The beginning of the end or the end of the beginning?

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The Hungarian offshore regime was introduced in 1994. Since that time, international investors have slowly discovered the tax-planning opportunities of this low-tax jurisdiction and the favourable geographic location of the country in the Central and Eastern Europe region. Currently, the total number of registered offshore companies in Hungary is almost 1,000. Based on the data published by the Hungarian Tax Authorities, HUF 19.3 billion (USD 84 million) in corporate income tax was paid by these companies in 2002.

In addition to its offshore regime, Hungary has proved attractive to foreign investors because of its stable economic and political position, good infrastructure, low costs, skilled workforce, duty-free zones and various tax incentives. In addition, the foreign exchange legislation was totally liberalised in 2002. As a consequence, companies started to set up operations, move headquarters and other distribution and logistic centers to Hungary. Giant manufacturing companies also recognised the advantages of the country and established factories in developing areas. These companies received special tax breaks and incentives from the Hungarian government and the local municipalities.

Another key component in attracting manufacturing companies to Hungary was the low labour costs. It would seem reasonable therefore that the payroll-related taxes that have been increased in the last number of years and which are high by international standards should be decreased.

Due to its forthcoming accession to the EU on 1 May 2004, Hungary, along with the other acceding countries, is under pressure to amend its tax regime and in particular its "offshore" tax regime.

Today it is the very tax breaks that currently apply to a number of multinationals that have established manufacturing operations in Hungary which are under scrutiny. The EU seems very adamant that Hungary should withdraw these tax breaks, however, this could result in the multinationals taking their business to other jurisdictions outside not only Hungary, but the EU.

Considering how Hungary has had to adapt to the expectations of the EU, the jurisdiction is doing well. It has created a stable, standard system which embodies the correct principles. Hungary was the first Central European country to start harmonising its legislation with EU law. The corporate tax law is a standard piece of European Union legislation, and the VAT law is in compliance with the European Union directive on VAT. However, the standard rate, at 25%, is very high and hurts the cash flow positions of the companies. As of January 2003 the government reclassified a range of products and services and lifted them into categories with normal rates instead of the 12% discount rates to satisfy the EU requirements.

Double tax treaties

Hungary has a wide double tax treaty network. It has concluded treaties on double taxation with almost sixty countries with unique characteristics. One of the main peculiarities of the Hungarian regime is that the benefits of these treaties are enjoyed by the offshore companies. This is not the case in several other low-tax countries, which are strongly considered in the international tax planning industry (eg, Cyprus, Malta, Luxembourg). This synergy of the offshore and treaty benefits provides additional advantages to Hungary.

New offshore regime

A new law to amend the tax legislation in Hungary was issued by Parliament effective as of 1 January 2003. Under the new legislation, offshore benefits can be maintained until the end of 2005, thereby still providing a number of tax planning opportunities.

Companies were able to qualify for offshore status and obtain offshore licenses only until 31 December 2002. Existing offshore companies can continue to operate and benefit from the 3% corporate income tax rate until the end of 2005 (the standard "onshore" rate is 18%).

From next year, there will be no change in the offshore requirements nor will offshore companies have to effect any change in their current structure or operations.

From 2003 if the majority shareholder of a Hungarian offshore company transfers its quotas to an outsider shareholder, the company will lose its offshore status. A majority shareholder is one who possesses more than 50% of the company's quotas. There is one exception to this rule, that is, if the new shareholder is an associated enterprise with the Hungarian Offshore Company. However, change of the owner can be solved in practice by using some professional advice to assist in the restructuring. Similarly it is still possible for investors to buy existing and operating offshore companies to use the benefits of the regime until 2005.

Other tax incentives

The legislation introduced this year allows for certain tax incentives beneficial to companies engaged in financing, intangible licensing or holding activities. All companies registered in Hungary, excluding offshore companies, may take advantage of these benefits.

Royalty related tax benefits

The new legislation enables taxpayers to reduce their corporate income tax base by 50% of their royalty income received from either abroad or Hungary. This would, in effect, make half of the royalty income of Hungarian companies tax exempt.

In general, this means that the effective tax rate can be reduced to 9% - without any real planning - from the standard 18% for companies not having any other significant tax deductions. This may be even less for companies who are in a position to take advantage of further reductions such as double deduction of research and development costs.

Interest related tax benefits

In addition, the law introduces a new tax incentive for taxpayers engaged in intra-group financing activities. This would be similar to that designed for intangible licensing companies; 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.

Under certain conditions, for companies in a net lending position, this new benefit exempts half of their interest income received from related parties from tax.

The amount of tax benefits relating to royalties and interest income received, however, is capped at 50% of the pre-tax profit of the taxpayer.

Expectation on withholding tax exemption on dividend payments

The law exempts dividends paid to foreign EU resident companies from Hungarian withholding tax after accession, 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.

All the aforementioned amendments are expected to apply from 1 May 2004 at the earliest, the date of Hungary's EU accession.

Conclusion

Although Hungary can not neglect the requirements of the EU and OECD regarding the "facelift" of its tax regime, the objective of the government is unambiguous: maintain the alluring tax benefits and develop Hungary's emerging position in the international tax planning industry.

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