

The Brief

January 2010

NEWSFLASH

Hungary

2010 Tax Law Changes

This newsletter outlines the major amendments to Hungarian tax legislation to be introduced in several steps throughout 2010, notably those passed on 8 July and 9 November 2009. Unless otherwise stated below, the amendments entered into force on 1 January 2010.

In brief, the major features of the amendments are as follows:

- Significant changes to corporate income tax base modifying items
- Stricter anti-avoidance rules for controlled foreign companies
- 30% corporate withholding tax
- Preferential corporate income tax rules for foreign-source interest
- Adverse corporate income tax and transfer tax law changes affecting the real estate sector
- New place of supply rules for VAT
- 'Super gross' calculation in personal income tax
- Changes in social security contributions
- More flexible functional currency bookkeeping rules

We confine ourselves to looking at the major amendments that are most relevant to our clients' activities. Please note that the summary below is by no means exhaustive and should not be taken as legal or tax advice. For individualised tax and legal consulting, please contact our advisors at the contact details displayed at the end of this newsletter.



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CORPORATE INCOME TAX

Changes in tax rate

The general corporate income tax ("CIT") rate is increased from the current 16% to 19%. However, the 4% solidarity surtax (historically increasing the former 16% corporate income tax rate to an effective 20%) has been abolished (except for the solidarity surtax on banks, which remains in force).

Changes in tax base modifying items

The most important changes in the increasing and decreasing items are the following:

- Local business tax paid is no longer deductible;
- 50% of the interest spread received from related parties is no longer deductible, while 50% of net related party interest expense no longer increases the tax base (replaced by a preferential taxation of foreign-source interest, as described later on);
- Grants and cash provided without a repayment obligation, assets and services granted without consideration, as well as cancelled liabilities no longer increase the tax base. At the same time, these items are now generally taxable at the recipient party. Preferential rules remain in place for donations, but are limited only to certain cases (see in detail later on);
- 50% of the gain from transactions made on regulated capital markets is no longer deductible;
- Certain grants provided to foreign recipients resident in non-treaty countries or controlled foreign companies are not tax-deductible;
- The tax exemption of capital gains on shares held in small and medium-sized enterprises is abolished;
- In addition to receivables qualifying as irrecoverable under the accounting provisions, taxpayers will be allowed to decrease the tax base by 20% of receivables that have been overdue for more than one year. This deduction is already applicable for the 2009 tax year;
- In addition to irrecoverable receivables, receivables are now also tax-deductible if forgiven to private individuals or to unrelated Hungarian corporations;
- Forgiven debts are now tax-deductible (and, accordingly, taxable at the beneficiary), unless forgiven to the benefit of a related party;
- Research and development costs only decrease the CIT base if incurred within the taxpayer's own activities;

- Representation costs and business gifts will qualify as non-business related expenses, thus becoming taxable;
- The modifications make it clear that any further preferential transformation or exchange of shares should not give rise to taxation at the shareholder level until the shares are disposed of by the shareholder;
- Development reserves shown as tied-up reserve in the 2008 annual report can be released tax free in six years instead of four years. The new provision can be applied already for the 2009 tax year;
- As a beneficial rule, training costs will qualify as business expenses irrespective of whether the training is provided to an employee or to another person, or whether it is related to the individual's duties;
- Credit institutions will also be entitled to carry forward losses (i.e. the negative tax base) to offset future profits already in the 2009 tax year.

Stricter rules for controlled foreign companies ("CFC")

The definition of CFC has undergone significant changes, potentially affecting various financing and holding structures. Under the new taxation rules, a foreign company will qualify as a CFC provided that:

- (i) it has a Hungarian tax resident private individual shareholder with at least 10% or a 'dominant' quota for the majority of the days ('real shareholder') of the tax year, *or*
- (ii) the majority of the foreign company's revenues derives from Hungarian sources in the tax year;

and

- (i) the ratio of the corporate income tax paid (payable) by the foreign company (decreased by any tax refunded) and the tax base is less than 12.67%, *or*
- (ii) no corporate income tax is due as the foreign company's tax base is zero or negative despite its positive profits.

As an exception, foreign companies meeting the above conditions will not qualify as a CFC if:

- (i) they are seated or resident in an EU member state, an OECD member state or a treaty country, and have a 'real economic presence' (i.e. at least 50% of the company's group-level revenues derives from manufacturing, processing or e.g. commercial services performed by using its own assets and employees), *or*



- (ii) at least 25% of the foreign company's shares are held on each day of the tax year by a company or its affiliate that has been listed on a recognised stock exchange for at least five years on the first day of the tax year.

It is important to note that the burden of proving the exemption from the above CFC definition lies with the taxpayer.

Taxation of a CFC's undistributed profits

There are a number of traditional anti-avoidance taxation rules pertaining to CFCs. In addition, it is now a new rule that even the *undistributed* profit from a CFC to a direct Hungarian shareholder of at least 25%, or having a 'dominant' quota, becomes taxable at the shareholder level, prorated to the quota held on the last day of the tax year. The participation exemption regime provides no relief from this, as it does not apply to CFC-source dividends.

This rule does not apply – i.e. the undistributed profit triggers no CIT – if the Hungarian taxpayer has a Hungarian tax resident private individual shareholder of at least 10% or having a 'dominant' quota (i.e. a 'real shareholder').

In practice, this means that such profits trigger accelerated taxation at the Hungarian shareholder level when performed by the CFC, even if distributed to the shareholder only in a later period. Nevertheless, we note that if the quota is alienated later on due to the termination of the CFC or a decrease in its capital, the tax on the undistributed profit can be recovered from the tax authority.

Withholding tax

From 2010, interest, royalties and service fees (including management, management consultancy, advertising, market survey, public survey and business agent services) will be subject to a 30% withholding tax if paid by a Hungarian company or a Hungarian permanent establishment of a foreign company to a foreign entity resident in a non-treaty country.

As an exception, interest paid by the Hungarian state, certain state-owned financial institutions and credit institutions, as well as interest generated on securities (bonds) introduced at a recognised stock exchange in EU, EEA or OECD member states, along with late payment interest are exempt from the withholding tax.

To avoid the withholding tax, the payer has to obtain the recipient's residence certificate, justifying that it is in fact resident in a treaty country.

Rules affecting the real estate sector

It is a significant change that foreign entities holding shares in 'real estate companies' will qualify as Hungarian taxpayers and will generally be subject to CIT in Hungary upon the termination of the participation. This involves the disposal (i.e. sale, in-kind contribution or transfer without consideration) or withdrawal of a quota in a 'real estate company'.

A taxpayer qualifies as a 'real estate company' if:

- (i) the value of Hungarian real estate exceeds 75% of the aggregate market value of the total assets shown in its financial statement on a group level (including the taxpayer, its Hungarian tax resident related companies and its foreign related companies with a Hungarian permanent establishment – either with or without Hungarian real estate); *and*
- (ii) any of the shareholders of the taxpayer or of the group members is resident on at least one day of the tax year in a non-treaty foreign country or in a treaty country where the double tax treaty allows Hungarian taxation on such capital gains.

These rules do not apply if the real estate company is listed on a recognised stock exchange.

The tax liability arises on the day when the shares are alienated or the registered capital is decreased, whereby the foreign entity has to register with the tax authority. The CIT is due by 20 November following the relevant tax year (for the first time by 20 November 2011).

The above entails several administrative burdens, including the evaluation of the market value of the real estate and the total assets of the real estate company and its related entities, notification obligations among the group members, and a reporting obligation with the tax authority.

Rules affecting financial enterprises

Already applicable to 2009, financial enterprises operating in accordance with prudential requirements:

- (i) do not have to increase their CIT base by the impairment of receivables derived from financial services;



- (ii) should not decrease their CIT base by the write-back of the historic impairment of receivables and bad debts, and the income exceeding the book value of their receivables;
- (iii) should not take into consideration for thin capitalisation purposes the debts related to their financial services.

Development tax allowance

The tax law amendments introduce several favourable changes in terms of development tax allowance:

- The development tax allowance will also be available to small and medium-sized companies provided that their investment value reaches HUF 500 million (EUR 1.8 million) and that certain other conditions are met;
- In the case of investments above HUF 3 billion (or, in certain cases, 1 billion), taxpayers are allowed to choose a more favourable base for monitoring their headcount/wage increase (i.e. the average of the data of the last three years preceding the investment instead of the data of the year before the investment). This alternative will also be available in the case of investments by small and medium-sized companies. The new provisions can be applied only to requests filed after 31 December 2009 (except for certain investments);
- A temporary relief is granted for the 2009 and 2010 tax years with respect to the headcount/wage increase criteria. Thus, if these criteria are not met in 2009 and/or 2010, the taxpayer does not lose eligibility for the development tax allowance. The relief may only be applied upon a request filed to the Ministry of Finance no later than the due date of the 2009 CIT return (failure to respect the deadline cannot be excused). Alternatively, the taxpayer can still repay the development tax allowance already received over three years in equal instalments without a self-revision interest;
- The development tax allowance can be claimed irrespective of the number of newly created jobs in the case of investments in job creation. The new rule applies to requests filed after 31 December 2009.

Reshaped scheme for grants and donations

From 2010, the grantor of donations does not have to increase its CIT base by the grants provided, i.e. it is tax deductible as opposed to earlier years. However, grants received qualify as a taxable income for the beneficiary.

As a special rule, certain donations received are partly tax-exempt, provided that the beneficiary is a priority public benefit organisation (deductibility ratio is 50%) or the grant is provided under a long-term donation contract (deductibility ratio is 20%). However, the overall cap for the deduction is 100% of the pre-tax profit.

Transfer pricing

The transfer pricing rules will be extended to the foundation of companies as well to the in-kind contributions to the registered capital if the contributor thereby obtains a majority control in the newly founded company.

Another change is that the transfer pricing rules will also cover transactions between foreign enterprises and their local permanent establishments, as well as the transactions between taxpayers and their foreign permanent establishments.

There are new rules relating to the administrative requirements for transfer pricing documentation, allowing the preparation of joint declarations for example. At the same time, the procedural fee for 'advance pricing arrangement' procedures has been significantly decreased.

Preferential rules for foreign-source interest

If receiving interest income from a foreign source, Hungarian taxpayers and the Hungarian permanent establishments of foreign companies have to exclude 75% of this interest from their CIT base, even if the relevant treaty prescribes that this income is taxable in Hungary. This means that only 25% of this interest will be subject to CIT, leading to an effective tax burden of only 4.75%.

Temporary tax amnesty extended

A temporary tax amnesty was set up earlier for 2008 and 2009 tax liabilities in early 2009, claiming that retrieving dividends and certain capital gains from a CFC are 75% tax exempt if at least 50% is invested into state bonds for at least two years.

This temporary tax amnesty is now extended provided that the underlying dividends are realised by 31 December 2009. A further benefit is that the investment into Hungarian state bonds will no longer be a precondition.



Other modifications of interest

- To *carry forward losses*, tax authority approval is no longer required, already applicable to 2009. However, it is a precondition that the negative tax base was generated observing the principle of the proper exercise of rights;
- The *definition of 'related party'* is extended to Hungarian taxpayers and their foreign permanent establishments, as well as the foreign permanent establishments and the related parties of the Hungarian company;
- The *tax deferral scheme for preferential transformations and preferential transfers of assets* will only apply in the case of a foreign recipient inasmuch as the assets and liabilities remain with the foreign company's Hungarian permanent establishment;
- In the case of the additional acquisition of *reported participation*, the participation exemption applies only if the participation obtained beforehand reached 30% and has been reported to the tax authority.

VALUE ADDED TAX

New rules for the place of the supply of services

As a main rule, the place of the supply of services is, from 2010, where the recipient is economically settled, providing that he qualifies as a taxable person for VAT purposes. Otherwise, the place of the supply will be where the provider of the service is economically settled.

In addition to the above rule, there will be certain exceptions, e.g. the following:

- The place of the supply of *services directly related to real estate* is where the real estate is located;
- The place of the supply of *personal transportation services* is where the route is situated;
- The place of the supply of e.g. *cultural, artistic or scientific services* falls where the service is rendered.

To comply with the new rules, it will be crucial to duly observe the taxability of the recipient of the given service, as well as – if the recipient has more than one fixed establishment – the application of the 'force of attraction' rule.

Self-assessment of VAT on the importation of goods

From 1 September 2009, there have been less severe criteria for the VAT self-assessment on the importation

of goods. Thus, the limit of the tax exempt sales that entitles the taxpayer to self-assessment will be cut:

- (i) from HUF 12.5 billion to HUF 10 billion if importation comprises at least 67% of total annual supplies; *or*
- (ii) from HUF 25 billion to HUF 20 billion otherwise.

Notwithstanding the above, a self-assessment is also allowed if the concerned party is in possession of an authorised economic operator certificate or a permit to release goods to free circulation under a simplified procedure, without any monetary thresholds.

Recapitulative statement on services

In addition to the intra-Community supplies and acquisitions of goods, the intra-Community supplies and acquisitions of services now must also be reported in a recapitulative statement. The statement, to be filed electronically, must be submitted by the deadline of the VAT return, i.e. a monthly filing obligation may replace the former quarterly submissions in certain cases.

Other VAT amendments

- In the case of tax-exempt real estate, it is possible to *opt for taxation* only in respect of the sale and/or rental of non-residential properties;
- A *decreased 18% VAT rate* has been applicable to accommodation services and distance heating as of 1 August 2009;
- EU taxpayers wishing to file a *foreign VAT reclaim package* can do so with the tax authority of their registration, which will be forwarded to the relevant foreign tax authority.

LOCAL BUSINESS TAX

The state tax authority will soon take over the current local business tax competencies of the local tax authorities. Among other things, this will allow taxpayers to submit one single tax return to the central tax authority even if they have several permanent establishments in the territory of different local municipalities. However, there will be a separate tax return to report top-up payment obligations close to year-end. As a result of these changes, taxpayers will have to self-assess their tax advances.

It is important to note that the transfer of competencies will temporarily shorten the period open to self revision significantly, only to 31 December 2011 in respect of the 2009 and earlier taxation periods.



Research and development costs incurred by the taxpayer may decrease the local business tax base. In addition, the part of the tax base attributable to a foreign permanent establishment will be exempt from the Hungarian local business tax without further preconditions.

PERSONAL INCOME TAX

From 2010, the personal income tax base is the gross income increased by the employer's 27% social security contributions ('super gross' income). At the same time, the tax brackets have been significantly widened. The changes are summarised in the table below:

2009		2010		
Gross	Rate	Gross	Super-gross	Rate
0 – 1,900,000	18%	0 – 3,937,008	0 – 5,000,000	17%
1,900,001 – 7,446,000	36%	3,937,009 and above	5,000,001 and above	32%
7,446,001 and above	40%			

In addition to the above, the following changes are applicable from 2010:

- *Abolition of several tax allowances* (e.g. insurance allowances, donations, voluntary contributions to private pension funds, etc.);
- Most of the former tax exempt *cafeteria elements* (such as meal vouchers, transportation tickets, holiday checks, etc.) now trigger either decreased or normal flat rate tax;
- *Dividends derived from a CFC* will be taxable at the above tax rates instead of the former tax rates, resulting in higher tax;
- To *encourage long-term savings*, interest income from an investment of at least three years at a credit institution is taxed at only 10%, while a five-year investment is tax exempt;
- Similarly to corporate income tax, foreign non-resident individuals will be liable to a 25% personal income tax on their *capital gains on a quota in a real estate company*, if the individual is resident in a non-treaty country or the given treaty allows Hungarian taxation;
- A 30% *withholding tax* will apply to interest, royalties and certain service fee payments made to individuals resident in a non-treaty country, with some exceptions;
- *Undistributed profit from a CFC* is subject to 25% personal income tax.

SOCIAL SECURITY AND OTHER LEVIES

The following changes have been passed as from 2010 in relation to the various social security contributions:

Employer

- Social security contribution dropped from 29% to 27%;
- 3% unemployment fund contribution abolished;
- Rehabilitation contribution increased from HUF 177,600 to HUF 964,500 per capita per annum;
- Itemised monthly health care tax of HUF 1,950 per capita is abolished.

Employee

- The annual upper cap for the base of the pension fund contribution rises from HUF 7,446,000 to HUF 7,453,300;
- The former 1.5% unemployment fund contribution is abolished and replaced by 1.5% health fund and labour market contribution.

Health care tax

Where applicable – typically on other income as defined under the personal income tax rules – the former rate of 11% is raised significantly to 27%.

Market value of activities

As opposed to the former minimum base of entrepreneur's social security contributions, it is now minimised at the market value of activities, which has to be ascertained and documented by the taxpayer.

TRANSFER TAX

Taxation of indirect real estate acquisitions

Due to the modifications, transfer tax is not only levied on the acquisition of real estate but also on the acquisition of a quota in a real estate company, if the quota obtained reaches 75% either by the acquirer alone or, for example, with close relatives or its related companies.

A *real estate company* comprises a business association that:

- owns real estate located in Hungary, or
- has a direct or indirect quota of at least 75% in a business association that owns real estate located in Hungary.



The transfer tax is levied on the market value of the real estate, prorated to the quota being acquired.

A quota obtained more than five years before or before 1 January 2010, as well as inherited quota or quota acquired without consideration, are exempt from the above transfer tax. Also, the acquisition of a quota within a preferential transfer of assets is also exempt.

Decrease in transfer tax rates

The general rate of transfer tax is reduced from 10% to 4%. For real estate, the general 4% rate applies up to HUF 1 billion, while the rate on the excess is only 2%. These are capped at HUF 200 million per real estate. These rates also apply to the acquisition of a quota in a real estate company.

For residential properties, the tax rate remains 2% up to HUF 4 million, but the excess is taxed at only 4% instead of the former 6%.

Other amendments

- The general exemption of *properties obtained due to the transformation of companies* (merger, split-off) has been cancelled and only properties acquired through a preferential transformation are exempt from transfer tax;
- The acquisition through a *preferential exchange of shares* is also exempt from transfer tax.

GIFT TAX

Since 9 July 2009, the *free transfer of receivables* between business associations (including the free cancellation of receivables and the free assumption of liabilities) has been generally exempted from gift tax. Moreover, the *acquisition of movable property through a free asset transfer* between business associations is generally not subject to gift tax either, provided that these would not trigger a transfer tax if there was a consideration in return.

ACCOUNTING

More flexible foreign currency bookkeeping rules

All preconditions for bookkeeping in EUR have been cancelled, allowing the use of EUR as the functional currency for each business entity if set out in the company's accounting policy and its deed of foundation.

Other than EUR, companies may also apply another foreign currency if at least 25% of both of the following are incurred in that foreign currency in both the current business year and the preceding year:

- (i) revenues, costs and expenses,
- (ii) financial assets and financial liabilities.

TAX PROCEDURES

- For a decreased procedural fee, it is now possible to *extend the scope of binding rulings*, if proven necessary due to legislative or factual changes. In addition, it is now possible to apply for a binding ruling for so-called *ongoing continuous transactions*;
- The *fees of advance pricing arrangements* will be significantly lowered. In addition, only the minimum fee for the procedure is payable if the arm's length price or the price range cannot be expressed in exact numbers;
- The *competencies of municipal tax authorities* will be taken over by the state tax authority, as described in greater detail in the Local Business Tax section;
- From 2010, *closing tax returns* cannot be replaced by declarations even if the tax liability is zero.

FURTHER MISCELLANEOUS CHANGES

- *Inheritance tax* – as of 1 January 2010, inherited company shares (quotas) will be subject to inheritance tax (i.e. earlier exemptions applicable to certain cases have been abolished);
- *Excise duties* – excise duty rates are growing once again for goods such as cigarettes, petrol, diesel oil and alcohol;
- *Energy tax* – the tax rates of electricity, natural gas and coal are growing by 17% on average;
- *Cultural contribution* – abolished as of 1 January 2010;
- *Simplified entrepreneurial tax* – the tax rate is raised from 25% to 30%, and to 50% on the tax base exceeding the preferential threshold of HUF 25 million per annum.



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