



U.S./Hungary Tax Alert

16 June 2009

U.S.-Hungary treaty update

On 3 June, the U.S. Department of the Treasury and the Hungarian Ministry of Finance jointly announced the conclusion of the negotiation of a proposed new bilateral income tax treaty (the "proposed treaty") to replace the existing tax treaty from 1979 (the "1979 treaty") between the two countries. Formal negotiations leading to this development had begun in 2001. On 5 June, the Treasury Department announced that "[o]fficial signing . . . is expected in the next few weeks." Neither government has announced the signing of the treaty as of today. Changes to the text can be made prior to signing, so our understanding of the proposed treaty's terms as of today could, of course, be altered if there are any such changes.

Effective date

Once signed, the proposed treaty will enter into force after ratification by each country, and their exchange of instruments of ratification. Subject to a grace period with an unusual fixed ending date, the proposed treaty would generally be effective, in respect of taxes withheld at source, for amounts paid or credited on or after the first day of the second month next following the date of entry into force; and in respect of other taxes, for taxable periods beginning on or after the first day of January next following the date of entry into force. For example, if the treaty enters into force in December 2009, it would generally affect the withholding tax on interest, dividends and royalties paid on or after 1 February 2010. However, if any person entitled to benefits under the 1979 treaty would have been entitled to greater benefits under the 1979 treaty than under the proposed treaty, such person generally¹ can elect to apply the 1979 treaty through 31 December 2010.

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¹ For the student and teacher articles, there is an unlimited grandfather provision for as long as the 1979 treaty would otherwise apply.

Substantive changes

Most importantly, the proposed treaty, unlike the 1979 treaty, includes a comprehensive anti-treaty-shopping, or “limitation on benefits” (“LOB”) provision, that is consistent with other recent U.S. treaties. In addition, the proposed treaty modernizes the 1979 treaty to take account of U.S. tax developments over the last 30 years: e.g. the enactment of the *Foreign Investment in Real Property Tax Act*, the branch profits tax, and the real estate mortgage investment conduit (“REMIC”) rules; the amendments to §§871(h), 877 and 894(c); the OECD *Report on the Attribution of Profits to Permanent Establishments*; and the elimination of independent personal services articles from tax treaties generally. The following is a brief comparison of selected provisions in the proposed treaty with provisions in the 1979 treaty, other recent U.S. tax treaties, and the 2006 U.S. Model Income Tax Convention (the “U.S. Model”).

Limitation on benefits

The proposed LOB article is similar to LOB articles in newer U.S. tax treaties with European countries, and includes a derivative benefits test; a triangular rule; a headquarters company test; a substantiality safe harbor in its active trade or business test; and a publicly traded company test. Significant additional points are discussed below.

Publicly traded companies: For a company to be a qualified person on the basis of public trading of its shares, the company must meet a test similar to the one first seen in the 2004 protocol to the U.S.-Netherlands treaty aimed at preventing inverted companies from qualifying for comprehensive treaty benefits. (Article 26(2)(c)(i) of the U.S.-Netherlands treaty; see *also* article 22(2)(c)(i) of the U.S. Model.) The test requires that either (a) the company’s country of residence be its primary place of management and control, or (b) certain economic activity zones be the location of the exchange on which its principal class of shares is primarily traded. To be a qualified person on the basis of place of primary trading of principal class of shares, a Hungarian resident company’s shares would need to be primarily traded on a recognized stock exchange located within the European Union or in any other European Free Trade Association (EFTA) state,² and a U.S. resident company’s shares would need to be primarily traded on a recognized stock exchange located in a country that is a party to the North American Free Trade Agreement.

Subsidiaries of public companies: To be a qualified person on the basis of direct or indirect ownership of a company’s shares by U.S. or Hungarian publicly traded companies, ownership by such companies must add up to 50% or more of the aggregate vote and value of the shares and at least 50% of any disproportionate class of shares, and in the case of indirect ownership, each intermediate owner must be a

² Iceland, Norway, Switzerland and Liechtenstein are the current EFTA members.

resident of either Hungary or the U.S. (See the identical provision in article 22(2)(c)(ii) of the U.S. Model.)

Ownership/base erosion test: The ownership prong of this test is essentially identical to article 22(2)(e)(i) of the U.S. Model, and for this reason is more stringent than most recent U.S. tax treaties. Thus, it includes a requirement that the income recipient be owned by persons in the *same contracting state*. In the case of indirect ownership, each *intermediate* owner must also be a resident of the *same contracting state*. The base erosion prong of the test is met if less than 50% of the company's gross income for the tax year (as determined in the company's state of residence) is paid or accrued, directly or indirectly, to persons who are not qualifying residents of either contracting state in the form of payments deductible in the company's country of residence. As under article 22(2)(e)(ii) of the U.S. Model, arm's-length payments in the ordinary course of business for services and tangible property are excluded from this calculation. Unlike the U.S. model, but similar to some other recent treaties, payments on obligations to banks (including, in the case of Hungary, a credit institution) are also excluded, provided that such bank or credit institution is not related to the payor. Unlike some treaties, including the U.S.-U.K. treaty, for example, there is no requirement that the bank be resident in, or that its permanent establishment be located in, a contracting state.

Active trade or business test: Unlike several recently revised U.S. tax treaties, and article 22(3) of the U.S. Model, the active trade or business test includes a safe harbor for satisfaction of the substantiality test that applies when a taxpayer seeks to apply the active trade or business test to income from a related person. There is also an example of a taxpayer that fails the substantiality safe harbor but nevertheless will still qualify for benefits.

Derivative benefits test: The derivative benefits test is similar to that in recent U.S. tax treaties with European countries (e.g. article 17(3) of the U.S.-Sweden treaty, article 23(3) of the U.S.-U.K. treaty and article 21(3) of the U.S.-Belgium treaty). The base erosion prong of the derivative benefits provision treats as non-base eroding payments all arm's length payments in the ordinary course of business for services or tangible property, but treats interest payments paid to non-equivalent beneficiaries as base eroding payments.

Like other derivative benefits provisions (with the exception of article XXIX A(4) of the U.S.-Canada treaty), the ownership prong of this test requires direct or indirect ownership of 95% of the aggregate vote and value of the treaty-resident company claiming benefits by seven or fewer persons that are equivalent beneficiaries. Unlike any other treaties of which we are aware, however, the proposed treaty casts a shadow on the ability of the competent authority to deny treaty benefits in certain cases where the seven-or-fewer test is *not* satisfied. It appears that it was agreed that the competent authorities of both countries *shall ordinarily grant* treaty benefits under the discretionary benefits provision in cases where a company claiming benefits under the derivative benefits provision is owned directly by *up to 10*

individuals, provided that such individuals are equivalent beneficiaries, the relevant base erosion test is satisfied, and any additional requirements prescribed by the treaty are satisfied.

Headquarters company test: The headquarters company test in the proposed treaty is substantially identical to the headquarters company test in article 26(5) of the U.S.-Netherlands treaty. The headquarters company test provides that a headquarters company for a multinational corporate group that is resident either in Hungary or the U.S. may qualify for benefits under the proposed treaty if it and its corporate group meet certain specified requirements.

Rates on dividends, interest, and royalties

In general, limitations on the rates of source country withholding tax permitted under the 1979 treaty on dividends (5% on direct investment dividends received by corporations, 15% otherwise) and interest and royalties (no withholding tax) are still applicable under the proposed treaty. Exceptions are provided, however, consistent with policies widely adopted in U.S. tax treaties since 1979, except that dividends are *in no case* exempt from source country tax other than when beneficially owned by a pension fund.

Dividends: The general tax rate for dividends remains at 15%, with an additionally reduced rate of 5% when the beneficial owner is a company that holds directly at least 10% of the voting stock of the company paying the dividend. Unlike the 1979 treaty, the 5% reduced rate generally will not apply to a dividend paid by a regulated investment company or a real estate investment trust (“REIT”), and the 15% rate will apply to a REIT dividend only in certain cases. Unlike newer treaties with other European countries, the proposed treaty will not contain an exemption from tax for some parent-subsidiary dividends.

Interest: The interest article is identical to that in the U.S. Model. Interest is generally exempt from source country withholding taxation, except that contingent interest paid by a U.S. resident that is not portfolio interest (see §871(h)(4)) may be taxed at 15%, and interest that is an excess inclusion with respect to a REMIC residual interest may be taxed in accordance with the applicable internal law.

Royalties: The royalties article is identical to that in the U.S. Model. Royalties are generally exempt from source state taxation.

Other Provisions

Under the proposed treaty, income, profit, or gain that is derived through an entity that is fiscally transparent under the laws of either Contracting State should be considered as derived by a resident of such contracting state, to the extent that such income, profit or gain derived is treated as income of a resident under the contracting state’s tax laws. This provision of the proposed treaty (unlike corresponding

provisions of other treaties) apparently does not apply to entities organized in a third country.

In addition:

- The §4371 insurance excise tax is not a covered tax;
- The shipping and air transport article covers container leasing;
- There is a treaty re-sourcing rule applicable to credit for Hungarian taxes; and,
- A specific provision in the exchange of information article addresses bank secrecy.

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