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Deferred tax in the financial statements of a real estate company

With the financial year coming to an end, businesses might want to look into the deferred tax, which is an important topic for real estate entities. There are issues specific to that industry and business events can be accounted for differently depending on whether they are recognised for accounting or tax purposes.

In Poland, the rules of calculating deferred tax are governed in the Accounting Act and Polish Accounting Standard 2 "Income Tax", in the international law — in International Accounting Standard 12 "Income Tax". Income tax that is charged to the accounting profit comprises:

– current tax – arising from annual corporate income tax calculations, payable to the tax office (fiscal);
– deferred income tax.

Current income and deferred taxes have become distinct accounting categories.

Current income tax is calculated for a given period in accordance with the tax laws in place. It is a tax liability for a given period payable on the taxable income stated in the tax return.

Deferred tax is the potential income tax arising from current period events that will be paid or deducted in future. Deferred tax is used to recognise the tax effects of a transaction and the transaction itself in the same period. Because of differences in tax laws and accounting rules, often a transaction is recognised in one period, and tax is chargeable in another.

Regulations require that deferred tax be calculated using the co-called balance-sheet treatment in which the carrying amount of assets and liabilities is compared with their tax base and temporary differences are calculated. There are revenue and expenses which – when recognised in the balance sheet – are not taxable, but become so once certain conditions have been met. As far as the balance sheet is concerned, they mainly arise from the obligation to follow overarching accounting principles: accrual accounting, the matching and prudence principles, which are not mentioned in tax regulations.

As at the end of the reporting period, the carrying amount of assets and liabilities is calculated in accordance with the accounting principles

The carrying amount of an asset reflects the benefits that an entity expects from the asset. The tax base of assets represents the amount which reduces the income tax base (tax basis), if such assets bring, directly or indirectly, economic benefits to an entity. This is how the tax base of assets the benefits of which are taxable is determined. If such benefits do not reduce the income tax basis, then the tax base of the asset is equal to its carrying amount. Such a situation has no consequences for the deferred income tax.

The carrying amount of a liability represents the expected reduction in future benefits. The tax base of a liability is its carrying amount less any amounts that in future will reduce the income tax basis (after deductions). If, as a result

of past events, future settlement of the entity's liabilities will increase the tax basis, the tax base of the liability will be the carrying amount increased by such amounts.

Under IAS 12, deferred tax assets/liabilities are recognised for temporary differences. Temporary differences are differences between the carrying amount of an asset or liability and its tax base. Where there are no differences in the tax and accounting treatment of a given transaction, there are no temporary differences and there is no basis for recognising deferred tax assets/ liabilities. There are the following types of temporary differences:

– taxable – that increase the taxable income;
– deductible – that decrease the taxable income.

Taxable temporary differences are the differences between the carrying amount of an asset or liability and its tax base that will increase the tax basis in the future. This will happen when the carrying amount of an asset is realised or that of a liability is settled, i.e. when the carrying amount of assets is higher or when the carrying amount of liabilities is lower than their tax base.

Deductible temporary differences are also differences between the carrying amount of an asset or liability and its tax base, but they will decrease the tax basis in the future. This will happen when the carrying amount of an asset is realised or that of a liability is settled, i.e. when the carrying amount of assets is lower or when the carrying amount of liabilities is higher than their tax base.

When there are taxable temporary differences, an entity recognises a deferred tax liability. When there are deductible temporary differences, an entity recognises a deferred tax asset. A deferred tax asset is also recognised for the carryforward of unused tax losses and unused tax credits.
Under the Accounting Act, the deferred tax assets and liability are calculated by reference to the income tax rates effective in the year when the tax liability arises (i.e. in future). Under IAS 12, deferred tax assets and liabilities should be measured at the tax rates that are expected to apply to the period when the asset is realised or the liability settled, based on the tax rates (and laws) enacted or substantively enacted by the balance sheet date.

Under the current legal framework, the basic corporate income tax rate is 19 percent; small taxpayers can benefit from a lower, nine-percent rate and those using the lower rate should analyse future tax liabilities and the rate to be applied in future years when the temporary tax differences are realised. Moreover, deferred tax assets and liability are not discounted.
Notably, under the Accounting Act, a company can apply a simplification – opt not to calculate deferred tax, if its figures for the prior financial year do not exceed certain levels in two out of the three: carrying amount, revenue from sales of goods/products and financial revenue, and average annual number of staff.

Entities that will decide not to apply the exemption from recognising a deferred tax asset/liability may wish to analyse the following examples which often result in deferred tax:

Balance-sheet and tax valuation of investment property

Measuring assets at cost both for accounting and tax purposes can lead to temporary differences. Most often, unrealised foreign exchange differences on liabilities are recognised as at the date a fixed asset is put into use, and the differences cannot be considered to constitute the tax base of the real property. Under the tax law, foreign exchange differences will be considered to be tax differences when realised, i.e. when the liability is paid. Therefore, depending on whether capitalised unrealised foreign exchange differences are gains or losses, the tax base will be higher or lower than the initial amount of the investment.

Another situation that results in a difference between the carrying amount and the tax base of a real property are various depreciation rates used for balance sheet and tax purposes. Real property in the balance sheet includes fixed assets classified to various groups. Real property, depending on its classification, is depreciated: for balance sheet purposes — over its estimated useful life, and for tax purposes — using the rates set out in appendix 1 to the tax law. Useful lives may be shorter or longer than or the same as the periods used for tax purposes. Following the restrictions on tax depreciation of buildings and with the land (in general) not being depreciable, a temporary difference will arise when there are various rates applied for other fixed assets that make up a real property, such as structures, fixtures and fittings.

As at the end of the reporting period entities test their assets, including real property, for impairment. If as at the end of the reporting period the book value of real property is higher than the expected economic benefits, this means that the real property has lost all or some of its potential to provide economic benefits to the entity. An impairment loss is then recognised to reduce the asset's carrying amount down to its real value. The cost of the impairment loss is not tax deductible so the carrying amount and the tax base will differ.

Many property businesses have an accounting policy in place by which they classify their property to investment property measured at fair value.
Such property is not classified as fixed asset and is not depreciated for accounting purposes. Until 2022 investments in a building were considered to be fixed assets and depreciated using the rates set out in the appendix to the Corporate Income Tax Act (for buildings at 2.5 percent). From January 2022, it became unclear whether the restriction on depreciation of Group 1 fixed assets also applies to the companies that classify real estate property to investment. Tax offices in their tax rulings pointed that tax depreciation is not possible when the real estate property is measured at fair value. The beginning of the year 2023 saw rulings of the Regional Administrative Courts favourable to the taxpayers, in which the courts found the new regulation that capped the tax depreciation expense to lack precision and ruled that tax depreciation of investment property should not be disallowed. The case has not been finally determined. Many entities remain cautious and do not classify depreciation charges on a building to tax-deductible expenses.

This way the tax base of a real property reflects its initial amount less any accumulated depreciation of fixed assets other than buildings, at the rates set out in appendix 1 to the Corporate Income Tax Act.
The carrying amount is the fair value usually determined by a property valuer.

This way as at the end of the reporting period, measuring an asset at fair value results in a temporary difference that will lead to deferred tax assets or liability.

Rent-free periods and fit-outs included in rental agreements

Rent-free periods or any types of fit-outs must be recognised on a straight-line basis over the term of the agreement and as such constitute prepaid expenses. An important issue to consider is different accounting for rent-free periods under the tax and accounting laws.

Property developer's capitalisation of costs

If a property developer capitalises costs as inventory, a cost capitalised in the balance sheet becomes a tax-deductible expense when it is incurred.

Tax losses

Property development companies incur tax losses when the project is being carried out, because they generate profits only when the project has been completed and individual apartments/building are sold. Tax losses can be set off against future profits, so a deferred tax asset must be recognised on a tax loss. However, entities must exercise caution in recognising

deferred tax assets, because it must be highly probable that the asset will be realised, namely profit must be generated in future so that any losses can be deducted from the taxable profit.

The examples show that calculating deferred tax is a critical step in calculating a company's bottom line. We said that in the beginning: deferred income tax is highly informative and has a decisive role in evaluating an entity's financial and economic situation.

If you need help with identifying economic events that could give rise to deferred tax, our multidisciplinary team is here to help. We have extensive, practical experience in calculating deferred tax both for companies following the Accounting Act and the International Accounting Standards.

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