Hungarian market due to full cost bases to be recognized for tax purposes, due to time and cost savings made because due diligence regarding the owner entity's legal and tax situation is not necessary. However, share deals still dominate the market as a preference of the seller, because in certain legal situations restrictions can make asset deals less favourable for them.

In the case of an asset deal, the alienation of the asset may have different accounting and tax treatment depending on whether the real property was recognised as inventory or as a fixed asset. In the case of the alienation of fixed assets, the positive difference between their sales price and

their tax value should be subject to CIT at 9%. In the case of inventories, the positive difference between their sale price and book value should be subject to CIT. Furthermore, as the revenues derived from the sale of inventories should be accounted for as net sales revenues, these revenues should also increase the LBT base of the seller. Purchase and development costs may be deducted from the LBT under certain conditions as costs of goods sold or material costs.

The potential VAT implications of the asset deal should be assessed on the basis of the actual circumstances, i.e. the residency of the buyer, whether the seller opted for taxable treatment, whether the deal should be subject to the reverse-charge mechanism etc. Nevertheless, as the place of supply is generally the country where the real property is located, Hungarian VAT rules should also be applicable in the case of transactions with a foreign purchaser.

In the case of asset deals, investors often intend to repatriate the profit from the empty project companies after the asset deal took place, especially when they do not wish to reinvest the cash or just want to close the given entity. The most common form of the repatriation of cash from a subsidiary (which does not require the official procedure of the Court of Registration) is the payment of dividends or interim dividends. Dividends can be paid from the positive aggregated amount of retained earnings and profit after tax (if the further statutory conditions are met), while interim dividends can be paid mid-year on the basis of interim financial statements. Other forms of cash repatriation may include the granting of a loan to the parent entity, the capital reduction in the subsidiary or the liquidation of the subsidiary. The latter two options, however, are more time-consuming than the preceding ones.

As Hungary does not impose withholding tax in respect of any payments made to foreign corporate entities, the above repatriation mechanisms do not trigger withholding tax liabilities in Hungary.

Upon the termination of lease agreements, the fit-outs left by the tenant in the building of the landlord (transferring their ownership to the landlord) may trigger a VAT liability for the tenant as this free transfer of goods should also be subject to VAT.

4.4.2. Share deal

If the shares of a real-estate holding company are held by a Hungarian company that reported the acquisition of these shares to the tax authority and held them continuously for at least one year, then the capital gain in a Hungarian holding company deriving from the alienation of these shares may be exempt from CIT. However, if the seller is not a Hungarian resident entity, then it cannot opt into the Hungarian participation exemption regime. This may result in the taxation of the capital gain if the country of the residence of the seller entity does not have a double tax treaty with Hungary or has concluded a double tax treaty with Hungary that allows Hungary to tax capital gains derived from the sale of shares.

The sale of real-estate holding entities can trigger non-resident capital gain taxation (i.e. a 9% CIT payment liability) on the side of the foreign resident investor, dependent on the provisions of the applicable double tax treaty concluded by Hungary. Furthermore, RETT liability should be triggered on the side of the buyer accordingly. RETT liability may also be triggered by the indirect sale of shares in a Hungarian real-estate holding entity.

Share deals should generally not trigger any VAT consequences (provided that the statutory conditions are met). Furthermore, the share deal exit scenarios should not trigger LBT consequences.

We note that in related-party transactions, the arm's length principle should be followed. Otherwise, transfer-pricing adjustments apply. According to Hungarian rules, transactions with a value that exceeds the annual threshold of HUF 50 million must be properly supported by transfer-pricing documentation.

4.5. Real Estate Hungarian tax – key points

Below we present the most important factors relating to Hungarian taxation matters, which must be considered in potential investment projects.

4.5.1. Real-estate investment funds and trusts

Real-estate investment funds (REIFs) and real-estate investment trusts (REITs) provide a very tax-efficient alternative for investors relating to their real-estate developments and other real-estate business activities.

REIFs should not be considered as companies, but as a different type of legal entity. Basically, a REIF is a set of passive assets which should be considered as a separate legal entity. The REIF issues investment units to its investors in exchange for their capital contribution and is managed by a fund manager, which is a separate company holding special licences.

REIFs are subject to very favourable tax rules, as they are not subject to CIT in Hungary (i.e. their revenues derived from renting out or selling their properties should be exempt from CIT). In addition, as per the current interpretation of the authorities, neither should they be subject to LBT or innovation contribution. The general rules should apply regarding VAT liabilities.

Based on the current interpretation, REIFs are subject to a preferential 2% RETT rate on their acquisitions. However, no cap should be applied. Participation exemption rules should not be applicable to the Hungarian investors in a REIF. REIFs are subject to certain special tax liabilities assessed on the basis of their net asset value.

As a REIF requires a significant amount of capital injection, their establishment should be generally recommended only in the case of larger investment portfolios.

REIT status is available to public limited companies, listed on the stock exchange with at least 25% free float, that meet

several additional conditions and submit a special registration form to the tax authority. The REIT status derives from a registration with the tax authorities and establishes a special taxpayer status for such public limited companies.

REITs are also subject to beneficial tax rules, i.e. in general their CIT base should be exempt from CIT payment liability, and they should also be exempt from LBT payment liability. Regarding VAT, the general rules should apply. REIT status is a relatively new opportunity for investors. They have started to spread across the Hungarian market recently following an amendment made to the relevant legislation.

4.5.2. VAT consideration

The sale of certain types of real properties, as well as the renting out of real properties, should in general be considered as VAT exempt activities. Nevertheless, taxpayers are entitled to opt for taxable treatment in respect of such activities. Opting in for taxable treatment generally allows taxpayers to deduct the input VAT they incur on acquisitions they carry out as part of their real-estate activities, as input VAT can only be deducted if it relates to the taxable activities of the taxpayer. For this reason, opting in for the taxable treatment is generally recommended for investors. However, this option should be carefully analysed prior to the decision being made.

The general VAT rate is 27% in Hungary. However, certain transactions are subject to preferential tax rates, i.e. 18% (such as in the case of the provision of accommodation for commercial purposes) or 5% (in the case of the sale of certain residential properties).

Regarding this latter option, please note that as a general rule the sale of newly built real properties should be subject to a 27% VAT rate (as these properties should not fall under the category of real properties where VAT exemption should apply). However, the preferential 5% VAT rate may be applicable for the sale of residential properties until 31 December 2023, provided the permit regarding the

construction work was issued before 1 November 2018.

4.5.3. LBT considerations

LBT is imposed by the local municipalities on whose territory the business activity is carried out. Although the rate of the LBT charged varies between different municipalities, it is capped at a maximum rate of 2%. The base of the LBT is the net sales revenue generated from the related business activity less certain items (e.g. cost of mediated services, COGS, cost of raw materials, fees of subcontractors etc.).

The definition of the cost of mediated services for LBT purposes is stricter than that set out by the accounting legislation, as strict, formal and substantial criteria must be met to qualify as cost of mediated services for LBT purposes and so be deductible for LBT purposes. One of these conditions is that the written leasing agreements entered into with the tenants should stipulate the possibility of mediation. Consequently, this should be taken into account during the conclusion of the leasing agreements. Substantial conditions are that the services should be resold in an unaltered format and calculated on the same basis for both input and output. Furthermore, certain costs included in the leasing fees (e.g. land and building taxes) cannot be considered as mediated services. As the deduction of the cost of mediated services from the LBT is currently under strict scrutiny by the tax authority, the tax authority's interpretation on the several formal and substantial conditions of the deductibility should be closely monitored. In summary, in order to achieve the highest possible LBT deduction, compliance with these conditions should be organised and developed prior to the completion of the relevant input and output contracts.

Regarding real-estate development activities, another main consideration is that the majority of the deductible items (COGS, fees of subcontractors etc.) are often accounted for in a tax year prior to that when the net sales revenue is generated due to the sale of the real property when its development is

completed. In this case, the total amount of the net sales revenue is taxable for LBT purposes as the deductible items cannot be carried forward from previous tax years. Proper business planning is therefore recommended by real-estate developers relating to the timing of how they allocate their costs.

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