

The post-joining

SITUATION IN HUNGARY:

a progress report

by Gabor Szabo, Law Offices of Dr Gabor B Szabo

Being in the European Union (EU) and simultaneously still being attractive for tax planning or investment purposes. This is a real challenge for an EU newcomer! Quite a few of the Brussels bureaucrats and some of the established members of the union (e.g. Germany) are posing question marks at efforts like this. However Hungary still has not given up the intention to develop an environment in which foreign investors can feel free to count on a stable economic and political situation, good infrastructure, low costs, skilled workforce and several tax incentives.

Thanks to the investor-friendly environment of the last 10 to 15 years many foreign companies of several sizes set up operations, moved headquarters and other distribution and logistical centres to Hungary. Many of those still take advantage of the opportunities provided by the classical offshore regime which applies only 4% corporate income tax rate until the end of 2005 (the standard corporate income tax rate remained at 16%). Despite the directive of January 1, 2004 which effectively ended the formation of offshore companies, many dormant companies are still available to make the most of the regime's benefits.

Nevertheless, all of us must take notice of the decline of the classical offshore operation. The good tax planner must use more sophisticated tactics against the never ending war with the aggressive army of the Code of Conduct and Harmful Tax Practices fanatics and enthusiastic blacklists of the international organisations and some national

governments. And the sophistication can be expected of course also from those national governments which are under the attack of the "eurocrats" in order to change the national tax system against the interest of the country. This is a very delicate affair, but the professionalism of a government is legitimate also by its talent to keep the healthy balance between the demands of a faceless and ever-hungry supranational power and the self-interest of its own country. Corporate income taxation is a very effective field for a national government to measure itself in this war.

BENEFITS STILL ALIVE

Dividends received decrease the corporate income tax base by 100% (unless the dividend is received from a CFC which is a taxable income). This and the extensive

treaty network provide a good opportunity to move holding centres to Hungary. Implementing the Parent – Subsidiary Directive of the EU, the law exempts dividends paid to foreign EU resident companies from Hungarian withholding tax, if the recipient has held at least 25% of the registered capital of the Hungarian payer for a minimum of two years before making the dividend payment.

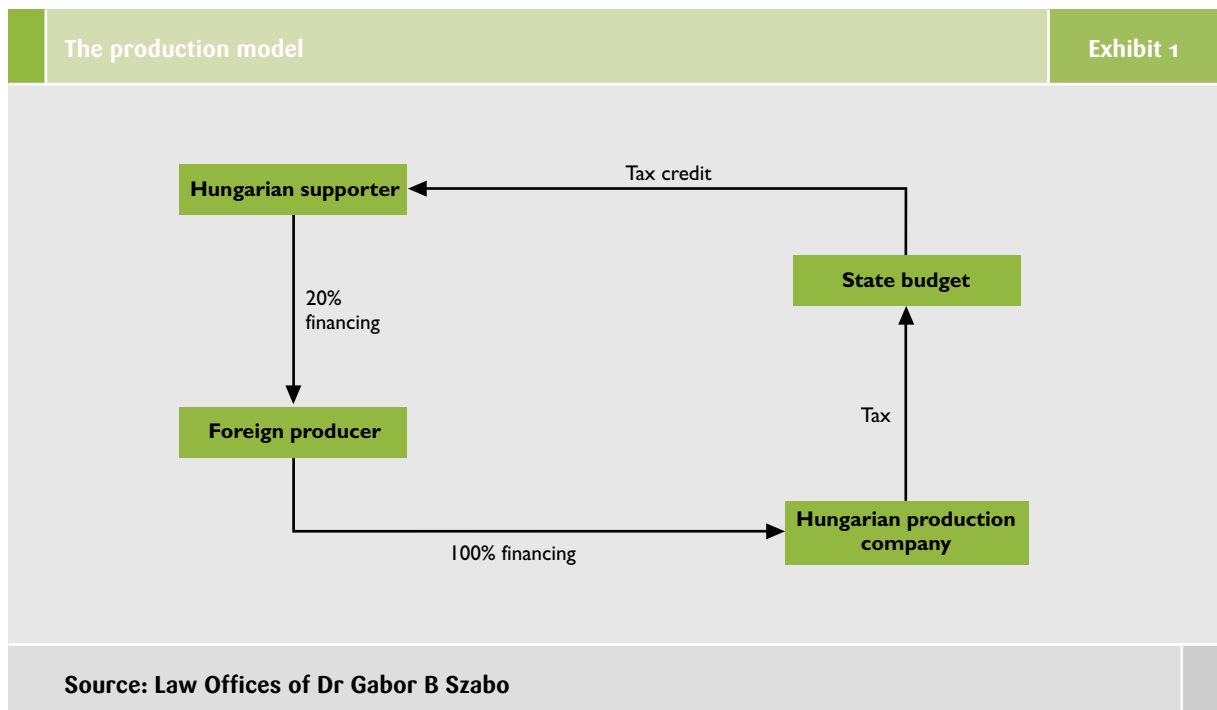
Enterprises under the “onshore system” are allowed to reduce their corporate income tax base by 50% of their royalty income received from either abroad or Hungary. Taxpayers shall continue to reduce their corporate income tax base by 50% of the interest income they receive from related parties that exceeds their interest expense paid (or payable) to related parties.

Hungary has a wide double tax treaty network. It means that Hungary concluded treaties on avoiding double taxation with almost 60 countries with unique characteristics. The treaty benefits are enjoyed also by

offshore companies. This is not the case in several other low-tax countries, which are strongly considered in the international tax planning industry.

“HUNYWOOD” OR HOLLYWOOD GOES TO HUNGARY

New tax planning opportunities have been introduced in 2004 for companies involved in the film production business. The new Act on Motion Pictures targets foreign film producers besides encouraging Hungarian filmmakers. The goal of the Act is to increase the competitiveness of the Hungarian film industry and as a consequence, to generate new employment, workplaces, and to attract tourists to visit the country. Although the EU does not support the favourable treatment of certain industries, the principle of cultural differences helped to pass the Act. The Parliament also amended the Act on



Corporate Income and Dividend Tax granting the advantages for companies involved in the film production business.

The new regime may attract foreign producers to make and promote movies in Hungary and will reduce production costs by up to 20%. Basically there are two types of incentives available. The difference between the two systems is the method of support mechanism.

Films produced by order (the production model)

This is available for films made in Hungary with the participation of a commissioned Hungarian film production company (production company) and Hungarian corporate supporter (supporter). In this

scheme the supporter does not hold interest in the production company and will not participate in the reserves. The supporter can finance up to a maximum of 20% of the qualifying expenditure and also obtain a 'Certificate of Support' from a semi-government body in charge. The supporter as a corporate taxpayer has a tax credit of three years for the full amount of the investment (foreign producer – based on a contractual relation – may also receive a refund from the Hungarian supporter).

Films not produced by order (the co-production model)

This is available for films made by a Hungarian film production company alone or in co-production where a Hungarian investor (investor) is involved. In this

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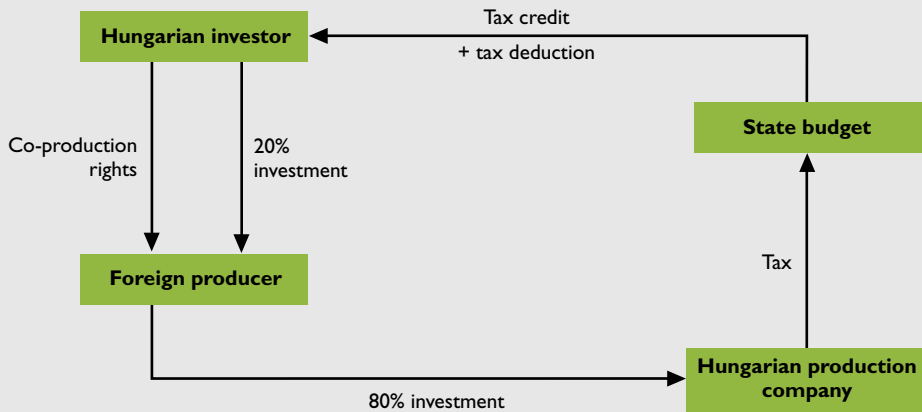
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The co-production model

Exhibit 2



Source: Law Offices of Dr Gabor B Szabo

scheme the investor should retain certain rights relating to the film. The investor obtains a 'Certificate of Investment' and again, finance up to a maximum of 20% of the qualifying expenditure. Similar to the above scheme, the investor as a corporate taxpayer has a tax credit of three years for the full amount of the investment. Moreover, the investor can deduct its tax base with 50% of the investment certified.

The first major name who has discovered the benefit of the new regime and also other comparative industrial advantages of Hungary is the famous Hollywood producer, the godfather of *Rambo* and *Terminator*, Mr Andrew Vajna who already took the first steps to build up the Hungarian "Cine Citta" next to Budapest. Further early birds may receive better positions in the very ambitious plan of the Government to create the world's largest film studio and become one of the worldwide centres of the film industry.

FOLLOWING INTERNATIONAL TRANSFER PRICING TRENDS

More recently, Hungarian tax authorities have started to audit the pricing of intra-group transactions with greater attention. Therefore, taxpayers now have to face strict regulations in respect of ascertaining the proper market prices and following the newly introduced documentation requirements.

Taxpayers are obliged to document the fair market prices, the method used in determining prices, and the supporting facts and circumstances related to the transactions performed with related parties. Such documentation for each qualifying inter-company agreement should be filed by the time the corporate income tax return is due. If taxpayers fail to meet the transfer pricing documentation requirements a penalty is charged for each qualifying agreement by the tax authorities.

The arm's length principles of transfer pricing, accepted worldwide have become an international standard used by multinational companies. Guidelines published by the Hungarian tax authorities intend to help taxpayers to follow the rules and take the requirements seriously.

A NEW KIND OF TAX: THE INNOVATION CONTRIBUTION

As an effect of EU harmonisation, the Act on the Innovation Contribution came into force on January 1, 2004 burdening enterprises with further charges. The provisions of the Act apply to companies registered in Hungary as of the above date. Micro-companies are not subject to the contribution. Newly established companies in the pre-corporation period (during the time of the registration process) and in the following tax year are exempt from this contribution as well.

The basis of the innovation contribution is the net income decreased by the purchases. The contribution is determined for a financial year as a set percentage,

which will increase from 2004 to 2006. The rate of this tax varies from 0.05% to 0.3% depending on the size of the company and the calendar year. Direct costs of research and development projects financed from an enterprise's own sources can decrease the gross contribution payment obligation. Where the tax year covers the entire calendar year, taxpayers have to pay their tax advance every three months. This advance is calculated as a quarter of the innovation contribution liability of the previous tax year. In the year when the tax liability first arises, the first and second advances are calculated as a pro-rata of an estimated annual contribution payment.

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