

Changing rules of the fixed-sum
compensation for debt recovery costs
Legal newsletter



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Deloitte Legal Szarvas, Erdős and Partners Law Firm provides its clients with a monthly newsletter on the most recent changes and newly adopted regulations in economic law and the most notable legal cases.

The rules of compensation for debt recovery costs have been amended and transferred from the Civil Code. The existing practice of both the accounting and the tax treatment of the compensation changes.

Rules of the fixed-sum compensation for debt recovery costs before the amendment

The rules of the fixed-sum compensation for debt recovery costs were incorporated into the Hungarian Civil Code in line with Article 6 of directive 2011/7/EU. According to the old rule, **companies and contracting authorities in default on contractual payments were required to pay to the creditor, in addition to default interest, a fixed-sum compensation for debt recovery costs in forints equivalent to at least EUR 40**. This obligation arose automatically, merely from **the fact of default on payment**, without the need for a reminder from the creditor or any other action aimed at the enforcement of the claim. The parties could not agree on a compensation lower than the statutory amount. The parties could not agree in advance to dispense with the compensation; however, once the debtor was in default, **the creditor could decide to waive its claim for the compensation**.

Previously, both the National Tax and Customs Authority and the Ministry of Public Administration and Justice published their opinion on the accounting treatment of the compensation. They agreed that the debtor (party in default) should enter compensation — both the paid and the due but unpaid — in its books as **other expenditure** even if the creditor had not yet claimed it. **Debtors whose obligation had been waived by creditors were required to derecognise the amount entered in books as extraordinary income. The extraordinary income thus recognised by the debtor was subject to corporate income tax**. The debtor incurred no stamp tax payment obligation in connection with the waived compensation.

The creditor had to account **compensation paid before the balance sheet preparation date as other income**. The **compensation waived did not need to be entered** in the books. Income from the compensation is subject to corporate income tax at the creditor. The fixed-sum compensation for debt recovery costs was the sanction for late payment so supply and service delivery in return for the paid compensation was not applicable under the VAT Act. That financial performance was not subject to the VAT Act, i.e. VAT payment obligation did not incur.

Practice related issues concerning the old regulation

According to the Civil Code, the **debtor in default had to pay the compensation even if the creditor ignored it**, although the directive implemented does not include such an obligation. Pursuant to the directive, the creditor is entitled to claim the compensation. **It means that Hungarian regulations had implemented applicable rules different from the content of the directive** and thus had made their practical application difficult.

According to the position of the National Tax and Customs Authority and the Ministry of Public Administration and Justice, the compensation for recovery costs could lead to situations where companies regularly in default for payment creditors may never be able to collect, could account considerable debt. So with time, financial statements could turn out to report poorer finances than the actual one, even unrealistic capital loss.

Furthermore, the compensation is not a real solution for smaller enterprises to tighten payment discipline, since they only risk their vendor position if they try to enforce their claim to the compensation from the debtor in default of payment.

New regulation

Act IX of 2016 on the Fixed-Sum Compensation for Debt Recovery Costs entered into force as of March 24, 2016. The bill had been discussed by the Parliament in an accelerated procedure in order for the provisions of the new regulation to be applicable even to FY 2015 financial statements.

The act removes the provisions concerning the compensation from the Civil Code. Compared to the previous regulation, **the new act reflects the directive better** since it is no longer the debtor's obligation to pay the compensation but it is the creditor's right to claim it. Therefore, as of the entry into force of the new law, the obligation to pay the compensation arises not from of the fact of default for payment, but solely from the creditor's claim.

While the Civil Code required the debtor to pay the compensation in case of default on payment obligation under any contract type, the new law, in line with the directive, allows the creditor to claim this amount **only in the case of sales and service contracts**.

The new law provides the creditor with a **1-year term of limitation commencing on the date of default on payment by the debtor**, to enforce its claim for the compensation. Creditors of unpaid debt arising from contracts signed before the entry into force of the new law will have 1 year from the law becoming effective to enforce their claim of compensation. This essentially gives the **law a retroactive effect**, as it will be applicable also to existing payment obligations and default thereof.

The law includes a **provision relevant for accounting**, which says that upon entry into force of the law, companies may write off compensation payment obligations kept in the books against other income should the creditor fail to claim them before it entered into force. The thus resulting proceeds qualify as income subject to corporate income tax. As a result, legal and accounting treatment of existing and future defaults on payment become identical. The law allows this retroactive provision to be applied also to FY 2015 financial statements that have not been closed yet.

Expected practical impact of the new act

The new law eliminates the deficiencies of the compensation provisions of the Civil Code arisen from particular provisions being needlessly stricter than the directive. So as of the entry into force of the new law, **the obligation to pay the fixed-sum compensation for debt recovery costs arises from the creditor's claim rather than from the act of default on payment.**

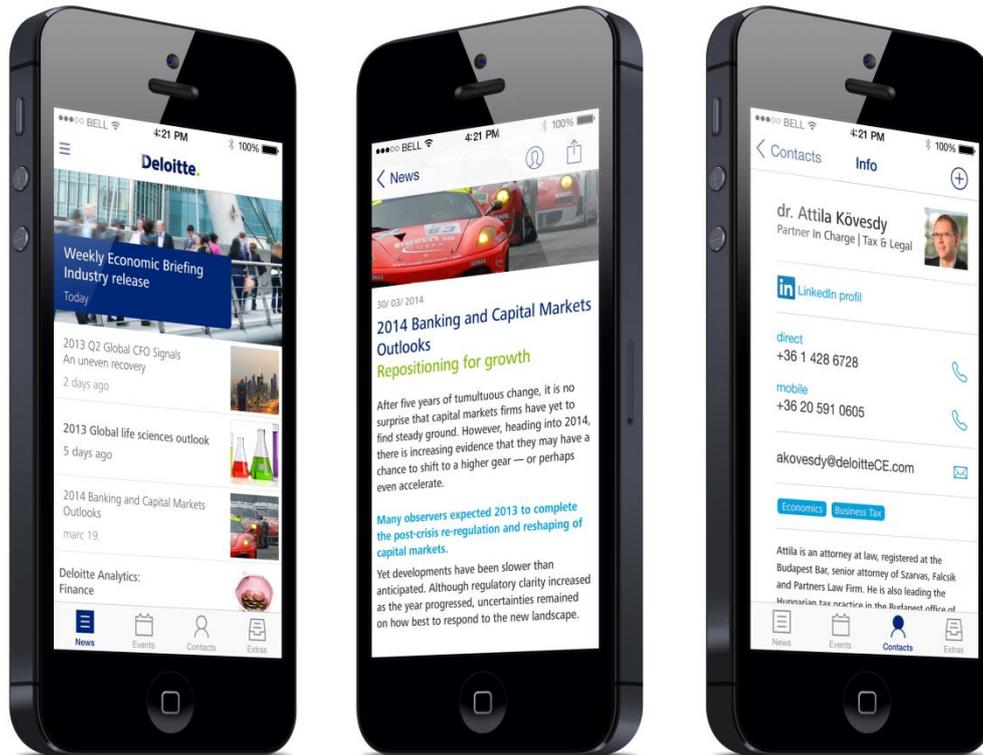
By limiting the time of the creditor to enforce its claim to 1-year, the Hungarian Parliament can effectively **reduce the gap between paid and due but yet unpaid compensation.** This will settle compensation claims faster either by the creditor enforcing its claim earlier, or through the sooner elapse of the period during which the debtor cannot know whether the creditor has waived its right to the compensation or has only not yet claimed it. As a result, **financial statements will provide a more accurate picture of debtors' finances** than what would be the case should the general term of limitation apply to the claim enforcement.

The most important change from the accounting perspective is that debtors in default of payment will only have to keep the obligation in their books if the creditor expressly claims it in a payment notice. Creditor related provisions remained the same by prescribing compensation to be entered in books only after it has been paid.

In case the creditor expressly claims the compensation and, therefore, the debtor discloses the amount in its books, should the creditor waive the debt, the income recognised with respect to the waived debt remains subject to corporate income tax.

All in all, the act changes those rules of the compensation that caused the highest uncertainty in practice, namely, that its **payment will not be an inevitable obligation under the law** but the creditor may claim it at its discretion. The change eliminates legal uncertainties and solves the questions of accounting treatment, as well.





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