

Challenges in the POST-OFFSHORE ERA

as 2006 brings changes to the corporate tax regime

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Although the Hungarian corporate taxation regime faces some important changes towards the end of 2005, the Government's intention to continuously develop an investor friendly economic environment remains in place. Nevertheless, ever since the 'Parkinson's law' by C. Northcote Parkinson (1957), we are aware that political intentions and economic opportunities are not always supported by the bureaucracy. In our particular case, this refers to the fanatic group of national tax bureaucrats and the support offered by the heavy artilleries of their good fellows in Brussels. So, the never ending war between the tax collectors and tax payers goes on, however we can assert that the position of the former is not too bad at all. Many tax benefits and breaks *mutatis mutandis* will survive the dawn of the offshore regime, making the country an exiting tax planning vehicle in the future.

THE END OF THE OFFSHORE REGIME IS NOT THE BEGINNING OF THE END BUT THE END OF THE BEGINNING

The classical, however very discrete, Hungarian offshore regime (re: 4% tax on profit as the only kind of corporate tax) will end on December 31, 2005. By this date every Hungarian offshore company will automatically lose this status and fall under the regular corporate tax regime which implies the following:

- 16% corporate tax (CT) on the profit;
- 0% to 2% local business tax (LBT) on the net income; and
- maximum 0.2% innovation contribution (IC) on the net income.

The 'normal' rate of the CT is still one of the lowest worldwide and itself alone would be a very promising tax planning vehicle. However the other two elements of the corporate taxation seem to destroy the pleasant picture at a first glance. Nevertheless, neither will be long-lived. LBT is not only sharply criticised by everyone, but – being classical turnover tax – simply

against the 6th VAT Directive of the EU. The first few court petitions have been already filed against this tax, and even the financial government has announced its abolition for 2007. The other 'masterpiece', IC is a typical example of how a bureaucrat creates a tax which results in inadequate income but disproportionately heavy administration and cost. By the way, IC is also against the 6th Directive. This is enough reason to abolish the tax together with (or sooner than) LBT.

After all, over a longer period of time we only have to consider the 16 % tax on profit. However, in those fields where Hungary was popular before and during the offshore era (holding, licensing, corporate/group financing) some EU compatible refined tax benefits will change the 'rough' offshore tax breaks.

TAX ON DIVIDEND

As of January 1, 2006 the dividend paid to a foreign corporate owner, member or shareholder will be free of any withholding tax irrespective of the resident country of the beneficiary of the dividend. (The received dividend has been tax-free for many years.) This means a tax-free exit for dividends not only from Hungary but also from the EU. With this planning solution, Hungary may compensate the labour and connecting costs that are generally higher than in the Central-Eastern European neighbourhood.

For the time being Hungary does not provide a participation exemption for capital gains. Therefore, the capital gains are taxed at 16%. As a tax planning opportunity, a tax-free realisation of the profit on the transfer of participation can be achieved by including an intermediate holding company and transferring the participation at a gain. Afterwards, the profit would be distributed to the Hungarian company in the form of exempt dividend, which can be distributed tax-free exit out of the country or EU.

TAX ON ROYALTY

Beside the abolishment 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 arises income from the sale or license of any kind of intellectual property (IP) like patent, know how, trade mark, image right, copyright etc., can enjoy this benefit even if the licensing activity is the main object of the company or not. The benefit is available to any company which holds the right of the intellectual property, even if the legal owner is a different entity. This allows back-to back licensing 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 will be free also from the LBT (see above) as of January 1, 2006.

All of the above has the result that the total corporate tax burden of a pure licensing company is only 8% on the profit.

Useless to say, that the benefits target first of all the R&D industry. The Government's message is as follows: come and set your R&D business up in Hungary which can provide you with, not only well-trained and relatively cheap labour force and a rapidly developing infrastructure, but with a very friendly tax environment too. But there is a second and less shrill part of the message: anybody can enjoy this tax benefit who shows activity in any part of the IP industry. The result is self-explanatory: a unique IP and R&D friend tax regime.

TAX ON INTEREST

Similarly to royalty income, in 2006 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. Probably more others will join the 'club'.

Purely in the case of group financing, the thin capitalisation rules shall also be taken into account. The debt to equity ratio is 3:1, which is quite unfavourable to use back-to-back arrangements. 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'.

TAXATION OF THE INTERNATIONAL TRADING AND SERVICING

Although special tax benefits will not promote these activities after December 31, 2005 (i.e. the general tax rules will be applied), proper legal restructuring of the contracts may help these trading and service providing companies to survive the drastic changes, without significantly increasing the present offshore tax burdens.

TAX BENEFITS ON FILM PRODUCTION

The regime was introduced in detail in the 'The Euromoney

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Global Tax Handbook 2005. Therefore in this article we simply remind the reader that the tax-planning opportunities, which were successfully introduced in 2004 for film producers, are still available. As a consequence, a number of movies were made in Hungary. Foreign producers, who were making movies in Hungary, could reduce the costs of the productions up to 20%.

EXTENSIVE TREATY NETWORK (AVOIDING OF DOUBLE TAXATION AND INVESTMENT PROTECTION)

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

The tax treaty network combined with the not less 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 the 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 characteristics of some of them (e.g. the US, Japan, Malaysia, Singapore) deserve special attention. For example Hungary can be a perfect gateway to the Far East 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, dividend paid by a Labuan company to a Hungarian holding company is not subject to withholding tax.)

SERVICE CENTRES

Hungary continues to attract regional facilities such as:

- business service centres;
- logistics and supply centres;
- headquarters of financial process;
- call centres;
- back offices of worldwide service providers; or
- other customer services.

Foreign investors or multinational companies can benefit the high quality local professionals, which helps to set up and operate a Hungarian company easily.

CONCLUSION

The above may convince anyone that Hungary endeavours to give proper answers to the challenges of the post-offshore era. The *status quo* may be far from perfect, but Hungary is undoubtedly playing an ever increasingly important role in the international tax planning industry year after year.

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