

2008: the year of fortification

by Gabor Szabo, Dr Gabor B Szabo & Partners

THE YEAR 2007 PROVED THAT HUNGARY COULD NOT ONLY HOLD ITS EMERGING POSITION IN THE FIELD OF INTERNATIONAL TAX PLANNING, BUT ALSO STRENGTHEN IT BY INTRODUCING ATTRACTIVE NEW TAX BENEFITS. HOWEVER THIS WAS NO SIMPLE BALANCING ACT. ONE 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 GENERAL PARLIAMENTARY ELECTIONS IN THE SPRING OF 2006. FOR NOW HUNGARY SHOWS THE SAME CONTRADICTIONS AS MANY OTHER EUROPEAN UNION (EU) COUNTRIES: ATTRACTING POTENTIAL NEW FOREIGN INVESTORS, YET APPLYING MAXIMUM PRESSURE TO DOMESTIC TAXPAYERS. IF ONLY GOVERNMENTS WOULD ACCEPT THE REVELATIONS: THE HIGH TAX RATES ARE IN NEGATIVE CORRELATION TO HIGH TAX INCOMES.

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From autumn 2006 to spring 2007 the world had to make acquaintance with a far from perfect new face and image of Hungary. Ever since the 1956 revolution and freedom fight against the Stalinist regime and the Soviet empire, there has been no occasion for the world's press to report burning cars and flaming public buildings in Hungary. Although the country has overcome this experience, questions that were taken by the world press have to be answered: Was it really a crisis? Was it a fundamental threat to the life of the constitution? Did foreign investors need to be afraid of it? I do not think so.

Although I do not wish to play down the significance of the economic and political problems of Hungary, I cannot avoid comparing the international reactions to the events in Hungary with the world's response to the similar or indeed more serious happenings in Paris, in Copenhagen and more recently in Zürich. Seeing the pictures of the burning

suburb of Paris, or the Molotov-cocktail throwing Danish house occupiers in Copenhagen, would anybody say that France or Denmark is an unsecured and politically unstable country, where the investments are not safe? Or would anybody think that Zürich is an unsafe place just because of the sight of the burning cars and street demonstrations on the May 1, 2007? Of course not: nobody would say or think that. We cannot judge countries by two or more different criteria, and particularly cannot do so inside the EU.

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Today, the economy is able to achieve relative freedom from the political powers and learn how to manage political malfunctions. Luckily the power of politics is simply not strong enough to force all of its will on the economy: that time has passed. Politicians have to deal with the economy's participants as partners. This partnership has now become vital in Hungary, since all the major indexes of the country are showing increasing problems. Although the very recent EU administration and government country reports show some improvement, the country is far from a satisfactory and reassuring situation. Hungary can be proud of the highest budget deficit in the EU which is more than 9%. The growing inflation rate and increasing taxes on the one hand and the decreasing GDP, volume of industrial production and foreign investments on the other show that the country will have a very hard struggle to normalise the situation.

What can a country like this offer in the international tax planning industry? My answer is 'a lot'.

Background

The re-elected government discovered in early summer 2006 that the cash reserves of the country was empty. The old-new social-liberal government (being continuously in power since 2002) was greatly surprised to discover that Hungary had accumulated the biggest (9%) 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 equilibrium: "We need a 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 from September 1, 2006, and the rest on January 1, 2007. Solidarity tax is a new form of income 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. Solidarity tax is levied on corporations on the pre-tax profit, as adjusted by specific tax base modifying items. The applicable rate is 4% on

the adjusted pre-tax profit. Companies are also subject to the normal corporate income tax (CIT), which is 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 at $16\%+4\%=20\%$. 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.

Until recently we believed that the local business tax (LBT) was – like the IRAP in Italy – contrary to the 6th (VAT) Directive of the EU, both being a classical turnover tax. However, the Court of Justice of the EU did not share this view when it declared recently that either the IRAP or the LBT was not a turnover tax. Nevertheless, the business community of Hungary has sharply criticised this tax for a long time, and even the old-new government had promised to abolish it – before the election. After the election, however, the same government realised that 'the new equilibrium' would collapse without the LBT, so it will stay indefinitely. The basis of the LBT is the net income (i.e. not the profit!) and the rate is maximum and generally 2%. However royalty income and group loan interest 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.

Hungary also has a real bureaucratic masterpiece called innovation contribution, which is practically a research and development (R&D) tax. This is a typical example of how a bureaucrat creates a tax, which delivers inadequate state income with disproportionately heavy administrative costs. The basis of the R&D tax is also the net income, and the rate is a maximum of 0.3%.

Zero-tax or tax-beneficial structures are available in three key sectors of the tax planning industry: dividends, royalties and interest.

Holding centre

First consider Hungary as a sophisticated holding centre. Dividends received have been exempt from the CIT (and also the solidarity tax) for a long time. Since January 1, 2006,

dividends paid to foreign corporate owners, members, and shareholders have also been free from any withholding tax, irrespective of the country of residence of the beneficiary of the dividend. This means a tax-free exit for dividends from any kind of business activity not only from Hungary but also from the EU. However this is only one pillar of a competitive holding regime. The other pillar is the capital gains participation exemption. This was missing until recently, but from January 1, 2007 capital gains on what is called an 'announced participation' (whether domestic or foreign) is exempt from corporate taxation, subject to three conditions:

- the participation must exceed 30%;
- the acquisition of the participation must be reported to the tax authority within 30 days; and

- the participation must be held for at least two years, but from January 1, 2008 only one year.

This may well lift Hungary into that small group of countries, which apply sophisticated and very beneficial holding regimes.

Intellectual property (IP) centre

Hungary also functions as an IP licensing centre.

Enterprises are allowed to reduce their corporate income tax base by 50% of their royalty income received from abroad or from Hungary. There is no restriction in relation to the company's activity: a company which realises income from the sale or licence of any kind of IP – like a patent, know-how, trademark, image right or copyright can enjoy this benefit, irrespective of whether the licensing activity

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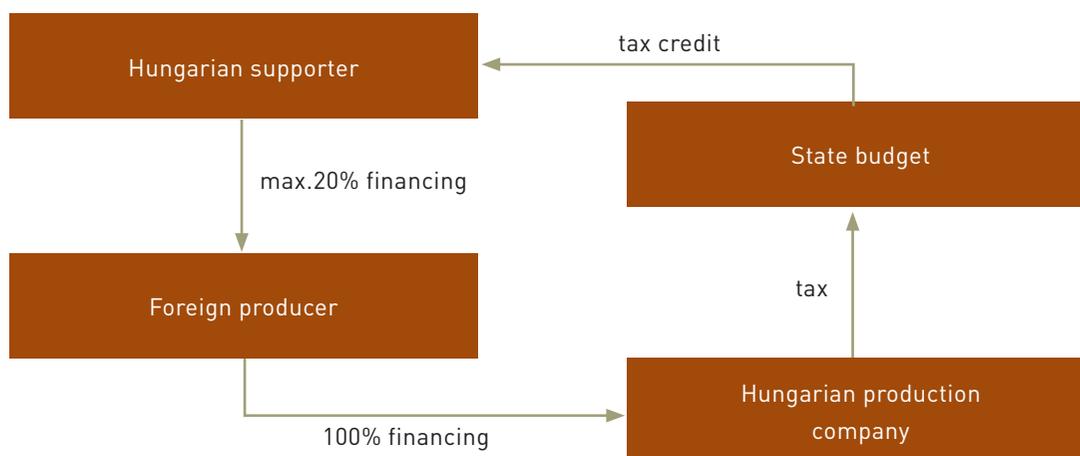
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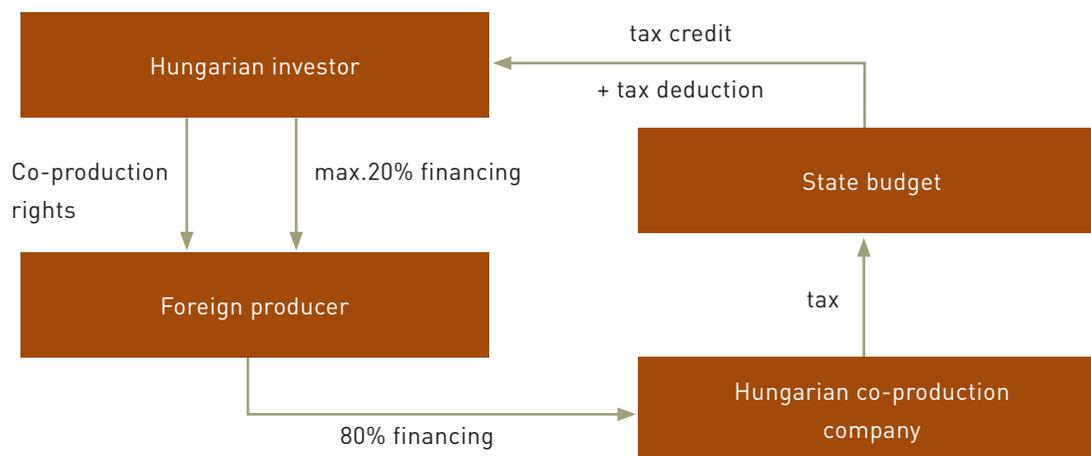
is or is not the main object of the company. The benefit is available to any company, which holds the right of the IP, even if the legal owner is a different entity. This allows back-to-back licensing arrangements to take advantage of this incentive. Moreover, for self-developed IPs, the tax base can be reduced by the R&D costs. An additional advantage is that the royalty income is also exempt from the LBT. However, the 4% solidarity tax is levied also on royalty income. All of this has the result that the total corporate tax burden of a pure licensing company is 12% on the profit.

Group financing centre

And thirdly let me consider Hungary as a group financing centre. Interest has a similar tax treatment to that accorded to royalties. Corporate taxpayers can 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 makes Hungary particularly attractive as a group financing centre. Traditionally, several multinational groups have used, and are still using, the country for this

purpose. However, the 4% solidarity tax is also levied on this kind of income – which may make others dubious to ‘join the club’. And in relation to group financing, the thin capitalisation rules must also be taken into account. The debt/equity ratio is 3:1, which is quite unfavourable.

Basically, this means that interest paid on debt is non-deductible to the extent that the debt exceeds three times the equity of the Hungarian company. Therefore group financing seems to be advantageous only to the highly capitalised large players. The other bad news is that the EU Commission recently challenged the intra-group interest taxation regime and opened a formal investigation procedure under EC Treaty State Aid rules. The Commission doubts whether the scheme constitutes a general measure and wants to investigate whether it is line with the State Aid rules, and whether it could distort competition unfairly, influencing the allocation of economic activities. The Hungarian scheme is similar to the Dutch Groepsrentebox scheme where the Commission also opened a formal investigation procedure in February 2007. The activities of the Commission show that EU bureaucrats



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will not miss a single opportunity to interfere in the national tax policies of member countries, even in indirect ways – by invoking the state aid doctrine.

Double tax treaty network

The number of Hungary's treaties now exceeds 60. Only a very few countries have more. In this respect, Hungary is ahead of several of the other low-tax countries, which are favourably regarded in the international tax planning industry (e.g. Cyprus and Malta). However not only the number of the tax treaties, but also the unique characteristics of some of them (e.g. US, Japan, Malaysia), deserve special attention. The exploitation of the synergy of the domestic and treaty benefits provides a lot of opportunities.

The treaty with the US, for example, does not have a limitation on benefit (LOB) article. Although there are some other US treaties (e.g. with Greece, Norway, Pakistan) which has no LOB provisions, Hungary is the only treaty partner of the US where the domestic tax benefits and exemptions can be combined with the treaty shelter.

The treaty with Japan has a 0% withholding tax on cultural royalties. This provides a perfect gateway to the country for film distributors, publishing houses and other cultural service providers.

But Hungary can be a discreet gateway also 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 dividends received and paid in Hungary, a very successful tax planning pattern can be developed. (Because of the treaty, a dividend paid by a Labuan trading company to a Hungarian holding company is not subject to withholding tax in Malaysia.)

Encouraging tax promotions for the film industry

The special beneficial tax regime, which was introduced in 2004 to promote the film industry, is still in force and enjoys growing success. The two models shown in Exhibits 1 and 2 are available.

Conclusions

The government's finances are in trouble. In addition, the effects of the tax increase package have been overestimated as usual. The Hungarian tax increase policy goes against the international trend of general tax cuts, as in Germany, France, Spain, the UK or in some neighbouring countries such as the Czech Republic, Slovakia, Romania and Poland. However, the 2008 tax package also preserved old

tax planning opportunities, which may reinforce Hungary's position in the international tax planning industry. The dividend, capital gains, royalty and group interest structures can work either in classical offshore or a very beneficial tax environment without the offshore label in a country, which is not on any black list. This shows that the government has finally recognised the strategic role of the international tax planning industry in Hungary's economy.