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APPLICATION OF MODEL TAX TREATIES IN HUNGARY (A national report submitted to for the 5th session of the European-Asian Law Congress)

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Recent developments:

- Hungary has already concluded almost 70 bilateral double tax conventions
- Revision of obsolete treaties is also a preference (examples: treaties with the US and Germany)
- Modernisation of the provisions of the existing treaties on the exchange of information is also a goal (examples: treaties with Austria and Luxembourg)
- In major part, Hungarian income tax treaties follow the 1977 model of OECD; however, the treaties concluded in the seventies follow the 1963 model
- Hungary has concluded inheritance tax conventions with four countries only
- Negotiations have started to conclude tax information exchange agreements in accordance with the OECD model on TIEAs with jurisdictions like Barbados, Bermuda, British Virgin Islands, Gibraltar, Guernsey and Jersey and the Isle of Man

Application of model treaties:

- There are just a few treaties, concluded with developing countries that apply the UN model, e.g., by providing for tax sparing credit
- Hungary does not have its own model treaty
- Hungarian treaty policy does not deviate from the OECD model unless the other contracting state invites Hungary to do that; examples: treaties with the US (extended scope of personal scope), Germany (taxation of partnerships), Switzerland (restricted exchange of fiscal information) or Luxembourg (exclusion from the scope of treaty of the 1929 holding companies)
- Hungary, being a member of the European Union, is bound to loyalty to Community interests

Relationship between model treaties and national legislation:

- The Hungarian income tax laws explicitly refer to OECD models by saying that the provisions of the law are compatible to those of the OECD model treaty on the taxation of income and capital and of the OECD transfer pricing guidelines

[Sec. 31 (2) of the Act LXXXI of 1996 on corporate tax, as amended; Sec. 84 (2) of the Act CXVII of 1995 on personal income tax, as amended]

Legal nature of the commentaries on model treaties from a Hungarian perspective:

- The commentaries on model tax treaties do not constitute any source of law
- Example: in a legal case, the tax authorities argued that the authorities did not establish their conclusions on the commentary on the model tax treaty on income and capital because they do not deem to be legal rules (Kfv.I.35.159/2010/3)

Competent authorities to be found on the Hungarian side to interpret double tax conventions:

- In Hungary, it is the Finance Ministry
- At the time when the tax authorities are obliged to explore the facts and circumstances relevant to the taxpayer’s liability to pay tax during a tax audit, they cannot avoid as the case arises approaching the Finance Ministry and apply for a mutual agreement procedure (Kvf.I.35.229/2005/5)

Transformation into national law of double tax conventions as international treaties in Hungary:

- An international treaty, including double tax conventions, is to be incorporated into an Act that is adopted on the promulgation of an international treaty (dualism)
- However, it flows from the Act on the constitution of the Republic of Hungary (Act XX of 1949, as amended) that the generally accepted principles of international law are in no need of incorporation

Transformation into national law of double tax conventions as international treaties in Hungary:

- Treaty law prevails over national law even to the extent that it is not precluded that treaty provisions may extend the taxpayer's liability to pay tax

[Section 2 (5) of the Personal Income Tax Act and Section 1 (4) of the Corporate Tax Act]

- International law may depart from national law even by way of reciprocity as covered by customary international law; in contrast to treaty-based international law, customary international law cannot extend the taxpayer's liability to pay tax, however

New treaties (not yet in force) with the US and Germany:

- The new US – Hungary double tax convention was signed at Budapest on 4 February 2010 (promulgated by Act XXII of 2010 on the side of Hungary), and the new Germany – Hungary treaty was signed at Budapest on 28 February 2011
- The old American treaty was signed at Washington on 12 February 1979 and promulgated in Hungary by Government Decree 49/19789 (6.XII.); the old German treaty was signed at Budapest on 18 July 1977 and promulgated in Hungary by Law-Decree 27 of 1979

Table (i): Review of the old and new American double tax treaties in the light of the OECD model

US – Hungary	OECD model	Old treaty	New treaty
Personal scope	Based on the permanent home (Article 1)	Extended scope [Article 1 (2)]; Partnerships are included [Article 3 (1)(d)(ii), Article 4 (1)(b)]	Extended scope [Article 1 (4)]; Partnerships are included [Article 1 (6), Article 3 (1)(j)(ii)]
Substantive scope	Income and capital (Article 2)	Income (Article 2)	Income (Article 2)
Residence	Tie-breaker applicable to business organisations [Article 4 (3)]	No such rule	No such rule

More explicit regulation in the new treaty concerning:

- citizens may be taxed in both countries even without a permanent home held their
- the extended personal scope, in the context of which the new treaty mentions, e.g., about those who are involved in tax emigration, but there are no particular rules on tax emigration in Hungary
- the income derived by partnerships as such that cannot be interpreted in the new treaty; the recognition for tax purposes of income derived either through a partnership or by the partnership itself is included in the old treaty

Residence:

- no tie-breaker rule exists on business organisations due to the incorporation principle as applied in the US; this is why LOB provisions appear

US – Hungary	OECD model	Old treaty	New treaty
Business profit and transfer pricing	Articles 7 and 9	No transfer pricing provisions	Article 9
Dividends	25% required participation in capital (Article 10); No branch remittance tax [Article 10 (5)]	10% required participation in capital (Article 10); Branch remittance tax [Article 9 (5)]	10% required participation in capital (Article 10); Branch remittance tax [Article 10 (8)]
Interest	No taxation in the source country (Article 11)	No taxation in the source country	No taxation in the source country; Source country taxation of contingent interest is possible up to 15% [Article 11 (2)]
Capital gains	Taxation in the source country of the gains arising from the alienation of shares deriving more than 50% of their value from immovable property [Article 13 (4)]	–	Taxation in the source country of the gains arising from the alienation of shares deriving more than 50% of their value from immovable property [Article 13 (4)]; Step-up in value calculated due to the application of an exit tax [Article 13 (9)]

Dividends, interest and capital gains:

- the branch remittance tax is currently irrelevant to Hungary
- under the new treaty, contingent loan (e.g., a participating loan) is a loan, subject to withholding tax; this is not relevant to Hungary where partnerships are not transparent
- taxation is allowed in both countries on the capital gains derived from the disposal of the shares of companies with significant immovable property; double taxation is excluded in connection with exit taxes

US – Hungary	OECD model	Old treaty	New treaty
Artists & sportsmen	No limitation on source country taxation (Article 17)	No provision on artists and athletes	Source country taxation is possible above a monetary threshold only
Pension	Taxation according to the beneficiary's residence (Article 18)	Taxation of social insurance pensions is possible in the source country (Article 15)	Taxation of social insurance pensions is possible in the source country (Article 17)
Students	No limitation on relief (Article 20)	No limitation on relief (Article 18)	Limitations on relief according to the length of stay and with reference to a monetary threshold (Article 19)

US – Hungary	OECD model	Old treaty	New treaty
Relief from international double taxation	Double non-taxation is not precluded upon the exemption method to be applied by Hungary	Double non-taxation is not precluded upon the exemption method to be applied by Hungary	Exemption to be applied by Hungary is subject to taxation in the US [Article 23 (1)(d)]
Exchange of information	Comprehensive (Article 26)	Petit clause (Article 23)	Comprehensive (Article 26)
Limitation on benefits	–	–	Comprehensive LOB provisions (Article 22)

Table (ii): Review of the old and new German double tax treaties in the light of the OECD model

Germany – Hungary	OECD model	Old treaty	New treaty
Personal scope	Based on the permanent home (Article 1)	Based on the permanent home (Article 1); There are no special rules on partnerships	Based on the permanent home (Article 1); There are no special rules on partnerships
Substantive scope	Income and capital (Article 2)	Income and capital (Article 2)	Income and capital (Article 2)

Germany – Hungary	OECD model	Old treaty	New treaty
Dividends	25% required participation in capital (Article 10); No branch remittance tax [Article 10 (5)]	25% required participation in capital (Article 10); The capital income paid out of silent partnerships may be taxed in the source country up to 25% [Article 10 (2)(b)]	10% required participation in capital [Article 10 (2)(a)]
Interest	Limited taxation in the source country (Article 11)	No taxation in the source country	No taxation in the source country
Royalties	No taxation in the source country (Article 12); No deemed source rule	No taxation in the source country; Source of the royalties received is extended to the State where the permanent establishment of a third-country enterprise operates if the permanent establishment is in connection with the indebtedness on which royalties are incurred [Article 12 (4)]	No taxation in the source country; Source of the royalties received is extended to the Sate where the permanent establishment of a third-country enterprise operates, if the permanent establishment is in connection with the indebtedness on which royalties are incurred [Article 12 (4)]

Dividends:

under the old treaty, the capital income paid out of silent partnerships falls within the scope of the dividends article, and subject to 25% withholding tax, the new treaty is silent in this respect; all this is not relevant to Hungary where partnerships are not transparent

Germany – Hungary	OECD model	Old treaty	New treaty
Capital gains	Taxation in the source country of the gains arising from the alienation of shares deriving more than 50% of their value from immovable property [Article 13 (4)]	–	Taxation in the source country of the gains arising from the alienation of shares deriving more than 50% of their value from immovable property [Article 13 (2)]; Step-up in value calculated due to the application of an exit tax [Article 13 (6)]
Pension	Taxation according to the beneficiary's residence (Article 18)	Taxation according to the beneficiary's residence (Article 19)	Taxation of social insurance pensions is possible in the source country [Article 17 (2)]
Students	No limitation on relief (Article 20)	Limitation on tax relief according to a stay of two years as a maximum [Article 20 (2)]	No limitation on relief [Article 19 (2)]

Capital gains:

taxation is allowed in both countries on the capital gains derived from the disposal of the shares of companies with significant immovable property; double taxation is excluded in connection with exit taxes

Germany – Hungary	OECD model	Old treaty	New treaty
Relief from international double taxation	Double non-taxation is not precluded upon the exemption method to be applied by Hungary	Double non-taxation is not precluded upon the exemption method to be applied by Hungary	Exemption to be granted by Hungary is subject to taxation in Germany [Article 22 (2)(d)]
Exchange of information	Comprehensive (Article 26)	Petit clause (Article 26)	Comprehensive (Article 25); The information received can be used not only for tax, but also for other purposes
Procedures on treaty implementation	–	–	Taxation at source procedure (Article 26)
Anti-avoidance legislation	–	–	Possible (Article 27)

Table (iii): Review of the new Russian model treaty and the effective Russia – Hungary:

- Постановление Правительства Российской Федерации от 24 февраля 2010 г. n 84 о заключении межгосударственных соглашений об избежании двойного налогообложения и о предотвращении уклонения от уплаты налогов на доходы и имущество

- Russia – Hungary double tax convention, signed at Budapest on 1 April 1994, promulgated in Hungary by Act XXI of 1999

OECD model	Russian model	Russia – Hungary treaty
Based on the permanent home (Article 1)	Based on the permanent home (Article 1); There are no special rules on partnerships	
Income and capital (Article 2)	Income and capital (Article 2)	
Fiscal residence (Article 4)	The Article does not imply Para. 2 of Article 4 (1) on the exclusion of residence of those who are liable to tax in respect only of income from sources in that State; No priority is given to the place of effective management comparable to the place of incorporation	The Article does imply Para. 2 of Article 4 (1) on the exclusion of residence of those who are liable to tax in respect only of income from sources in that State; Priority is given to the place of effective management comparable to the place of incorporation
Permanent establishment (Article 5)	The concept of PE is extended to the services performed by those who are present in the source country at least 183 days and who derive more than half of their worldwide sales receipts from this place of business	The concept of PE is not extended to the services performed by those who are present in the source country at least 183 days and who derive more than of their worldwide sales receipts from this place of business

What is the Russian position held on tax arbitrage, taken into account the fairly broad scope of the term of residence, and given that incorporation cannot for tax purposes be superseded unless by way of mutual agreement? What is the reason for the Russian reservation made on Article 4 to keep the right to prefer the incorporation principle?

OECD model	Russian model	Russia – Hungary treaty
Income from immovable property (Article 6)	No priority is given to this Article comparable to the business profit Article	Priority is given to this Article comparable to the business profit Article
Associated enterprises (Article 9)	There are no provisions on a procedure of adjusting profits with all affected contracting parties	There are no provisions on a procedure of adjusting profits with all affected contracting parties

Why is Russia reluctant to insert into the transfer pricing Article a second Paragraph on adjustment?

OECD model	Russian model	Russia – Hungary treaty
25% required participation in capital (Article 10); No branch remittance tax [Article 10 (5)]	Limits on withholding taxes are 10% and 15%, respectively; 25% participation and meeting of a threshold is required; The dividends paid to pension funds are exempt from withholding tax; The term of dividends includes constructive dividends arising from thin capitalisation; Benefits are to be withdrawn where the basic purpose of the taxpayer was to obtain treaty benefit in connection with the payment of dividends (similar provisions are inserted in connection with the payment of interest and royalties as well)	Withholding tax is uniformly reduced to 10%; No deviation is in any other respect from the OECD model

OECD model	Russian model	Russia – Hungary treaty
Limited taxation in the source country (Article 11)	There are exceptions to the 10% withholding tax that apply to the following: - interest received by public institutions - interest paid out of securities released by public institutions - interest paid to pension funds	Withholding tax is uniformly 0%; No deemed source rule
No taxation in the source country (Article 12); No deemed source rule	Source country taxation is limited to 10%; Source of the royalties received is extended to the State where the permanent establishment of a third-country enterprise operates if the permanent establishment is in connection with the indebtedness on which royalties are incurred	Withholding tax is uniformly 0%; Deemed source rule applies

OECD model	Russian model	Russia – Hungary treaty
Taxation in the source country of the gains arising from the alienation of shares deriving more than 50% of their value from immovable property [Article 13 (4)]	Taxation in the source country of the gains arising from the alienation of shares deriving more than 50% of their value from immovable property	No taxation applies in the source country of the gains arising from the alienation of shares deriving more than 50% of their value from immovable property
Article 14 on independent personal services is deleted	Same as the OECD model	An independent Article 14 on independent personal services exists

Why did Russia stick to an independent Article on the taxation of income from independent personal services? What has been changed in respect of the new Russian model?

OECD model	Russian model	Russia – Hungary treaty
Artists and sportsmen (Article 17)	The fee paid out of public institutions is exempt from taxation in the source country	The same applies as in the Russian model
Taxation according to the beneficiary's residence (Article 18)	Taxation of social insurance pensions is possible in the source country	No source country taxation at all
No limitation on the relief of students (Article 20)	Limitation on tax relief according to a stay of two years as a maximum	No threshold of the qualification for relief

OECD model	Russian model	Russia – Hungary treaty
Foreign tax credit (Article 23B)	Foreign tax credit with the application of ordinary credit	On the Hungarian side, exemption applies to active income with progression
Non-discrimination (Article 24)	The provisions of this Article are confined to the taxes covered by the respective treaty only; Those who are not resident in one of the contracting States are excluded from the scope of this Article; The national application of thin capitalisation rules or CFC legislation is not affected by the non-discrimination Article	No deviation from the OECD model in general; There is no reference to those who are resident in third countries; It is provided for that the most favoured nation principle cannot apply in any respect

Why does Russia hold a strict position on the scope of non-discrimination, not extending the benefit of non-discrimination to those who are resident in third countries?

OECD model	Russian model	Russia – Hungary treaty
Mutual agreement procedure (Article 25)	No arbitration is provided for as an alternative to MAP	Arbitration does not apply
Exchange of information (Article 26)	Comprehensive (covers foreseeably relevant information, banking secrecy is superseded)	Comprehensive, but does not refer to the foreseeable information to be exchanged; There is no reference to banking secrecy
Assistance in the collection of taxes (Article 27)	There is a full Article	No such Article exists

OECD model	Russian model	Russia – Hungary treaty
Limitation on benefits	There is an independent Article on the limitation on treaty benefits (Article 29), making reference in particular to the following: - treaty benefits may be withdrawn upon any treaty abuse - contracting States may reserve the right to introduce CFC legislation or similar legislation - conduit companies may be disregarded, except if substantive business activity is carried on	No such Article exists

What is the logic of the Russian LOB Article? How are the different components (general anti-abuse rule, “de lege ferenda” CFC legislation, conduit company legislation) interrelated with each other?

How can a foreign-registered company benefiting from a ring-fencing-based offshore regime be identified for Russian tax purposes, with particular regard to a possible test of passive income or passive assets?

How can bona fide criteria be determined from the perspective of Russian tax law, resulting in safe harbours for the purposes of the tax treatment of conduit companies?