Hungary's new position in the Royalty Planning Industry

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Although times are changing and more pressure is coming on Hungary to keep in line with the mostly high-tax EU member states, some interesting tax planning opportunities still remain which place Hungary firmly on the map of the international tax planning industry. One of them is Hungary's attractive royalty regime.

New royalty structure

In the past, the Netherlands royalty regime had a significant role in tax planning and, as a result, there were numerous Dutch licensing (royalty) companies. They had a favourable system for obtaining advance rulings on the tax treatment of international flows of interest and royalties. However, as from 1st April 2001, the former Dutch regime is no longer available.

While it is still possible to apply for advance tax rulings in the Netherlands, the new system is not attractive for purposes of tax planning because of the conditions to be met for obtaining a ruling including the computation of an arm's length price for royalties payable. Although Dutch tax practitioners are still very experienced in setting-up tax effective royalty structures, the conditions to obtain a ruling have become very time consuming and more stringent in general. Tax practitioners, therefore, have been forced to look for other solutions.

Many alternative structures were complicated, artificial and/or expensive and none were as effective and simple as the former Dutch system of advance rulings.

Since Hungary has a very simple and straightforward system of inter-corporate royalties, it has emerged as a viable alternative to the Netherlands' structure.

Taxation of royalties in Hungary

Firstly, the Hungarian corporate income tax (CIT) rate is among the lowest in Europe at 16% of net profits. One of the incentives contained in Hungarian tax law is a provision according to which 50% of the pre-tax amount of the royalties received may be deducted from the tax base, thus reducing the effective corporate tax rate on such royalties to 8%.

However, since 1st September 2006, an additional type of corporate tax has been introduced in connection with the elimination of the big deficit in the state budget. The new tax, called Solidarity Tax (ST), is based also on pre-tax profit, although the tax base must be adjusted separately from the base of "normal" CIT considering the different modifying (increasing and decreasing) items. The rate of ST is 4%. Despite CIT, the provision for a 50% deduction on pre-tax royalties does not apply to ST. So, the applicable new total corporate tax rate for a Hungarian royalty company is 12% on the profit. However this is still attractive and competitive. The company is permitted to have additional business activities. No special conditions are required to be fulfilled. Moreover, there is no withholding tax on royalty paid.

In addition, the royalty (just like dividend and interest) income is exempt from the local business tax (2% of the net income), which burdens any other kind of income. Finally, royalties paid out by Hungarian licensees or sub-licensors are tax-deductible, just as the self-developed IP's research and development costs can be deducted from the corporate income tax base.

Hungarian tax treaty network

Hungary has a dense network of double taxation treaties with 65 countries. Under many of these treaties, the withholding tax on royalties is reduced to 0%, while under some, the rate is reduced to 5 or 10%. This is only of relevance for royalties received by a Hungarian sub-licensor, as royalties paid abroad by a Hungarian licensee are not subject to a withholding tax by virtue of Hungarian domestic law.

The US–Hungary tax treaty requires particular attention. This treaty provides the possibility of using Hungary to channel US-source royalties to third parties in other countries without being hit by US anti-treaty shopping rules, such as limitation on benefits. The current treaty between Hungary and the US dates back to 1974 and does not contain a limitation on benefits provision. Although the US initiated the renegotiation process recently, experts do not expect a new or amended treaty before 2010 (actually no deadline has been set as yet).

Other treaty partners worth mentioning are Japan (0% withholding tax on cultural royalties), Korea (0% withholding tax on all kind of royalties), Malaysia (which also covers Labuan) and Singapore.

Transfer pricing rules – an independent solution

It is clear that the combination of an attractive royalty regime and extensive treaty-network makes Hungary an interesting environment for tax planning. Nevertheless, transfer pricing rules can create problems for inter-group royalty flows in Hungary. One of the few difficulties in current Hungarian tax practice is that it might prove difficult (although not impossible) and time-consuming to obtain an advance tax ruling for transfer pricing. Although Hungarian transfer pricing regulations meet EU standards, tax audit practice (particularly in the field of intangibles) is still behind that of the Dutch and some other EU members. However, it is only a question of time before Hungarian tax auditors apply these rules with the same efficiency as such other jurisdictions.

The proposed solution (and foreseeable trend) is the independent licensing company. This vehicle can offer the perfect solution for structuring cross-border flows of royalties in a tax-effective manner by developing a contractual basis between the owner of the intellectual property and the licensing company on the one hand, and between the licensing company and the licensee on the other hand. In this way, the licensing company is only a contractual partner to both the owner of the intellectual property and the licensee without becoming an affiliated party. Therefore, the problem, if any, of applying for and obtaining a ruling from the Hungarian tax authorities can be avoided. Likewise, the need for determining an arm's length spread between the amount of the royalties received and the amount of the royalties paid to the licensor can be avoided.

Naturally, the contracts to be concluded by the licensing company with the owner of the IP and the licensee will be to a large extent tailor-made, so as to guarantee a correct expression of the parties' intentions, as well as an optimal tax effectiveness of the structure as a whole. Indeed, such a tax planning method covers all forms of royalties, including patent, trademark, cultural and film royalty (copyright), payments for the use of image rights, etc.

Last but not least, the concept of the independent royalty-flow company is also cost effective and competitive to the "inter-group" solution, because there is no requirement for one or more dedicated royalty-flow companies to be established within the group and there is no need to pay the full management costs of such companies.

Hollywood goes to Hungary?

We should now take a quick glance at the new incentives introduced by the Hungarian Government in 2004 in the form of the Act on Motion Pictures. This initiative has succeeded in creating a boost for the Hungarian film industry and has already attracted a number of foreign producers.

Consequently, the Act on Corporate Income and Dividend Tax has being amended and with the use of two types of incentive, production costs can be reduced by up to 20%. The method of support-mechanism will determine which kind of incentive will apply:

a) Films produced by order (the production model)

This scheme applies to films made in Hungary with the participation of a commissioned Hungarian film production company (production company) and a Hungarian corporate supporter (supporter). The supporter does not hold interest in the production company and will not participate in the reserves. A maximum 20% of the qualifying expenditure can be financed by the supporter. He can also obtain a "Certificate of Support" from a semi-governmental body. The supporter, as a corporate taxpayer, has a tax credit of three years for the full amount of the investment (a foreign producer, based on a contractual relation, can also receive a refund from the Hungarian supporter).

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

This scheme applies to films made by a Hungarian film production company alone or in co-production with a Hungarian investor (investor). In this model, the investor should retain rights relating to the film. He obtains a "Certificate of Investment" and, again, he can only finance up to a maximum of 20% of the qualifying expenditure. As well as in the first model, the investor, as a corporate taxpayer, has a tax credit of three years for the full amount of the investment. Moreover, he can deduct his tax base with 50% of the investment certified.

While the EU Harmful Tax Competition watchdog, the Primarolo Group, remains watchful over member states, Hungary is trying to strike a balance between keeping Brussels happy and maintaining an attractive tax planning environment. The balance to date is not so bad.

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