

TaxAlert

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U.S. – Hungary Treaty update

We would like to draw attention to the new comprehensive income tax treaty signed by the US and Hungary on 4 February 2010.

The new treaty replacing the existing treaty concluded in 1979, mainly follows the 2006 US Model Income Tax Treaty and will be accompanied by a Memorandum of Understanding ("MOU") as well.

1. Effective Date

The new treaty should enter into force on the date of exchange of instruments of ratification, which is likely to happen by the end of this year. Nevertheless, in connection with taxes withheld at source, the new treaty should only be applicable for amounts paid or credited on or after the first day of the second month next following the date of entry into force. In respect of other taxes, the first day of January following the date of entry into force should be the effective date.

It is important to note that persons entitled to the benefits of the existing treaty, should be allowed – at their election – to apply the old treaty until 31 December 2010.

2. Limitation on Benefits clause

Unlike the old treaty concluded in 1979, the new treaty contains a comprehensive LOB article, the main points of which are set out below.

2.1. Publicly traded companies and their subsidiaries

Companies, the shares of which are regularly traded on one or more recognised stock exchanges can qualify for the treaty benefits but only if either a) the primary place of management and control of the company is in the contracting state of which it is a resident, or, b) in case of a Hungarian company, its shares are also primarily traded on a recognised stock exchange located in the European Union or EFTA, or in case of a US company, its shares are primarily traded on a recognised stock exchange located in a NAFTA country.



At least 50% owned subsidiaries of the above mentioned qualifying companies can also claim the benefits of the new treaty, but in case of indirect ownership, each intermediate owner should be resident of either Hungary or the US.

Recognised stock exchanges are defined as including the US stock exchanges, including NASDAQ, the stock exchanges of Budapest, Amsterdam, Brussels, Frankfurt, London, Paris, Vienna, Warsaw, Zurich and any other stock exchange agreed upon by the competent authorities.

2.2. Ownership/Base erosion test

This test provides access to the treaty benefits for companies that are more than 50% owned by certain qualifying companies and in case of indirect ownership, each intermediate owner is a resident of either Hungary or the US. The base erosion test requires that less than 50% of the gross income of the company for the tax year is paid or accrued directly or indirectly to persons who are not qualifying residents of Hungary or the US. Nevertheless, arm's length payments in the ordinary course of business for services or tangible property and payments in respect of financial obligations to a non-related bank (including, in case of Hungary, a credit institution) are excluded.

2.3. Active trade or business test

A company being a non-qualified person can still qualify for the benefits of the treaty if it is engaged in active trade or business in the contracting state where it is resident. When applying this test, all facts and circumstances will have to be analysed, but it is expected safe harbor examples will be provided by the MOU.

2.4. Derivative benefits test

This test requires a 95% direct or indirect ownership by seven or fewer equivalent beneficiaries, which means a resident of a member state of the EU, EFTA or NAFTA that is a qualifying person based on the respective treaty. In connection with interest, royalty or dividends, the respective treaty should contain withholding tax rate as low as the new US-Hungary treaty. Similarly to the other points, a base erosion test is also included that limits the payments for non-equivalent beneficiaries to below 50%.

2.5. Headquarters company test

A headquarters company resident either in Hungary or in the US may qualify for treaty benefits if it fulfils all the specific conditions described, for example it should provide a substantial portion of the group-level supervision and administration, which may include but cannot principally be group financing.

2.6. Limitations in connection with third country PEs

The new treaty will contain restrictions in respect of using low-tax PEs in third countries. According to the new wording, if the profit of such a PE is subject to a combined aggregate effective tax rate in the PE and the head office country which is less than 60% of the tax rate that would generally be applicable in the head office country, the treaty benefits should not be accessible.



3. Other provisions

A building site, drilling rig or ship used for exploration of natural resources would create a PE if it lasts for more than 12 months, instead of the 24 months provided by the old treaty.

The general withholding tax rates for dividends, interest and royalties will remain the same (no WHT on interest and royalty, and 5/15 percent on dividends from the US).

However, it is expected that the reduced dividend WHT rate would not be granted in case the payer company is a regulated investment company (RIC) or real estate investment trust (REIT). Also contingent interest arising from the US which does not qualify as portfolio interest may be taxed in the US but not exceeding 15%. Interest that is an excess inclusion for residual interest of a real estate mortgage investment conduit (REMIC) may be taxed in accordance with the applicable domestic law.

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