

Hungary

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1 General: Treaties

1.1 How many income tax treaties are currently in force in your jurisdiction?

Hungary entered into income tax treaties with over 60 countries spanning the globe including the Member States of the European Union, most of the European countries outside the EU and with several American, Asian, Australian and African countries. The tax treaty with the US is one of the last US treaties not to include a LOB ('limitation of benefits') clause. Although this treaty has been under renegotiation since 2000, the new text, including the wording of the LOB clause which will undoubtedly be inserted, has yet to be agreed upon. There are no predictions on when the text will be finalised and accepted. We note that while a grandfathering period of at least one year is usually applied to re-negotiated US treaties, we understand that Hungary might ask for an even longer grandfathering period just as Ireland did. As a result, no changes to the existing structures are expected before 2008 under the worst case scenario, where benefits may still be available until 2009 or longer.

1.2 Do they generally follow the OECD or another model?

As a general rule the income tax treaties follow the OECD Model Convention.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

In compliance with the Constitution of Hungary, the treaties must be incorporated into Hungarian law by enactment of legislation. The date of entry into force is generally the day or the day following the day of publication, but it may also be that while the treaty is incorporated into domestic legislation immediately after its execution, all or part thereof may enter into force at a later date.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

As a general rule, the double taxation treaties do not contain 'limitation of benefits' clauses; however, in line with the OECD Model Convention, some of the treaties rely on the concept of beneficial ownership to eliminate treaty shopping with regard to incomes from dividends, interest and royalties.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

The provisions of double taxation treaties override domestic legislation with absolute supremacy, irrespective of their effect on the tax burden of taxpayers. Reciprocity also overrules domestic tax legislation; however its application cannot result in adverse consequences on the taxpayer.

2 Transaction Taxes

2.1 Are there any documentary taxes in your jurisdiction?

The companies must pay stamp duty for certain administrative procedures such as registration procedures and court proceedings.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

Hungary's VAT rules comply with the Sixth VAT Directive with minor exceptions. The general VAT rate is 20% and the preferential rate 5%. While the former applies to most transfer of goods and performance of services, the latter applies to the sale of a defined group of human pharmaceuticals, medical equipment, books and newspapers.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

In general, VAT must be charged by all individuals, legal entities and PEs that supply goods or services on a regular basis in Hungary. Certain transactions however are exempt from VAT with or without the right for deduction. Export, intra-Community supply or services, and sales relating to the international transportation and trade are exempt with the right to deduction. Numerous transactions are exempt without the right to deduction, important examples for which are:

- sale, rental of land;
- sale and rental of residential real property (excluding its first sale);
- rental of educational instruments;
- postal services;
- financial services;

- insurance;
- transfer or receivables and liabilities; and
- medical and social services, etc.

Under certain conditions, small businesses can elect to be VAT-exempt.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

The Hungarian legislation generally follows the Sixth VAT Directive, although there are minor exemptions.

Taxable persons registered for VAT have the possibility to deduct input VAT from the amount of tax payable. Foreign entities without a business presence in Hungary may reclaim the tax charged to them in accordance with the regulations of the Eighth Directive (VAT Refund Decree), provided that they are registered in their home country for VAT purposes.

As a general rule, input tax deriving from business activity is fully deductible. However, input tax on supply of goods and services used for exempt or non-business activities are not deductible to the extent they serve these activities. Moreover, the Hungarian Act on VAT defines further cases, when the input tax is not recoverable (e.g. purchase of fuel or a passenger car, purchase of food, taxi and parking services, etc.).

Input VAT in excess of VAT payable is generally reclaimable provided that certain conditions i.e. tax registration, proper invoice, the full payment of the purchase price, having exceeded a certain threshold of non-VAT-exempt activity or purchase of fixed assets) are met.

2.5 Are there any other transaction taxes?

The transfer of property for consideration is subject to transfer tax payable by the purchaser, calculated on the market value of the property purchased.

The duty on the transfer is usually 10% of the market value. The duty on the transfer of a residential property is 2% for the first HUF 4 million (approximately EUR 15,390 - a foreign exchange rate of 260 HUF/EUR is used throughout the chapter) and 6% above that amount.

The acquisition of a building site may be exempt from stamp duty provided that the purchaser builds a residential real estate within 4 years from the date of transfer.

The acquisition of the real property by a real estate investment fund or by an entrepreneur engaged in trading real estate or financial lease is only subject to a duty of 2% under certain circumstances, one of the most important of which is that the real estate is sold or leased (financial lease) within 2 years from the date of purchase.

2.6 Are there any other indirect taxes of which we should be aware?

Excise duties are payable by companies selling or importing certain goods i.e. alcoholic beverages, tobacco, mineral oil (petrol, gasoline, and other derivatives of crude oil). The tax payable is calculated on the basis of an amount per unit sold, or as a percentage of the price.

3 Cross-Border Payments

3.1 Would there be any WHT on royalties paid by a local company to a non-resident?

Royalties are not subject to withholding tax, irrespective of residence.

3.2 Would there be any WHT on interest paid by a local company to a non-resident?

Interest is not subject to withholding tax, irrespective of residence.

3.3 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

Hungarian thin capitalisation rules do not involve WHT.

Based on the Hungarian thin capitalisation rules, interest expense paid on the proportion of debt exceeding three times the borrower's equity is not deductible. The ratio is calculated on the basis of the daily average debt and equity at the end of the financial year.

The thin capitalisation regulations apply on all debt (including cash-pooling) other than towards suppliers, irrespective of whether the lender is a related or non-related party. However, they do not apply to debts towards banks or financial institutions.

3.4 If so, is there a "safe harbour" by reference to which tax relief is assured?

This question is not applicable as no WHT applies.

3.5 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

Keeping in mind that the thin capitalisation rules also apply to all debt except debt from financial institutions (even to cash-pooling arrangements), the application of the Hungarian thin capitalisation rules might be avoided through a so-called "quasi back-to-back" involving a bank. As indicated, the debt-to-equity regulations do not apply to loans, bonds or bills from Hungarian banks or financial institutions or authorised foreign banks with a local registered branch. As a result, routing the loans via a bank could reduce thin capitalisation issues.

3.6 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

No WHT is levied on such dividends.

3.7 Does your country have transfer pricing rules?

Yes. The Hungarian rules on transfer pricing are based on the arm's length principle, and the OECD's transfer pricing guidelines apply. If the prices applied by related parties are not arm's length, the parties should adjust their tax bases to reflect the difference between the fair market prices and the prices applied. If the respective adjustments are not made the tax authority may identify a tax shortage for the tax underpayment and impose i) a penalty of 50% of the tax shortage; and ii) a late payment interest of twice the prime rate of the National Bank of Hungary.

The market price must be determined by applying one of the following methods:

1. comparable uncontrolled price method;
2. resale price method;
3. cost-plus method; and
4. any other appropriate method.

The transactions between associated companies must be documented in accordance with the operative legal regulations.

For each type of transaction, transfer pricing documentation should be prepared to substantiate that the prices applied are at arm's length.

The documentation package can be prepared in-house (no third party valuation is necessary) and must be ready by the deadline of filing the corporate income tax return of the given tax year, e.g. 31 May 2007 if the acquisition takes place in 2006. The documentation package should not be filed with the tax authority but should be available if ever requested. If the documentation is not ready by the statutory deadline, a fine of HUF 2 million (approximately EUR 7,700) can be levied by the tax authority.

The necessary content of a transfer pricing documentation is regulated by law. Among others, the documentation package should:

- include a comprehensive functional analysis of the transaction and the activities of the related parties;
- introduce the method used when setting the transfer price; and
- detail the reasoning behind the choice of the given method.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

The headline rate of tax is 16%.

For the first HUF 5 million (approximately EUR 19,230) of taxable income, the tax rate is 10% provided certain conditions are met.

4.2 When is that tax generally payable?

The deadline for paying corporate income tax is generally 31 May of the year following the relevant business year. If the tax year of a taxpayer does not coincide with the calendar year, the deadline is 150 days from the end of the fiscal year.

Companies should top up their taxes payable for the given tax year by 20 December each year, up to 90% of their tax liability.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

If a company is a Hungarian resident, its taxable income is its worldwide income. The tax base is the accounting profit in the annual financial statements prepared based on the Hungarian accounting standards, adjusted by special increasing and decreasing items prescribed by the Tax on Corporate Income Tax.

Some of the key adjustment items are the following:

Tax base increasing items:

- accounts depreciation;
- costs and expenses incurred not directly in the interest of

business operation;

- 50% of the difference between interest paid to and interest derived from an associated company; and
- the book value of assets transferred without consideration, etc.

Tax base decreasing items:

- loss carried forward;
- tax depreciation;
- 50% of capital gains derived from stock exchange transactions (limited);
- the amount of development reserve, which can be 25% of pre-tax profit but up to a maximum amount of HUF 500 million;
- dividends received (with the exception of dividends received from a CFC);
- 50% of the difference between interest received from and interest paid to an associated company (limited);
- 50% of royalty income (limited); and
- the book value of assets received without consideration, etc.

From 1 January 2007 a compulsory tax base is introduced as a minimum tax base for corporate entities. If the tax base of an entity is less than 2% of the entity's total revenues reduced by the cost of goods sold and by the income attributable to a PE abroad, the minimum base (calculated as the latter) will apply. This rule does not apply in the pre-company period and the first tax year, and in those tax years when income from sales is less than 75% of the sales in the preceding year.

4.4 Are there any tax grouping rules?

There is no group taxation under the Hungarian legislation.

Although the Hungarian jurisdiction gives the parent company and its subsidiaries the possibility of preparing a consolidated annual report, the tax law does not permit company groups to file a consolidated tax return.

However, for the purposes of VAT it is possible to apply a tax group for financial institutions, but it may include a very limited scope of activities.

4.5 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

No, the corporate tax rate is the same for distributed and retained profits.

4.6 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

The question is not applicable.

4.7 What other national taxes (excluding those dealt with in "Transaction Taxes", above) are there - e.g. property taxes, etc.?

Solidarity tax

A 4% "solidarity" surtax featuring certain characteristics of the corporate income tax has been introduced and levied on the business profit of corporations from 1 September 2006. The tax

base will be calculated from the modified pre-tax profit, with a limited tax base increasing and decreasing items. Items which reduce the tax base are dividends received (if not from CFC); income attributable to a PE that is taxed abroad; free funds received without repayment obligation; and services received free of charge. Items which increase the tax base are tax paid abroad on foreign source income; funds granted without repayment obligation; and service provided free of charge.

The most relevant Hungarian taxes are (excluding the abovementioned property tax, VAT, corporate income tax, solidarity tax and local taxes below) the following:

- personal income tax;
- innovation contribution;
- bank tax;
- customs duties;
- excise duties;
- other contributions (social security contributions: pension fund and health care contribution, unemployment insurance contribution, vocational training contribution, contributions to the Cultural Fund, contributions to the Rehabilitation Fund);
- health tax;
- duties on inheritance and gift; and
- environmental charges, etc.

4.8 Are there any local taxes not dealt with in answers to other questions?

Local business tax

Companies registered in Hungary are subject to local business tax at a maximum rate of 2%. The tax base is the sales income less the costs of materials, costs of goods sold and mediated service fees.

Introduction of the local business tax is an option for local authorities, it is not introduced (or not at the highest rate) by every local government.

Property taxes

There are two types of real estate taxes which may be imposed by the local municipalities: (1) building tax; and (2) tax on land based on the Act on Local Taxes.

a) Building tax

The building tax is an annual levy imposed on the registered owners of a real property as at 1 January of each given year. The tax may either be calculated based on either the area of the building (in square metres) or on its adjusted market value. The adjusted market value of the property is 50% of the market value for transfer tax purposes.

The annual rate is determined by the municipality and therefore varies from region to region. The Act on Local taxes fixes the upper limit of the rate at HUF 900/m² (approximately EUR 3.5/m²) or at 3% of the adjusted market value of the building.

b) Tax on land

The owner of the undeveloped land (that is not built on) situated in the territory of an urban area may be taxed by the municipality. The tax is payable by the registered owner on the first day of the given year.

The method of calculation is the same as for the tax on buildings (see above).

The upper limit of the tax is fixed by the Act on Local Taxes at HUF 200/m² (approximately EUR 0.8/m²) or at 3% of the adjusted market value of the land.

Community tax of entrepreneurs

The tax is based on the number of employees and it may be imposed at a maximum rate of HUF 2,000 (approximately EUR 8) per employee per year.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

As a general rule, gains realised on investment in another company (resident or non-resident) are subject to corporate income tax (16%), while capital losses upon the transfer of shares are generally deductible. Hungarian legislation classifies as a tax base decreasing item the 50% of capital gains derived from certain stock-exchange transactions.

As of 1 January 2007, special rules are introduced concerning capital gains realised on "reported" investments. Capital gains on the sale of qualifying participations will be exempt from corporate income tax. To qualify for the relief on "reported" investments the participation should be at least 30%, have been held for at least two years, and have been reported to the Revenue within 30 days following its acquisition.

The two year holding period is not a criterion for tax relief on capital gains realised due to a reduction of capital or a termination without legal succession. On the other hand, the losses incurred on the qualifying participations will not be tax-deductible.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

The rate of tax imposed upon capital gains is the same as the general corporate income tax rate (16%); however as of 1 January 2007 the sale of qualifying "reported" participations will be exempt from corporate income tax under the abovementioned conditions.

5.3 Is there a participation exemption or relief for reinvestment?

No, there is no participation exemption or relief for reinvestment.

6 Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

There is no capital duty imposed upon the formation of a subsidiary or a branch, just minor registration fees.

The registration fees are as follows:

- HUF 600,000 (approximately EUR 2,300) for a public company limited by shares and European company limited by shares;
- HUF 100,000 (approximately EUR 390) for a private company limited by shares and limited liability companies;
- HUF 100,000 (approximately EUR 390) for other legal entities;

- HUF 250,000 (approximately EUR 960) for branch offices of foreign companies; and
- HUF 150,000 (approximately EUR 580) for representative offices of foreign companies.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

There are no such other duties.

6.3 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

A branch is the organisation unit of a non-resident entity with economic independence, and it is taxed at the general corporate tax rates (10% and 16 %) and is subject to solidarity tax (4%). If a non-resident entity has several branches in Hungary, the tax base of each branch must be calculated separately.

6.4 Would a branch benefit from tax treaty provisions, or some of them?

As branches registered in Hungary are not Hungarian tax residents,

these entities may not benefit from the treaty protection of the Hungarian double tax treaties. The treaty of the head office country should apply.

6.5 How would the taxable profits of a local branch be determined?

The tax base of a local branch must be determined as if it was an independent entity with special regard to some special adjustment items concerning administrative costs, and a special rule determining its minimum tax base.

As opposed to the minimum tax base of resident entities, the minimum tax base in case of branches is 12% of all costs and expenses accounted for by the branch in the given tax year.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

No withholding tax or other tax liability should apply in case of remittance of profits by a branch.



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Building from a premier position in France into a powerful independent international law firm, Gide Loyrette Nouel operates offices all around the world. GLN Budapest advises clients in all areas of business law, and has developed particular expertise in the areas of privatisation, corporate mergers and acquisitions, finance and banking law, taxation, competition law, real estate transactions, insurance law, communication, media and new technologies, employment law, intellectual property and litigation.

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The growth in our tax practice over 2005-6 has enabled us to build a core group of 4 tax lawyers with particular expertise in this area, now led by Dr. Orsolya Bárdosi. This group can, in turn, call upon the support and advice of the firm's highly-rated specialists in tax teams around the firm's 20 international offices.