

2007:

THE YEAR OF

contradictions

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The year 2006 proved that Hungary could not only hold its emerging position in the field of international tax planning, but strengthen it by introducing attractive new tax benefits. However this was no simple balancing act. On the one hand the regime had to survive the end of the classical offshore era (1994-2005); on the other, the general tax aggravation programme was announced after the parliamentary elections in the spring of 2006. For now Hungary shows the same contradictions as many other EU countries: attracting potential new foreign investors, whilst applying maximum pressure to domestic taxpayers. If only governments would recognise two elementary rules of the economy. Firstly the new foreign investor will soon become an angry national taxpayer, and secondly, high tax rates are in negative correlation to high tax incomes. Until governments accept these revelations we can only expect minor results.

Hungary is balanced between general tax aggravation and making the country more attractive in the international tax planning industry

THE BIG SQUEEZE CALLED 'THE NEW EQUILIBRIUM'

The real revelation of the re-elected government made in the early summer of 2006 was that the petty cash desk of the country was empty. The old-new,

social-liberal government was greatly surprised to discover that Hungary had accumulated the biggest state budget deficit in the EU in the last four years. The immediate order was given: 'We have to make an equilibrium!' But not only a simple and average equilibrium: 'We need the new equilibrium!' Of course nobody knows what is new in the 'new equilibrium', because the two pillars of the programme are very old: cut the costs of state administration and public subsidies, and increase taxes and other public contributions. Anybody can

imagine which of the two was sooner achieved. Some of the tax increases were introduced with effect on September 1, 2006, and the rest on the January 1, 2007. Hereunder I'll concentrate only on the changes to corporate taxation.

THE 'SOLIDARITY TAX'

The name of this new corporate profit tax is pure self-deception on the part of the government and very misleading. Of course the income from this tax will not provide the necessary public funding, but it could produce an extra source of income to fix the holes in the state budget. However the government has ensured that the greater part of society is liable for the tax. So maybe this is the only tax in the world, which is paid by individuals as part of their personal income tax and also by corporations on the basis of their profit.

As of September 1, 2006, solidarity tax was levied on corporations on the pre-tax profit reported in the annual financial statement, as adjusted by specific tax base modifying items. The applicable rate is 4% on the adjusted pre-tax profit. The subjects of this tax are also subject to the normal corporate income tax (CIT), which is set at 16% of the pre-tax profit. However the modifying items and method of the two taxes are different, so we cannot exactly say that the corporate profit is taxed by $16\%+4\%=20\%$. The two tax bases, must be adjusted separately considering the different modifying (increasing and decreasing) items. However for the sake of simplicity we can consider the applicable tax rate as being 20% of the profit.

THE LOCAL BUSINESS TAX (LBT)

Just like the IRAP in Italy, LBT is also against the 6th (VAT) Directive of the EU, both being classical turnover

tax. The business community of Hungary has sharply criticised this tax for a long time and even the old-new government had promised the abolition of it before the end of 2007 – before the election. However after the election the same government realised that 'the new equilibrium' would fall down without the LBT, so it will stay indefinitely. The only hope for taxpayers is that the first few court petitions against LBT have been already filed in the European Court of Justice in Luxembourg. The basis of the LBT is the net income (i.e. not the profit!), and the rate is maximum and generally 2% (the municipalities have the right to determine the exact rate from 0% to 2%).

However the royalty and group loan interest incomes are not subject to the LBT and this makes the country competitive for those who are looking for a proper tax environment for international royalty and group financing companies (see more below).

INNOVATION CONTRIBUTION (R&D TAX)

This is a real bureaucratic masterpiece, a typical example of how a bureaucrat creates a tax which delivers inadequate income with disproportionately heavy administrative costs. The basis of the R&D Tax is also the net income, and the rate is maximum 0.2%. Incidentally, R&D tax is also against the 6th (VAT) Directive of the EU.

HUNGARY AS A HOLDING CENTRE

The received dividend has been exempt from both the CIT and the solidarity tax for a long time. Since January 1, 2006 the dividend paid to foreign corporate owners, members, and shareholders has also been free from any withholding tax irrespective of the resident country of the beneficiary of the dividend. This means a tax-free exit for dividends not only from Hungary but

also from the EU. However this is only one pillar of a competitive holding regime. The other pillar, i.e. the capital gains participation exemption, was missing until recently. But from January 1, 2007 the capital gains on the so-called 'announced participation' (domestic or foreign) will be made exempt from corporate taxation with three conditions:

- the participation must exceed the 30%;
- the obtaining of participation must be announced to the Tax Authority in 30 days; and
- the participation must be held for at least two years.

This is the biggest issue of 2007 which may lift Hungary into the closed group of countries which apply sophisticated and very beneficial holding regimes.

HUNGARY AS AN IP LICENSING CENTRE

Beside the abolition of dividend tax, enterprises are also allowed to reduce their corporate income tax base by 50% of their royalty income received from either abroad or Hungary. There is no restriction in relation to the company's activity. Any company which realises income from the sale or license of any kind of intellectual property (IP) like a patent, know-how, trademark, image right, copyright etc., can enjoy this benefit irrespective of whether the licensing activity is the main object of the company. The benefit is available to any company, which holds the right of the IP even if the legal owner is a different entity. This allows back-to back licensing

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arrangements to take advantage from the incentive. Moreover, for self-developed IPs, the tax base can be reduced by the research and development (R&D) costs.

An additional advantage is that the royalty income is also exempt from the LBT (see above) as of January 1, 2006.

However the 4% solidarity tax (see above) is levied also to the profit from the royalty incomes. All of this has as a result that the total corporate tax burden of a pure licensing company is 12% on the profit.

HUNGARY AS GROUP FINANCING CENTRE

Similarly to royalty income, also in 2007 taxpayers shall continue to reduce their corporate income tax base by 50% of the interest income they receive from related parties that exceeds their interest expense paid (or payable) to related parties. This benefit is qualified to make Hungary more attractive as a group financing centre. Traditionally several multinational groups used, and are still using, the country for this purpose. However the 4% solidarity tax on the profit of this kind of income may make others dubious to join the 'club'.

Purely in the case of group financing, the thin capitalisation rules shall be also taken into account. The debt to equity ratio is 3:1, which is quite unfavourable. Basically it means that interest paid on debts is non-deductible to the extent that the debts exceed three times the equity of the Hungarian company. Therefore group financing seems to remain the game only for the highly capitalised 'big boys'.

AND WHAT ABOUT THE TRADERS?

Although special tax benefits are not promoting the international trading activities since January 1, 2006 (i.e. the general tax rules are applied), proper legal restructuring of the commercial contracts may help these trading and service-providing companies to survive the

drastic changes, without significantly increasing the offshore tax burdens.

TREATY SHELTER

Hungary's wide double tax treaty network requires special attention. It means that Hungary concluded treaties on avoiding double taxation with more than sixty countries to date (very few countries boast more). In this respect Hungary is ahead of several other low-tax countries, which are highly considered in the international tax planning industry (e.g. Cyprus, Malta).

The tax treaty network combined with the extensive network of investment protection treaties (nowadays Hungary has this kind of treaty with 54 countries) can provide a safe shelter to global investors even in those target countries where political risk is also a factor, which shall be taken into consideration when making long-term investment plans.

However not only the number of the tax treaties but also the unique characteristic of some of them (e.g. US, Japan, Malaysia, Singapore) deserves special attention. For example Hungary can be a perfect gateway to Asian trading, exploiting the unique benefits of the treaty with Malaysia, which also shelters the Labuan Offshore Companies. By combining the classical offshore taxation of the trading profit in Labuan with the zero taxation of the received and paid dividend in Hungary, a very successful tax planning product can be developed. (Based on the treaty, a dividend paid by a Labuan company to a Hungarian holding company is not subject to withholding tax.)

CONCLUSION

The budget is in trouble, therefore the government is also in trouble although it tries to make us believe that everything is under control. The most certain sign of the

trouble is the lack of the medium and long-term tax conception. In addition the effects of the tax increase package have been overestimated as usual. However in a paradoxical way this package contains certain new elements, which may reinforce Hungary's position in the international tax planning industry.

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