

Newsalert

International Tax Services – Hungary

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PwC International Tax Services network

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PwC is a leading provider of international tax services to companies operating cross border. The International Tax Services network provides access to recent tax news and advice on holding company structures, cross border financing and treasury solutions, controlled foreign company planning, profit repatriation, loss utilization, inbound and outbound structuring, managing intellectual property, tax efficient supply chain and shared services, and European, Asian, and Latin American tax law.

This Newsalert does not provide a comprehensive or complete statement of the taxation law of the countries concerned. It is intended only to highlight general issues which may be of interest to our clients.

For issues relating to this news alert please contact your local international tax services advisor, Christoph Schreiber at +49 69 9585 6300 or the specialists listed at the end of this article.

Update on Hungarian International Tax Structures

The purpose of this letter is to provide you with an update on the recent changes to the Hungarian tax legislation, in particular those that will affect the activities of the companies formerly having offshore status and those that are in Hungarian international tax structures. These companies are still able to continue their operations in Hungary under the following favorable provisions.

1. Low effective income tax with the 50% exemption regime

The general corporate income tax rate for Hungarian companies is 16%. Besides that, another type of income tax called solidarity tax is also levied on companies at a rate of 4%. The corporate tax legislation provides an exemption from taxation for 50% of income from royalties and for 50% of related-party net interest. The deduction cannot exceed 50% of the pre-tax profit. For solidarity tax purposes, the accounting depreciation is allowed; however, no 50% deduction is available for licensing and for financing activities. This results in an effective income tax rate on related party interest income of around 12-13% and maybe even less on royalty income. If a Hungarian company uses a foreign branch to carry out its licensing or financing activities from the branch, the effective income tax rate could be reduced to 2-3% depending on the circumstances. Most commonly used branch locations for Hungary are Luxembourg and Switzerland.

The EU has opened a formal investigation procedure under EC Treaty state aid rules into the tax deduction relating to the taxation of interest in the context of intra-group transactions. PwC has been contacted by the Government and Ministry of Finance to form an Expert Panel with the other Big 4 firms to assist in dealing with this issue. We note that an adverse decision on current branch structures should have relatively little impact on the effective tax rate; worst case: about 0.4% increase in tax rate.

We would like to highlight the transfer pricing requirements that currently exist in Hungary. All taxable entities are required to ensure that the corporate income and solidarity tax base on which their tax liability is based is determined at arm's length prices, in accordance with specific provisions. In addition, Hungarian companies with inter-company transactions are required to have transfer pricing documentation with specific contents in place.

2. Holding company regime

Hungary also offers a good holding company regime. Due to the recent positive changes we experienced that Hungary is more commonly used as holding location in global international structures, e.g. parent of US companies or Intermediary to Asia.

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Income tax exemption on dividends and capital gains

Dividends received by a Hungarian company from its foreign subsidiary are exempt from corporate income taxation and from solidarity taxation except those from controlled foreign companies. Additionally, a participation exemption for capital gains is available. Under the current regime, a shareholding tax over 30% held for at least one year, with an acquisition of which is reported to the Tax Authority in 30 days could be regarded as a “registered shareholding”. Capital gains earned on a registered shareholding are exempt from corporate income tax and from solidarity taxation. We note that capital losses or impairment losses on a registered shareholding are non-deductible. In addition, a controlled foreign company cannot be qualified as a registered shareholding.

No withholding tax on dividends, royalties, interest paid from Hungary

Based on domestic rules Hungary abolished from its domestic rules the withholding tax on dividends, royalties and interest paid out from Hungary to companies, which are resident abroad.

Favorable double tax treaty network

Hungary has over 60 double tax treaties (including Singapore and China) which mostly follow the OECD Model Convention. Many of Hungary's double tax treaties provide an exemption method for income from foreign permanent establishments and zero withholding tax on interest and royalties.

In Hungary's international tax structures, the double tax treaty with the US from 1979 has a key role, which has been and is currently under negotiation with the U.S. The main expected amendment that potentially has an impact on our operations is the introduction of a limitation on benefits (i.e. anti-treaty shopping article) in the new treaty.

No local business tax and no R&D tax

Commercial activities in Hungary are subject to local business tax. The maximum tax rate that can be levied is 2%. The tax base is a specially adjusted turnover, however, royalty, interest, dividend and capital gain income do not form part of the local business tax base. A smaller tax called R&D tax of 0,3% is levied on the local business tax base thus the mentioned income types are not subject to R&D tax either.

Foreign currency bookkeeping available

The possibility of having foreign currency books is one of the key factors to consider when structuring. In Hungary, former offshore companies are entitled to use any foreign currency for bookkeeping until Hungary joins the European Monetary Union. In addition, companies which carry out

their activities in one currency, called functional currency, are also entitled to keep books in this currency subject to complying with the conditions that at least 75% of financial assets and liabilities, revenues and costs & expenses should occur in the chosen currency.

Binding tax rulings available

Upon the request of the taxpayers, the Hungarian Ministry of Finance issues binding tax rulings for future transactions or future structurings. The binding ruling is recommended for international tax structurings especially for those that are the branch structures. Since the Tax Authority is in practice entitled to audit a company for 7 years, the binding ruling is a good vehicle to achieve a pre-transaction certainty of the future taxation consequences.

More favorable CFC regime from 2008

The new legislation greatly simplifies the definition of a controlled foreign company. A foreign company may be regarded as a controlled foreign company if the effective tax rate is less than 2/3 of the Hungarian tax rate. However, the CFC rules will not have to be applied if the entity is resident in a country which is an EU-member, an OECD member or if there is a double tax treaty between the country of entity and Hungary.

3. Separation of seat and central place of administration from September 2007

The new provisions of the Company Registration Act provide a new definition for the term ‘seat’. It became more specific and now only pertains to a company's registered office. At the same time, a company can have its central place of administration (decision-making) at a location different to its seat, which provides greater room for maneuver.

4. More favorable value added tax (VAT) reclaim rules from 2008

Financing is a VAT exempt activity in Hungary, which means that according to the general rules, the input VAT charged by domestic suppliers is not deductible and cannot be reclaimed. Since May 1, 2004, Hungary's accession to the EU, financing activity is still VAT exempt, however, financing to non-EU companies gives rise to right to deduct the related input VAT. Companies carrying out licensing activities also have the right to deduct input VAT. Effective from January 1, 2008 a new value added tax act was issued which significantly simplifies the VAT reclaim rules.

5. Audit of the Annual Financial Statements

The rules of the compulsory audit of the Annual Financial Statements have changed and with effect to financial

years starting after December 31, 2006, the obligation of the one-member companies to audit their financial statements irrespective of any other circumstances was abolished.

6. REPO structures

It is possible to implement a REPO structure using Hungary and we are seeing more of these being done. A REPO is a hybrid debt instrument that is treated as equity in Hungary for legal and accounting purposes but as debt in the US or other foreign jurisdiction for tax and accounting purposes. The benefits in Hungary are the following: (i) easy to implement; (ii) risk free in Hungary as a binding ruling can be obtained in advance; (iii) participation exemption on dividends received by a Hungarian company; (iv) no withholding tax on dividends paid out; (v) minimum cost is a minor profit to be left at the Hungarian company.

We trust that you find the above information useful. Should you have any questions, please contact your regular advisor or the Hungarian International Tax Structuring (ITS) team members below.

For more detailed information, please do not hesitate to contact:

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