Classical offshore operation without offshore recognition?

Hungary's discreet position in international tax planning

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Due to the lack of government promotion and publicity, very few professionals know about the opportunities and benefits provided by the Hungarian offshore regime, which was introduced in 1994. However, Hungary is perhaps the best example of how to use a typical continental onshore country - deep in the heart of Europe, and free from any offshore connotations in the public mind - just like a traditionally secure and versatile offshore jurisdiction.

The benefits of the Hungarian structure are based on two main pillars: the extensive treaty network of more than fifty treaties, each with unique characteristics, and the low-tax offshore legislation which follows the Cyprus model.

Some history

Even in the second half of the "Soviet-block" epoch, from the late sixties to 1989, Hungary had acquired a reputation for a relatively entrepreneurial and adventurous approach to "Western-style" business, partly under the pressure of economic necessities, and partly thanks to a sort of independence which the former political elite had obtained from Moscow. This is well illustrated by the fact that in 1972 Hungary was the first, and for many years the only one, "in the block" to allow foreigners to form companies and take part in joint ventures, in spite of quite a lot of criticism received from the other "block members". The "quasi tax-free zone companies" which were established under this legal opportunity can be interpreted as the forerunners of the classical offshore companies, due to the fact that these entities were allowed to be active only out of Hungary.

It appears that there has been a trend over the past 5-10 years for international investors to move away from the traditional "tax haven" countries and instead to base their tax planning on the "low-tax" jurisdictions, which provide a network of double tax agreements as well.

Up to the revolutionary political changes of 1989, Hungary had already established all the elementary legal infrastructure associated with free enterprise and the market economy and adopted, among others, modern tax law, company law and laws protecting the investments of foreigners. It had also joined multilateral international organisations and introduced treaties protecting foreign investments like ICSID or MIGA, while simultaneously concluding two thirds of the double tax treaties in force today, including treaties with the major Western countries.

The fact that Hungary had demonstrated its greatest achievements in the field of treaty negotiations contributed to the situation where Hungary became the key target for foreign investors in the Eastern European region. Considering the latest statistical figures, this key position is still being maintained, thanks to the political and legal stability, the extensively developing financial, infrastructural and professional services, the continuously decreasing inflation and unemployment and, last but not least, the competitive labour force and low overhead costs.

Treaty characteristics

It appears that there has been a trend over the past 5-10 years for international investors to move away from the traditional "tax haven" countries and instead to base their tax planning on the "low-tax" jurisdictions, which provide a network of double tax agreements as well. Hungary, and its beneficial treaty network, was recognised in the international literature in the early nineties, before the introduction of the offshore regime. However, at that time Hungary was only recommended as a possible location for "holding companies", and to date, no one has considered that the double tax treaties provide similar, and often better, conditions for other types of companies (such as trading, licensing and management companies).

Most of the treaties follow the basic OECD model, and only a few, with developing countries, are based on the UNO model.

One of the most important tools in the area of international tax planning is the withholding tax rate applicable on different types of income, especially on dividend, interest and royalty payments. Most treaties provide 0% withholding tax on interest and royalties paid or received by Hungarian companies and the key treaties also apply low withholding tax on dividends at 5% (or rarely at 10%).

Another significant aspect of the treaty network is that offshore companies can also enjoy the treaty benefits. For the time being at least, none of the partner countries have attempted to change this, or called for the exclusion of the offshore entities. Instead, an offshore company is viewed as a "resident of Hungary" for treaty purposes and is entitled to the tax credits provided by the treaties. In fact, to comply with the treaty network the Hungarian Tax Authority will, upon request, issue a certificate of tax residence in the case of the offshore companies as well.

The table below shows the rates of withholding taxes in the cases of major partner countries and also, at the end, the rates with non-treaty countries.

Although offshore companies enjoy the treaty benefits, rapidly emerging - and increasingly sophisticated - domestic tax law has introduced a number of anti-avoidance rules (for example, thin capitalisation, controlled foreign corporations) on international standards avoiding treaty shopping. Nevertheless, both domestic tax regulations and the treaty network allow the most advantageous structures to be professionally planned.

Due to the way in which the tax authority operates, there are two ways for the assertion of the lower treaty rates on dividend. The beneficiary from the treaty country is either entitled to claim back the difference between the domestic 20% and the treaty rate in question or they can request the prior approval of the tax authority to pay the treaty rate from the outset. In both cases, the tax-residency certificate of the beneficiary is required.

The above may convince the reader that treaty benefits can predestine even the regular Hungarian "onshore" companies to get key positions in tax planning structures. The regular rate of the corporate tax (18%) and the domestic (non-treaty) withholding taxes are still lower than in most OECD countries. However, the "newcomer" offshore regime provides further advantages to international investors.

Offshore Characteristics

The additional advantages of Hungary, on top of the non-offshore consideration and developed treaty network can be summarised as follows:

- Political security with good country image;
- Central and strategic location with the most developed business infrastructure in the region;
- Low living and overhead costs;
- Skilled and relatively cheap labour force;
- No disclosure of the beneficial owners (no reference required either);
- No distinction between regular and offshore companies in the corporate documents and public registry (it is nearly impossible for an outside inquiry to determine whether the company in question qualifies for the preferential offshore tax rate or pays the full corporate tax rate of 18%).

As far as the criteria and conditions for the formation and operation are concerned, international offshore standards are followed more or less, with the exception of a few tiresome (but not intolerable) bureaucratic and employment restrictions that can be managed by good management services. The most important real restriction regards the activity of these companies. Due to this, offshore companies can only carry out commercial activities and non-financial business services. Financial services (bank, insurance, broker, financial leasing and so on) are a restricted area for Hungarian offshore companies, for the time being at least.

Following the Cyprus-based low-tax model, Hungary levies corporate tax on offshore companies at a rate of 3% on their net profits. Up to the end of 1998, municipal business tax was also levied on offshore companies at rates varying between 0-1.4% of their gross profits, but since the tax law was amended on 1st

TREATY COUNTRY	DIVIDEND (%)	INTEREST (%)	ROYALTIES (%)
Austria (1976)	10	0	0
Cyprus (1982)	5/15	10	0
France (1981)	5/15	0	0
Germany (1979)	5/15/25	0	0
Italy (1980)	10	0	0
Japan (1980)	10	10	0/10
Netherlands (1988)	5/15	0	0
Poland (1996)	10	0/10	10
Russia (1998)	10	0	0
Spain (1988)	5/15	0	0
Switzerland (1982)	10	10	0
Ukraine (1998)	5/15	10	5
United Kingdom (1978)	5/15	0	0
United States (1979)	5/15	0	0
Non-treaty country	Min. 20	0/18	18

January 1999, offshore entities are no longer subject to this tax.

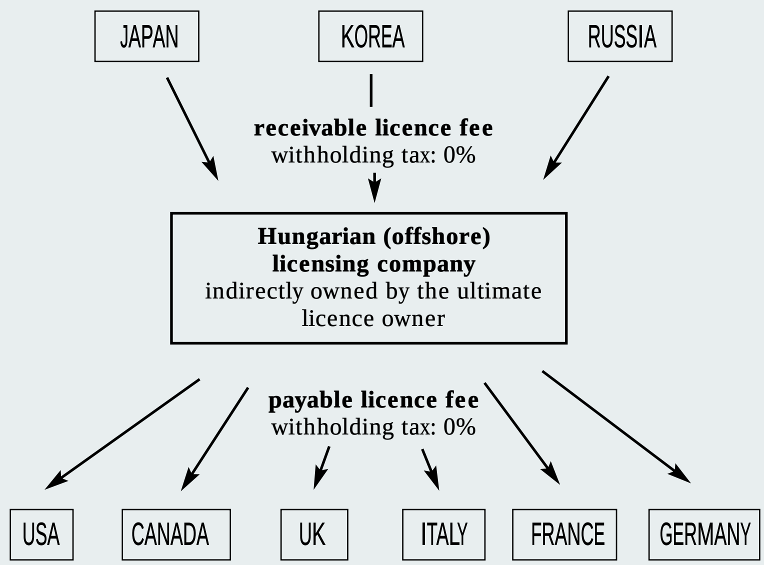
One less advantageous characteristic of the regime is that under certain conditions, VAT can be levied on offshore companies at a rate of 25%. This is typically true in the case of copyright traders and some other licensing companies. Although the VAT is refundable over monthly periods, cash-flow problems may arise. Practical experience shows that investors prefer to use the Hungarian structure most commonly for holding or licensing companies, although the number of trading companies is also growing.

Summary

Although the total number of registered offshore companies does not exceed a couple of hundred, many of those belong to multinational companies which have, over time, recognised the benefits of their unique characteristics. Critics of the regime say that the system is less established and sophisticated than traditional offshore legislation and therefore it is not suitable for high profile arrangements. Some aspects of this objection are true, as demonstrated in the young age of the regime and the stiff onshore-friendly continental legal environment. Nevertheless the system does work.

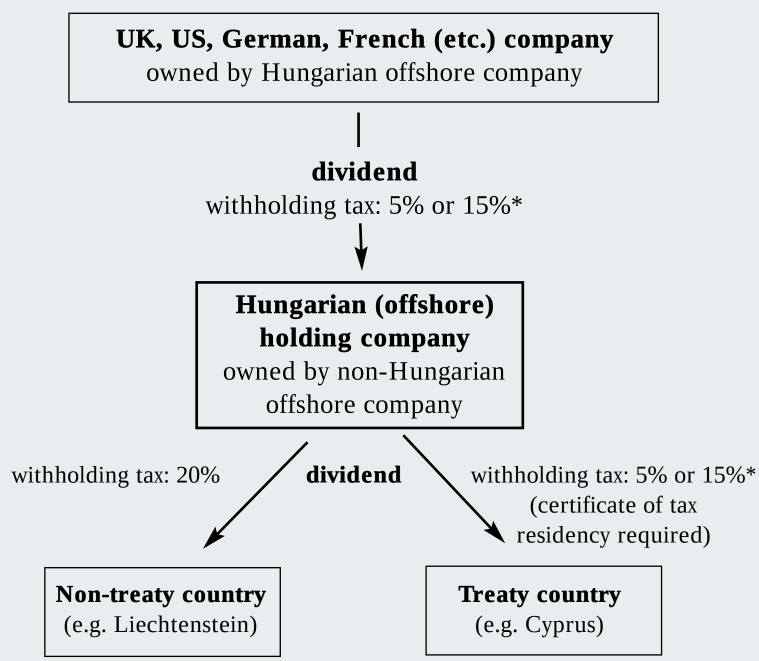
In addition, I believe that nowadays, when the whole offshore industry is under fire by governments and government-controlled international organisations (see the OECD Report on the concept of Harmful Tax Competition or the EC Code of Conduct), the international community of corporate tax payers needs new "faces" and locations. They also need new opportunities to encourage business, not only in terms of offering a low level of taxes without the risk of tax evasion or illegal tax avoidance, but also in a more discreet manner as well. Undoubtedly, Hungary has the advantage that its name is not associated internationally with any kind of tax avoidance, and there are certainly transactions where Hungary's central location and its treaty network will make the Hungarian offshore company the preferred and perfect vehicle. ■

HUNGARIAN (OFFSHORE) LICENSING COMPANY



Note: Due to the actual VAT law of Hungary the licence imported by the Hungarian licensing company is subject to 25% refundable VAT

HUNGARIAN (OFFSHORE) HOLDING COMPANY



*The lower rate applies if the receiving company owns more than 10% or 25% of the payer.