Investments on rented property – end of story

This edition of our Hungarian accounting newsletter deals with investments on rented property, which also may have tax implications.

Investments on rented property

In practice, investments on rented property mainly give rise to the question: what should be done by the lessee after the term of the contract when assets have been built in to rented property? At best, the rental contract stipulates that the property should be restored to its original state and also specifies who shall bear related costs. However, many questions arise even in this case. How should 'original state' be interpreted? Does it mean that all assets installed by the lessee should be dismantled and the assets which were previously there should be reinstalled? For example, the lessee may have replaced the dilapidated parquet flooring previously covering the floor with brand new tiles, or replaced the electric wiring. In such a case, should the tentant smash the tiles up and re assemble the old parquetry, or should it pull the new wiring out of the wall? How should it be booked if he does not do this?

The contract may also stipulate that the installed assets are transferred to the lessor's ownership at the end of the term of the contract. This can be for consideration or for free. It may happen that the contract contains no provisions relating to the installed assets; if this is the case, it may be questionable how the abandoned assets at the property should be accounted for.

Scrapping or free transfer?

Besides investments on rented property, other situations may arise when a company discontinues the use of a tangible asset, but does not dismantle the asset, as on the one hand, the company has no such obligation, and, on the other, it would not be worth dismantling the asset due to the high costs of dismantling. An example is a construction project for which the contractor builds a substructure for the cement mixer on an area owned by the customer, then uses the mixer for making concrete during the construction work, but after completing the building, the contractor does not dismantle the substructure which is no longer being used - instead it is left on the customer's territory (similarly to the assets left in a rented property). This gives rise to several questions. One is whether it should be scrapped. If yes, then how should the scrapping be documented in a credible way that also meets the requirements of tax legislation, when the asset is not dismantled or destroyed physically? But, if the asset is not dismantled or destroyed, as in the case of the substructure of the cement mixer built on an area owned by the customer in the above example (or the wiring and tiles left in a rented property), can it be scrapped at all? The question arises whether there was a free asset transfer by the contractor to the other party, the tax consequences of which should be taken into account. In the example, was it not an enrichment for the customer that the constructor abandoned the substructure, i.e. did they not receive assets free of charge? Just think of a situation where the customer in the example can use the substructure of the cement mixer for nothing: conversely, he may even incur costs because he

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has to dismantle it (or must pay a contractor for dismantling it), and compare it with a situation where the substructure was not dismantled because the customer could use it for some purpose. From a taxation perspective a further question exists as to whether the assets written down to nil in the books may have any tax effects, as according to the Act on Corporation and Dividend Tax, these assets may still have tax carrying values or their market value may be above zero.

Returning to the example of the rented property, therefore it is a question whether the asset transferred still has any value – can the lessor use it for any purpose? But even if the lessor can use it, it is questionable whether it really received these assets free of charge. Did the lessor not compensate the lessee for the assets through the rental over the rental period by requiring a lower rental (or in the example above, compensation by the customer to the contractor through the contractor's fee), particularly if the contract cannot be terminated via notice? If the lessor can no longer utilise the assets and therefore the assets have to be dismantled, who shall bear the costs of dismantling? If the lessor undertakes dismantling, is it actually he who bears the costs of dismantling? Do the rentals cover the dismantling costs as well, and are therefore these costs borne by the lessee after all? An additional question may be what amount of the value of the investment on rented property should be allocated to the abandoned assets and using what method, i.e. how should their value be determined (for example the value of the built-in wiring or the value of the tiles)?

Useful life and residual value

Tangible assets created in the framework of investment on rented property are recorded among the tangible assets of the company and their useful lives and residual values have to be determined in order to account depreciation. However, this may give rise to several questions for investments on rented property. Determining the useful life of a tangible asset created in an investment on rented property may be relatively easy in the case of some fixed-term rental contracts which cannot be terminated by notice, since basically the useful life cannot be longer than the rental period (but it can be shorter). In other cases however, it is a question how the useful life and the rental period relate to each other. For example, can the useful life be longer than the rental period, if the fixed-term rental contract can be extended, or can the useful life be longer than the non-cancellable period under an open-ended rental contract? If termination or extension is up to the lessee, then can the lessee's expectations relating to whether it wants to extend the contract be taken into account, and how should a change in the lessee's expectations be taken into account? The Act on Accounting prescribes that if any material change has occurred in the factors (duration of use of the asset, actual value and estimated residual value of the asset) taken into consideration at the time of the establishment (planning) of the annual depreciation to be claimed in respect of tangible assets, the ordinary depreciation to be claimed may be amended, but the quantified effect thereof on the profit or loss shall be disclosed in the notes on the accounts. If the lessee has the right to extend the rental contract then it may review its estimate for the useful life in each year. If the expectations of the lessee relating to the extension of the contract change from one year to the next, then it can re-estimate the useful life and, when this is performed, can account for the depreciation based on the new useful life. The change in the estimate relating to the useful life may involve a change in the estimate for the residual value as well.

Another question is, if the rental contract is terminated by the balance sheet preparation date, how should this be taken into account as of the reporting date, and what shall be done if the termination takes place after the balance sheet preparation date, during the year? Does the termination of the rental contract justify changing the useful life so that the asset be written down to zero or to its residual value by the last day of the termination period? Should extraordinary depreciation be accounted for? The Act on Accounting does not fix any date for the review of changes in the factors relating to the useful life, but the termination of a rental contract seems to be an event that would justify such a review.

End note

This newsletter was neither intended to deal with all possible transactions, nor to give answers to all questions which may arise. If you still have any uncertainties or our newsletter gave rise to some, we recommend that you contact your tax or accounting advisor or contact us, since a thoroughly thought-out and well-developed methodology may contribute significantly to the ability of the books to give a true and fair view of the financial position of a company, of its financial performance and of the result of its operations.

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