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Real Estate Accounting Guide 2023

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Contents

Foreword

Welcome to the eighth edition of the Real Estate Accounting Guide which provides comprehensive information about accounting and tax matters for all real-estate practitioners across Central Europe. The report examines the regulatory landscape and provides invaluable insight and guidance to help real-estate investors navigate the increasingly complex accounting and tax regulations. It also presents both theoretical and real-life examples to demonstrate how to address those issues and problems that pose particular challenges to many of the accounting functions of real-estate companies.

The accounting elements of the report are based on the IFRS Accountung Standards, and this year's Guide includes new topics on deemed cost concept for first time adopters of IFRS, IESBA's recent decision on accounting for rent reliefs, surrender premiums as well as accounting for retentions payable, sale and leaseback and functional currency considerations.

A separate chapter is devoted to the growing importance of Environmental, Social and Governance considerations on financial statements. This reflects how significant global issues such as the rising cost of energy, disruption to supply chains and the war in Ukraine have impacted constantly evolving consumer expectations, legislation and the requirements of financial institutions. This chapter includes insightful commentary and guidance on integrated reporting, reporting requirements, new regulations and EU taxonomy as well as how to avoid annual reporting pitfalls.

In addition to presenting the specifics of property appraisal used for financial reporting purposes, the valuation section of the Guide also includes more information on the potential impact of ESG matters on fair valuations of investment properties.

We very much hope you find this year's Real Estate Accounting Guide both useful and informative. As always, we welcome your feedback and suggestions so we can ensure future editions of the Guide continue to meet all of your requirements and expectations.

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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 21, IAS 23, IAS 36, IAS 37, IAS 40, IFRS 1, IFRS 3, IFRS 5, IFRS 9, 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 February 14th, 2023. as listed in the Bibliography on page 153. 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 Accounting 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."

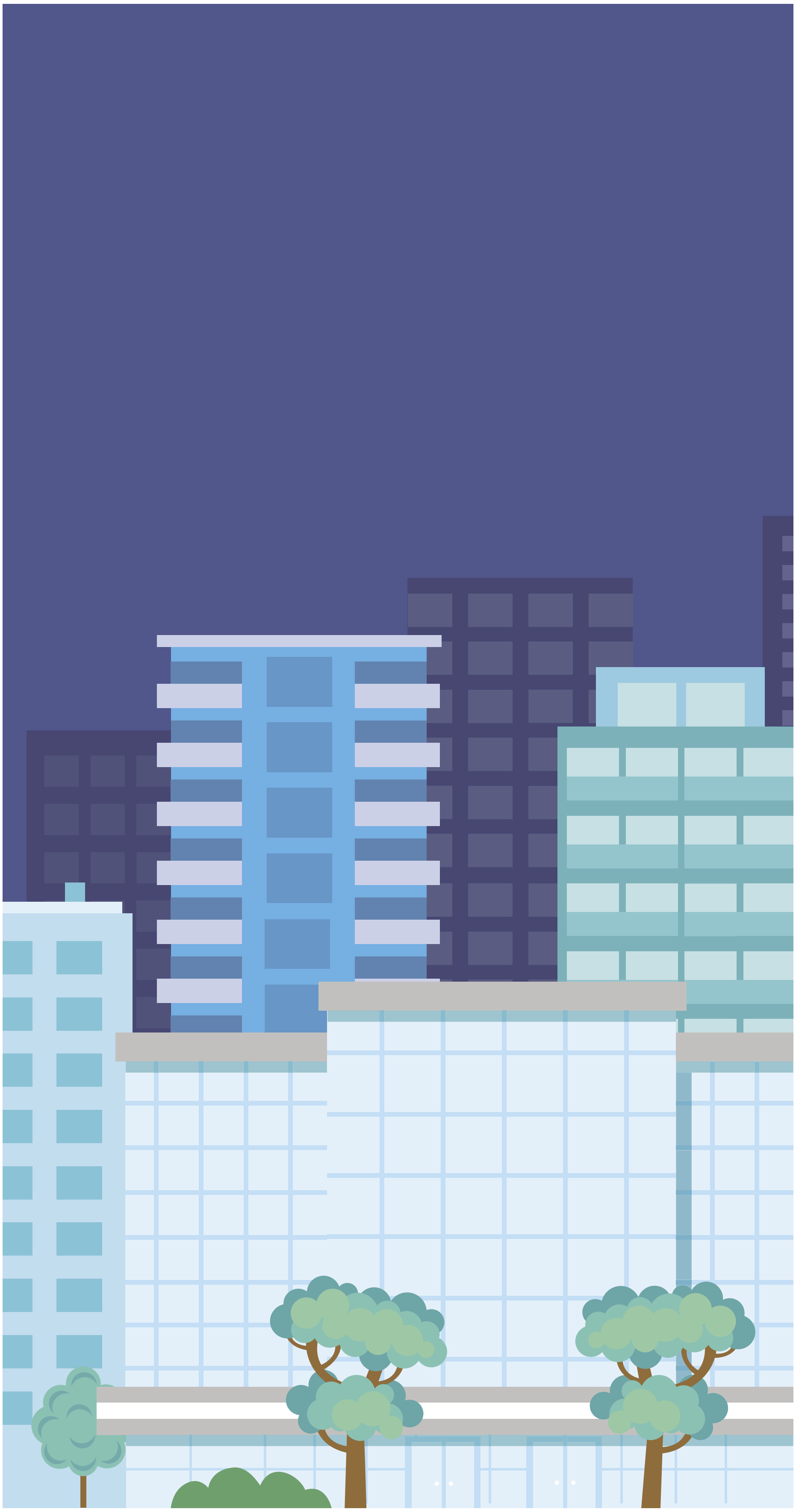
Included in this definition [IAS 40:8]:

- 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 owneroccupation 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 and assets has outputs:

Does an acquired set of activities and assets have outputs at the acquisition date (i.e. generates revenue/income)?

Yes

An acquired process (or group of processes) shall be considered substantive if, when applied to an acquired input or inputs, it:

- is critical to the ability to continue producing outputs, and the inputs acquired include an organised workforce with the necessary skills, knowledge, or experience to perform that process (or group of processes); or
- significantly contributes to the ability to continue producing outputs and:
  - is considered unique or scarce; or
  - cannot be replaced without significant cost, effort, or delay in the ability to continue producing outputs.

No

An acquired process (or group of processes) shall be considered substantive only if:

- it is critical to the ability to develop or convert an acquired input or inputs into outputs; and
- the inputs acquired include both:
  - an organised workforce that has the necessary skills, knowledge, or experience to perform that process (or group of processes) and
  - other inputs that the organised workforce could develop or convert into outputs.

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.

Step 1

- Measure the fair value of gross assets acquired

Step 2

- Identify a single identifiable asset or a group of similar identifiable assets

Step 3

- Determine if substantially all of the fair value of gross assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets

2.2.1. Step 1 - measure the fair value of gross assets acquired

The fair value of gross assets acquired includes any non-controlling interests in a partial acquisition and any previously held interests in a step-acquisition, such that the concentration test is performed by comparing 100 % of the fair value of a single identifiable asset (or group of similar assets) to 100 % of the fair value of gross assets acquired.

Certain assets should be excluded from gross assets for the purposes of the concentration test:

Excluded from gross assets

- cash and cash equivalents;
- deferred tax assets;
- goodwill resulting from the effects of deferred tax liabilities.

Instead of measuring the fair value of gross assets acquired directly (i.e. by determining the fair value of identifiable assets acquired and any goodwill other than goodwill arising from deferred tax liabilities), IFRS 3:B7B(b) indicates that fair value of gross assets acquired may generally be determined indirectly as the total obtained by adding the fair value of the consideration transferred (plus the fair value of any non-controlling interest and the fair value of any previously held interest) to the fair value of the liabilities assumed (other than deferred tax liabilities), and then excluding the items listed in IFRS 3:B7B(a) (namely cash and cash equivalents, deferred tax assets, and goodwill resulting from the effects of deferred tax liabilities).

2.2.2. Step 2 - identify a single identifiable asset or group of similar identifiable assets

An identifiable asset is an asset, or group of assets, that would be recognised and measured as a single identifiable asset in a business combination. [IFRS 3:B7B(c)]

Similar identifiable assets are considered as a group for the purposes of the concentration test. When assessing whether assets are similar, an entity considers the nature of each single identifiable asset and the risks associated with managing and creating outputs from the assets. [IFRS 3:B7B(e)]
IFRS 3:B7B(f) clarifies that the following assets are not similar:

- a tangible asset and an intangible asset;
- tangible assets in different classes unless they meet the criteria in IFRS 3:B7B(d) to be considered as a single identifiable asset;
- identifiable intangible assets in different classes (for example, brand names, licences and intangible assets under development);
- a financial asset and a non-financial asset;
- financial assets in different classes (for example, accounts receivable and investments in equity instruments); and
- identifiable assets that are within the same class of asset but have significantly different risk characteristics.

2.2.3. Step 3 - determine if substantially all of the fair value of gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets

The concentration test is met if substantially all of the fair value of the gross assets acquired (as determined in step 1) is concentrated in a single identifiable asset or group of similar identifiable assets (as determined in step 2). [IFRS 3:B7B]

IFRS 3 does not define what percentage constitutes 'substantially all'. In our view, it should generally be presumed that the concentration test is met if 90 % of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar assets.

Accordingly, if an entity that chooses to perform the concentration test determines that the single identifiable asset or group of similar assets does not represent 90 % of all of the fair value of the gross assets acquired, it must perform a more detailed assessment to conclude whether an acquired set of activities and assets constitutes a business combination.

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 singlefamily 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.

Determining whether a transaction or event is a business combination

No

Account for a transaction or event as an asset acquisition

Yes

Identifying the acquirer

Determining the aquisition date

Recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree

To qualify for recognition as part of applying the acquisition method, an item acquired should:

- meet the definition of an asset or a liability at the acquisition date; [IFRS 3:11] and
- be part of the business acquired (the acquiree) rather than the result of a separate transaction. [IFRS 3:12]

Identifiable assets acquired and liabilities assumed are measured – as a general rule - at their acquisition-date fair values.

Measuring consideration and determining what is part of the business combination

IFRS 3 requires the consideration transferred in a business combination to be measured at fair value. This is calculated as the sum of the acquisitiondate fair values of: [IFRS 3:37] assets transferred by the acquirer, liabilities incurred by the acquirer to former owners of the acquiree; and equity interests issued by the acquirer. Acquisition-related costs are generally recognised in profit or loss.

Recognising and measuring goodwill or a gain from a bargain purchase

Goodwill (or gain from a bargain purchase) arising from a business combination is determined as follows: Consideration transferred (generally acquisition date fair value) + the amount of any non-controlling interest + the fair value of any previously held equity interest in the acquiree - the fair value of the identifiable net assets of the acquiree.

Subsequent measurement and accounting

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 selfconstructed 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 ecessary 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

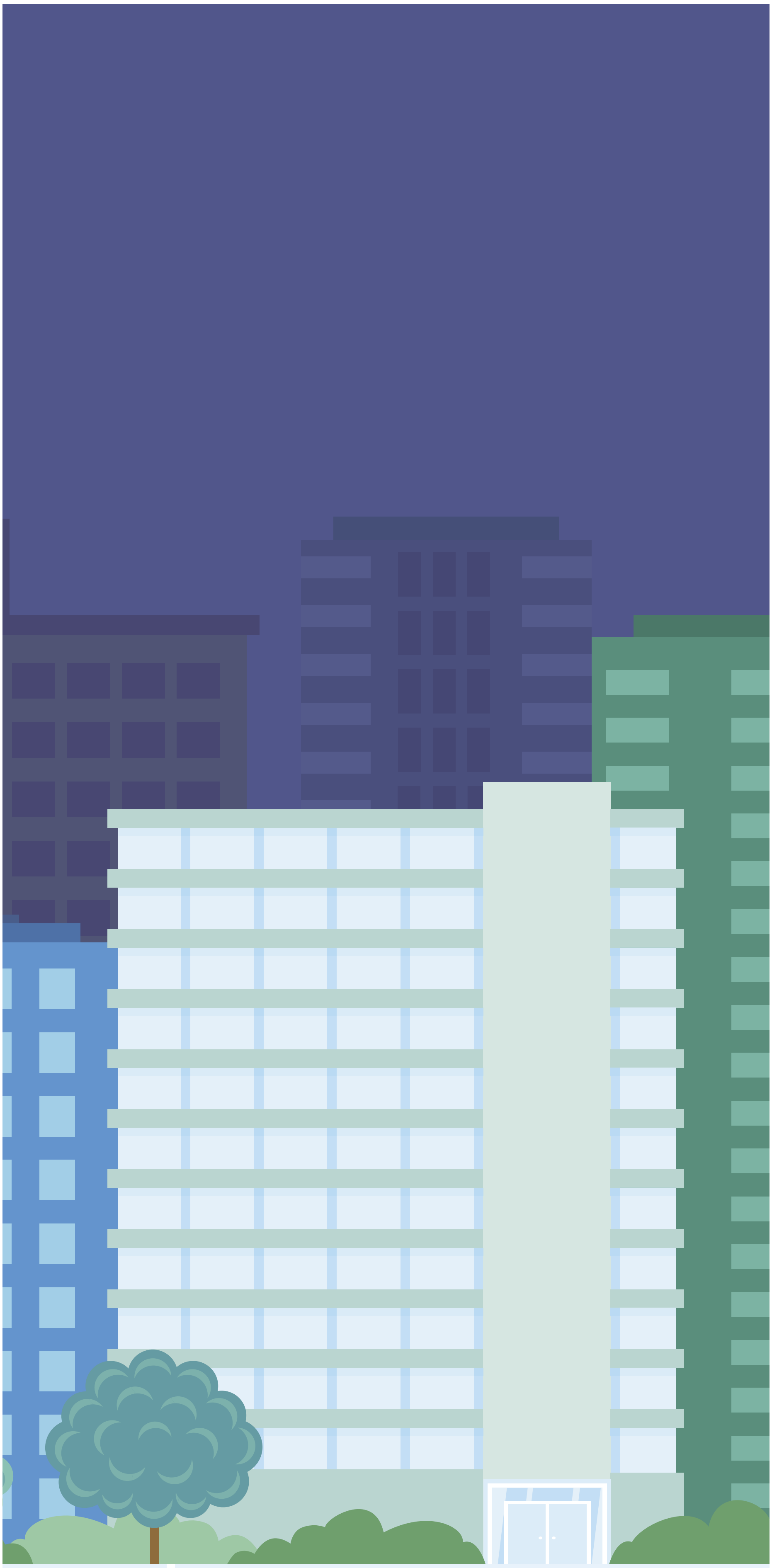
Appropriate application of the recognition principle set out at 3.1 results in: [IAS 40:18 & 19]

- 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]

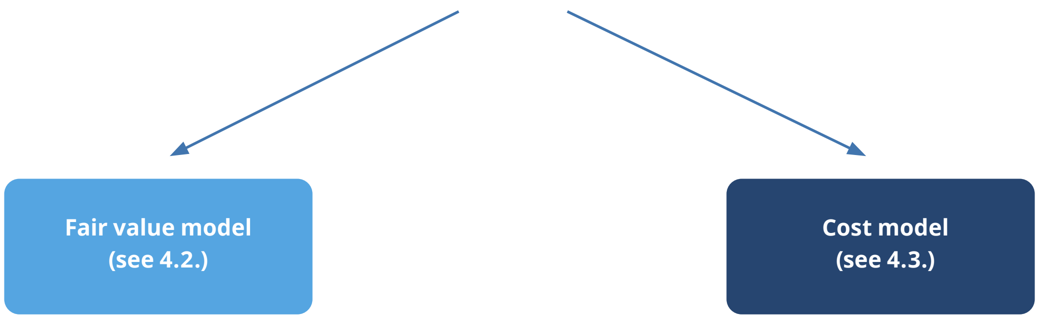
If the entity has been using the cost model (see 4.3.) to measure its investment property, but the replaced part was not being depreciated separately, and the carrying amount of the replaced part cannot be determined, the cost of the replacement may be used as an indication of what the cost of the replaced 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 rightof-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 doublecounted 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 recognizes 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 recognizes 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 recognizes 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 thirdparty 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 rightof-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 rightof-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 rightof-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 ecognizes 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 10.2.1.).

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 inplace 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.

	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.

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

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:

Commencement of depreciation	Cessation of depreciation - the earlier of:
When it is available for use, i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.	The date that the asset is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with IFRS 5 (see section 10); and
This is the same point in time at which the entity is required to cease capitalising costs within the carrying amount of the asset (see 3.2.4 for guidance as to when this point in time occurs).	The date that the asset is derecognised.

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.Deemed cost - exception available for first-time adopters

4.4.1. Deemed cost exemptions – general

In drafting IFRS 1, the IASB acknowledged that the costs of requiring entities to reconstruct cost information or other transactional data for property, plant and equipment and other long-term assets (i.e. to apply full retrospective approach for these items as if IFRS Accounting Standards had been the framework for an entity's accounting since its inception) could be particularly onerous when entities might not have retained the necessary historical information. The IASB also noted that reconstructed data might be less relevant to users, and less reliable, than current fair value data. As a result, IFRS 1 includes optional exemptions that relieve first-time adopters from the requirement to recreate cost information for property, plant and equipment, investment property and (to a much more limited extent) intangible assets. When the exemptions are applied, deemed cost is the basis for subsequent depreciation and impairment tests.

Deemed cost is defined as "[a]n amount used as a surrogate for cost or depreciated cost at a given date.

Subsequent depreciation or amortisation assumes that the entity had initially recognised the asset or liability at the given date and that its cost was equal to the deemed cost". [IFRS 1:Appendix A]

When an asset is initially recognised under IFRS Accounting Standards on a deemed cost basis, subsequent depreciation is based on that deemed cost and starts from the date for which the fair value measurement or revaluation was established. [IFRS 1:IG9]

Although not an implicit requirement, the deemed cost exemption can be applied to investment property if an entity elects to use the cost model in IAS 40. If the fair value model in IAS 40 is adopted, investment property should be measured at fair value at the date when transition to IFRS Accounting Standards occurred. The transition requirements in IAS 40 do not apply. [IFRS 1:IG61]

4.4.2. Details of the exemption

IFRS 1:D5 permits any asset in the designated categories to be measured at the date of transition to IFRS Accounting Standards at its fair value and that fair value to be used as the asset's deemed cost at that date. When this election is made, the disclosures required by IFRS 1:30 should be made in the entity's first IFRS financial statements.

The date of transition to IFRS Accounting Standards is defined as "[t]he beginning of the earliest period for which an entity presents full comparative information under IFRS Accounting Standards in its first IFRS financial statements". [IFRS 1:Appendix A].

4.4.3. Selective use of fair value as deemed cost

The exemption described in IFRS 1:D5 to B7 may be used selectively within the classes of assets described. IFRS 1:BC45 confirms that "the IFRS does not restrict the use of fair value as deemed cost to entire classes of assets".

In practical terms, this means an entity that adopts the cost model for investment property can apply a deemed cost exception to a building, for example, while adopting a full retrospective approach to other investment property components such as land and equipment. When an entity applies a deemed cost exception to the investment property as a whole, however, the group of assets are effectively measured at fair value. For the application of cost model, the entity will have to allocate the fair value to respective components of the investment property – the building, land and equipment. **IFRS 13 does not provide any guidance on the method of allocation, so the entity will have to develop an appropriate method that reflects specific facts and circumstances.**

4.5. 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 marketobservable 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

	31/12/22	31/12/21
	CU'000	CU'000
Fair value		
Completed investment properties	4,968	4,941

	Year ended 31/12/22	Year ended 31/12/21
	CU'000	CU'000
Balance at the begining 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 2022 or 31 December 2021.

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 (2021: 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 (2021: 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 2022 and 31 December 2021 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 31/12/22
	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 31/12/21
	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% (2021: 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] (2021: 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 CityResidential 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% (2021: 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] (2021: 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:

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.

IFRS 13.97

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.

IFRS 13.95

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 straightline 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	Operatinglease 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.

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 operatinvg lease payments with a time-value-of-money payment increase

IFRS 16:81

Lessor C is a lessor in an operating lease

Year	Original annual rent payments	Revised annual rent payments	Operatinglease 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

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 × 19 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. Lessor forgiveness of lease payments related to past periods

Lessor A is negotiating a rent concession with a lessee that will be effective on the date the rent concession is granted. The rent concession changes the original terms and conditions of the lease contract classified by Lessor A as an operating lease in accordance with IFRS 16. Lessor A legally releases the lessee from its obligation to make specifically identified lease payments. These payments include:

- some lease payments for which amounts are contractually due but not paid. IAS 32:AG9 states that "a lessor does not regard an operating lease as a financial instrument, except as regards individual payments currently due and payable by the lessee". Therefore, Lessor A has recognised these amounts as an operating lease receivable. Applying IFRS

16:81, Lessor A has also recognised the amounts as income; and

- some lease payments which are not yet contractually due.

No other changes are made to the lease contract, nor are there any other negotiations between Lessor A and the lessee which might affect the accounting for the rent concession.
Before the date the rent concession is granted, Lessor A applies the expected credit loss model in IFRS 9 to the operating lease receivable.

5.3.1. Applying the expected credit loss model in IFRS 9 to the operating lease receivable

As required by IFRS 9:2.1(b)(i), Lessor A applies the impairment requirements in IFRS 9 to the gross carrying amount of an operating lease receivable from the date on which it recognises that receivable, taking into account applicable derecognition requirements in IFRS 9.
Consequently, Lessor A applies the impairment requirements in IFRS 9 to the operating lease receivable and estimates the expected credit losses on the operating lease receivable by measuring any credit loss to reflect 'all cash shortfalls'. These shortfalls are the difference between:

- all contractual cash flows due to Lessor A in accordance with the lease contract (and included in the gross carrying amount of the operating lease receivable); and
- all the cash flows Lessor A expects to receive, determined using 'reasonable and supportable information' about 'past events, current conditions and forecasts of future economic conditions'.

Therefore, before the rent concession is granted, Lessor A measures expected credit losses on the operating lease receivable in a way that reflects 'an unbiased and probability-weighted amount ...', 'the time value of money', and 'reasonable and supportable information ...' as required by IFRS 9:5.5.17. This measurement of expected credit losses includes Lessor A considering its expectations of forgiving lease payments recognised as part of that receivable.

5.3.2. Accounting for the rent concession – IFRS 9 and IFRS 16

5.3.2.1. Applying the derecognition requirements in IFRS 9 to the operating lease receivable

IFRS 9:2.1(b)(i) states that operating lease receivables recognised by a lessor are subject to the derecognition requirements in IFRS 9. Consequently, on granting the rent concession, Lessor A considers whether the requirements for derecognition in IFRS 9:3.2.3 are met.

Through the rent concession, Lessor A legally releases the lessee from its obligation to make specifically identified lease payments, some of which Lessor A has recognised as an operating lease receivable. Accordingly, on granting the rent concession, Lessor A concludes that the requirements in IFRS 9:3.2.3(a) have been met (i.e. its contractual rights to the cash flows from the operating lease receivable expire) because it has agreed to legally release the lessee from its obligation and thus ha s given up its contractual rights to those specifically identified cash flows. Therefore, on the date the rent concession is granted, Lessor A remeasures expected credit losses on the operating lease receivable (and recognises any change to the expected credit loss allowance in profit or loss) and derecognises the operating lease receivable (and associated expected credit loss allowance).

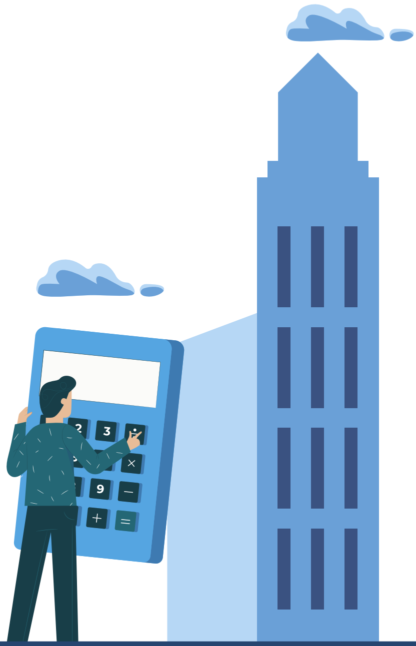
5.3.2.2. Applying the lease modification requirements in IFRS 16 to future lease payments under the lease

The rent concession granted by Lessor A meets the definition of a lease modification in IFRS 16. The rent concession is "a change in ... the consideration for a lease ... that was not part of the original terms and conditions of the lease". Therefore, Lessor A applies IFRS 16:87 and accounts for the modified lease as a new lease from the date the rent concession is granted.
IFRS 16:87 requires a lessor to consider any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease. Lease payments contractually due from the lessee which the lessor has recognised as an operating lease receivable (to which the derecognition and impairment requirements in IFRS 9 apply) are not

accrued lease payments. Consequently, neither those lease payments nor their forgiveness are considered as part of the lease payments for the new lease.
In accounting for the modified lease as a new lease, Lessor A applies IFRS 16:81 and recognises the lease payments (including any prepaid or accrued lease payments relating to the original lease) as income on either a straight-line basis or another systematic basis.
In summary, Lessor A accounts for the rent concession on the date it is granted by applying:

- the derecognition requirements in IFRS 9 to forgiven lease payments that Lessor A has recognised as an operating lease receivable; and
- the lease modification requirements in IFRS 16 to forgiven lease payments that Lessor A has not recognised as an operating lease receivable.

This conclusion was confirmed by the IFRS Interpretations Committee in the September 2022 IFRIC Update.



5.3.3. Lessor forgiveness of lease payments – an example

Lessor A has a 30 June year-end. In the jurisdiction in which it operates, many lessees were required to close their operations for the period from 1 May to 30 June 20X1 due to difficult circumstances (e.g. a pandemic or political unrest). Operations are expected to remain closed until 31 August 20X1.

Lessee B has not paid its rent for the months of May and June 20X1. Nevertheless, Lessor A has recognised operating lease income applying IFRS 16:81 and the resulting operating lease receivable for these months. Lessor A is considering modifying the lease agreement with Lessee B by forgiving the rent due for each of the months in the period from 1 May 20X1 until 31 August 20X1.

However, these modifications are not finalised until after year-end, on 1 August 20X1. On that date, Lessor A legally releases Lessee B from the amounts owed in respect of May, June, July and August 20X1. No other changes are made to the lease terms. Under IFRS 16:87, a modification to an operating lease is accounted for from the effective date of the modification, which is defined as the date at which the lessor and lessee agree to the changes. In the scenario presented above, the effective date of the modification is 1 August 20X1. Therefore, Lessor A does not account for the lease modification at 30 June 20X1.

At 30 June 20X1, Lessor A applies the expected credit losses requirements of IFRS 9 in respect of the operating lease receivable from Lessee B, which is in the scope of IFRS 9 for purposes of impairment recognition as set out in IFRS 9:2.1(b)(i). The measurement of expected credit losses under IFRS 9 necessarily involves judgement and estimation. Applying IFRS 9:5.5.17, Lessor A measures and recognises the expected credit losses associated with the operating lease receivable in its 30 June 20X1 financial statements using reasonable and supportable information that is available without undue cost or effort at 30 June 20X1 regarding past events, current conditions and forecasts of future economic conditions. This includes Lessor A's expectations of forgiving lease payments recognised as part of the operating lease receivable. Lessor A also considers any collateral in estimating expected credit losses. Any expected credit losses are recognised immediately in profit or loss.

When the lease modifications are finalised on 1 August 20X1, Lessor A determines that the operating lease receivable (which now also includes the amount owed by the lessee in respect of July 20X1) should be derecognised applying IFRS 9:3.2.3 because it has agreed to legally release Lessee B from its obligation and thus has given up its contractual right to the lease payments for May, June and July 20X1. Therefore, on 1 August 20X1, Lessor A remeasures expected credit losses on the operating lease receivable (and recognises any change to the expected credit loss allowance in profit or loss in a separate line item as required by IAS 1:82(ba)) and derecognises the operating lease receivable (and associated expected credit loss allowance).

Additionally, at this date, Lessor A applies IFRS 16:87, which requires a lessor to account for the modification to an operating lease (the forgiveness of the lease payment for August 20X1) 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 lease receivable relating to May, June and July 20X1 which has been derecognised does not form part of the accounting for the new lease.

5.4. Surrender premium - exercise of a termination option in an operating lease arrangement – An example

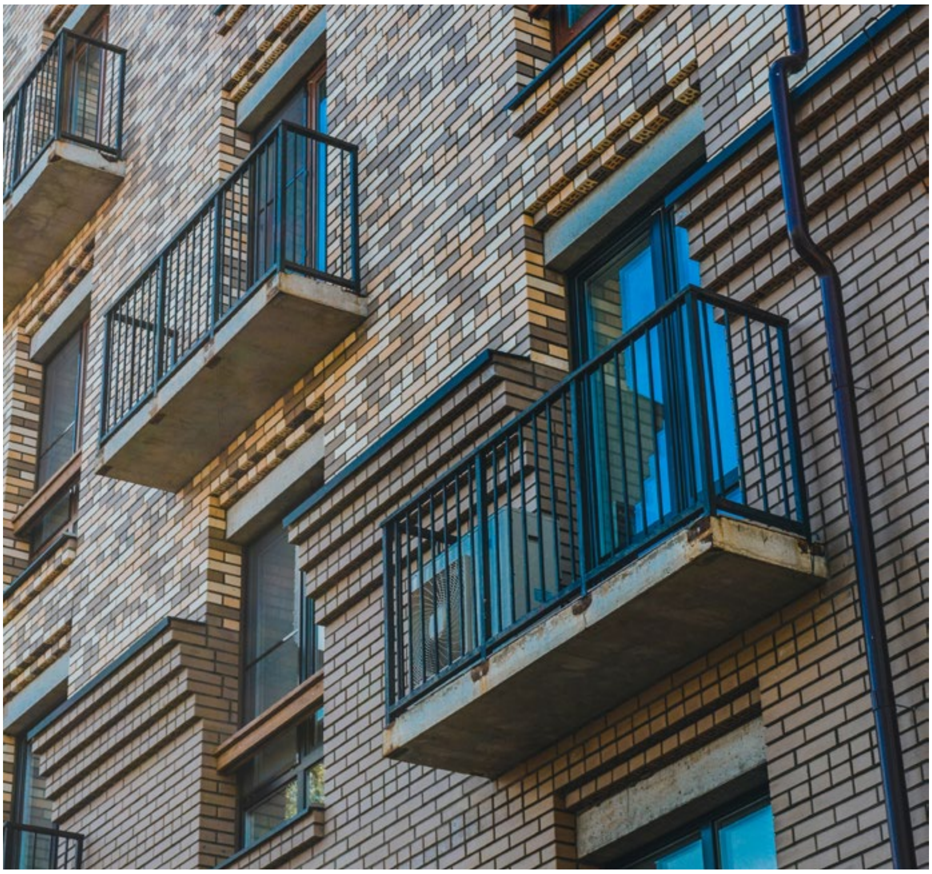
Lessor A leases a property to Lessee B for 10 years. The lease includes a termination option under which Lessee B may reduce the lease term to eight years. The lease contract also specifies that if Lessee B exercises the option, a specified surrender premium is to be paid by Lessee B to Lessor A during Year 8. Lessee B must exercise the option no later than the end of Year 7 of the lease. The commercial rationale for this deadline is to allow Lessor A to market the leased asset for sale or lease to another party if Lessee B chooses to exercise the termination option.

At the inception date, the lease is classified by Lessor A as an operating lease. At the commencement date, exercise of the termination option is not considered to be reasonably certain such that the lease term is 10 years.

Towards the end of the seventh year of the lease, Lessee B exercises the termination option, thereby reducing the remaining lease term to one year and triggering the requirement to pay the surrender premium during Year 8.

Because the option was part of the original terms and conditions of the lease, its exercise does not constitute a lease modification as defined in IFRS 16:Appendix A. Accordingly, applying IFRS 16:66, Lessor A does not reassess the lease classification.

It continues to account for the lease as an operating lease, albeit with a lease term in accordance with IFRS 16:21(a). In accordance with its accounting policy, Lessor A revises its calculation of the lease income to ensure that the remaining lease payments (which include the surrender premium) and any remaining prepaid or accrued lease payments are recognised on a straight-line basis over the remaining lease term of one year. Other accounting policies may be acceptable.



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

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	-

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

Evntity 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. Recognition by a lessor of security deposits received as financial liabilities

On or before the date of commencement of a lease, a lessor may require a lessee to pay a security deposit that:

- is held as a collateral by the lessor throughout the term of the lease;
- is refundable in full to the lessee at the end of the lease term except when there is a breach of any provisions in the lease contract; and
- bears no interest throughout the term of the lease.

A security deposit of this nature should be accounted for as a financial liability by the lessor. The deposit does not meet the definition of a lease payment under IFRS 16 because it is not a payment relating to the right to use the underlying asset. The security deposit should be recognised initially at fair value in accordance with IFRS 9:5.1.1 and will normally be measured subsequent to initial recognition at amortised cost, resulting in the recognition of interest expense over the lease term for the difference between the fair value at the commencement of the lease and its nominal amount payable at the end of the lease term.

The difference between the nominal amount of the deposit and its fair value at the commencement of the lease represents, in effect, an additional lease payment which is received in advance by the lessor. If the deposit relates to an operating lease, the additional lease payment is presented as an advance lease payment and is recognised as lease income over the lease term. If the deposit relates to a finance lease, the additional lease payment adjusts the gross investment in the lease and affects the determination of the interest rate implicit in the lease.

For example, Lessor P enters into a five-year lease of a property with Lessee Q. Annual rent of CU1,200 is receivable by Lessor P at the beginning of each year. Lessee Q is also required to pay a deposit of CU600 (equal to six months' rent) to Lessor P at the commencement of the lease. That amount will be returned to Lessee Q at the end of the lease term with no interest payments made in the intervening period.

At the commencement of the lease, the fair value of the CU600 payable in five years (calculated using an appropriate market rate for a similar lending transaction by Lessor P) is CU495.

If the lease is classified as an operating lease.

At the commencement of the lease, Lessor P recognises:

- a financial liability in respect of the CU600 deposit, due to be repaid at the end of five years, at its fair value at the commencement date of CU495; and
- an aggregate advance lease payment of CU1,305 being the sum of CU1,200 received upfront for the first year's rent and the additional advance lease payment of CU105 (being the difference between the nominal amount of the deposit and its fair value at the commencement date).

The following journal entry is recorded by Lessor P at the commencement date.

		CU	CU
Dr	Cash (CU1,200 + CU600)	1,800	
Cr	Financial liability (deposit)		495
Cr	Advance lease payment		1,305

Subsequent to initial recognition:

- the deposit is measured at amortised cost and accreted to its nominal value over the term of the lease, with the difference (CU105) recognised as interest expense, using the effective interest rate method; and

- the advance lease payment is recognised as lease income on either a straight-line basis or another systematic basis in accordance with the requirements of IFRS 16:81. The amount of lease income recognised each year on a straight-line basis would be CU1,221 ((CU1,200 × 5 + CU105)/5).

If the lease is classified as a finance lease

Assume that at the commencement of the lease the carrying amount of the underlying property, which equals its fair value, is CU5,370 and that the residual value of the property and the initial direct costs of the lease are both CUnil.

At the commencement of the lease, Lessor P recognises:

- a financial liability in respect of the CU600 deposit, due to be repaid at the end of five years, at its fair value at the commencement date of CU495; and

- a net investment in the lease of 4,065, being the present value of the sum of the four CU1,200 annual payments not received at the commencement date, and the additional advance lease payment of CU105 (being the difference between the nominal amount of the deposit and its fair value at the commencement date), discounted at the interest rate implicit in the lease, in accordance with the requirements of IFRS 16:67.

The following journal entry is recorded by Lessor P at the commencement date.

		CU	CU
Dr	Cash (CU1,200 + CU600)	1,800	
Dr	Net investment in the lease	4,065	
Cr	Financial liability (deposit)		495
Cr	Property, plant and equipment		5,370

The interest rate implicit in the lease in this example is seven per cent, which is the rate that causes the present value of (a) the lease payments (total undiscounted amount of CU6,105, of which CU1,305 is received in advance) and (b) the unguaranteed residual value (CUnil) to equal the sum of (i) the fair value of the underlying asset (CU5,370) and (ii) any initial direct costs of the lessor (CUnil).

Subsequent to initial recognition:

- the deposit is measured at amortised cost and accreted to its nominal value over the term of the lease, with the difference (CU105) recognised as interest expense, using the effective interest rate method; and

- the net investment in the lease increases by finance income accrued at the interest rate implicit in the lease of seven per cent and reduces by any rental receipts.

9. Functional currency

9.1 Functional currency – general

The functional currency of an entity is the currency of the primary economic environment in which the entity operates. [IAS 21:8]

In preparing financial statements, each entity is required to determine its functional currency in accordance with IAS 21:9 to 14. This applies whether the entity is a stand-alone entity, an entity with foreign operations (such as a parent) or a foreign operation (such as a subsidiary or branch). There is no concept of a 'group functional currency' in IFRS Accounting Standards.

An entity's functional currency is a matter of fact, not of choice. In practice, judgement is required in assessing which currency is the functional currency. Because this is a question of fact, an entity's functional currency will change only if there is a change in the primary economic environment in which the entity operates (see 9.4.1.).

IAS 21 provides primary and further indicators of a functional currency:

Primary indicators [IAS 21:9]

- the currency that mainly influences sales prices for goods and services (which is often the currency in which those sales prices are denominated and settled) and the currency of the country whose competitive forces and regulations primarily determine the sales prices of its goods and services; and
- the currency that primarily influences labour, material and other costs of providing goods or services (which will often be the currency in which such costs are denominated and settled).

Further indicators [IAS 21:10]

- the currency in which funds from financing activities (i.e. issuing debt and equity instruments) are generated; and
- •the currency in which receipts from operating activities are usually retained.

9.2. Assessing whether the functional currency of a foreign operation is the same as that of a reporting entity to which it is related

If an entity is a foreign operation, additional factors may also need to be considered in determining whether its functional currency is the same as that of the reporting entity of which it is a subsidiary, branch, associate or joint arrangement: [IAS 21:11]

- whether the activities of the foreign operation are carried out as an extension of the reporting entity, rather than being carried out with a significant degree of autonomy. An example of the former is when the foreign operation only sells goods imported from that reporting entity and remits the proceeds to it. Conversely, when the foreign operation accumulates cash and other monetary items, incurs expenses, generates income and arranges borrowings primarily in its local currency, its activities are far more autonomous.
- whether transactions with the reporting entity reprrsent either a high or a low proportion of the foreign operation's activities
- whether cash flows from the activities of the foreign operation directly affect the cash flows of the reporting entity and are readily available for remittance to it
- whether cash flows from the activities of the foreign operation are sufficient to service existing and normally expected debt obligations, without funds being made available by the reporting entity

If a foreign operation carries on business as if it were an extension of the reporting entity of which it is a subsidiary, branch, associate or joint arrangement, the functional currency of the foreign operation is the same as that of the reporting entity; it would be contradictory to assert that such a foreign operation (sometimes referred to as an 'integral foreign operation') operates in a primary economic environment different from the reporting entity of which it is a subsidiary, branch, associate or joint arrangement. [IAS 21:BC6]

Additional factors to consider in identifying the functional currency of a foreign operation [IAS 21:11]:

Consideration of the following additional factors, based on the nature of the foreign operation, may assist in the determination of functional currency:

If an intermediate parent carries out duties related to the sub-group in which it holds investments, this would indicate that the functional currency of the entity is not necessarily the same as that of its parent entity. Examples of this are when intermediate parent has different directors/employees from the ultimate parent entity, has its own reporting responsibilities, produces consolidated financial statements including the sub-group and actively manages a series of operations in a geographical area and, consequently, incurs costs in a local currency. If the intermediate parent exists solely in order for the ultimate parent to obtain a tax, regulatory, jurisdictional or legal type of benefit that it would not otherwise receive, this indicates clearly that it is an extension of its parent entity.

If the foreign operation is clearly set up as a structured or special purpose entity, its activities are being conducted on behalf of the parent entity (such as employee benefit trusts, leasing vehicles etc.) and the structured or special purpose entity is an extension of the parent entity, this indicates that it should have the same functional currency as that of the parent entity.

For a treasury entity, it is necessary to assess whether it exists to serve the funding and cash management needs of the group as a whole (i.e. it constitutes an extension of the parent entity) or exists solely to service a specific sub-group. In the latter case, the functional currency of the treasury entity may be different from that of the parent entity.

A 'money-box' entity is an entity that holds cash only. In accordance with the factors in IAS 21:9 to 12, the currency of the cash that the entity holds is not the deciding factor in determining functional currency. To determine its functional currency in such cases, it is necessary to consider who benefits from the money-box entity.

9.3. Identifying the functional currency when the indicators are mixed

When indicators are mixed and the functional currency is not obvious, management should **use judgement** to determine the functional currency that most faithfully represents the economic effects of transactions, events and conditions. As part of this approach, **management should give priority to the primary indicators.**

9.3.1. Identifying the functional currency when the indicators are mixed – an example

Real Estate Investor A is domiciled in a Eurozone country with EUR as a functional currency, and has acquired 5 shopping centers in Country B through series of separate share deals. Country B does not belong to the Eurozone and has its own local currency. Each property is owned by a separate legal entity registered in Country B. Legal entities are typical SPV's - they don't hire any employees and property and asset management as well as accounting services are outsourced. Rents are denominated in EUR and indexed by CPI applicable in the Eurozone but are invoiced in the local currency.

The cost base is mixed: property tax, utilities, costs of maintenance of the property - all recharged to tenants - are incurred in the local currency, while management fees paid to the Group are incurred in EUR.

The acquisition of the properties was financed with the combination of bank and intercompany loans, all d
enominated in EUR.

Real Investor A owns a broad portfolio of real estate assets in various countries.
In this case, the indicators for each SPV are mixed and the management needs to exercise judgement when determining the functional currency of each SPV acquired in Country B. The following additional considerations could be taken into account:

- Who are the tenants and what drives the rent prices for a particular SPV? Are the tenants local brands with rent prices driven by local market competition? Or, are the tenants multinational brands that are also renting retail spaces in other shopping centers in other Eurozone countries owned by Real Estate Investor A, where the rent prices in all shopping centres (including the SPVs) are driven by central negotiations between Real Estate Investor A and the multinational brands?
- How autonomous is the operation of each SPV?

If analysis reveals that rent prices for a particular SPV are driven by central negotiations, it doesn't have any significant degree of autonomy and its activities are carried out as an extension of Real Estate Investor A, the SPV's functional currency will be EUR.

9.4. Change in functional currency

9.4.1. Circumstances in which an entity's functional currency can be changed

The functional currency of an entity reflects the underlying transactions, events and conditions that are relevant to the entity. Accordingly, once determined, the functional currency can be changed only if there is a change to those underlying transactions, events and conditions. [IAS 21:13] For example, a change in the currency that mainly influences the sales prices of goods and services may lead to a change in an entity's functional currency. [IAS 21:36]

9.4.2. Date at which change in functional currency is recognised

A change in functional currency should be reported as of the date it is determined that there has been a change in the underlying events and circumstances relevant to the reporting entity that justifies a change in the functional currency. This could occur on any date during the year. For convenience, and as a practical matter, there is a practice of using a date at the beginning of the most recent period (annual or interim, as the case might be).

In accordance with IAS 21:35, when there is a change in an entity's functional currency, the entity applies the translation procedures applicable to the new functional currency prospectively from the date of the change.

In other words, all items are translated into the new functional currency using the exchange rate at the date of the change. The resulting translated amounts for non-monetary items are treated as their historical cost. Exchange differences arising from the translation of a foreign operation previously recognized in other comprehensive income are not reclassified from equity to profit or loss until the disposal of the operation. [IAS 21:37] An entity should disclose when there has been a change in functional currency, and the reasons for the change.

9.4.3. Change in functional currency – an example

One of the SPV's domiciled in the Country B from the example in 9.3.1. constructed the shopping centre. The construction lasted 2 years, with the SPV incurring construction and administrative costs in the local currency. There was no rental income during that time. The construction was financed with the bank loan denominated in EUR and an equity contribution in the local currency from the owners of the SPV. During the period of the construction, the functional currency of the SPV was the local currency. However, once the operations started and acquisition by the Real Estate Investor A was complete, the conclusion on the functional currency may change as explained example 9.3.1.

10. Accounting for disposals

10.1. 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:

Sale of the property

The date of disposal for investment property that is sold is the date when the recipient obtains control of the investment property in accordance with the requirements for determining when a performance obligation is satisfied in IFRS 15.

Entering into a finance lease

IFRS 16 applies to a disposal effected by entering into a finance lease.

Sale and leaseback

IFRS 16 applies to a disposal effected by entering into a sale and leaseback.

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]

10.1.1. 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 ncentives that need to be incurred to attract new tenants. At the ransaction 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:

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

10.2. 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.

10.2.1. Assets that are to be sold – general requirements

The overall principle of IFRS 5 is that a noncurrent 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 noncurrent 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 noncurrent 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 noncurrent 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]

10.2.2. 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.

10.2.3. Examples of plan of sale requiring shareholder approval

Scenario A

At the end of the reporting period, an entity's board of directors has approved a plan to sell a non-current asset. The eventual disposal requires approval by a majority of the entity's shareholders through a formal vote which will take place after the reporting period. At the end of the reporting period, a majority of the entity's shareholders have provided the entity with signed irrevocable agreements stating that they will vote in favour of the disposal.

The 'highly probable' test is met because the shareholders have irrevocably committed to approving the transaction and the vote by the shareholders is therefore merely a formality.

Scenario B

Company A holds an 80 % interest in a subsidiary, Company B. At the year end, the board of directors of Company B has approved a plan to sell a noncurrent asset to Company A. The eventual disposal requires approval by a majority of Company B's shareholders through a formal vote which will take place after the reporting period. For a transaction with a major shareholder (in this case, the parent), the minority shareholders are given protection in law if the value of the transaction exceeds a specified threshold. The law prevents Company A from participating in the formal vote on such a transaction. Company B has not received any undertakings to vote in a particular manner from any of the shareholders. It is possible that the proposed transaction may be controversial, and the outcome of the shareholder vote is uncertain.

From Company B's perspective, the 'highly probable' test is not met at the end of the reporting period because the outcome of the formal vote by the remaining shareholders is too uncertain

10.2.4. 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 oneyear requirement in IFRS 5:8 would not be met. The asset would be reclassified as held and used in accordance with IFRS 5:26.

10.2.5. Held for sale criteria met after the reporting period

If the held for sale criteria are not met until after the reporting period, noncurrent 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].

10.2.6. 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.

10.2.7. Individual assets held for sale

As described at 10.2., 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.

10.3. 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.

10.4. Sale and leaseback transactions

10.4.1. Sale and leaseback transactions – general

If an entity (the seller-lessee) transfers an asset to another entity (the buyer-lessor) and leases that asset back from the buyer-lessor, both the seller-lessee and the buyer-lessor are required to account for the transfer contract and the lease by applying IFRS 16:99 to 103. [IFRS 16:98]

In considering whether a transaction should be accounted for as a sale and leaseback transaction, an entity should consider not only those transactions structured in the form of a legal sale and leaseback, but should also consider other forms of transactions for which the economic effect is the same as a legal sale and leaseback (e.g. a sale and leaseback transaction may be structured in the form of a lease and leaseback). [IFRS 16:BC261]

10.4.2. Assessing whether the transfer of the asset is a sale

An entity should apply the requirements for determining when a performance obligation is satisfied in IFRS 15 to determine whether the transfer of an asset is accounted for as a sale of that asset. [IFRS 16:99]

IFRS 16 provides no additional application guidance regarding the determination as to whether there is a sale in a sale and leaseback transaction (i.e. regarding how to apply the IFRS 15 requirements relating to the satisfaction of performance obligations to sale and leaseback transactions). This is because the Board considers that the principles in IFRS 15 can be applied appropriately and consistently to sale and leaseback transactions without any further guidance. [IFRS 16:BC264] Applying the guidance in IFRS 15, the transfer of an asset is accounted for as a sale when the buyer-lessor obtains control of the asset. In the context of sale and leaseback transactions, it can generally be assumed that the relevant requirements are IFRS 15's requirements regarding satisfaction of a performance obligation 'at a point in time' (as opposed to 'over time') (see guidance in IFRS 15:31 to 34 and indicators of the transfer of control in IFRS 15.38).

10.4.3. Transfer of the asset is a sale at fair value – general requirements

If the transfer of an asset by the seller-lessee satisfies the requirements of IFRS 15 to be accounted for as a sale of the asset: [IFRS 16:100]

- the seller-lessee should measure the right-of-use asset arising from the leaseback at the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee. Accordingly, the seller-lessee should recognise only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor; and

- the buyer-lessor should account for the purchase of the asset applying applicable IFRS Accounting Standards, and for the lease applying the lessor accounting requirements in IFRS 16

10.4.3.1. Sale and leaseback with variable payments – an example

Entity A, a seller-lessee, enters into a sale and leaseback transaction whereby it transfers a building (Item C) to Entity B, a buyer-lessor, and leases Item C back for five years. The transfer of Item C satisfies the requirements in IFRS 15 to be accounted for as a sale of the building. Immediately before the transaction, the item C is carried at a cost of CU1 million, and the amount paid by Entity B for Item C is CU1.8 million (the fair value of Item C at that date). All the payments for the lease (which are at market rates) are variable as defined in IFRS 16, calculated as a percentage of Entity A's revenue generated using Item C during the five-year lease term. At the date of the transaction, the present value of the expected payments for the lease is CU0.45 million. There are no initial direct costs.

IFRS 16:100 requires Entity A to measure the right-of-use asset arising from the leaseback at the proportion of the previous carrying amount of the asset that relates to the right-of-use retained by Entity A. Consequently, to measure the right-of-use asset arising from the leaseback, Entity A should determine the proportion of Item C transferred to Entity B that relates to the right-of-use retained. It does so by comparing, at the date of the transaction, the right-of-use it retains via the leaseback to the rights comprising the entire Item C. IFRS 16 does not prescribe a method for determining that proportion.

Entity A determines that it is appropriate to calculate the proportion by comparing, for example, the present value of expected payments for the lease (including those that are variable) with the fair value of Item C at the date of the transaction. On this basis, the proportion of Item C that relates to the right-of-use retained is 25 per cent, calculated as CU0.45 million (present value of expected payments for the lease) ÷ CU1.8 million (fair value of Item C). Consequently, the proportion of Item C which relates to the rights transferred to Entity B is 75 per cent, calculated as (CU1.8 million − CU0.45 million) ÷ CU1.8 million. Applying IFRS 16:100(a), Entity A:

- measures the right-of-use asset at CU0.25 million, calculated as CU1 million (previous carrying amount of Item C) × 25% (proportion of Item C that relates to the right-of-use it retains); and
- recognises a gain of CU0.6 million at the date of the transaction, which is the gain that relates to the rights transferred to Entity B. This gain is calculated as CU0.8 million (total gain on sale of Item C (CU1.8 million – CU1 million)) × 75% (proportion of Item C which relates to rights transferred to Entity B).

Applying IFRS 16:100(a), the right-of-use asset would not be measured at CUnil at the date of the transaction because this would not reflect the proportion of the previous carrying amount of Item C (CU1 million) which relates to the right-of-use retained by Entity A.

Entity A also recognises a liability at the date of the transaction, even if all the payments for the lease are variable and do not depend on an index or rate. The initial measurement of the liability is a consequence of how the right-of-use asset is measured and the gain or loss on the sale and leaseback transaction determined, applying IFRS 16:100(a).

At the date of the transaction, Entity A accounts for the transaction as follows:

		CU million	CU million
Dr	Cash	1.8	
Dr	Right-of-use asset	0.25	
Cr	Property, plant and equipment		1
Cr	Liability		0.45
Cr	Gain on rights transferred		0.6

This conclusion was confirmed by the IFRS Interpretations Committee in the June 2020 IFRIC Update.

In September 2022, the IASB issued Lease Liability in a Sale and Leaseback (Amendments to IFRS 16). The amendments add IFRS 16:102A which addresses the subsequent accounting for this liability requiring that, subsequently, the lease payments should be determined in a way such that no gain or loss that relates to the right of use retained by the seller-lessee is recognised.

The amendments do not prescribe a specific method for achieving this outcome and entities entering in to such transactions should develop an appropriate accounting policy in accordance with IAS 8 which should be applied consistently to all similar transactions. The amendments also clarify that the liability recognised is a lease liability. The amendments are effective for annual reporting periods beginning on or after 1 January 2024 with earlier application permitted.

10.4.4. Transactions other than at market terms

If either (1) the fair value of the consideration for the sale of an asset does not equal the fair value of the asset, or (2) the payments for the lease are not at market rates, the following adjustments are required to measure the sale proceeds at fair value: [IFRS 16:101]

- any below-market terms should be accounted for as a prepayment of lease payments; and
- any above-market terms should be accounted for as additional financing provided by the buyer-lessor to the seller-lessee.

The entity should measure any potential adjustment required by IFRS 16:101 (see above) on the basis of the more readily determinable of: [IFRS 16:102]

- the difference between the fair value of the consideration for the sale and the fair value of the asset; and
- the difference between the present value of the contractual payments for the lease and the present value of payments for the lease at market rates.

Example 24 from the illustrative examples accompanying IFRS 16 (IFRS 16:IE11) (reproduced in 10.4.4.1), illustrates the application for the requirements in IFRS 16:99 to 102 for a seller-lessee and a buyer-lessor when the sales proceeds exceed the fair value of the underlying asset.

In September 2022, the IASB issued ***Lease Liability in a Sale and Leaseback (Amendments to IFRS 16)***. The amendments updated this example to present separately the lease liability and the financial liability.

10.4.4.1. Sale and leaseback transaction – an example

Example 24—Sale and leaseback transaction with fixed payments and above-market terms [updated with September 2022 amendments]

An entity (Seller-lessee) sells a building to another entity (Buyer-lessor) for cash of CU2,000,000. Immediately before the transaction, the building is carried at a cost of CU1,000,000. At the same time, Seller-lessee enters into a contract with Buyer-lessor for the right to use the building for 18 years, with annual payments of CU120,000 payable at the end of each year. The terms and conditions of the transaction are such that the transfer of the building by Seller-lessee satisfies the requirements of IFRS 15 Revenue from Contracts with Customers to be accounted for as a sale of the building. Accordingly, Seller-lessee and Buyer-lessor account for the transaction as a sale and leaseback.

The fair value of the building at the date of sale is CU1,800,000. Because the consideration for the sale of the building is not at fair value, Seller-lessee and Buyer-lessor make adjustments to measure the sale proceeds at fair value. Applying paragraph 101(b) of IFRS 16, the amount of the excess sale price of CU200,000 (CU2,000,000 – CU1,800,000) is recognised as additional financing provided by Buyer-lessor to Seller-lessee.

The interest rate implicit in the lease is 4.5 per cent per annum, which is readily determinable by Seller-lessee. The present value of the annual payments (18 payments of CU120,000, discounted at 4.5 per cent per annum) is CU1,459,200, of which CU200,000 relates to the additional financing and CU1,259,200 relates to the lease—corresponding to 18 annual payments of CU16,447 and CU103,553, respectively.

Buyer-lessor classifies the lease of the building as an operating lease.

Seller-lessee

Applying paragraph 100(a) of IFRS 16, at the commencement date Seller-lessee measures the right-of-use asset arising from the leaseback of the building at the proportion of the previous carrying amount of the building that relates to the right of use retained by Seller-lessee, which is CU699,555. Seller-lessee calculates this amount as: CU1,000,000 (the carrying amount of the building) × CU1,259,200 (the discounted lease payments for the 18-year right-of-use asset) ÷ CU1,800,000 (the fair value of the building).

Seller-lessee recognises only the amount of the gain that relates to the rights transferred to Buyer-lessor of CU240,355 calculated as follows. The gain on sale of the building amounts to CU800,000 (CU1,800,000 – CU1,000,000), of which:

1. **(a)** CU559,645 (CU800,000 × CU1,259,200 ÷ CU1,800,000) relates to the right to use the building retained by Seller-lessee; and
2. **(b)** CU240,355 (CU800,000 × (CU1,800,000 – CU1,259,200) ÷ CU1,800,000) relates to the rights transferred to Buyer-lessor.

At the commencement date, Seller-lessee accounts for the transaction as follows.

Cash	CU2,000,000	
Right-of-use asset	CU699,555	
Building		CU1,000,000
Lease liability		CU1,259,200
Financial liability		CU200,000
Gain on rights transferred		CU240,355

Buyer-lessor

At the commencement date, Buyer-lessor accounts for the transaction as follows.

Building	CU1,800,000	
Financial asset	CU200,000 (18 payments of CU16,447, discounted at 4.5 per cent per annum)	
Cash		CU2,000,000

After the commencement date, Buyer-lessor accounts for the lease by treating CU103,553 of the annual payments of CU120,000 as lease payments. The remaining CU16,447 of annual payments received from Seller-lessee are accounted for as (a) payments received to settle the financial asset of CU200,000 and (b) interest revenue.

11. IFRS Accounting Standards versus local Generally Accepted Accounting Principles

The table below highlights key differences in the main accounting principles described in chapters 1-10 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 measurment 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 asssessed	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	Measurment 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 lessess 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 asssessed	At the end of each reporting period	N/a	N/a	At the end of each reporting period
5	Measurment 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 lessess 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	
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 measurment 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 asssessed	With sufficient regularity to ensure that the carrying amount does not differ matteriallly 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	Measurment 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 lessess is straight-lined as well)	No, income is recognized on a straigh-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 measurment 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 asssessed	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	Measurment 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 lessess 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

Real estate measurement: the appraiser’s perspective

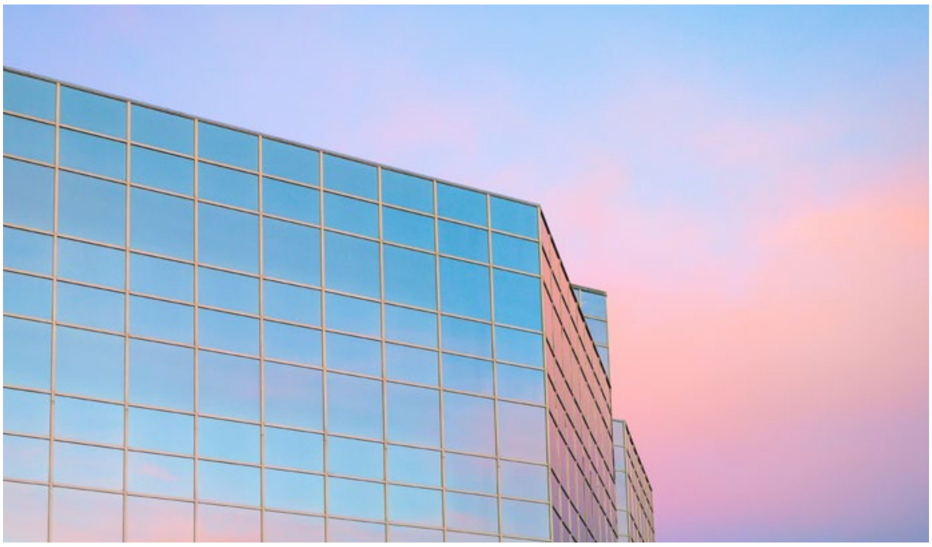
The purpose of the section is to present the specifics of property appraisal that are used for financial reporting purposes.

Valuations for financial statements must be prepared in accordance with the relevant financial reporting standards adopted by the entity. Today, the International Financial Reporting Standards (IFRS) are the most commonly used. In all cases, however, valuers are obliged to specify which standards have been adopted by their clients and provide the corresponding definition of value in reporting as well as the applicable measurement requirements. Valuers should also determine the classification of assets to be valued and refer to the corresponding accounting standard in the valuation report. It is also important to bear in mind that financial reporting standards are constantly evolving, so valuers should always refer to the standards in place at the time of valuation.

For entities that have adopted IFRS Standards, 'fair value' is the basis of value. This is a market-based valuation, not an entity-specific measurement, and 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". The standard sets out a framework for measuring fair value and requires disclosures about fair value measurements. Any information deemed helpful needs to be disclosed to the users of an entity's financial statements so that the following assessments can be made:

- **"for assets and liabilities that are measured at fair value on a recurring or non-recurring basis in the statement of financial position after initial recognition, the valuation techniques and inputs used to develop those measurements."**
- **" for recurring fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on profit or loss or other comprehensive income for the period."**

1. Basis of real estate valuation for financial reporting purposes



Financial statements must be prepared with appropriate rigour. The same is true for valuations of assets. As it is important for valuers to be unbiased, it may be advisable to be sceptical when undertaking valuations.

Real estate is a company asset and is usually a significant balance sheet item that may have a bearing on the assessment of the company's standing. In accordance with the financial reporting standards that have been adopted (whether IFRS Standards or PAS), the value of assets including investment property cannot be lower than the higher of two figures - the recoverable amount based on fair value less the costs to sell; or the value in use of an asset or CGU.

Fair value is, therefore, crucial for measuring investment property or inventories that include real estate under construction or completed (stated at cost in a developer's accounting records) for which fair value is frequently calculated for impairment-testing purposes.

A fair value measurement of real estate considers the highest and best use of the asset, that takes into account what is physically possible, legally permissible and financially feasible:

- A use that is physically possible considers the physical characteristics of the asset, especially those that could affect its pricing such as the location and size of a property.

- A legally permissible use considers any legal restrictions that could affect the pricing of the asset, such as zoning regulations that may be applied to a property,

- Taking full account of what is physically possible and legally permissible, a financially feasible use considers the ability of the asset to generate an adequate income or cash flow to deliver a return on an investment. The costs of converting the asset to that use are also taken into account.

Even if a different use for the asset is intended by the entity, highest and best use is established from the perspective of market participants.

Transaction costs are not taken into account when determining the price in the principal or the most favorable market that is being used to measure the fair value of the asset or liability. Transaction costs are settled in accordance with other IFRS Standard and are not features of an asset or a liability. Such costs will differ and are dependent on an entity's approach to a transaction for the asset or liability.

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. **The statement that the market value can be considered the fair value is true. However, 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, even though it does not meet the market value definition. In practice, the replacement value is rarely considered as the fair value equivalent of investment property or property under construction where there is a view to sell apartments that are classified in financial statements as inventories. This is because the cost approach does not consider actual market transactions (supply and demand). It refers only to the depreciated construction cost of buildings located on a plot of land. Financial reporting allows acceptance of such a calculation as fair value for specific types of real estate that lack 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. It is an additional condition that allows the use of the depreciated replacement cost in valuation.

In accordance with the updated RICS Valuation Global Standards (effective from 31 January 2022) and where appropriate, the valuer is expected to determine and declare whether the basis of value adopted by the entity is deemed consistent with the basis of market value. The valuer is also responsible for confirming if the specific application of the defined accounting basis of value results in different values.

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 based on fair value. A particular focus should be on all reports that define non-market value such as investment value/worth, liquidation value or where special assumptions have been made. Here, the value calculation resembles a scenario analysis (optimistic or pessimistic compared to typical market conditions), so it does not meet the fair value definition. Fair value estimates for financial reporting purposes should comply with the requirements arising 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 should refer to general principles without ignoring the details of the accounting standard used by the client (PAS, IFRS Standards, US GAAP or other accounting principles) and industry specifics. The updated RICS Valuation Global Standards has helped to provide clarity around the role and responsibility of the valuer in the provision of financial reporting valuations. This highlights the need for both the engagement letter and the valuation report, to include full details of the accounting standards to be adopted in the valuation; the definition of the basis of value, including reference to the basis of value definition (e.g., IFRS 13 or FRS 102, etc.); and details of the relevant accounting standard body.

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 earlier reports to ensure consistency of valuation methodology. The only exception should be where there are indications that support a change in the approach to valuation. For example, modification to a spatial plan might allow the adoption of another valuation method or other assumptions.

2. Real estate valuation techniques

Various valuation techniques are used to estimate fair value. Entities are required to use techniques that take into account the specific circumstances and provide sufficient data to measure fair value. In addition, they should maximise the use of relevant observable inputs while minimising the use of unobservable inputs. In some cases, a single valuation technique will be appropriate. In other cases, multiple valuation techniques will be required. The measurement should be carried out using the characteristics of the asset that market participants would consider when pricing the asset at the measurement date including, for example, the condition or location of the property. Sometimes those characteristics will lead to the need for an adjustment to be made, such as a premium or a discount.

The IFRS 13 establishes a fair value hierarchy comprising three levels of inputs to the valuation techniques used to measure fair value. The aim of creating such a hierarchy is to increase consistency and comparability in fair value measurements and related disclosures. In this hierarchy, quoted prices (unadjusted) in active markets for identical assets or liabilities have the highest priority (Level 1 inputs), with the lowest priority given to unobservable inputs (Level 3 inputs).

Those inputs not included within Level 1 that can be observed for the asset or liability directly or indirectly are considered as Level 2 inputs. In case of real estate valuation, the most common are level 2 and 3 inputs.

The principal valuation approaches are:

1. Market approach

"The market approach uses prices and other relevant information generated by market transactions involving identical or comparable (i.e. similar) assets, liabilities or a group of assets and liabilities, such as a business."

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. The land and residential property markets also include groups of homogenous properties that share a number of features to make comparison easier. Land for single-family houses or three-room flats is a good case in point.

2. Income approach

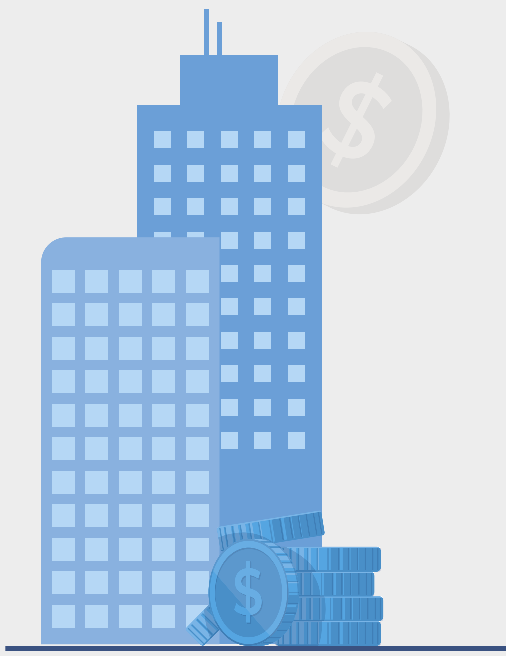
"The income approach converts future amounts such as cash flows or income and expenses to a single current (i.e. discounted) amount. When the income approach is used, the fair value measurement reflects current market expectations about those future amounts."

The income approach is applied mostly to the measurement of income-generating property such as office buildings, shopping centers, warehouses, industrial facilities, hotels and fuel stations.

3. Cost approach

"The cost approach reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost)."

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



3. Valuation basis in Poland

The following legal acts provide the legal framework for a valuation appraisal in Poland:

- The Act on Real Property Management of 21 August 1997 (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, (Journal of Laws no. 207, item 2109 as amended).

The 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 that includes National Basic Appraisal Standards (NBAS) and National Special Appraisal Standards (NSAS). The solutions adopted in the Appraisal Principles take account of international experience from organisations such as The European Group of Valuers' Association (TEGOVA) and the International Valuation Standards Council (IVSC).

The Appraisal Principles provide proceeding principles that comply with best practices, but they do not provide a legal basis for real estate valuation in Poland (except for the Standard on Appraisal for collateral purposes). From the financial reporting perspective, the NSAS report "Appraisal of Titles to Real Estate, Property and Equipment for Financial Reporting Purposes" is of particular importance as it is dedicated to valuations for inclusion in financial statements, in accordance with both the Accounting Act and IFRS Standards. The standard includes requirements in connection with fair value presentation (introduced by IFRS 13) and presents them as good practices that can also be adopted for PAS reporting purposes.

To a large extent, the standard implements the terminology used in **IFRS 13** to ensure valuation reports are consistent with financial reporting requirements. For compliance and consistency purposes, appraisers also apply methods that are convergent with an entity's accounting policies.

Definitions introduced by IFRS 13 specify those procedures that should be applied in reports for these purposes. As good practice, solid arguments should be used to support assumptions arising from market analyses or sensitivity analyses of estimates.

In accordance with Article 152 of ARPM, **approaches to real estate valuation include the comparison/market 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. And, in accordance with 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 approaches noted above, as well as the form of a valuation report, are defined in the Regulation.

4. Property valuation verification

A valuation report may determine different types of real estate value. To verify that the value arising from a valuation report may be regarded 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, basis and date of the valuation;
- Methodology;
- Valuation assumptions;
- Valuation conditions and any related restrictions;
- The fair/market 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 readily correlated with an appropriate item in the fixed assets register.

4.2. Purpose, basis and date of the valuation

An appraiser is obliged to determine the purpose, basis and date of the valuation in the initial section of the valuation report. Such information may indicate that the analysed valuation report should not be used for financial-reporting purposes. In the first instance, the purpose, basis and date of the valuation should be verified. The following examples of incorrect practice for valuation reports, highlight the mis-use of financial statements generated 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 in the financial statements of the company prepared as at 31.12.2022. The appraiser indicated the purpose, basis and date of the valuation in the following manner:

Selected sections of the valuation report (incorrect)

Valuation purpose: The valuation was prepared for individual investment purposes.
Basis of value: Investment value
Valuation date: 31.12.2020
Company X should notice that the value estimated in the valuation report refers to investment value, so it does not meet the market/fair value definition. In addition, the valuation was performed two years prior to the financial statements, so the estimated value is out of date. The purpose, basis and date of the valuation, as stated in the valuation report, disallow its use as fair value as at 31.12.2022, so further verification would be meaningless. The company should obtain a new valuation report from an appraiser, determining the valuation purpose, basis and date of the valuation as follows:

Selected sections of the valuation report (correct)

Purpose of the valuation: The valuation was prepared for the financial reporting purpose.
Basis of value: Fair Value
Valuation date: 31.12.2022

Table: 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	• Residual method • Assumed construction of a commercial facility	No legal or spatial conditions to construct a commercial facility, which disallows the use of the residual method to fair value measurement.	• Market approach • Analysis of transactions of similar undeveloped plots of land
Industrial facility Description: intended for demolition.	• Income approach • Facility commercialisation assumed	The assumption to commercialise the building intended for demolition is non-viable.	• Residual method • Assumed liquidation costs and market approach of the undeveloped land
Office building Description: A class building, fully leased	• Market approach	The commercialised A class office building should be valued using the income approach as it generates rental income.	• Income approach

4.3. Methodology

An appraiser should select a valuation approach and method in accordance with the subject and the stated objectives. 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.

The above examples are by no means an exhaustive list of incorrect valuation methodologies for estimation of fair value. 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 market and income approach.

4.5. Fair/market 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 are not consistent with current market prices.

Comparing the value presented in a valuation report to available transaction prices is, therefore, of key importance. This is particularly true 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.

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 31.12.2022

Methodology
Market approach: assumptions in the valuation report. The appraiser presented transactions regarding similar properties in order to estimate the market value of the industrial plot as at 31.12.2022. The following table presents selected aspects of the above property that undermine the validity of the approach.
This is not an exhaustive list of incorrect transactions used for comparison valuation purposes. Valuation of developed plots

Transaction date	Transaction subject	Location	Purpose	Size	Comment
31.12.2020	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 approximately 24 months of the valuation date can be used.
30.10.2022	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.
23.11.2022	Undeveloped land	Location B	Production	110 ha	Location is of key importance for the property and affects its value. It is vital, therefore, that plots of land treated as the benchmark are located within the local market or within comparable parallel markets.
24.12.2022	Undeveloped land	Location A	Residential	80 ha	Comparative transactions should regard property with the same or similar purpose as the one that is subject to valuation. Comparing residential property to industrial property is incorrect.
28.12.2022	Undeveloped land	Location A	Production	0.05 ha	The size of property used for market approach purposes should not differ too much from the one subject to valuation.

of land requires a focus on additional parameters such as the function, size or the technical condition of the facility. It should be noted that appraisers do not always indicate the purpose of a given plot of land when describing similar property. In such cases, verification based on publicly available local spatial development plans will be required.

Example 2 - Property valuation assumptions part 2

Subject of the valuation
A plot of land with C class office facility located at C, valuation as at 31.12.2022

Methodology
Income approach, investment method, direct capitalisation technique

Assumptions
The following table presents a selection of incorrect assumptions underlying valuation under the income approach, together with methods of verification.

Parameter	Assumption	Comment
Market rent rate	EUR 25/sq.m per month	• The assumed rent rate is equal to those applied in the best office locations in the region. 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: – a lease of office space in the facility undergoing valuation; – leases of office space in similar facilities; – market reports for the office sector, published by commercial agencies; – analysis of generally available office space lease offers published on the internet.
Market vacancy rate	5%	• 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 commercial agencies.
Capitalisation rate	4.50%	• The capitalisation rate for the facility undergoing valuation should be based on data derived from the investment market. In Poland, capitalisation-rate information is only readily available for the prime properties. The 4.50% rate is the one applicable to the highest-quality properties. • 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.

5. Impact of ESG on valuation

The growing importance of Sustainability & Environmental, Social and Governance (ESG) factors corresponds to the expectations, perceptions and awareness of customers and the wider public. There is, as a result, an increasing need to quantify these factors in the valuation process. Valuation organisations (including IVS, RICS and TEGOVA) have addressed some of Sustainability and ESG issues in their updated valuation standards, Guidance Notes and Perspectives Paper. While the proposed changes provide continuity and address recognised challenges, this is still an area of development that is continuing to evolve.

First of all, the valuers should understand the trends and analyse comparables in order to consider the influence of ESG-related matters. It is important to understand how ESG is influencing leasing and other behaviours among market participants. Valuers should also liaise with building cost experts to understand CapEx requirements in the ESG area, while also keeping abreast of the steps being taken by governments that will affect real estate. The EU, for example, is aiming to reach climate neutrality by 2050. This target, as well as the intermediate target of a minimum 55% net reduction in greenhouse gas emissions by 2030, are set in the European Climate Law. Various initiatives have been launched by the EU to reach these targets, including the Effort Sharing Regulation which is being updated as part of the Fit for 55 legislative package.

In its standards, TEGOVA discusses possible methods of placing a value on wider environmental sustainability concerns that focus primarily on costs issues:

3.1. "A legal obligation to renovate a building to a higher level of energy efficiency by a fixed date or at a certain inflection point (e.g. rental, sale) creates an unavoidable major cost that impacts Market Value."

3.2. "Valuers must be aware of these legal deadlines and inflection points and, when they appear, must estimate the cost of a renovation deep enough to meet the required new level of energy efficiency or future requirements that are sufficiently close to coming into force and consider the extent to which these costs affect the Market Value at the date of valuation."

In the case of IVS, the matters of ESG are stated under IVS 101 20.1 - "all valuation advice and the work undertaken in its preparation must be appropriate for the intended purpose." This is further referenced in IVS 102 20.1, where it states that "investigations made during the course of a valuation assignment must be appropriate for the purpose of the valuation assignment and the basis(es) of value". In IVS 105 50.36 - 50.4, it also states that adjustments within the cash flow for additional risks, including ESG issues, must be considered. Furthermore, IVS

410 Development Property section 100 provides the following requirements in relation to the asset:

- **"(c) whether there are other non-financial obligations that need to be considered (political or social criteria)**
- **(k) sustainability and any client requirements in relation to green buildings."**

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. In addition, the main purpose of the Guidance Note adopted in January 2022 is to encourage valuers to be explicit in the process of identifying and communicating Sustainability & ESG issues and the impact these issues have on valuers' thought process, as well as supporting the reporting procedures.

IFRS Standards are evolving to align with the requirements of the Taskforce on Climate Related Disclosures ("TCFD"). International investors with global investment portfolios are demanding that companies provide high quality, transparent, reliable and comparable reporting on climate and other environmental, social and governance matters. As a result, the IFRS Foundation Trustees formed a new standard-setting board—the International Sustainability Standards Board (ISSB) - to provide a comprehensive global baseline of sustainability-related disclosure standards that provide market participants with information about the sustainability-related risks and opportunities of companies in order to support more informed decision-making.

In March 2022, the ISSB launched a consultation on the first two proposed standards:

- S1 –General Sustainability-Related Disclosures
- S2 –Climate-related Disclosures (Real Estate specific content within Volume B36)

The proposed standards, when finalised, intend to "form a comprehensive global baseline of sustainability-related disclosures designed to meet the information needs of investors in assessing enterprise value". The consultation was closed at the end of July 2022 and implementation is scheduled for early 2023.

In our market, certain sustainability characteristics are less apparent and often don't filter through to market pricing. With limited data in the market, it is likely that it will be some time before sufficient information exists to provide empirical evidence in support of a valuer's decision to differentiate values based on the full range of sustainability criteria. There are, of course, many factors influencing the property value, from technical (certificates, the fit-out quality of accommodation) and financial (rental rates) to operating costs and capex. Nevertheless, there is a growing recognition of the brown discount on price for the conventional building stock.

Part 3

Tax issues in real estate market

Introduction

The tax section of this guide focuses on selected topics that investors must 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 in the life of an investment property: from construction or acquisition, through the operating phase to its ultimate disposal - including the distribution of profits.

The publication also covers tax regulations effective from January 2023 and highlights the tax benefits and tax burdens connected with operating in Central Europe's real-estate market.

We trust this comprehensive guide to real-estate taxation in Central Europe will prove invaluable in helping you to meet your business objectives and that you will not hesitate to contact us should you have any further questions on the issues it covers.

POLAND

Real-estate investment process

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

(1) the construction or acquisition phase;
(2) the operational phase; and
(3) the exit phase.

Each of these stages is associated with different tax issues. The chapter presents a selected range of issues that are typical for a given investment stage and includes examples showing the most appropriate way to proceed in each case.

1. Acquisition or construction phase

The basic problem faced by investors in an investment acquisition from an unrelated entity is selecting the form of acquisition: 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 and the scope of tax succession (tax losses, deferred tax, depreciation) while also deciding 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:

+ The potential for entering real estate into the tax books at the market-purchase price.
+ The 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.
+ The potential for performing only limited due diligence.
+ No tax liability for the seller's tax arrears if the assets do not constitute an enterprise or organised part of the enterprise (OPE). In other cases, there is potential for limiting the liability of the buyer by obtaining certificates of tax arrears from the seller (up to the presented amount of tax arrears).
+ The potential to obtain 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 that a joint individual interpretation (joint tax ruling) is obtained to confirm the tax consequences of the transaction for both the seller and the buyer.
- 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 to establish if it qualifies as a sale of real estate / enterprise or an OPE as this significantly changes the tax consequences of the transaction.
- Verification that the seller's bank account is included on a so-called White List of VAT taxpayers. This enables 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. If the seller's bank account is not white-listed, the purchaser may avoid such sanctions by submitting a special notification (via the ZAW-NR form) to the head of the purchaser's tax office 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. (Here, it may be necessary for the buyer to analyse whether the acquisition of a loss-making company qualifies as a reportable tax scheme. This is because 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 the generic hallmark must be met alongside the main tax benefit test to qualify for the reportable tax scheme.
+ The potential to negotiate a price reduction through unrealised profits (latent capital gain).
+ There is no need to analyse the qualification of the transaction as an enterprise / OPE. Unlike an asset deal, there is no risk of potential reclassification of the transaction by the tax authorities.
+ There is no need for an individual tax ruling to provide confirmation of the nature of the transaction for tax purposes.

Disadvantages:

- Continuation of tax settlements (the tax history) of the acquired company. As a result, it is 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 need to be secured in the Sale and Purchase Agreement (SPA) than is the case with an asset acquisition.
- 1% tax on civil law transactions (CLAT) on the fair market value of the shares / stocks purchased.
- There is no potential for updating the property's value to its market value.
- There may be certain tax consequences if the investment is being refinanced. 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 that is the 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. Since January 2021, additional safeguards need to be taken by the buyer. 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 should be verified and appropriate warranties should be applied to secure this issue in the SPA.

Limitation to restrict debt-push down benefits

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

Additional limitation of deducting financing costs in capital transactions

According to Polish tax provisions, the taxpayer is obliged to exclude any debt-financing costs **obtained from a related entity** from the tax costs if 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 (the buy-back of shares) or making additional payments. However, the provisions for excluding debt financing expenses that have been incurred for the purpose of capital transactions from tax deductible costs will not apply, if:

- a) the debt financing has been provided for the acquisition of shares (stocks) **in a non-related entity**. This includes the acquisition or subscription of further shares in those unrelated entities where the taxpayer has previously acquired or taken up part of the shares (stocks), if the next acquisition or subscription takes place within 12 months from the date of acquisition or subscription of the first shares (stocks);
- b) the debt financing has been provided by a bank or a credit union that has its seat in an EU member state or in an EEA country.

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 for an investor to determine which type of transaction will be most favourable from a tax perspective, a potential buyer should carefully examine the deferred tax items of the company to be acquired. These may include the tax value of the property on the seller's books, unrealised exchange-rate differences on the loans and the company's accumulated tax losses. Such factors may provide the opportunity to reduce the company's income in the future. Each transaction requires a case-by case approach and pre-acquisition analysis of any tax consequences.

If factors such as a higher tax value than the market value of the property, a high level of accumulated tax losses, negative unrealised exchange-rate differences and the lack of significant tax risks are present, it may be preferable to opt for a share deal transaction. If, on the other hand, significant tax risks are identified in the due diligence phase of pre-acquisition, an asset deal transaction may be a better decision. Similarly, if the transaction as a share deal will be subject to non-recoverable CLAT (instead of deductible VAT), this may be an argument for choosing an asset deal instead. The same may be applicable due to recent legislation shifting the obligation to settle tax on the sale of shares in a real estate company to that company. As a result, the buyer may opt for an asset deal as, in the case of a share deal, additional verification of the tax calculation and appropriate warranties should be applied to secure this issue in the SPA.

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

An arrangement that uses a tax resident company in Poland to acquire financing to purchase the shares, followed by a merger with the target, is no longer a tax efficient option due to the restrictions on debt push-down benefits. This is because of the limitation on tax-deductibility of interest incurred within debt push-down structures introduced in January 2018. In addition, the tax regime effective from January 2022 for Polish tax resident holding companies that allowed full tax exemption gain 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 company.

Foreign holding company

The foreign buyer may choose to make the acquisition itself. Non-residents are not subject to tax in Poland from 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 is applicable).

The real estate-rich company clause is gradually being introduced to the tax treaties with countries that have, hitherto, served as the holding jurisdictions for real-estate investments in Poland. For example, ratification of the amending protocol to the DTC with the Netherlands has now been completed, and the provisions of the protocol apply from 1 January 2023. A real estate-rich company clause provided for in this protocol introduces taxation of gains derived by a Dutch tax resident from the sale (or other disposal) of shares in a company (or comparable interests) if the shares directly or indirectly derived more than 75% of their value from immovable property located in Poland (as well as any indirect shareholding) at any time during the 365 days preceding the disposal.

1.2. Acquisition funding

A buyer needs to decide whether an acquisition will be funded with debt or with equity.

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'). Unlike interest distribution, this is because the payment of a dividend does not reduce the tax base of the Polish entity that is paying the dividend.

Until the end of 2017, a typical scheme used the debt push-down structure. From the start of 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. This is particularly true in the event of a merger and the transformation of a company's legal form. As a result of the limitations on the tax-deductibility of interest incurred within such structures and the new distinction between types of revenues (capital vs. other source of revenues), such options are no longer available.

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

Loans from banks or financial institutions and shareholder loans granted to companies are CLAT-exempt. Loans granted by partners to partnerships are generally 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%, but 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. Since January 2018, interest on a loan granted for shares acquisition is classified within the capital source of revenue. It therefore cannot be deducted from the revenues belonging to another 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. With effect from 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.).

1.2.2. Equity financing

Any establishment or increase of the share capital in the Polish company is subject to 0.5% CLAT in Poland, but 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 but dividends are not deductible for Polish tax purposes.

Although equity offers less flexibility when the parent subsequently wishes to recover the funds it has injected, the use of equity may be more appropriate than debt in some circumstances. For example:

- 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
- if the borrower is loss-making, it may not be possible to deduct all the cost of interest for tax purposes.

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

It can be difficult to correctly classify the real-estate investment for tax purposes when the investor develops the real-estate property.

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 when the revenue from their sale is earned.

However, there are still many contradictory interpretations in connection with the classification of 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 general operations of the company. In some cases, the tax authorities define expenses that are closely related to the construction process as indirect costs that are 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 years of investment execution, a taxpayer will be able to settle no more than 50% of the accumulated tax loss in the year when revenue is obtained 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 up to PLN 5 million of tax loss. For a large real-estate investment project this may be still insufficient.

A single project carried out by a special purpose vehicle is typical in the real-estate business, but such cases may result in an inability to use a significant part of the tax losses. Additional doubts arise in connection with financial costs. The general rule that interest is recognised as tax costs at the time of its payment is not questioned in the case of real-estate properties being constructed for sale. However, the tax authorities issue tax rulings that allow taxpayers to defer the moment financial costs are recognised (in particular interest, commissions, loan-related fees etc.) until the tax year when the taxpayer obtains revenue from the sale of the real-estate property.

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 in order to avoid potential problems. At the same time, it is possible to indicate a group of indirect costs that, as a rule, will have to be of a nature that is not 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 used for development of the real investment for sale.

Example 8.1.

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 payments 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 where 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. once confirmation has been received that a given stage of development has been completed.

Question: Consider a development agreement that obliges purchasers to make periodic payments to the open housing trust account in accordance with the payment schedule that corresponds to the advancement of the housing project. In such a case, 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 that are then transferred by the bank operating this account to the account of the developer once a given stage of development of the project has been confirmed, 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 that will be delivered in subsequent reporting periods. Such payments made by purchasers are considered to be in the nature of an advance and are not treated, therefore, as a definitive benefit for the developer.

Example 8.2.

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 after payment of a reservation fee. The reservation fee will be refundable to the customer's bank account if the development agreement is not executed. Conversely, the reservation fee will be credited towards the sale price of the residential apartment if a development agreement is executed.

Question: Does receipt of the reservation fee constitute taxable revenue for the developer?
Answer: The reservation fee is a returnable benefit that 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 8.3.

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

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

Answer: Signing the hand-over protocol and handing over the keys to the apartments do not result in transferring the right of ownership to the apartment to the buyer. 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 8.4.

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 such costs incurred during the investment period continue to be recognised on an ongoing basis?

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

Example 8.5.

Scenario
E Sp. z o.o. carries out real-estate development activity. The company is currently implementing three residential projects for sale and 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 advertisements in the press, billboards, brochures and leaflets in connection with 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 the aim is to attract potential buyers for this particular residential investment). The company should also recognise such expenses at the moment of earning revenue from the sale in proportion 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 (such as advertising products with the company's logo) one may also consider recognising these as indirect costs that are deductible on the date they are incurred.

Example 8.6.

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 in 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 always straightforward. As a rule, the costs incurred for the construction of an entire housing complex should be allocated to the particular houses in accordance with a set proportion based, for example, on their area or value.

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

There have not been major doubts raised in connection with the capitalisation of a wide range of expenses relating to the cost of one's own real-estate properties. For several years, however, contradictory trends have been observed, indicating the recognition of certain categories of cost on the date of incurrence rather than through depreciation. This particularly applies to expenditures concerning the transfer of road infrastructure to the municipality and technical infrastructure (such as 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 8.7.

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. During the course of construction, the company incurred various categories of costs, such as general management costs and accounting services. It also received a loan in foreign currency for the construction of the shopping centre and the adjacent car park, purchased the land for the construction of the shopping centre, paid the real estate tax on the land 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 be considered as a tax-deductible cost at the moment of being incurred and not as an element determining the initial tax value of the building. The cost of land acquisition, is not included in the initial tax value of the building. This will only be a cost at the time of disposal of the property.

The company will include the cost of interest on the loan paid before the fixed asset was put into use in the initial tax value and it 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 line with general rules, i.e. as a rule at the moment of payment/ compounding.

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

Expenditures for the services of the construction company shall be qualified as the cost of building and the construction of accompanying structures. Part of the expenditures shall also be allocated proportionally to the building and part to the structure (such as the car park). 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 that will be applicable at a later date.

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 own use buildings 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, the building or its parts has commenced before its final completion. In the view of the tax authorities and the courts, this moment should be determined as the day of completion of the construction (for example, based on details in the construction logbook) and not according to 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 construction. If this occurs at the beginning of the year, it allows the moment of tax obligation to be postponed until 1 January of the year following construction completion.

Example 8.8.

Scenario

The company completed the construction of an office property in mid-December 2021 and, in turn, the occupancy permit was issued on 10 January 2022.

Question: Will the property tax liability arise in 2021?

Answer: Although the company only received the occupancy permit in 2022, the completion of the construction took place in 2021. When the tax obligation is dependent on the existence of a building, the tax obligation arises on 1 January of the year following that in which the construction was completed or when 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 2023. For the emergence of the real-estate tax obligation, the relevant date is the moment when the earlier of the events occurs, i.e. completion of construction or commencement of use. This does not have to be the same as the date of obtaining the occupancy permit.

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

During this phase, real-estate companies earn their revenues primarily from the rental of property (or other contracts of a similar nature). They incur costs that related primarily to the real-estate property and its rental. These include 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. These changes are having an impact on both the operating activities of real-estate companies as well as the wider business environment. We list below the general tax rules that apply and the most important modifications affecting the real-estate business, taking into account the most recent tax amendments introduced by the so-called Polish Deal 3.0.

3.1.General taxation rules

3.1.1. Tenant acquisition costs

At the commercialisation stage of the real-estate investment, the costs of acquiring and attracting tenants are incurred in the form of remuneration for a real-estate broker and also 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 8.9.

Scenario
Company ALFA intends to acquire a major tenant (an anchor tenant) for the office building it constructed in January 2021. For this purpose, ALFA has secured an agreement with a real-estate broker to seek tenants. Thanks to the efforts of the broker, a lease agreement was signed with a tenant for a period of five years and the company paid a fee to the broker for 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 as this is an expense incurred to earn revenue from rent paid by the new tenant. The only doubt concerns the moment of recognising the cost for tax purposes. Here, the position of the tax authorities has changed over time. The prevailing approach currently is that this cost is not directly connected to revenue and may be recognised as a tax cost on a one-off basis on the date on which it is incurred. That said, the tax authorities' approach considers that 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 is because the definition of the day on which the cost was incurred is regarded as the day on which the expense was entered in the books (booked).

Example 8.10.

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 and, 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 an expense in the form of a bonus for a new tenant for concluding a long-term lease agreement as a tax cost. This is because it is a cost that has been incurred in order to earn revenue in the form of rent from the lease to be paid by the tenant. The only doubts concern the moment the cost is recognised for tax purposes. There is no uniform approach taken by tax authorities to confirm if 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. This is understood to be the day on which the cost is entered in the company's books. If the expense is recognised in the books as a one-off cost, then it should also be recognised in the full amount on a one-off basis for tax purposes. 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. In accordance 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 - in other words, on the date the invoice is entered in any account in the company's books. This is true even if, for accounting purposes, the company would settle it over time.

Example 8.11.

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

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

Answer: According to the approach of tax authorities, 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 to use free of charge. From the perspective of the entire term of the lease, the use is of a chargeable nature. 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 demonstrate that the total rent payable for the entire lease period does not differ from the market rent.

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 capitalised costs per annum. An annual rate of 4.5% applies to structures and higher rates may also apply to other specific categories of fixed assets. It may be possible to disaggregate other specific fixed assets (such as sprinklers, air-conditioning etc.) from the building which may be depreciated with higher depreciation rates (e.g. 10%).

In some cases, however, limitations concerning tax-deductibility of depreciation are applicable.

With effect from 1 January 2022, real-estate companies (as defined in point 3.2.1) have been entitled to include write-offs in their tax-deductible costs for the consumption of fixed assets (depreciation write-offs) to an amount that is no higher than the depreciation write-offs for the consumption of fixed assets in accordance with the accounting provisions.
In practice, this means that:

A. if a taxpayer recognises real-estate property as a fixed asset and depreciates it for accounting purposes, they are entitled to include depreciation write-offs as a tax-deductible cost although the fixed asset must be presented in a historical value. In practical terms, this means that the taxpayers' tax result will be decreased by the depreciation write-off cost, but the financial result and dividend capacity will also be decreased by depreciation write-offs.

B. if a taxpayer recognises real-estate property as an investment property for accounting purposes, they will not be entitled to make depreciation write-offs (neither for accounting nor for tax purposes). This means that the taxpayers' tax result will not be decreased by the cost of depreciation write-off. At the same time, however, this cost will not decrease the financial result and its dividend capacity will be higher than indicated in the previous case. Even so, the taxpayer will be able to recognise the undepreciated value of the property upon its disposal.

Since 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. Therefore, it has been vital to correctly recognise the character of the costs of the fit-outs for tenants. This is because the qualification of such costs (i.e. increasing the initial tax value of the building vs. being ongoing tax cost) may have a significant impact on the tax costs in companies that recognise real-estate property as an investment and on their RE CIT burden (details on RE CIT below in 3.1.3).

Example 8.12.

Scenario

In order to encourage potential tenants to conclude a lease agreement, the Company either completes adaptation/arrangement works for finishing/adapting the premises ("Fit-out") or participates in the costs of this type of work by granting, for example, a fit-out contribution to the tenant to cover the costs of the tenant's fit-outs. The scope of these works is primarily driven by the nature of the tenants' business, is specified in the lease agreement each time and relates to the work performed in order to meet the needs of the tenant. Fit-out works are carried out for the needs of a specific tenant, they are a sine qua non condition for the entry into force of the lease agreement and their results can only be used in principle by a specific tenant.
After the end of the lease agreement and in accordance with the prevailing business standard, each new tenant expects to adapt the rented premises to meet their own commercial needs. Due to the prevailing standards of a given tenant, these are in principle completely different from the existing tenant occupying a given space. The period of economic usefulness of Fit-outs is, therefore, defined by the Company as not having a lasting impact on the value of the building where the leased premises are located.

Question: Are the expenses for the Fit-out contribution paid to the tenant or the costs incurred on performing the Fit-outs, tax-deductible costs (other than directly related costs) and should they be recognised at the time they were incurred. In other words, are they ongoing tax costs or do they increase initial tax value of the building?

Answer: In recently issued tax rulings, Tax authorities have confirmed that, as a rule, the expenses for the Fit-out contribution paid to the tenant or the costs incurred on performing Fit-outs are tax-deductible costs recognised at the time they were incurred. This means they should be seen as ongoing tax costs instead of increasing initial tax value of the building. Usually, there are a number of conditions that need to be met in order to recognise the Fit-out cost as ongoing tax cost:

(i) Fit-out works are carried out to meet the needs of a specific tenant and their results can only be used in principle by that specific tenant.

(ii) the period of economic usefulness of Fit-outs does not have a lasting impact on the value of the building in which the leased premises are located. For example, they will be removed once the lease agreement is terminated and the tenant moves out from the building, as the Fit-out needs of the new tenant are different.

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 and dedicated tax regime.

Although there are some exceptions, taxation generally involves buildings that are the property or in the joint ownership of the taxpayer, are wholly or in part intended for use under a rental, lease or other similar agreement and are located in 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). This means the taxpayers are entitled to deduct the monthly RE CIT from monthly CIT advances. As part of the COVID measures, RE CIT was suspended from March 2020 to May 2022. 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. It is important to note, as of 2023, that the obligation to issue a tax refund decision whenever the amount of the refund of RE CIT is not in doubt has been abolished. It is expected that these amendments will allow for earlier refunds of RE CIT in standard cases.

3.1.4. Thin capitalisation (earning stripping rules)

During the operating phase of real-estate investment, financing costs (such as 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. Since January 2018, debt-financing costs affected by the earning 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 such as interest, commission fees, bonuses and the interest part of the lease instalment.

With effect from 1 January 2022, the limitation of tax-deductibility of the debt financing costs in the Polish CIT Act was amended to oblige the taxpayer to exclude from tax-deductible costs expenses where the amount of the surplus of the debt financing costs exceeds whichever is the higher of :

- PLN 3m or
- 30% of Tax EBITDA,

There will therefore be no basis for combining both limits and applying them simultaneously.
The amended provisions will apply to debt financing costs incurred from 1 January 2022 and, in the case of a taxpayer's tax year that does not match the calendar year, it will start from the tax year beginning after this date.
Debt-financing costs disallowed in a given tax year may be used within the following five years so long as they comply with the applicable tax-deductibility limit.

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

3.1.5.1. Dividends

Dividends paid by a Polish resident company to another resident company are not generally subject to witholding tax. Dividends paid to a resident individual are subject to witholding 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. This is dependent on the dividend not being related to a transaction (or a set of transactions) that has been undertaken to benefit from a tax exemption and that it does not reflect economic reality.

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. This is dependent on the interest not being related to a transaction (or a set of transactions) that have been undertaken to benefit from a tax exemption and that it does not reflect economic reality. An exemption based on the Directive may only be available if the recipient is the beneficial owner of the interest.

The amendments in the Polish CIT Act in force from January 2022 include the new definition for 'beneficial owner' that is now understood to be an entity that:

A. receives payments for its own benefit, decides on its own regarding its use and bears the economic risk of losing this payment (or part thereof);

B. is not an intermediary nor a representative, trustee or any other entity obliged to transfer the received payment (or part thereof) to another entity;

C. conducts genuine business activity in the country of its residence – in other words, 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

A due care requirement exists under the Polish CIT Act requiring a WHT remitter to execute due care when considering the nature and scale of business activity in the verification and documentation that determines if 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.

3.1.5.3. WHT collection rules

The collect and refund withholding tax regime in connection with payments exceeding PLN 2 million per annum (to an individual recipient of payments) came into effect on 1 January 2022. Any excess over this stated 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 (WH-OSC) that a withholding tax exemption or that reduced rate is applicable; or
- obtains advance tax opinion from the tax authorities that an exemption may be applied based on the EU directives or that exemption /reduced tax rate may be applied on the basis of double tax treaty provisions.

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).

3.2. Ongoing CIT taxation

3.2.1. Definition of the real-estate company

The definition of a real-estate company was introduced to Polish CIT Act with effect from 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 given 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 the rights to such properties;
- the balance sheet value of these properties exceeded PLN 10 million or the equivalent of this amount. This is determined in accordance with 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 given tax year;
- in the year preceding the given 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 obligations on this category of companies:

01. 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 advance payment of income tax on the realised income from the transaction on behalf of the seller;
02. 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);
03. appointing a tax representative if such real-estate companies have no seat or place of management in the EU or in an EEA Member State.

3.2.2. Shifted income

Under the regulation on shifted income that has been in force since 2022, the new separate source of income was introduced in the CIT Act.

The shifted income is taxed with a flat-rate income tax of19% of certain qualifying expenses. This includes 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:

A. 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). In this case, 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

B. 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 above taxation rules will not apply if the indicated costs are incurred for the benefit of a related entity that is 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 it is conducting significant actual business activity in that country.

Changes in the regulations in force from 2023, resulted in the legislator adding provisions to clarify the condition for applying the shifted income regulation to the preferential taxation of the shifted income. This condition will be satisfied, if under the tax laws of the related entity's country of residence, management, registration or location, its income (revenue) from sources explicitly mentioned in the provision (such as payment for intangible services and fees for the use of intangible assets) is subject to:

- income tax at a rate lower than 14.25 percent or
- tax exemption/exclusion.

The lower tax rate does not concern the tax actually paid as calculated from all the economic activities or the total income of the related entity, but refers to the related entity's revenue from one of the sources specified in Article 24aa.3 of the CIT Act. The main objective of changes in the tax on shifted income is to clarify the regulations in order to dispel doubts over the interpretation of the laws. The changes:

- provide that only tax-deductible expenses will be subject to tax;
- clarify that the related party for which the shifted income has been incurred is a non-resident entity;
- clarify the condition regarding the 50% of revenue generated by the related entity and the condition that income is shifted to another entity (at least 10%);
- impose the rule of application of the provisions governing the tax on shifted income to specific arrangements that involve tax transparent entities or foreign entities that shift income to other foreign entities set to benefit from low tax rates.

The conditions for considering costs as shifted income will automatically be considered fulfilled, if the costs have been incurred for the benefit of a related party having its seat, place of management or registration in the territory which use harmful tax competition or with which Poland or the EU has not ratified an agreement for the exchange of tax information. This applies so long as such an entity is not the taxpayer's controlled foreign company and its revenues have not been taxed in Poland.

3.2.3. Tax-deductibility of certain expenses on intangible services

Starting from 1 January 2022, the legislator decided to repeal the provision where 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 so-called minimum CIT.

For more details on minimum CIT taxation, please see below.

However, taxpayers who have already acquired the right to deduct their expenses and did not manage to deduct them within 5 consecutive years, as a result of this repeal, shall retain the right to make such a deduction "to the extent and under the rules set forth in that provision".

3.2.4. Minimum CIT taxation

From 1 January 2022, a new income tax (the so-called minimum CIT) was adopted as part of the Polish Deal. This has subsequently been amended with effect from 2023.

Minimum CIT is imposed on the entities:

A. which report a tax loss from the sources of income other than capital gains (i.e. operating income tax source); or

B. whose profitability in this income tax source does not exceed 2%.

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

The taxable base would be calculated as the sum of:

A. 1.5% of the value of revenues from sources other than capital gains;

B. costs of debt financing incurred on behalf of related entities, exceeding 30% of the so-called tax EBITDA;

C. the value of costs regarding purchasing of some services and intangible rights in the part exceeding 5% of tax EBITDA plus PLN 3 million.

As a result of the changes introduced from 2023, a taxpayer will be able to choose a simplified method for determining the tax base. This is an amount equivalent to 3% of the value of the income earned by the taxpayer in the tax year from a source of income other than capital gains.

The amount of the minimum income tax due will be deductible from CIT. This is calculated according to the 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,
- to those having the status of small taxpayers,
- taxpayers who have gone into bankruptcy or liquidation or who are undergoing restructuring proceedings,
- taxpayers being a party to a cooperation agreement,
- taxpayers whose profitability in 1 of the last 3 tax years was above a rate of 2%.

The legislator decided to introduce the exemption from minimum income tax for two years – the minimum CIT will not be payable for the period from 1 January 2022 to 31 December 2023.
In the case of taxpayers who have a tax year that is different from the calendar and started before 1 January 2024 and ends after 31 December 2023, this exemption will apply by the end of this fiscal year.

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:

A. Capital relations threshold at the level of 25%, personal connection (for example, the same individuals on management also trigger the TP relation);

B. The obligation to prepare TP documentation applies only to transactions exceeding PLN 10 million (for goods and financial transactions) or PLN 2 million (for other transactions, including inter alia services), depending on the type of transaction and irrespective of the level of revenues or costs incurred by a taxpayer;

C. The safe harbours for loans meeting specific criteria and low value-added services are introduced. This application exempts the taxpayer from the obligatory benchmarking requirements;

D. The materiality threshold for the Master File is PLN 200 million of the consolidated revenues;

E. The Master File is allowed to be prepared in English, also by another group entity (translation will only be required at the request of the tax authorities);

F. The deadlines for the preparation of the Local File and Master File is extended to the end of the tenth and twelfth month after the end of the given tax year, respectively;

G. The deadline for the submission of local file documentation by the taxpayer during a potential tax audit is extended to 14 days at the request of the tax authority;

H. The taxpayers are obliged to submit a new electronic TP-R form within eleven months after the end of the tax year;

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. With effect from 1 January 2023, some amendments have been implemented to the regulations that are applicable to TP documentation for transactions with the tax havens. In particular, they aim to:

A. modify the scope of the documentation obligation for indirect tax haven transactions;

B. eliminate the presumption that the beneficial owner has its place of residence in a tax haven;

C. increase materiality thresholds for direct and indirect tax haven transactions, which – if exceeded – give rise to the tax obligation. Tax thresholds for the above-mentioned transactions will rise to PLN 2.5 million for financial transactions and PLN 0.5 million for other transactions.

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

3.3.1. Notification on shareholders of the real-estate company

According to the CIT changes which came into effect from 1 January 2021, a real-estate company and the taxpayers holding directly or indirectly at least 5% of shares (or an interest of a similar nature) in the company are obliged to notify tax authorities about entities such an interest whether it is held directly or indirectly. The shareholders 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. This information should reflect the data as of the last day of the tax/financial year.

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

Under CIT provisions that have applied since 1 January 2021, taxpayers with revenues earned in the tax year that have exceeded the equivalent of EUR 50 million in a tax year and tax capital groups are obliged to prepare and publish information on the execution of their tax strategy. Here, the taxpayer revenues should be 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 that individual data of taxable persons are made public.

In this case, taxpayers should prepare and disclose information on such factors as:

i. their approach to processes and procedures for managing obligations arising from tax regulations and for ensuring their proper execution;

ii. the number of submitted reports on tax schemes (MDR) - separately for each tax;

iii. transactions with related entities, where the value exceeds 5% of the asset's balance-sheet total;

iv. restructuring activities that are planned or undertaken by the taxpayer;

v. submitted applications for a tax ruling.

The above listing is not exhaustive. The report itself should be prepared in a way that takes full account of the nature, type and size of the business.
Any information that is classified as trade, industrial, professional or production-process secrets is excluded from this obligation for disclosure.
The report covering the period of 2022 should be presented by the end of 2023. It should be noted that there is an administrative fine up to PLN 250,000 (approx. EUR 53,000) for failing to present the competent tax authority with the notice on the website where the information on the execution of the tax strategy has been published.

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

There is specific requirement for Tax capital groups, and CIT taxpayers who have exceeded the equivalent EUR 50 million in revenues in the previous tax year and who were included in the list published by the Minister of Finance (https://www.gov.pl/web/finanse/indywidualne-dane-podatnikow-cit). In such cases, the provisions on payment gridlocks impose 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 payment dates applied for commercial transaction). The reports shall be submitted by the above entities by 30 April of each following year. The report for 2022 should be submitted by 2 May 2023.

3.3.4. Corporate reorganisations

In general, the Polish regulations follow EU law. In some cases, restructuring projects may potentially be treated as tax neutral. This would be the case if certain conditions are met, particularly in terms of business justification of the transaction. However, the ultimate consequences of transactions aimed at reorganisation should be subject to case-by-case analysis as recent regulations in connection with taxation of restructurings have been tightened up. Such transactions are also currently receiving special attention from the Polish tax authorities.

CIT regulations in force since 2021 limit the taxpayer's right to deduct an incurred tax loss in the case of certain restructuring activities such as mergers, in-kind contribution of an enterprise or an organised part of an enterprise, the contribution of funds followed by purchase of an enterprise or an organised part of an enterprise. This applies if the result of such reorganisation 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 that did not have such shares on the last day of the tax year in which the taxable person incurred the loss.

Provisions in force since 2022 also mean that it is very challenging to maintain the tax neutrality of a reorganisation because only the 'first' in a chain share-for-share exchange, spin-off or merger can be tax neutral.

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.

The 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, generally, should 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. For CIT purposes, this is not decreased with its tax-depreciation.

RET compliance is an annual requirement, with the RET return filed annually upon acquisition or by 31 January each year.

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 for 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). Here, the main considerations for the vendor 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.

From a tax perspective, an individual examination of the possible tax consequences for each transaction is required 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.

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. This depends on the provisions of the relevant double-tax treaty and whether a real-estate clause is applicable.
- 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 this is agreed by the parties 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. This is because 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 this needs a prior joint tax ruling that secures the tax treatment of the transaction.
- Verification of the subject of the transaction. This relates to its proper qualification as a sale of real estate / enterprise or an organised part of the enterprise (OPE), as it changes the tax consequences of the transaction significantly.
- The need to take additional measures to distribute profits to the parent company – such as liquidation of the company, redemption of shares etc.
- The need to consider the tax consequences concerning repayment of a loan/bank facility that has been used to finance 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. This relates to the possible obligation to prepare a tax strategy as the sale of real estate property may result in the threshold of EUR 50 million in a tax year being exceeded.
- The need to analyse whether profit distribution by a seller to a non-resident entity may qualify as a tax-planning scheme. Such distribution, in addition to being subject to WHT, may trigger obligations under the MDR rules. This is particularly true if the income earned by the non-resident exceeds the PLN 25 million limit.

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. This entailed submission of an appropriate statement to the head of the tax office competent for the buyer before the real-estate delivery date. Under a recently introduced provision, however, transaction parties may also opt for VAT taxation of the delivery of buildings, structures or their parts in the form of a statement that is included directly in the sale agreement and has the form of notarial deed.

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

The parties to the transaction should also consider submitting a joint application in advance for a tax ruling in connection with the appropriate classification of the transaction for VAT purposes.

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 where 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 will be subject to taxation in Poland. This income is determined by the difference in price between the acquisition cost and the sale of shares and is qualified into the capital source of income.

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

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

  A. The real-estate company would be obliged to transfer an advance payment to the competent tax office for CIT equal to 19% of the taxable basis (the taxable revenue reduced by any tax-deductible expenses) by the 20th day of the month following the month when a taxable gain occurred;

  B. 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 shares of the sold company.

- **The seller's or sellers' obligation**

  A. Sellers are obliged to provide information regarding the sold company and the amount of the advance CIT payment related to 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:

  B. 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; and,

  C. the seller should file the CIT-8 return for the year in which the disposal took place.

Example 8.13. 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. It is the sole shareholder of the Polish company whose main asset is an office building that 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.

THE CZECH REPUBLIC

1.Development phase

1.1. Acquisition of the investment

In the case of an investment acquisition, the choice of the form of the acquisition is crucial for the investor. The transaction might be realised as an asset deal (a direct acquisition of property), 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. These include income taxation (Corporate Income Tax ('CIT')), indirect taxation (Value Added Tax ('VAT')), the scope of potential tax-base succession elements (tax losses, deferred tax, depreciation costs) and the consequences of financing. For the sake of completeness, real estate transfer tax was abolished.

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 therefore 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 the seller (income minus tax net value) might be transferred to the buyer in form of an increased purchase price.

From the VAT perspective, the asset can be sold by the seller as taxable (subject to VAT of 21% or 15% applicable for residential buildings or family buildings for social housing) 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 usually be 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. In other words, 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 as would be applicable for the residential buildings for rent, for example.

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 that looks at 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. This is the case if the Czech participation exemption is not applied or the relevant double tax treaty does not state otherwise. There is no stamp duty or transfer tax applicable on share deal transactions.

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 that both companies have proper legal forms and both companies are EU tax residents.

Share-deal transactions when the place of supply is in the Czech Republic are generally 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. In other words, 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. This 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).

1.2. Business deal

From the seller's perspective, the transfer of a business (so called a transfer of going concern or 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. Here, the business must 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.

1.2.1.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 when such buildings/land are sold.

The interest related to the acquisition of the building or to the financing of construction costs might also be 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 - under the arm`s-length principle, with documentation and the ability to prove the provision of services.

At the same time, 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, for example, sales administration, accounting and 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 expenses such as marketing or advertising 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 with VAT deduction calculated 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. A good example of this would be VAT exempt rent of the real estate on residential premises.

Development costs resulting in the creation of fixed assets are subject to VAT adjustment rules. This has to be monitored during the adjustment period (five or ten years-applicable for the immovable property or its technical improvement), 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. 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 those 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.

2.1. Real estate tax

Land and building owners are subject to an annual real estate tax. The rate depends mainly on the size of the land or building (including paved surfaces as a special type of land) and usage/classification of the real estate. Multiplying coefficients may apply to reflect location and size of building.

2.2. Real-estate tax depreciation

The building might be tax depreciated either for 30 years (buildings for living in, such as flats) or 50 years (hotels, shopping malls, administrative buildings etc.), 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 wise to consider the advantages and disadvantages of both methods before making a choice. The accounting depreciation of buildings should reflect the actual use of buildings. There are no other rules and 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.

2.3. 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. Interest from loans relating to the acquisition of shares or the interest derived entirely or mainly from the debtor´s profit are two cases in point.
If interest is paid abroad (within cross-border financing), withholding tax of 15 %/35 % applies unless a relevant double tax treaty states otherwise (beneficial ownership and tax residency are crucial).
The tax deductibility of other interest costs on the loans is further limited by 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 since 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 (the difference between financing expenses and financing revenues) provided by both the related and third parties such as 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 carried forward to future tax periods without limitation. No carry forward is allowed for legal successor companies.

2.4. 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. That said, it is always necessary to assess every contract individually as well as the actual substance of the remuneration provided. This 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 always be assessed individually. Based on the principle of purpose, the remuneration might be considered as a provision of the service, discount or not subject to VAT at all.

2.5. Rent-free periods

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

2.6. 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. Where settlement of the fit-outs is paid by the tenant to the building owner, it can be subject to VAT of 21% or as an adjustment of original deducted VAT.

2.7. VAT consequences of the lease of the real estate

The lease of the immovable property is generally VAT exempted without the right to VAT deduction (i.e. no VAT is applied). This means that the VAT payer is not entitled to claim the input VAT deduction that arise from the inputs relating to such building/units such as construction costs, repairs and so on.

However, the Czech VAT Act defines several exceptions, when the respective rent of the immovable property has to be subject to the VAT. Examples include a short-term rental of immovable property (within 48 hours), provision of accommodation services or a separate rental of parking spaces.

There is a possibility to opt for voluntary taxation of the rent of the immovable property where VAT is applied on the rent. This is possible only if the counterparty is a VAT payer who uses the respective property for the purposes of its economic activity. Since 1 January 2021 voluntary VAT taxation is not allowed in respect of the lease of the following:

- A family house according to the legal regulations of the land register;
- Residential premises/apartment;
- A building in which at least 60 % of the floor area (or part of that building if only a part is leased) are residential premises;
- Land that includes the above stated immovable properties;

For the VAT exempt lease of the real estate such as the lease of the residential building, no VAT deduction can be claimed from the costs that are directly related to the building, including construction costs and repairs.
In the case of the taxable lease such as the lease of the commercial premises, a full/partial VAT deduction can be claimed from the costs directly related to the building (like construction costs, and repairs etc.) under the conditions stipulated by the law.
2.8.VAT–partial and pro–rata ratio
Real-estate investors, owners or operators might be required to calculate a VAT co-efficient. This, in essence, determines their position regarding the recoverability of input VAT. The transactions that might result in an obligation to calculate VAT coefficients include VAT exempt rents, the provision of financing services or holding structures.

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

For costs linked to economic and non-economic activities alike, only a partial ratio can be applied, with the tax deduction calculated in proportion 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 such as management fees, legal and tax advisory or other overhead costs. Where incurred costs are related only to VAT exempt transactions (without an entitlement to deduct VAT), it is not possible to claim any VAT.

Provided that the incurred costs are fully re-invoiced to tenants, there is potential to consider the possibility to claim full VAT and not to apply the pro-rata coefficient on these costs.

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 primary factors to consider.

3.1. Profit distribution

Generally, the profit distribution is subject to withholding tax of 15 % / 35 % in the Czech Republic, unless relevant double tax treaty or Czech income taxes act states otherwise. 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, or if both companies have proper legal forms and or both companies are EU tax residents and not considered as income tax exempt. The exemption might also be 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%.

3.2. Exit taxation

Effective from the taxable period that began on 1 January 2020, an amendment to the CIT Act introduced a tax on the relocation of assets without a change of ownership - an 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 an exit tax might be deferred over five years based on the taxpayer's request although this may have very limited impact on real-estate companies.

3.3. Asset deal

Generally, a capital gain from the direct sale of the assets (the 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. This approach applies on the sale of both buildings and flats.

If the sale of assets such as 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, there is no obligation to return part of the previously claimed VAT in respect of non-current assets (or their technical improvement).

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).

Latent capital gain tax ('LCGT') negotiations within real estate business are relevant where the market value of the underlying asset(s) owned by an SPV (and therefore to be paid for shareholding in such an SPV) is above the remaining asset tax value. In the case of a share deal being realised, the buyer is not able to apply the value being paid as tax deductible costs, as is the case with an asset deal where tax residual value (if any) could be deducted. Put simply, the share deal can be tax exempt (if conditions are met) for the seller in contrast to an asset deal that is taxable. Overall LCGT is usually divided between seller and buyer (a 50:50 split applies).

No 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.

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 fulfilled fully. For example, 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. It is always necessary to precisely evaluate all aspects of the transaction.

Czech real estate: tax key points

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:

- Review the tax value of the property, especially if the proper documentation is available;
- Consider 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;
- Impact on the VAT coefficient due to related investment financing and the sale of shares; and
- Consider a possible VAT adjustment of the input VAT deductions claimed in the past from the long-term assets in case of the change in the use of such assets.

ROMANIA

Acquisition and development phase

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. This 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, the right of usage, or the right of usufruct.

In 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 who 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 these criteria, then the sale may be freely performed to any purchaser.

For 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, economic or military activities that may impact the quality of the soil, it is mandatory to obtain a soil-quality certificate prior to any sale. The sale of agricultural lands without observing the above-mentioned procedures may trigger the annulment of the sale agreement.

If agricultural lands are sold within a period of eight (8) years following their acquisition, the seller must pay a tax of 80% of the difference between the sale price (in the new transaction) and the purchase price (at its acquisition date by the seller). The tax in question applies for both the direct sale of the extra-muros lands (in the case of asset deals) as well as for the transfer of the control package over the target companies that own extra-muros agricultural lands (in the case of share deals).

The ownership title over a property listed as a historical monument may be transferred only with the observance of the Romanian State’s pre-emption right upon acquisition. Any sale agreement concluded that is in breach of the legal provisions shall be null and void.

1.1. Types of real estate rights

The superficies right is the most frequent right that developers resort to when an ownership transfer is not performed and 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 it being prolonged.

In accordance with Romanian law, usufruct rights may be established on a 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 so it may have a duration equal to the lifetime of the usufructuary if established in favour of an individual. If established in favour of a legal person it may have a duration up to a maximum of 30 years.

For the purpose of ensuring the connection of utilities to a property, easement rights may also be established. Such rights represent a limitation of the ownership right. The right of passage is the most common right of easement established by land owners. It represents the right of a land owner (or the owner of the construction erected on the land) who lacks access to a public road, to have access to a neighbouring property which does have access to a public road. Urbanism certificates should be obtained by the parties to the agreement so such rights can be constituted validly. Easement rights may also be established for the benefit of public-utility operators.

Agreements on the basis of which real-estate rights are established are required by law to be formalised in a notarised form. Furthermore, all such rights should be registered with the relevant land books in order to ensure their awareness by third parties.

1.2. 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 from the date when the cadastral works for each local municipality are completed. Consequently, 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) once the cadastral works are finalised.

The registration is also relevant for secured creditors (e.g., financing banks) as 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 in which the acquirer may prove its good faith).

1.3. 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:

A. 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 (with effect from 1 January 2012; and
   - agricultural land and forestry land under the same conditions provided by law for Romanian nationals (with effect from 1 January 2014).

B. 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.

1.4. 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 a plot 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.

Where archaeological works are required in a specific area, any other activities shall be suspended until the termination of archaeological investigation. This is evidenced by a certificate indicating archaeological completion.

1.5. Planning and developing real estate

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

- Government Decision no. 525/1996 that approves the general urbanism regulation;
- Law on territorial planning and urbanism no. 350/2001 and the related Implementation Norms (approved through Order no. 233/2016); and
- The Administrative Code of Romania, approved through Government Emergency 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, 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 the General Urbanism Plan, the Zoning Urbanism Plan and 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.

Specific legislative and governmental controls help to ensure the strategic planning and zoning of certain areas / objectives of public interest. These include highways, national roads, bridges, railways, environmental protected areas and historical monuments etc.

1.6. Construction permissions

The first step in the process to permit construction is the issue of the urbanism certificate. This presents the building parameters, restrictions, limitations and / or specific requirements to be observed in connection with 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:

- Location of the land within the city limits or outside the limits - a general interdiction to erect new constructions applies to land located outside the city limits (except for limited cases such as irrigation infrastructure and farm houses). In such a case, an urbanism documentation must be prepared and approved for the inclusion of lands within city limits. We note that new legislative changes provide the scope to build projects specifically designed to obtain/generate energy from renewable sources on plots of land located outside the city limits (if such are removed from the agricultural circuit). It is no longer necessary for the plots of land located outside city limits to be included within the city limits.
- Specific restrictions deriving from zoning regulations such as the permitted and prohibited use of the plot of land and building parameters;

- Restrictions deriving from the specific location of the plot. Examples include the vicinity of special types of facilities / infrastructure such as historic monuments, archaeological sites, special protection areas, industrial objectives generating a technological risk (i.e. SEVESO objectives), military units, airports, utilities networks and so on;
- General building restrictions / prohibitions on plots qualified as green areas, forests or arable lands.
- Specific height requirements and other demands deriving from the location of buildings near air traffic corridors;
- Specific requirements for the approval of neighbours 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 and for change of purpose in the existing buildings.

The construction permission procedure therefore entails the following main steps:

A. The issue of an urbanism certificate;
B. The preparation and approval of an urbanism documentation (either a zoning urbanism plan – PUZ, or a detailed urbanism plan - PUD), if required under the urbanism certificate;
C. The issuance of all prerequisite approvals requested under the urbanism certificate such as fire permit approval, approval issued in connection with environmental protection and approvals referring to the connection of various utilities;
D. The issuance of the building permit.
E. In addition to the above, a complex technical project endorsed by specialist verifiers provides the basis for the building permit.

Once the building permit has been obtained, the investor is requested to submit a written notice certifying the certain date when the execution works effectively start to the City Hall and the State Inspectorate in Constructions. Commencement of works must occur within the deadline specified in the building permit up to 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. This may be prolonged at a later date 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.

2. Acquisition of land – tax matters

Depending on the route chosen (asset deal or share deal), several implications should be considered under the acquisition phase when determining the most efficient solution for tax purposes. These include the possibility of taking over the tax losses carried forward, depreciation costs, the deductibility of borrowing costs with respect to financing the transaction and potential VAT liabilities and more.

2.1. Asset deal

Following the acquisition of a real-estate property, the acquisition cost will become the new tax value of the asset. This should provide the basis for the acquirer to start computing 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 year of handover on completion of construction. For new buildings and building land, the sale will be subject to VAT as follows:

- If the buyer is not VAT registered in Romania, VAT at the standard 19% rate will be charged by the seller directly on the invoice. 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.

- If the buyer is VAT registered in Romania, no VAT will be charged on the invoice. 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. That said, 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 is for 20 years for immovable property. There is an option to apply VAT to the sale of old buildings and non-building land as well. This is achieved by submitting a special notification to the tax authorities (formatted according to legal requirements). The notification can be submitted anytime within the five-years statute of limitations and can take effect from an earlier date.

The asset deal may qualify in some cases as a transfer of a business as a going concern ('TOGC') if the assets transferred constitute an independent economic activity after 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 and the reference date is when the seller acquired the assets and is not the date of transfer to the buyer.

2.2. Share deal

A detailed due-diligence exercise of the company's historical tax settlements is recommended prior to the purchase. 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) as such factors could 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 for the holding company acquiring the shares should also be analysed carefully. In this case, it is important to consider provisions from the current Anti-Tax Avoidance Directive and the proposed Shell 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 this is not the case for real-estate property. Here, a 20-year adjustment period should be observed in case activities that do not give rise to a VAT deduction right were performed or will be performed after acquisition.
For asset deals and share deals, transfer pricing rules should be observed if a transaction is carried out between related parties.

2.3. Property development by the investor

2.3.1. Tax implications triggered by the applicability of the microenterprise regime

With effect from 1 January 2023, the microenterprise tax regime becomes optional. A company may choose to apply this if the following conditions are cumulatively met:

A. it has revenues, other than those from consulting and/ or management, in a proportion that is over 80% of the total revenues;
B. has at least one employee;
C. has shareholders who hold over 25% of the value/ number of participation titles or voting rights to maximum three Romanian legal entities that fall under micro-enterprises tax system, including the person for whom the fulfilment of the conditions is verified;
D. it has revenues of EUR 500,000.

The tax is computed by applying 1% to the revenues obtained (except for certain types of income specifically excluded by the law from the taxable base).

Applying the microenterprise regime may raise the following tax implications:

- Financing costs are not allowed for deduction – under the microenterprise regime and in accordance with the applicable legislative provisions, the developer will not be able to deduct the borrowing costs booked.

- 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. This starts from the moment when it reverts to the CIT system, and these tax losses will be allowed for deduction within a seven year timeframe (including the period during which the company was a microenterprise).

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 at a later date 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 provided 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 VAT 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.

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 for monitoring them during the implementation process.

Operating and commercialisation phase

1. Legal matters related to the operational stage

1.1. Eases of business premises:

Applicable laws

The general framework that applies 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 Government Emergency Ordinance no. 40/1999 on residential tenant protection. Specific provisions may apply in a case where the premises are located within an industrial park (as qualified according to the law).

Apart from the mandatory legal requirements, other exceptions to the parties' entitlement to freely negotiate lease agreements may apply. This would be the case 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 last example, lease agreements must take into account that the project has to fulfil certain parameters undertaken upon the granting of the EU financing (such as granting microenterprises several facilities in terms of lower rents) for a certain period of time.

Types

Although not expressly regulated by law, the market standard includes two main types of leases, namely - Triple Net Leases (although, in Romania, capital repairs are born by the landlord) and Non-Triple Net Leases.

Typical provisions

Typical provisions should refer to:

A. The 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.

B. Frequency of rent payments
Rent is typically paid in advance. Rent payments are made either monthly or, as in the case of anchor/large scale leases, quarterly.

C. 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.

D. 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 that are 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 which is calculated by reference to an agreed percentage of the tenant's annual turnover.

E. 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 (in any case under the reserve of excluding 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 assets located within the premises that are not under the landlord's ownership.

F. Execution of fit-out works within the premises

As a general rule and for any works where it is a requirement, a 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. Examples of such works are those that:

- 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.

G. Service charge

Paid in advance on a monthly basis, the service charge is an estimated amount multiplied by the gross leased area. This is 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:

- the repair, renewal, decoration, cleaning, maintenance and lighting of the common areas of the building,
- the cleaning of the outside external glass façade,
- the clearance of snow and ice,
- 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.).

H. Termination of the lease

A lease agreement can be terminated unilaterally (break options) as per the contractual provisions or for default or 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. This is subject to serving a prior written notice a reasonable time in advance.

2. 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;
- potential VAT implications on early termination fees.

2.1. Lease incentives granted to tenants

Romanian law provides the real-estate owner with 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 such as a contribution to the fit-out works undertaken by the tenant. Accounting-wise, the aggregate cost for lease incentives granted to tenants should be deferred over the leasing period and recognised as a reduction of the lease income. This is usually undertaken 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 may be out of the scope of VAT.

Aspects such as when incentives were granted, contractual terms and the status of the tenants will determine the treatment of the incentives. These should be analysed case-by-case. During VAT audits, the subject of lease incentives is highly scrutinised by tax inspectors. This often results in additional VAT liabilities.

Key aspects during the disposal stage

1. Legal matters related to the structuring / stages of a transaction

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 common market practice within the early stages of a transaction for a preliminary agreement to be concluded. Examples include a letter of intent, a memorandum of understanding, a term sheet to help secure 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. Certain conditions apply to this entitlement. The relevant claim must be filed with the court no later than six months after the date the final agreement should have been concluded. 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 depends on the intended structure and ranges from a couple of weeks to a much longer period. The asset-based operations are the elements likely to be concluded in a shorter period, as a one-time operation. On the other hand, share deals require at least two stages in principle - namely signing and closing, once the precedent conditions have been fulfilled.

Cases where 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 that may need to provide consultation or approval to finalise a real-estate transaction. The impact on timing may vary depending on which authorities need to be involved in the approval of the transaction. When structuring a share deal that involves change of control, the Competition Council's clearance is required if certain parameters are exceeded.

Particular attention should also be paid to foreign direct investment regulations. These may become applicable in both share deal and asset deal scenarios, if certain conditions specified by the Government Emergency Ordinance no. 46/2022 are met. It may be the case, therefore, that the transaction should also be authorised from this perspective.

Share deals will require registration of the transfer with the Trade Register. On the other hand, 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 has been issued, the new owner of the real estate undertakes to register its ownership title with the local fiscal authorities.

1.2. Applicable costs in the 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. In other cases, the calculation is based on the official values. The notary fee shall be calculated as a fixed fee for each bracket where the transaction value is included and an additional percentage is applied to the value of the transaction that exceeds that threshold. For example, a fixed fee of RON 5,080 [approx. EUR 1,130] applies for a transaction value exceeding RON 600,001 [approx. EUR 122,500] plus an additional percentage of 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 but the parties may agree to share these costs.

1.3. Representations and warranties in real-estate transactions

The Civil Code regulates only two types of warranties (that are applicable for an asset deal) - the warranty against eviction (i.e., total or partial loss of title), and hidden defects in the real estate. The seller's liability against eviction and defects 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. These can be further settled in court or in arbitration. Generally, the seller gives representations including:

- 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.

1.4. Limitation of liability

The representations and guarantees granted by the seller may be subject to disclosure of information to the purchaser.
The Civil Code also allows the parties to negotiate and establish limitations of the seller's liability for eviction and / or the hidden defects. This may affect the realestate asset that is subject to the transaction.

According to Romanian law, however, there are certain limits on the way parties may regulate the liability of the seller. For example, the liability of the seller may not be limited for matters that were known by the seller or which the seller should have known when performing the sale of the asset, but were not disclosed to the purchaser.

2. Tax matters related to the structuring / stages of a transaction

2.1. 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 and local simplification measures apply 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 the standard 19% VAT rate. In addition, old buildings and non-building land where an option to tax is exercised are subject to the standard 19% VAT rate.

Under certain conditions (depending on the price and surface area), the reduced 5% VAT rate is applicable in the specific case of supplying houses to natural persons,

2.2. 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 that is received free of charge or contributed. The tax value also includes any accounting revaluations required by law.

Where revaluations result in a decrease of value below the acquisition cost/ production cost/market value, tax depreciation should be computed taking into account 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 the provisions in Romanian tax law, accounting depreciation expenses are non-deductible but are an allowed for tax deduction and land is a non-depreciable asset from a tax perspective.

2.3. Debt financing investments costs

New rules on the limitation of deductibility of interest and other costs that are economically equivalent to interest were introduced in FY 2018. This resulted from the implementation of the EU Directive 1164/2016 – Anti-Tax Avoidance Directive (ATAD).

Such costs are, in short, deductible within the limit of EUR 1 million + 30% of the base computation (EBITDA). This represents the difference between income and the expenses that have been booked in accordance with accounting rules, minus the non-taxable income and plus the corporate income tax expenses, any exceeding borrowing costs and tax depreciation amounts. 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. There is also the possibility of reporting such costs without any 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.

In addition, close attention should be paid to the purpose of the financing agreement. The general deductibility rule where expenses are deductible if incurred for business purpose should also be met in order to benefit from interest deduction.

2.4. 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 so long as 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 if the transactions in question have no purpose and are considered artificial.

The Tax Code contains specific provisions regarding the tax treatment of certain expenses incurred by companies that are part of a group. Here, the costs incurred from services provided by affiliated entities - such as administration, consultancy, management, control or similar functions - can only be deducted by the parent company if their legal base is the only legal connection between the affiliated entities. All 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 those documents that prove that such services have been rendered as well as their economic benefit.

2.5. 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. Local tax authorities may establish higher rates by applying a maximum 50% increase. Legal entities should evaluate buildings for local tax purposes every five years. If this is not the case, the tax authorities are entitled to increase the tax rate to 5%.
It is envisaged that this tax regime is likely to change, so it is advisable to remain fully updated on such developments.
Land tax – this is calculated by taking account of 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 and so on.

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.

2.6. Fiscal consolidation for the companies within a group

Since 2021, companies have been able to opt to apply the consolidation of the CIT results when certain conditions are met (for example, when members are related parties and are subject to the CIT regime, when members have the same fiscal year etc.). In this respect, companies from the same group are allowed to aggregate their tax results. This lightens the tax-reporting burden at the group level. It also allows the group to reduce its total cost with the taxes paid, as the current tax losses of some of member companies can be offset by the profits of others.

Each member of the fiscal group should individually compute its tax on the profit due. The results should then be consolidated and a single tax return should be completed and submitted to the tax authorities.

It should be noted that any tax losses registered by a company before it joined the group cannot be used at a consolidated level. When it comes to the transfer-pricing file, the transactions between the group members will still have to be analysed and included in the file.

3. Exit from the investment

A. 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 that are 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% tax.

According to the Tax Procedure Code, the owners of the assets can transfer the ownership for buildings by presenting tax certificates attesting the settlement of all tax liabilities that are owed to the local budget. Where such certifying documentation doesn't exist, 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 case the supply is exempt.

Depending on the assets transferred and the conditions of the transfer, the sale may benefit from the 'no supply rule' for TOGC.

B. 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 when there is no tax due in Romania there is still 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. In accordance with the arm's length principle, the price should be set at market value,.

Romanian real estate: key points

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. According to this legislation, it is prohibited to transfer the immovable assets (land or buildings) for which restitution proceedings (administrative or judicial) were initiated at the request of the expropriated persons. The prohibition shall be applicable until completion of the restitution proceedings (administrative or judicial). The transfer deeds concluded with the inobservance of such prohibition to transfer shall be subject to absolute nullity of the transfer deeds.

It is wise, therefore, for purchasers of real-estate assets in Romania to carry out certain verifications with the public authorities to confirm whether the asset of the envisaged transaction is affected by such special restitution claims. Such checks should be completed prior to concluding the transaction documents.

2. Debt financing investments costs

New rules on the limitation of deductibility of interest and other costs considered to be economically equivalent to interest were introduced in 2018 as a result of the implementation of the EU Directive 1164/2016: the Anti-Tax Avoidance Directive (ATAD).

In short, such costs are deductible for corporate income taxpayers within the limit of EUR 1 million + 30% of the base computation.

The base computation (EBITDA) represents the difference between income and expenses booked in accordance with accounting rules, minus non-taxable income and plus the corporate income tax expenses, exceeding borrowing costs and tax-depreciation amounts. 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 in excess of the EUR 1 million threshold are non-deductible in the respective tax period, and there is the scope to report 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. 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 such as a contribution to fit-out works undertaken by the tenant. Accounting wise, the aggregate cost connected to lease incentives granted to tenants should be deferred over the leasing period and recognised as a reduction of the lease income. Unless another systematic approach is more representative of the timing of the asset's lease benefit, this should be undertaken 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 VAT scope depending on several aspects such as status of the tenant or contractual arrangements.

4. Tax implications triggered by the applicability of the microenterprise regime

Tax is computed by applying 1% to the revenues received except for certain types of income that are specifically excluded by the law from the taxable base.
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 applicable legislative provisions.

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 from 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).

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. The following pages summarise the key points to consider regarding tax liabilities arising in connection with a real-estate investment.

Development phase

1. Acquisition of the investment

In 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). To achieve an efficient solution, the investor in Hungary must take into account a wide range of tax implications:

- 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 way that has been selected to finance the real-estate investment.

1.1. 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 to reflect the value of the property at the time of the transaction. Here, the potential tax losses relating to the real-estate 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 where the tax losses attributable to the property would be transferred to the acquirer.

One of the main tax considerations at the time of a real-estate 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-estate 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-estate property i.e. land registry plot). However, preferential tax rates and tax-exemption titles are available in some instances such as 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). It is important to note that from January 2023, the conditions set-out for related party RETT exemption has changed for the direct acquisition of real-estate properties (i.e. the assets). Previously, this exemption has been dependent on the main business activity of the acquiring entity. Now, however, certain revenue-based criteria must be fulfilled to apply the RETT exemption.

The VAT implications from the acquisition of a real-estate property should also be carefully analysed. As a general rule, the sale of certain categories of real-estate properties and the leasing out of real-estate properties are to be considered as VAT-exempt transactions. However, taxpayers are entitled to opt for the taxable treatment of such activities. When the seller opts for this approach, the acquisition of the real-estate property will be subject to VAT according to the reverse charge mechanism. In the sale of undeveloped land (which does not qualify as a building plot) and in case of the sale of a built-in real estate that does not qualify as "new" from a VAT perspective, the reverse charge mechanism should apply.

A built-in real estate should qualify as new from a VAT perspective, if:

- the related authority license is not yet issued,
- less than two years have elapsed from the issuance of the related license and the sale, or
- as of 1 January 2023, where a change of function took place, but less than two years have elapsed from the issuance of the related license and the sale.

In the case of the reverse charge mechanism, the VAT does not need to be financed. This is because the same entity (i.e. the acquirer) 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-estate property. Input VAT can only be deducted for those acquisitions (goods and services) that serve the taxable activities of the acquirer. In many cases, therefore, it is recommended to opt for the taxable treatment of business activities relating to real estate.
The supply of building plots and new built-in real estates are always taxable and subject to VAT according to the general direct taxation rules.

1.1. Share deal transaction

Real-estate 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. Although the utilisation of the available tax losses may also be restricted, in most cases they can be utilised subsequent to the acquisition if the company's activity remains unaltered. It may be recommended a proper due diligence process is performed prior to the acquisition of a real-estate holding company. This will help to identify historical tax elements such as potential tax risks from previous tax years and deferred tax assets such as tax losses, FX-related tax deferrals, depreciation, development reserves etc.

In accordance with general rules, the acquisition of the shares of a real-estate holding company should be subject to RETT. 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-estate properties located in Hungary or if it holds at least 75% of the shares of a real-estate holding company.

As far as VAT is concerned, the share deals should generally be VAT exempt or fall outside the scope of the VAT legislation (i.e. no VAT consequences are triggered), provided that certain conditions are met. Acquisitions are often financed from intra-group loans that 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. This has, in essence, 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-estate property through an asset deal or a share deal, an investor should carefully analyse all financial and tax aspects of the property and its owner company.

2. Development

At the development stage, the main tax implication considerations 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 developed real-estate property. In the case of fixed assets, such costs and expenses may therefore 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 of the real-estate property development. Costs and expenses that 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 therefore the CIT base of the investor. Without any potential revenue in the real-estate property development phase, this should generally result in the generation of tax losses. These 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-estate properties they use but do not own). Furthermore, the related VAT consequences (like when the fit-outs are left in the real-estate property by the tenant at the end of the leasing period) should also be assessed properly.
Construction and installation works should generally be subject to the reverse-charge mechanism. This means 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.
Free of charge handover of public utilities (such as road, roundabout, water utility etc.) to the state or municipalities should generally be subject to VAT. Following a recent court case, however,new aspects are now of relevance and, in certain cases, the developer may be relieved of a VAT payment obligation.

The operating and commercialisation phase, leasing of the real-estate property

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. This 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) and real-estate properties that are 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-estate 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-estate 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-estate properties under IFRS rules (for CIT purposes), depreciation can be taken into account in respect of those components as well. Tax depreciation may also be recognised for investment properties which are measured in the fair value model under IFRS rules, under certain conditions, even though they cannot be depreciated for accounting purposes under IFRS.

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, the cost of goods sold (COGS), the cost of raw materials, the 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, such as utility and other services purchased and re-charged to tenants, is defined more strictly in the LBT legislation than in the accounting rules. This is because the costs of mediated services accounted in the books of a taxpayer should meet several formal and substantial criteria in order to also qualify as the cost of mediated services for LBT purposes.

With the exception of micro- and small enterprises, companies should also be subject to an innovation contribution (0.3 %) assessed on the same base as the LBT. Hungarian branches (and permanent establishments) of foreign enterprises have also become subject to the innovation contribution in Hungary since the summer of 2022.

As a general rule, the leasing of real-estate 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, it is generally true to say that the input VAT can only be deductible if it relates to an acquisition (goods or services) serving the taxable business activities of the taxpayer.

2. Discounts

Landlords often provide discounts to their tenants in respect of factors such as the first months of the leasing period. The VAT base of the leasing fee may be decreased by the amount of the discount if this is provided for promotional purposes and is included in the invoice or if the original invoice is corrected in the event of a subsequent discount. 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.

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 according to the VAT legislation may vary depending on the payment due date and the date of the invoice (as opposed to the settlement period). Therefore, the tax point date depends on various factors and should be determined with care to ensure that the invoice indicates the tax point date properly. This also safeguards the VAT deduction right of the tenants.

4. Real-time invoice reporting

In principle, taxpayers are required to provide information to the Hungarian tax authority on all invoices issued in real time, without any human intervention. The data should be submitted to the tax authority in a predefined format. This will generate a unique identification code. Taxpayers must comply with the real-time invoice reporting obligation in order to avoid potential default penalties.

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.

6. Financing aspects

With effect from 1 January 2019, new interest limitation rules have been implemented in Hungarian tax legislation in accordance with the provisions of the ATAD. Previous thin capitalisation rules have been abolished. 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). That said, 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 investors who intend to fund their project with a large amount of loan financing. Such a scenario is particularly true in the real-estate development phase as this is a time when investors do not generally derive significant revenues.

7. Tax incentives

Hungarian companies may be entitled to apply several tax incentives set out in the CIT legislation, such as the tax incentive related to the support of popular team sports, development tax allowance for certain investments.

Hungarian tax legislation 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 that aim 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.

Municipalities are also entitled to provide tax allowances for certain investments carried out in their territory. This may vary from one municipality to another and the local decree should be consulted for the details.

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 exit from the investment. Here, the seller may either sell the property itself (in an asset deal transaction) or sell the company owning the property (a share deal transaction).

1. Asset deal

Asset deals are generally preferred by buyers on the Hungarian market, due to full cost bases being recognised for tax purposes and the time and cost savings arising from the fact that 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. This is because restrictions can make asset deals less favourable for sellers in certain legal situations.

In the case of an asset deal, the alienation of the asset may have different accounting and tax treatment depending on whether the real-estate 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. 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 such as the residency of the buyer, whether the seller opted for taxable treatment or whether the deal should be subject to the reverse-charge mechanism. Nevertheless, as the place of supply is generally the country where the real-estate 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. This is particularly true when they do not wish to reinvest the cash or just want to close the given entity. The payment of dividends or interim dividends is the most common form of the repatriation of cash from a subsidiary (which does not require the official procedure of the Court of Registration). 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 as well as the more time-consuming options of capital reduction in the subsidiary or liquidation of the subsidiary.

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.

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 derived 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, depending 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 and 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 assuming the statutory conditions are met. This is because the transaction may be out of scope of VAT or VAT exempt. Likewise, the share deal exit scenarios should not trigger

3. LBT consequences.

In related-party transactions, the arm's length principle should be followed or transfer-pricing adjustments will 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.

Real Estate Hungarian tax – key points
The following topics cover the most important factors to be considered in potential investment projects as far as Hungarian taxation matters are concerned,.

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 in connection with 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 that is a separate company holding special licences. REIFs are subject to very favourable tax rules. This is because they are not subject to CIT in Hungary (i.e. revenues derived from renting out or selling their properties should be exempt from CIT) and, according to the current interpretation of the authorities, they should not 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, although no cap should be applied. Participation exemption rules should not be applicable to the Hungarian investors in a REIF. It should also be noted that REIFs are subject to certain special tax liabilities assessed on the basis of their net asset value.

REIFs requires a significant amount of capital injection so, generally speaking, their establishment should only be recommended for larger investment portfolios.

REIT status is available to public limited companies that are listed on the stock exchange with at least 25% free float, for those companies 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. In general their CIT base should be exempt from CIT payment liability, and they should also be exempt from LBT payment liability. The general rules should apply for VAT. REITs have recently started to spread across the Hungarian market following an amendment made to the relevant legislation and their status is a relatively new opportunity for investors.

2. VAT consideration

Generally speaking, the sale of certain types of real-estate properties, as well as the renting out of real-estate properties should 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 the acquisitions they carry out as part of their real-estate activities. This is because 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 although this option should be carefully analysed prior to the decision being made as, once it is taken, it binds the taxpayer for 5 years. The general VAT rate is 27% in Hungary. However, certain transactions are subject to preferential tax rate of 5%. This is the case when accommodation is provided for commercial purposes and in sale of certain new residential properties.

The preferential 5% VAT rate may be applicable for the sale of certain new residential properties if the sale takes place before 31 December 2024. Based on a transitional provision it may also be applicable if the sale takes place between 1 January 2025 and 31 December 2028 and:

- if the construction is subject to building permitting, the building permit for the construction work will be finalised and issued by 31 December 2024, or
- if the construction work is subject to a simple notification procedure, it will be announced to the relevant authorities by 31 December 2024.

Sale of certain new apartments constructed on brownfield areas are also subject to 5% VAT.

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 such as the cost of mediated services, COGS, the cost of raw materials, the 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. Strict, formal and substantial criteria must be met to qualify as cost of mediated services for LBT purposes and therefore 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. This should, therefore, 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.

The tax authority is currently scrutinising the deduction of the cost of mediated services from the LBT and its interpretation on the formal and substantial conditions of the deductibility should be closely monitored. 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.
As far as real-estate development activities are concerned, 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-estate property on completion of the development. 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. It is recommended by real-estate developers that proper business planning is undertaken to determine the timing and allocation of their costs.

Part 4

ESG

1. Integrated reporting — an urgent need and an opportunity for transformation[1]

The evolving expectations and opportunities in today's business ecosystem

Integrated reporting is a broad approach to corporate reporting that not only addresses stakeholders demands today, but also creates a foundation for future standards in a constantly evolving landscape. In today's business ecosystem, there is a disconnect between what is being disclosed by companies, what investors need to make informed decisions and what is expected by broader stakeholder groups.

There is now a heightened sense of urgency to implement holistic reporting solutions as a result of the changing landscape and the new global reporting standards that are on the horizon. Consequently, there is an ongoing shift to integrate and embed Environmental, Social, and Governance (ESG) goals and performance into mainstream reporting across different industries and sectors.

The many mandatory and voluntary disclosures that organisations are providing today have evolved into piecemeal reports that focus on individual corporate issues in relation to climate change, diversity and other ESG-related matters. Such an approach fails to provide a broad and holistic understanding of an organisation's strategy, business model, risks and opportunities and its performance against stated strategic objectives and governance practices. This form of disconnect in performance and disclosures can leave investors and broader stakeholder groups with more questions than answers.

A path forward: embrace integrated thinking

The paradigm shift in corporate reporting expectations has put unprecedented pressure on companies to think more about the resilience of their business models and the need to integrate non-financial and financial considerations into their core strategies. By taking this approach, organisations are adopting the concept of integrated thinking. This approach refers to the connectivity and interdependencies between a range of factors (such as corporate purpose, the business model, strategies, risks and market

1 Based on a Deloitte article by Mark Hoffmann (Partner Audit & Assurance Services Deloitte South Africa): "Integrated reporting: an urgent need and opportunity for transformation — meeting stakeholder demands today, while driving financial and non-financial information connectivity to unlock future value" opportunities) that can impact the ability of an organisation to create long-term value for its stakeholders.

As a result, many organisations are exploring the potential for introducing greater agility in their reporting practices and, in turn, are adopting integrated reporting — based on the principles of the Integrated Reporting Framework. This "Framework" is jointly supported by the IFRS Foundation's International Accounting Standards Board (IASB) and the International Sustainability Standards Board (ISSB) through the consolidation process of the Value Reporting Foundation, with both Boards taking responsibility for the Integrated Reporting Framework in August 2022. The inherent adaptability of integrated reporting is particularly significant as global reporting standards and regulations continue to evolve.

Although Integrated reporting is supported by various principles and concepts, the goal is always the same - to accurately and concisely communicate the essence of why an organisation exists (its purpose) and how it creates, preserves or erodes sustainable value for itself and for its stakeholders.

There is no specific formula or template for measuring and interpreting value. Every organisation will have its own unique approach for delivering long-term value. Once established, the approach and value creation model will serve as a blueprint for way the organisation communicates its strategy, purpose, business model and its risks and opportunities as well as its performance against the strategic objectives and way it creates value for its investors and broader stakeholder groups.

Developing an integrated report in this way is not only more effective – especially for delivering greater impact and quality - but can also improve internal and external reporting efficiencies significantly.

Integrated reporting as a solution to corporate reporting needs

- Integrated reporting offers principles-based guidance for the structure and content of internal and external reporting and includes both financial and non-financial value-drivers.
- It is a process founded on integrated thinking that demonstrates how the combination of integrated decision making and actions impact the value creation of an organisation.
- An integrated report explains to providers of financial capital how an organisation creates, preserves, or erodes value over time - enabling investors and broader stakeholder groups to make informed decisions on capital allocation.
- It offers a powerful tool that can help an organisation move away from a siloed way of working towards more integrated thinking, planning, performance and value management.

The benefits and outcomes of an integrated report as part of a corporate reporting system:

- It provides a universal and enduring foundation for corporate reporting
- It helps to ensure coherent and cohesive messaging across all aspects of an organisation's narrative.
- It provides management with a much deeper insight into the impact of decisions and business activities e.g. those activities that drive value creation and those that do not.
- It provides stakeholders with a broader and deeper understanding about how the management team of an organisation makes decisions, invests capital and measures performance.

A convergence of events is driving urgent action

In recent months, there has been a significant trend to coalesce around a set of global ESG reporting standards that will not only serve the future requirements of organisations but are also closely aligned with integrated reporting expectations. Previously, many organisations would apply the Value Reporting Foundation's (VRF) "Integrated Reporting Framework" (the Framework) and "Integrated Thinking Principles" (the "Principles") when preparing an integrated report. Progress made on the consolidation of the Value Reporting Foundation (VRF) into the IFRS Foundation culminated with an announcement in May 2022 regarding the future role and governance for the Framework and Principle's (while acknowledging that ISSB standards are still in development). Most notably, the IASB, and the ISSB will work together to use principles and concepts from the Framework in their standard-setting work and corporate reporting framework. The announcement marks a long-term and shared commitment for incorporating the principles and concepts from the current Integrated Reporting Framework into standard-setting projects and requirements.

Other initiatives include the recent formation of the ISSB, regional policy initiatives (such as the EU Corporate Sustainability Reporting Directive - EU CSRD) and the Securities Exchange Commission's (SEC) Proposed Rule on Climate Disclosures. And, in the UK it became mandatory for Britain's listed companies to disclose their climate-related risks and opportunities in line with the Task Force on Climate-Related Financial Disclosures (TCFD).

The adoption of standards based on specific subject matters may meet direct requirements, but it can lead to siloed and disparate reporting on different subject matters. The adoption of integrated reporting is universal. It creates a foundation for multi-dimensional corporate reporting standards to be integrated around a single strategy for value creation strategy. It also provides a framework for more coherent adoption of multiple specific standards, including mandated disclosures, to meet the legal and regulatory requirements for disclosing on a range of ESG themes.

The integrated reporting maturity assessment

As organisations can start from different points, the first requirement is to determine their maturity in corporate reporting.

01. First time adoption: An organisation looking to adopt ESG and integrated reporting to help ensure that a holistic and integrated approach to reporting is implemented both internally and externally.

02. Enhanced reporting: An organisation has adopted and implemented some level of integrated thinking and reporting, but is now looking to capitalise on the value creation model to enhance strategic, operational and financial considerations. This will support an integrated strategy and help to focus the organisation on what really matters.

03. Optimising current state: Integrated thinking and reporting are underway in the organisation, but it is now looking to optimise processes, systems, and assurance around reporting and improve the alignment and streamlining of internal and external reporting.

2. Annual reporting

ESG introduces new requirements for companies to measure the impact of the environment on the business as well as the impact of the business on the environment. But that's not all.

There are non-financial disclosure obligations with which a business must comply and also financial measures to consider. Such additional information reflects the rising expectations of investors and the growing public interest in the impact businesses have on the climate.

Annual reporting must include an analysis of ESG's impact on the entity's operations as well as on accounting and reporting matters. Potential business and accounting risks that may arise from ESG requirements, include:

- asset impairment — a risk that assets may be impaired because they will not be able to bring sufficient economic benefits, e.g. coal-fired power plants, gas infrastructure.
- useful life of the assets — a risk that the useful life of assets may change as a result of strategies or other operating decisions being modified as a result of climate-related requirements or legal constraints.
- financial ratios in loan agreements / terms of bonds issues — a risk that an entity will not be able to comply with the financial ratios set out in loan agreements or to meet the bond terms.
- financing costs — a risk that the interest rate on bonds/loans will be higher due to a low ESG score.
- compliance — a risk that an entity will not provide the required EU Taxonomy/ CSRD disclosures and will be fined by the regulator.

3. What is ESG — introduction

It is not just the price of energy, supply chains and inflation where businesses have been impacted by the climate crisis, Covid-19 pandemic and the war in Ukraine.

Such significant issues have also had an impact on constantly evolving consumer expectations, laws and the requirements of financial institutions. In order to meet such challenges, organisations are embracing ESG. But, what does it mean?
There are many definitions of ESG (short for Environmental, Social and Governance) and many other acronyms. But, in essence, they all refer to the same principle – acting in the spirit of sustainable development, where it is not just the profit a business makes that is important but also how it impacts the environment and the society (the positive impact as well as minimising the negative one). The European Union has adopted directives and regulations that impose specific ESG requirements on financial institutions and businesses. These include:

- The EU Taxonomy — its goal is to enhance environmental protection by redirecting capital flows towards more environmentally friendly investment.

- SFDR (Sustainable Finance Disclosure Regulation) — requires financial market participants to publish information about sustainability risks.

- CSRD (Corporate Sustainability Reporting Directive) — more businesses to disclose sustainability information and more detailed reporting.

ESG is a response to the requirements of financial institutions, legislative changes and the expectations of counterparties and clients. What ESG measures do businesses take? First of all, they prepare annual sustainability or integrated reports to provide clients and investors with a reliable source of information about the organisation. A good practice is to prepare the report in line with the international GRI standards (once the CSRD Directive takes effect, EU businesses will apply the European sustainability reporting standards (ESRS). This helps to ensure the report discusses all critical issues and can be compared with the reports of other organisations. Typical areas covered in such reports include: the organisation's approach to management, business ethics, employee matters (such as types of contracts, development training, diversity, Workplace Health and Safety), supply chain considerations, greenhouse gas emissions, the volume of raw materials and the amount of waste.

Some businesses develop and pursue an ESG strategy that comprises specific goals around all three themes (E, S and G). A good practice is to align the ESG strategy with the business strategy or to make it a single strategy, taking full account of the organisation's material obligations.

Another step is an ESG maturity assessment performed by an independent rating agency. Annual ratings help track the progress of a business and are useful indicators for investors. They also serve to highlight any areas where the organisation needs to improve its ESG performance. The requirements set out for suppliers is often the catalyst for many businesses to put ESG into a sharper focus. A business will not be able to demonstrate that human rights are respected in its supply chain unless it works closely with its business partners. Neither will it be able to demonstrate decarbonisation, without having the data and the details of any action taken by its supply chain partners.

Typically, businesses draw up codes of conduct for suppliers that require compliance with specific rules and include the right to carry out audits. Here, the selection of a supplier is not only about the price and dates. More and more frequently, it is about compliance with certain ESG rules and values. This, in turn, will encourage suppliers and contractors of services to adopt ESG policies to give them competitive advantage.
Environmental (E), social (S) and governance (G)issues are becoming increasingly important in all areas of the real estate sector, although awareness of the three areas seem to vary. Buildings, for example, are considered to be one of the key factors in climate change mitigation, so it comes as no surprise that primary emphasis is often placed on the "E" theme. Social aspects, as well as governance, usually receive less attention in public debate but both areas are important for businesses in the sector.

Governance factors in real estate

Governance scrutiny is central to the ability of a company to continue business operations. There is no doubt that the promotion of corporate governance can present an opportunity for real estate companies to drive long-term value. However, there are high risks if governance considerations are not addressed, including severe penalties and fines as well reputational damage and diminished market penetration.

Key governance elements include compliance with governance rules and guidelines, promoting transparent disclosure of governance issues, taking action against corruption, fostering diversity in management and governing bodies, as well as establishing and communicating the core values of an organisation. A corporate culture of ethics, compliance and integrity provides a firm foundation for delivering a positive and long-term impact.

Social factors in real estate

In recent years, the COVID-19 pandemic put greater attention on the social factor. Since real estate companies have a significant social impact, they should consider this area as a value driver. Social aspects in real estate include involvement in the rehabilitation of public spaces and the provision of affordable housing, social housing or care centres. Steps taken to ensure security in buildings and to provide assurances on human rights are other social factors to consider. From an internal perspective, social elements may comprise workplace safety policies and delivering high standards in labour practices as well as maintaining responsible marketing and promoting diversity across the company. An important consideration is that social factors can increase the ability of a company to attract talent – especially among millennials. Conversely, neglecting social elements can lead to reputational loss, lost work, a higher employee turnover, increased operating costs and may even threaten the ability of a company to operate.

Environmental factors in real estate

The real estate sector plays a huge role in the environmental area. It's not just a case of a business managing its environmental objectives and taking steps to minimise its environmental impact — climate in particular —to enhance reputation and market value in the eyes of investors.It is also an obligation arising from imminent regulations and pressures from the market. The measures taken in the environmental area include specifically reducing emissions as well as setting and achieving decarbonisation targets. Other initiatives that are equally important include reducing the use of raw materials, and minimising waste and transport as well as protecting biodiversity and incorporating the principles of circular economy into nearly all decision-making processes.

Although of particular importance in the real estate sector, the environmental area is not an isolated consideration within ESG. As described above, the role of social and governance elements should not be underestimated and could present high risks.

Real estate companies need to adapt to changing investor, consumer and commercial expectations — ensuring acceptance of their business practices and operating procedures by stakeholders and the wider public. A holistic approach to ESG is required to establish a successful "ESG-proof" business. This can lead to a greater ability to attract talent, secure reputational gains and ensure continuation of the social license to operate.

4. Reporting requirements and new regulations

4.1. Changes in the regulatory landscape

The purpose of the European Green Deal is to define the climate change challenge and turn it into a new opportunity by setting the goal of reducing CO2 emissions by 55% by 2030 and becoming climate neutral in 2050. Over the past few years, ESG policies have helped to shape the real estate sector and the European Union has adopted an action plan to finance the transition to carbon neutrality. It has also introduced several regulations to help achieve this goal, including the Sustainable Finance Disclosure Regulation (SFDR). A year after SFDR's implementation, the sector is now facing the challenge of classifying real estate funds based on their ESG characteristics and goals (funds referred to in Articles 8 and 9). Another important regulation is the EU Taxonomy. This aims to enhance environmental protection by redirecting capital flows towards more environmentally friendly investment. CSRD is the directive that changes the rules of corporate sustainability reporting and replaces the EU Non-Financial Reporting Directive (NFRD). The proposal for a directive on corporate sustainability due diligence (CSDDD) combines all of the above regulations and emphasises the importance of ESG due diligence throughout the organisation's value chain.

4.2. The EU's new sustainability directive as a game changer for real estate

The Corporate Sustainability Reporting Directive (CSRD) will radically improve the scope and existing reporting requirements of the EU's Non-Financial Reporting Directive (NFRD). This ambitious package will make it mandatory for many real estate organisations to report on all relevant inward and outward environmental, social and governance (ESG) issues and will have a significant short term impact. The proposed regulations will take effect from 2024, so effective preparation it is essential. To comply with the requirements of the CSRD, a materiality analysis and baseline assessment are crucial. So too is the need to set ESG goals within a long-term ESG strategy and to prepare the organisation's management systems and internal controls. The time to start is right now.

The purpose of the CSRD is to strengthen the foundations of sustainable investments in the EU's transition to a fully sustainable and inclusive economic and financial system, in accordance with the European Green Deal and the UN Sustainable Development Goals. CSRD aims to achieve radical improvement in the existing NFRD reporting requirements to increase transparency of corporate progress in sustainability and to align sustainability reporting with financial reporting. Companies will have to report on how ESG issues affect their business as well as the impact of their activities on the environment and on society.

Why is the CSRD affecting the real estate industry?

The real estate industry is responsible for approximately 40% of CO2 emissions and greatly impacts our daily lives. To meet the EU's climate and energy targets for 2030 and reach the objectives of the European Green Deal, more and more real estate organisations are committing themselves to sustainable climate targets such as zero emissions, and keeping global warming below 1.5 degrees. However, with the new CSRD reporting requirements, commitment and ambition aren't enough for real estate organisations to achieve their sustainability objectives.

The CSRD (Corporate Sustainability Reporting Directive), extends the EU's sustainability reporting requirements under NFRD (Non-financial Reporting Directive) and businesses will be expected to report under ESRS (EU Sustainability Reporting Standards). The new requirements aim to improve the quality, comparability and reliability of sustainability disclosures and to ensure that sustainability reporting is on an equal footing with financial reporting. The guidelines are consistent with other EU regulations (e.g the Taxonomy, SFDR), but they also take account of international standards and guidelines such as: TCFD, GRI, SASB, TNFD, OECD Guidelines for Multinational Enterprises, OECD Due Diligence Guidance for Responsible Business Conduct. Adapting to the new rules will be easier for businesses that have already been reporting according to GRI or SASB and have analysed climate risks in accordance with TCFD.

ESRS — who and when

Large EU undertakings

Listed and non-listed

2 of 3

Balance sheet total:

EUR 20M

Net turnover:

EUR 40M

Average number of employees during the financial year:

250

NFRD undertakings

In 2025 for FY 2024

Other large undertakings

In 2026 for FY 2025

Small and Medium EU undertakings

Only listed

2 of 3

Balance sheet total:

EUR 350K

Net turnover:

EUR 700K

Average number of employees during the financial year:

10

In 2027 for FY 2026

Possibility for opt-out till 2028 (In 2029 for FY 2028)

LISTED:

What: securities (shares, bonds, mortgage bonds, depository receipts, etc.)

Where: admitted to trading on a regulated market in the EU (plus Norway and Iceland)

Non-EU capital groups

Listed and non-listed

Net turnover in the EU of the whole group in 2 previous FYs:

EUR 150M

In 2029 for FY 2028

at least one EU subsidiary subject to CSRD; or

EU branch with net turnover

EUR 40M

ESRS — what can be found in the new standards

The first part of the guidelines are cross-cutting standards that apply to all businesses. Sector specific standards will be appear in the coming years, with those for the real estate sector due to be published in Q4 2024.

The new guidelines will affect the business decisions taken by the largest organisations. Emphasis is placed on climate disclosures. The entire "Climate change" standard (including the main climate goals and emissions across the three scopes) will be mandatory for all undertakings irrespective of the outcome of their materiality assessment. An organisation's strategy and business model must be aligned with the Paris Agreement (i.e. limiting the temperature increase to 1.5ºC and accounting for the principles of circular economy) and it will be necessary to report how the organisation will prevent pollution and support biodiversity.

Governance matters deal with the business conduct including corporate culture, the prevention of corruption, relationships with suppliers and payment practices.

The concept of double materiality is basis for defining the scope of reporting i.e. financial materiality (triggering of financial effects) and impact materiality (the actual or potential impacts on people or the environment).

Disclosures should be reported within identifiable parts of the management report - with some requiring initial auditing - and should be presented in accordance with the regulation and in a machine-readable format.

Cross-cutting standards (12 DRs)

Cross-cutting standards (12 DRs)	E: Environmental standards (32 DRs)	S: Social standards (32 DRs)	G: Governance standards (6 DRs)
ESRS 1 General principles	**ESRS E1** Climate change	**ESRS S1** Own workforce	**ESRS G1** Business conduct
ESRS 2 General disclosures	**ESRS E2** Pollution	**ESRS S2** Workers in the value chain	
	ESRS E3 Water and marine sources	**ESRS S3** Affected communities	
	ESRS E4 Biodiversity and ecosystem	**ESRS S4** Consumers and end users	
	ESRS E5 Resource and circular economy		

Drafts avaiable at: https://www.efrag.org/lab6

12 Standards

82 DISCLOSURE REQUIREMENTS

(qualitative or quantitative information)

1 144 DATA POINTS

(398 data points mandatory)

DOUBLE MATERIALITY

- Impact materiality
- Financial materiality

4 areas of reporting

- Governance
- Strategy
- Impact, Risk, opportunities
- Targets and measures

The impact of the new guidelines on the real estate sector will be twofold - through the requirements placed on the businesses subject to CSRD and through the requirements of clients subject to the same directive. To get ready for the new arrangements, the first step should be to ensure a good understanding of the standards and to ensure all procedures and management structures have been put in place, relevant indicators are being measured and all necessary documents are held. The coming months are a good time to get ready for the changes.

What is going to change for the real estate industry?

Because of the CSRD, real estate organisations can no longer report on their financial status without mentioning their environmental and social impact. In order to do so, it is essential to follow the materiality concept when determining which ESG topics to report. Materiality is the concept that defines why and how specific issues are significant for a company. By introducing the concept of ”double materiality”, organisations need to consider both the impact of climate-related risk and opportunities on the company's value (”financial materiality” or ”inward impact”), and the external impacts of the company's activities on the environment (”environmental and social materiality” or” outward impact”).

In addition to mandatory requirements, CSRD will be a major game changer for the industry in terms of transparency and insight into sustainability risks and opportunities. In order to comply with the CSRD, real estate organisations will need a long-term sustainability strategy and extend their sustainability management to include both inward and outward sustainability risks and opportunities. Because the real estate market is stimulated by financing and investments from a wide range of investors, it will become increasingly important to understand sustainability performance and strategy and the sustainability risks and opportunities for attracting capital, gaining competitive advantage and achieving sustainability goals.

What can be done now?

The CSRD will have far-reaching implications for the real estate industry in terms of corporate ESG reporting. Real estate organisations, investors, regulators, auditors and other stakeholders will all need to devote significant time and resources to prepare for the implications of the CSRD. Given the significance of the Directive and the time that will be needed for effective preparation in 2023, these are the key topics that should be considered now:

- Perform a double materiality assessment to determine which ESG issues are material for the organisation from both an inward and outward perspective. Perform an ESG baseline assessment for material ESG issues to determine the starting point.
- Set measurable ESG goals in line with the EU Green Deal and UN Sustainable Development Goals.
- Develop a future-proof ESG strategy that includes the purpose, vision, objectives, performance indicators, a strategic roadmap and policies required to comply with EU legislation and mandatory third party limited assurance with effect from 2024.
- Set up reporting and monitoring procedures in order to keep track of the ESG goals over time and to reassess material ESG issues.

4.3. EU Taxonomy and SFDR regulatory requirements for the real estate industry

The direction for the development of the real estate industry is significantly impacted by the EU Taxonomy[1] and SFDR[2], which have helped to establish the framework for the EU Sustainable Finance Strategy. Both set out new sustainability reporting obligations and support investors in directing capital to sustainable investment.

EU Taxonomy — a system for classification of environmentally sustainable activities.

The EU Taxonomy is a classification system set to ensure a harmonised and uniform approach for identifying economic activities that are environmentally sustainable and to explain what can be regarded as sustainable and/or economic activity. The EU Taxonomy sets out four criteria that environmentally sustainable economic activities must fulfil[3]:

01. Substantially contribute to one or more of the environmental objectives
02. Do no significant harm to any of the other environmental objectives
03. Comply with the minimum safeguards (i.e. aligned with the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights)
04. Comply with technical screening criteria that have been established by the Commission through delegated acts.

Moreover, the EU Taxonomy sets out six environmental objectives that an activity can help achieve[4]:

01. Climate change mitigation
02. Climate change adaptation
03. Sustainable use and protection of water and marine resources
04. Transition to a circular economy
05. Pollution prevention and control
06. Protection and restoration of biodiversity and ecosystems

The definition of a substantial contribution to one or more of the environmental objectives and presenting no significant harm to any of the other environmental objectives have been defined in the technical screening criteria (i.e. the European Commission's delegated acts). As at 31 December 2022, the technical screening criteria were applied to only two first environmental objectives - climate change mitigation and climate change adaptation. Work continues on the remaining four environmental objectives. The delegated act lists over 80 activities which represent 93 percent of all greenhouse gas emissions in the EU. These can be assessed for alignment with the environmental sustainability criteria. Although the delegated act does not include all industries and types of economic activities, the absence of an economic activity does not imply it is not environmentally sustainable. It is more likely that the European Commission has yet to assess the activity. The EU Taxonomy and delegated acts are living documents and will be subject to regular review but the delegated act currently covers 13 sectors.

1 Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088

2 Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability related disclosures in the financial services sector

3 Article 3 of the EU Taxonomy

4 Article 9 of the EU Taxonomy

Moreover, under the delegated act to Article 8 of the EU Taxonomy, certain non-financial undertakings and financial institutions are obliged to disclose information about how and to what extent the activities of an organisation are associated with environmentally sustainable economic activities. So far, the obligation was imposed only on large organisations, required to disclose non-financial information under NFRD[1] (i.e. those that meet two of the following three criteria: net turnover > €40 million, balance sheet total > €20 million, >500 employees — the size criterion must be met for at least two consecutive years).

With the CSRD coming into force[2] from 1 January 2024, the scope of entities subject to the reporting obligation will increase significantly to include all listed companies (except listed micro-enterprises) and all large undertakings. For large undertakings although the net turnover and balance-sheet total requirements will not change compared to the NFRD, the average number of employees in a financial year will be reduced to 250. The EU Taxonomy disclosures cover information about taxonomy-eligible activities (as listed in the technical screening criteria with no need to meet any requirements set out in the criteria) and taxonomy-aligned activities (those satisfying the four criteria that fulfil the requirements for environmentally sustainable economic activities).

Fig1. Sectors with examples of activities covered by the delegated acts

FORESTRY
- Afforestation
- Forest management
- Conservation forestry

ENVIRONMENTAL PROTECTION AND RESTORATION ACTIVITIES
- Restoration of wetlands

MANUFACTURING
- Manufacture of renewable energy technologies

ENERGY
- Electricity generation using renewable energy sources

WATER SUPPLY, SEWERAGE, WASTE MANAGEMENT AND REMEDIATION
- Construction and renewal of water and waste water collection and supply systems

TRANSPORT
- Low carbon infrastructure

CONSTRUCTION AND REAL ESTATE ACTIVITIES
- Construction and renovation of buildings to improve energy efficiency

INFORMATION AND COMMUNICATION
- Data processing, hosting and related activities

Differences in the activities depending on the environmental objective

PROFESSIONAL, SCIENTIFIC AND TECHNICAL ACTIVITIES
- Market research, development and innovation support

Differences in the activities depending on the environmental objective

FINANCIAL AND INSURANCE ACTIVITIES
- Non-life insurance: underwriting of climate-related perils
- Reinsurance

EDUCATION
- Public or private education at any level or for any profession

HUMAN HEALTH AND SOCIAL WORK ACTIVITIES
- Residential care activities

ARTS, ENTERTAINMENT AND RECREATION
- Creative, arts and entertainment activities

Environmental objective: **climate change mitigation**

Environmental objective: **climate change adaptation**

Source: Deloitte

1 Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups

2 Directive (EU) 2022/2464 of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting

EU Taxonomy requirements for the real estate industry

The incorporation of the "construction and real estate activities" (category 7) into today's climate change mitigation and adaptation delegated acts emphasises their significant potential to reduce emissions in the EU.

Fig2. Activities included in category 7 (construction and real estate activities)

Activity 7.1.
- Construction of new buildings

1

Activity 7.2.
- Renovation of existing buildings

2

Activity 7.3.
- Installation, maintenance and repair of energy efficiency equipment

3

Activity 7.4.
- Installation, maintenance and repair of charging stations for electric vehicles in buildings (and parking spaces attached to buildings)

4

Activity 7.5.
- Installation, maintenance and repair of instruments and devices for measuring, regulation and controlling energy performance of buildings

5

Activity 7.6.
- Installation, maintenance and repair of renewable energy technologies

6

Activity 7.7.
- Acquisition and ownership of buildings

7

Source: Deloitte

Individual activities in the delegated acts have been assigned technical screening criteria and guidelines to ensure no significant harm is done to the individual environmental objectives.

An analysis of **activity 7.1 and 7.7** makes it easier to understand the specifics and the level of detail of the technical screening criteria as well as the challenges associated with their implementation. To satisfy the "substantial contribution" criterion (activity 7.1), the Primary Energy Demand of a building should be at least 10% lower than the threshold set for the nearly zero-energy building (NZEB) requirements and for buildings larger than 5000 m2 — testing for air-tightness and thermal integrity and calculating the Global Warming Potential. The criteria for determining whether an economic activity causes no significant harm specified the detailed requirements for analysing physical climate risks, maximum water flow in sanitary installations and recycling construction and demolition waste[1].

The guidelines published by the Ministry of Economic Development and Technology[2] specify that the substantial contribution criterion for **activity 7.1 requires preparation of an Energy Performance Certificate** (in line with the methodology[3]). This sets out the **annual non-renewable primary energy demand** and compares it with a maximum primary energy demand, as set out in the Ordinance of the Minister of Infrastructure on the technical conditions to be met by the buildings and their location. This has been in place since 31 December 2020[4]. The technical requirement has been met if the primary energy demand for a new building is at least 10% lower than the maximum primary energy demand.

To satisfy the "substantial contribution" criterion (activity 7.7), a building built before 31 December 2020 **has at least an Energy Performance Certificate (EPC) class A.** As an alternative, **the building is within the top 15% of the national or regional building stock expressed as operational Primary Energy Demand (PED).** In Poland, buildings are not assigned classes of energy performance so the alternative criterion should be used. In line with the Central register of the energy performance of buildings, the Ministry specified that the primary energy demand of 15% of the most energy efficient residential buildings built before 31 December 2020 is below 76.59 kWh/(m2*year). For non-residential buildings built before 31 December 2002, it is 118.26 kWh/(m2*year). Therefore, buildings with the primary energy demand below these stated values meet the criterion.

Interpreting the requirements is one of the challenges when applying the technical screening criteria. For example, the description of activity 7.1 specifies that buildings should be constructed for the purpose of developing building projects for later sale. This may suggest that own use is excluded. However, the European Commission stipulated in a notice[5] that constructing a new building for own use can be covered by both activity 7.1 and 7.7. This way, depending on the type of entity (a construction undertaking or an entity requesting the construction), the Taxonomy-aligned funds can be assigned to an appropriate category such as revenue, capital expenditure or operating expenses.

EU Taxonomy and BREEAM certification

BREEAM is one of the most common methods of assessing the sustainability of buildings. When the development of the EU Taxonomy is taken into account, BREEAM will be adjusted to support clients with comprehensive sustainability disclosures. As far as the substantial contribution and 'Do No Significant Harm' are concerned, 42% of the BREEAM criteria are aligned with the technical screening criteria (general score). For 'Do No Significant Harm' alone, it is 50%. BREEAM will be reviewed once all of the technical screening criteria are published for the remaining four environmental objectives. This helps to ensure the closest alignment with the EU Taxonomy and clearly demonstrates the important role that EU Taxonomy plays in developing new "sustainable construction" standards.

1 https://eur-lex.europa.eu/legal-content/PL/TXT/?uri=CELEX%3A32021R2139

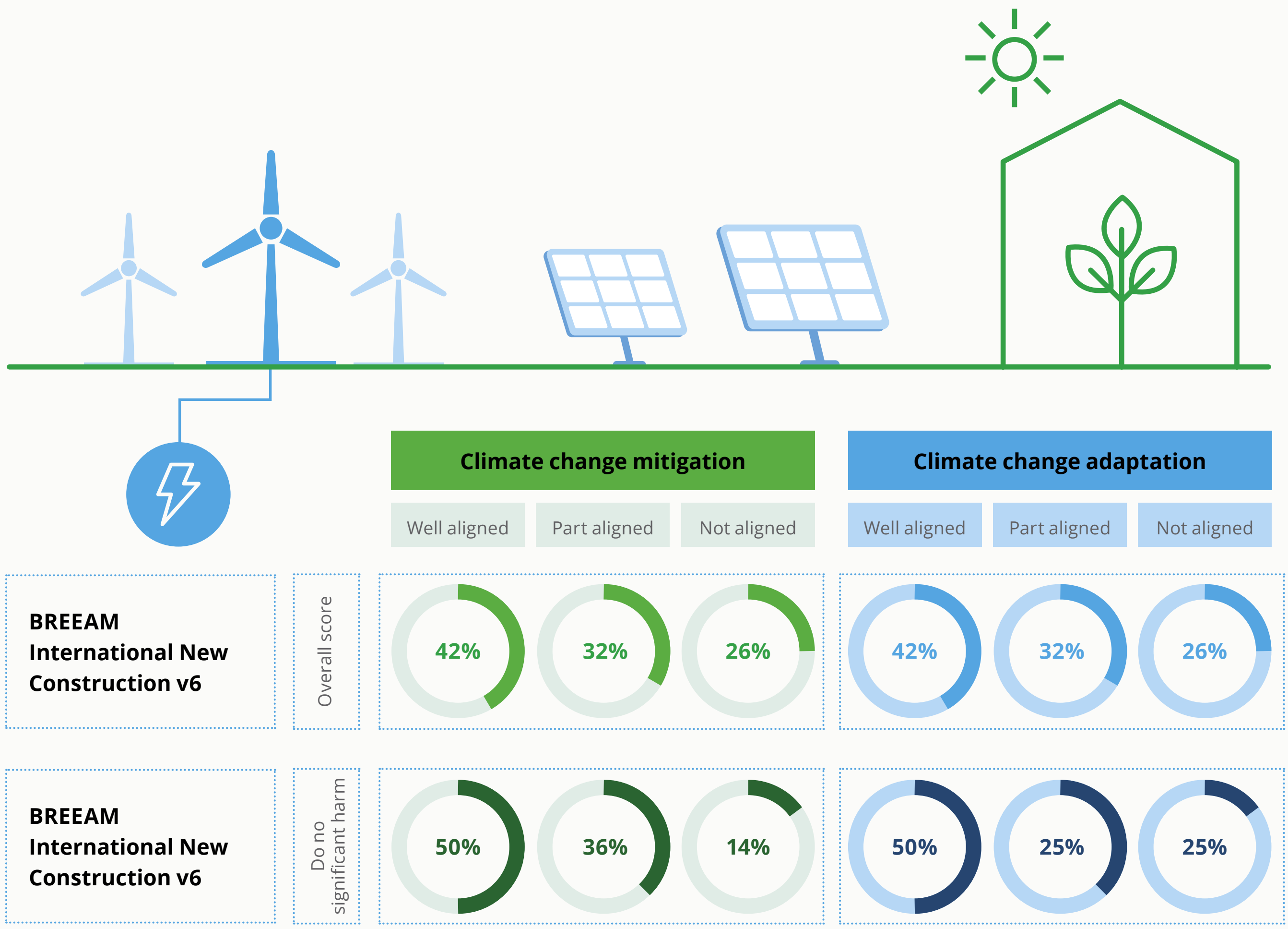
2 https://www.gov.pl/web/rozwoj-technologia/Taksonomia-zrownowazonego-finansowania-inwestycji-budynk

3 Ordinance of the Minister of Infrastructure and Development of 27 February 2015 r. on the methodology of calculating the energy performance of buildings or their parts and energy performance certificates, Journal of Laws of 2015, item 376.

4 Announcement of the Minister of Economic Development and Technology of 15 April 2022 on announcing a uniform text of the Ordinance of the Minister on Infrastructure on the technical conditions to be met by the buildings and their location, Journal of Laws of 2022 item 1225

5 The draft Commission Notice on the interpretation and implementation of certain legal provisions of the EU Taxonomy Climate Delegated Act establishing technical screening criteria for economic activities that contribute substantially to climate change mitigation or climate change adaptation and do no significant harm to other environmental objectives, https://ec.europa.eu/finance/docs/law/221219-draft-commission-notice-eu-taxonomy-climate.pdf

Fig3. BREEAM's alignment with the EU Taxonomy



Source: BREEAM and EU Taxonomy mapping, https://www.bre.group/a-guide-to-the-eu-taxonomy-and-breeam/breeam-eu-taxonomy-mapping

Sustainability disclosures in the financial sector under SFDR and their significance for the real estate industry

Another major act is SFDR — a regulation that has been in place since 10 March 2021. This has brought harmonised rules for financial market participants and financial advisers to follow for delivering transparency around sustainability risks and the sustainability disclosure obligations for end-investors.
The SFDR does not refer to non-financial undertakings, but they will be required indirectly to make sustainability disclosures. Specifically, financial market participants should disclose certain mandatory indicators[1] when considering the principal adverse impacts (PAI[2]) of investment decisions on sustainability factors. **The investee companies will, therefore, be obliged to provide them with certain environmental and social information.** A similar situation can apply to **real estate investment.** SFDR will also increase investor interest in non-financial information about an undertaking's commitment to sustainability. This will lead to greater transparency of ESG information and increase the demand for eligible "green" projects. SFDR is also closely connected with the EU Taxonomy as financial market participants are obliged to apply the EU Taxonomy to the "green investment products" they offer and to make sustainable investment share disclosures under the regulation.

Taxonomy and SFDR and further development of the construction industry

There is little doubt that both the EU Taxonomy and SFDR will have a significant impact on the further development of the European construction industry.
The current "sustainable construction" standards will change as future construction projects or existing certifications will need to be aligned with the requirements set out in the regulations.

1 SFDR regulatory technical standards set out 18 mandatory and 46 optional reference indicators to assess the principal adverse impacts. Financial market participants will be obliged to publish the mandatory indicators and information about one or more optional indicators for the environmental and social categories.

2 Principal Adverse Impacts (PAI)

Fig4. Mandatory PAI indicators as per SFDR

Indicators applicable to investments in investee companies

1. Greenhouse gas emissions
2. Carbon footprint
3. GHG intensity of investee companies
4. Exposure to companies active in the fossil fuel sector
5. Share of non-renewable energy consumption and production
6. Energy consumption intensity per high impact climate sector
7. Activities negatively affecting biodiversity-sensitive areas
8. Emissions to water
9. Hazardous waste and radioactive waste ratio
10. Violations of UN Global Compact principles and Organisation for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises
11. Lack of processes and compliance mechanisms to monitor compliance with UN Global Compact principles and OECD Guidelines for Multinational Enterprises
12. Unadjusted gender pay gap
13. Board gender diversity
14. Exposure to controversial weapons (anti-personnel mines, cluster munitions, chemical weapons and biological weapons)

Indicators applicable to investments in sovereigns and supranationals

15. GHG intensity
16. Investee countries subject to social violations

Indicators applicable to investments in real estate assets

17. Exposure to fossil fuels through real estate assets
18. Exposure to energy-inefficient real estate assets

Source: Deloitte

5. Challenges brought about by the new reporting

Being well-prepared for the CSRD and improving the sustainability performance starts with an organisation understanding the bigger picture, the objectives and the consequences of its actions for their reporting framework. This requires a clear focus on three key perspectives.

Overview of requirements: What data does the organisation need to report on ESG performance?

The CSRD requires that organisations report on non-financial ESG themes where they can make the most impact. To do so, companies perform a materiality assessment identifying the ESG themes and business risks from a double materiality perspective (see paragraph 2.2). By introducing the concept of "double materiality", organisations need to consider how sustainability risk and opportunities will impact on the company's value ("financial materiality" or "inward impact") and how the activities of the company will have an impact on the environment ("environmental and social materiality" or "outward impact").

After determining the themes that are material for organisations, three steps are essential to create an effective overview of requirements:

01. Companies have to analyse the current standing of the material themes and set their ambitions and targets.
02. Companies have to define the KPIs required to reach these targets.
03. Companies have to generate an overview of the data they need to report on these KPIs.

The data required to measure and report on the KPIs might be available within the organisation. A significant part of this non-financial data is, however, only accessible outside the organisation - such as a construction organisation needing its suppliers to specify greenhouse gas emissions during the transportation of materials. Determining the source of the necessary data is, therefore, the next step.

From which sources should the organisation collect its data?

Ownership of the non-financial data that organisations require could be widespread within the real estate industry. Consequently, the organisation's position in the real estate ecosystem is crucial for determining the data sources necessary for CSRD reporting. This requires informed insight into dependencies so the organisation can create an overview of how other players in the real estate ecosystem impact its processes and their willingness to disclose the data required. By way of example, if a Real Estate Investment Trust wants to report on the energy usage of its portfolio, it will need the usage data of its tenants.

After completing this assessment, the next step is to determine how to collect the data from other players in the real estate ecosystem.

Accessibility through strategic partnerships: Which players should organisations work with to access all necessary data?

After creating an overview of the data sources and deciding which players a company relies on to gather the data, it is time to define the necessary process of data collection, transformation, analysis, and reporting and to identify the changes that are needed to the current process. This demands starting dialogue with partners and other players in the real estate ecosystem to establish strategic partnerships for sharing ESG data. For this to be successful, companies have to create clear incentives to ensure that all involved players gain from data sharing and to establish a reliable partnership founded on mutual agreements concerning the correctness and accuracy of the shared data.

6. Managing decarbonisation in the building sector

Buildings are responsible for **37%** of global carbon emissions and **36%** of global energy consumption[1], so decarbonising the sector will play a major role in achieving **net zero global emissions by 2050.** However, decarbonisation is challenging task for several reasons.There are not only links with other sectors (transport, energy, heating) and the involvement of various stakeholders (government agencies, investors, contractors, designers, residents or tenants) to consider. It is also important to take account of the implementation of measures for different types of building and the different stages of the construction project and, specifically, whether the buildings to be decarbonised already exist or are newly designed.

Poland has the highest number of certified buildings in Central and Eastern Europe, with **45%** of all certificates in the region. Over the past few years, the number of certified buildings has been growing by more than 20% each year. In March 2022, certified buildings in Poland had the total floor area of 28.6 million square meters[2], although nearly 90% are offices, logistic and retail facilities and only 8.7% are residential buildings (only multi-family buildings). Residential premises account for 68% of all floor area, with single-family houses representing 58% of Poland's total building stock in 2015[3], but the certificates are not given to single-family houses.

When looking at the development of the real estate sector and the projected growth of the floor area (by approximately 75% over 2020-2050)[4] , it is essential that new and more restrictive requirements are developed for new facilities. Additionally, approximately 58% of residential buildings in Poland were built before 1980 and prior to any energy efficiency requirements, and estimates suggest the majority of these buildings will still be in use in 2050. Although it is more difficult to achieve refurbishment requirements, such actions are clearly required for decarbonising the real estate sector.

The multiple criteria assessed in building certification that provide a measurable way to implement green initiatives and cover many ESG aspects are a noticeable trend in the Polish market (mainly BREEAM and LEED certificates). The measures taken depend on the selected certification system as well as on the the decision of investors regarding which criteria need to be satisfied. Implemented solutions span the following areas:

Management: responsibilities of the parties involved, sustainable investment planning.

Energy: minimising the use of energy and carbon dioxide emissions, monitoring energy in the building (with the use of BMS).

Water: monitoring and measuring water consumption or implementing systems for effective water management as well as detecting and preventing leaks.

Materials: assessing the building's impact on the environment throughout its life cycle (greenhouse gas emissions) and focusing on sustainable sourcing of building materials.

Waste, Health and well-being aimed at ensuring user comfort **Management:** responsibilities of the parties involved, sustainable investment planning.

1 Decarbonizing the building sector: opportunities and challenges — Science Based Target
2 Zrownowazone-certyfikowane-budynki-2022.pdf (plgbc.org.pl)
3 https://www.climate-kic.org/download/43685/
4 Buildings — Science Based Targets

The environmental impact of buildings

A building has an impact on the environment throughout its entire life cycle so special attention should be given to every stage of its development. Conscious decisions should not only be made from the planning stage through to design, construction and commissioning but also through usage, renovation and potential demolition. To ensure a building has minimum adverse impact on the environment, all measures must be carefully planned, regularly monitored and, if necessary, improved.

The most popular method for assessing a building's impact on the environment throughout its reference service life of 50-60 years is the Life Cycle Assessment required, for example by the EU Taxonomy. LCA presents the total gas emissions generated from the use of energy, fuel and other resources during different phases throughout the building's entire life cycle. There are two types of a building footprint - operational and embodied.

The **operational carbon footprint** relates tothe usage of the building and the emissions it generates - electricity and fuel used for heating, cooling, ventilating, hot water, lighting and other energy demands. The **embodied carbon footprint** concerns the remaining stages of constructing a building and howemissions are impacted by the flow of materials throughout the building's life cycle - such as the production and transportation of materials, recycling renovation or demolition waste.

Currently, the operational phase is the most energy-consuming. That said, energy consumption in this phase is being gradually reduced as a result of technological advancements and new laws and regulations. This is **leading to a lower operating carbon footprint** and a **higher embodied carbon footprint.** Therefore, more emphasis should be placed on how buildings are designed and what materials are used, instead of purely focusing on what systems are to be installed. There is an important role to be played by Type III Environmental Product Declarations.These disclose the actual environmental impact of materials or products throughout their life cycle. Careful selection of building materials from manufacturers that develop the EPD labels for their products increases the chances of performing an accurate analysis of the facility's impact on the environment.

Decarbonisation opportunities in various phases of a construction project

The potential for reducing greenhouse gas emissions is at its highest in the planning phase (both the embodied and operational carbon footprint). The decisions taken at this stage affect every subsequent phase so special attention should be paid to the selection of:

- the right location for the investment project.
- a multidisciplinary team that is fully aware of climate matters.

- solutions that will significantly contribute to reducing the building's carbon footprint.

In the **design** phase, it is possible to focus the design of a building on achieving the net-zero target by:

- following the Passive Building principles which have a direct impact on reducing the building's energy demand.

- reducing the amount of materials used by only building the necessary area (the lower the use of materials or the less m3, the lower the building's carbon footprint).

- selecting appropriate materials such as recycled materials that comply with the principles of the circular economy or natural materials sourced or produced near the construction site that have a lower carbon footprint.

- effective project coordination - the use of BIM technology, for example, helps to reduce the amount of unused materials and any construction errors.

- selecting appropriate systems in the buildings - by focusing on renewable energy sources, heat pumps and recovery rather than relying on fossil fuels or district heating.

- planning what will happen with the various elements of the building after demolition.

In the **construction** phase, it is particularly important to monitor the entire construction process by:

- monitoring the transportation of materials and waste to and from the site and reducing transport mileage as much as possible.

- careful waste management that is focused on sorting waste and handing it over to recycling or recovery undertakings for reuse.

- using more energy-efficient tools and machines in place of outdated and energy-hungry equipment.

In the **handover** phase, it is important to check:

- the operability of all systems.

- airtightness and to perform thermographic inspections in the building to eliminate any unnecessary heat loss.

There are a number of important considerations during **usage**:

- Property developers should regularly monitor the use of utilities.

- It is important to consider using Smart Home technology to monitor and control the use of energy or the building temperature.

- Informing tenants about the steps they can take to ensure maximum energy efficiency of the building.

The remaining phases of a facility life cycle are **renovation** and finally **demolition when** our decisions can contribute significantly to a reduction in greenhouse gas emissions. As far as the environment is concerned, renovating a facility is always a better option than demolition and the erection of a new building. In these phases particular attention should be given to compliance with the principles of circular economy as reusing and recycling building materials help to improve circularity and reduce the environmental impact.

The Directive on the energy performance of buildings requires an energy performance certificate to be drawn up during construction of a building to show the annual non-renewable primary energy demand (kWh/(m2year). It has been noticed that a building's energy demand indicated in the certificates often differs from the actual demand. A good practice is to monitor and report the actual energy and fuel consumption of a building during the first few years after construction to verify that it corresponds with the energy performance certificate.

Decarbonisation roadmap

One of the key means of achieving decarbonisation is using green energy but there are limits as to what building owners can do to reduce carbon dioxide emissions without transformation of the energy grid. In 2021, coal accounted for 71% of electricity generation in Poland, with only 17% coming from renewable energy sources[1]. Nevertheless, there are other solutions that building constructors or administrators can use to decarbonise the real estate sector.

- The focus should be to minimise the use of fossil fuels when designing facilities. Businesses should be committed to developing plans for phasing out the use of coal.

- Using renewables — external purchases of green energy or using energy from the business's own renewable sources. In contrast to other EU states, Poland has not set any required renewable energy share for buildings although it should be 49% to be in line with FIT FOR 55[2].

- Use of renewable energy installations in the building such as solar panels and heat pumps.

- A satisfactory energy performance certificate that is considerably below the maximum EP set out in Polish laws (as in[3])

- Focus on projects to improve energy efficiency — monitoring and optimising consumption through the use of BMS data.

- Every building is recommended to undergo an LCA to identify its actual impact on the environment.It should be noted that some countries have mandatory LCAs with set carbon dioxide emission limits for buildings.

- Use of environmentally-friendly materials

- Focus on energy efficiency education with information provided to the investors, property developers, tenants and users.

1 https://stat.gov.pl/download/gfx/portalinformacyjny/pl/defaultaktualnosci/5485/4/17/1/gospodarka_paliwowo-energetyczna_w_latach_2020_i_2021.pdf

2 EUR-Lex - 52021PC0557 - EN - EUR-Lex (europa.eu)

3 laws in ISAP (sejm.gov.pl)

Recommendations

To become climate neutral, Poland's construction and real estate sectors must undergo transformation. By 2050, all buildings should have no operational carbon footprint (use phase) and newly designed buildings should have no embodied carbon footprint throughout their life cycle. This means abandoning fossil fuels, only using renewable energy, using reused materials in construction and dismantling the building at the end of its life cycle in accordance with the principles of the circular economy.

The sector's focus of decarbonisation should be targeted at modernisation (at a rate of 3% per annum) and thermal renovation of existing buildings, instead of demolishing them and building new facilities. Additionally, stakeholders should focus on the construction of buildings that are highly energy efficient by reducing the direct energy demand in the first instanceand then by gradually satisfying the reduced demand with renewables.

To become carbon neutral and decarbonise the real estate sector, new regulations must be adjusted to the changing landscape. Material manufacturers must also be committed to low carbon footprint production using, for example, different technologies. Some initiatives will be challenging. Others will be fully dependent on the goodwill of the investor or the property developer and will not require any significant expenditure.

The real estate industry should seek new opportunities for reducing the carbon footprint of buildings and adjust its activities to reflect the changing landscape and the new regulations introduced by the EU and the government. Decarbonisation measures may attract new investors and help a business maintain its leading position, but it is important a business confirms its commitment to environmental protection by joining global organisations that promote best practice in the reduction of greenhouse gas emissions.

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