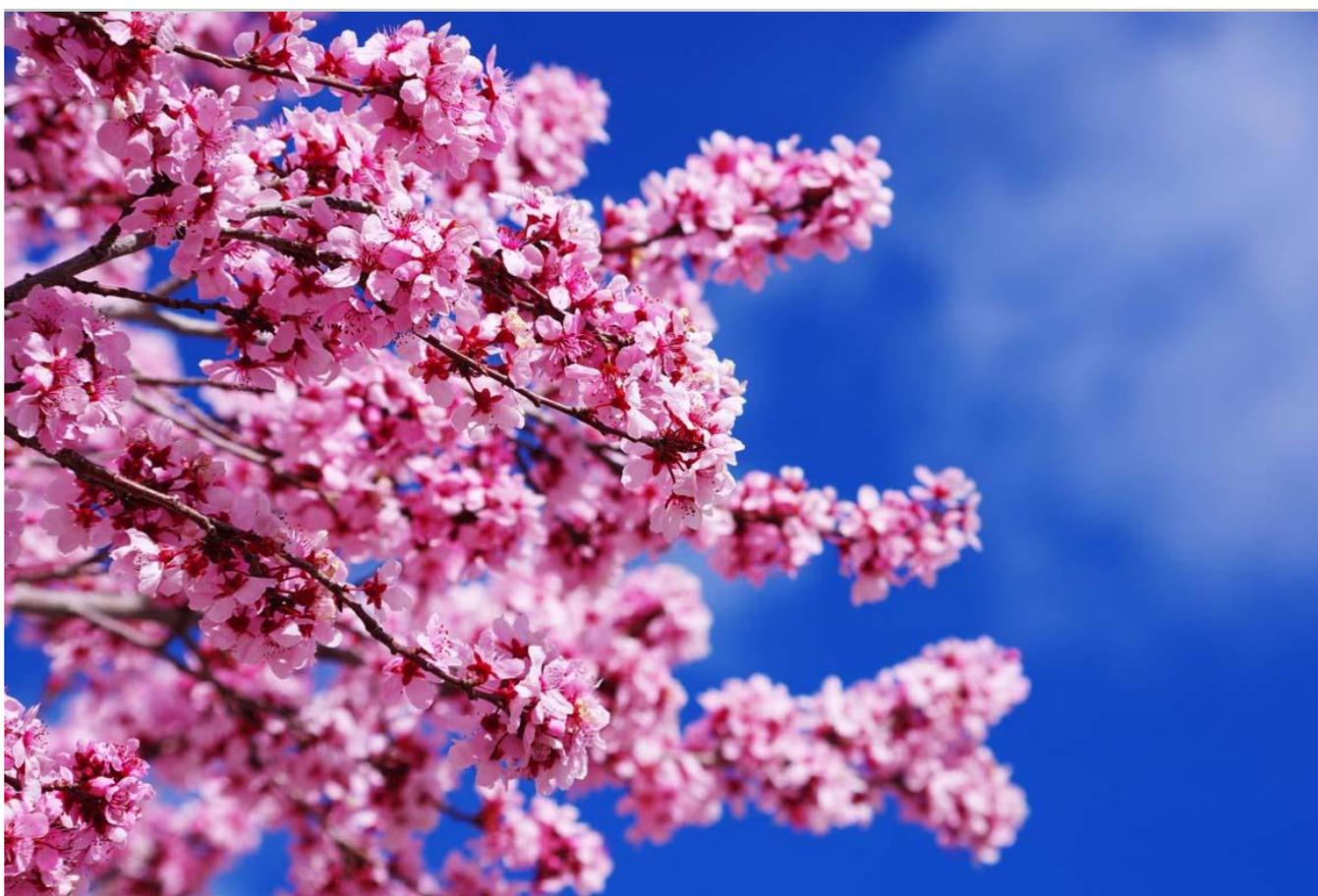


## Tax News+



# Tax News+

**Below you will find the tasks and potential issues arising from key tax law changes of the past month and recent weeks. We would be ready and glad to discuss with you any of your company specific issues.**

## **Tax treatment of interests paid on loans borrowed for financing dividends**

Based on our experience, in the past the tax authority has in many cases not recognized the interests from loans borrowed with the aim of financing dividend payments as business-related costs. However, the tax authority's current practice appears to have changed based on a statement issued in respect of a similar case.

In the given case, the tax authority questioned whether the interests related to loans borrowed by subsidiaries from their parent company – aiming to comply with their liabilities incurred in connection with capital decrease or dividend payment – should be considered as deductible for corporate income tax purposes. No specific regulation currently exists that sets forth how to treat the interests related to this kind of loan. In Annex 3 of the Act LXXXI of 1996 on Corporate Tax and Dividend Tax – based on which such costs could be clearly defined as deductible or non-deductible –, the general deductibility rules should be applicable. In relation to the general rules, the tax authority confirmed the business-related nature of the interest paid in relation to parent company loans. Thus, the tax base does not have to be increased by the amount of such interests. Nevertheless, thin capitalization rules should be taken into account, as – once the subsidiary exceeds the threshold set out for thin capitalization purposes by borrowing the loan – the profit before tax should be increased by the proportionate part of the related interests.

According to the above, we recommend appealing the potential decision of the tax authority in situations where the tax authority treated the interests on loans borrowed for capital decrease or dividend payment as non-deductible for corporate income tax purposes.

## **VAT cross-border rulings**

As we previously informed our Clients, within the frame of the European Union's VAT Forum, Hungary – together with 13 other Member States – participates in the initiative of VAT cross-border rulings. Such rulings can be requested in an extended test period until the end of 2014.

The purpose of cross-border rulings is to entitle taxpayers to request confirmation on the VAT implications of a transaction from the tax authority of their country of residence. The ruling should cover the VAT implications of all the countries involved in the transaction.

Ruling requests should be submitted to the Public Relations and Information Department of the National Tax and Customs Office. Detailed procedural rules will be introduced after the test period. The ruling procedure is not subject to an administrative fee. Similarly to normal non-binding ruling requests, the VAT cross-border rulings issued by the tax authority are considered as professional opinions without legal binding force.

The initiative aims to strengthen the cooperation between the tax authorities of the EU. The advantage of such a procedure is that the tax authorities have the opportunity to conciliate their views on the VAT treatment. This should be specifically requested by the taxpayer submitting the ruling. The tax authorities may not necessarily come to a final agreement.

Requesting VAT cross-border rulings may be advantageous as the taxpayer would not need to contact more than one tax authority and/or foreign tax authority.

Based on the above, there may be multiple reasons for requesting VAT cross-border rulings. If the VAT treatment is ambiguous, we recommend requesting VAT cross-border ruling.

## European Court of Justice's ("ECJ") judgment concerning the special tax levied on retail trade

In a court case that came before the Székesfehérvári Törvényszék ('Court of Székesfehérvár', hereinafter referred to as "Hungarian Court"), Hervis claimed that the rules of the special tax levied on the turnover of retail trade is contrary to EU law. The related provisions were introduced by Hungary for the years from 2010 to 2012 (Act XCIV of 2010 on the Special Tax on the Turnover of Certain Sectors, hereinafter referred to as "Special Tax Act"). Hervis – as a member of Spar Group – stated that the Company was subject to a higher tax rate than it should have been. This was due to the fact that consolidation rules were applicable regarding the tax base of related companies. Therefore, a strongly progressive tax rate had to be used. If Hervis operated as an independent entity, then, the base of the special tax would apply only to its own turnover.

The Hungarian Court has suspended the case and referred the case to the ECJ. The Hungarian Court requested clarification on whether the rules of the Special Tax Act were in line with the freedom of establishment and the principle of equal treatment.

In its judgment of 5 February, the ECJ stated that the method of calculating the tax base and the progressivity of the tax rate together may harm the freedom of establishment. Related entities that are members of a foreign group of companies may be discriminated against based on these regulations. According to the ECJ judgment, the Hungarian Court has to investigate whether discrimination actually took place in the Hungarian market, i.e. whether the retail tax was paid mostly by Hungarian subsidiaries of foreign group of companies. If the Hungarian Court finds that the retail tax was paid mostly by Hungarian subsidiaries of foreign group of companies, then, the Court should rule that the discriminative regulations of the Special Tax Act cannot be applied.

The ECJ did not actually state that the tax contravened EU law. This issue remains to be decided by the Hungarian Court in accordance with the principles set forth by the ECJ. The ECJ provided the Hungarian Court with exact guidance on the circumstances required to examine the decision. Taking into account the above, the main objective of the Hungarian Court shall be the examination of the facts.

A number of issues will arise if the Hungarian Court rules in favor of Hervis. Among these issues, the most important ones are the following:

- Is the whole Special Tax Act or only certain regulations of it to be considered as discriminative?
- Is the judgment exclusively applicable to Hervis or may other concerned companies reclaim the amount of tax paid by referring to the judgment?
- Is the judgment applicable to taxpayers not subject to the consolidation of tax bases of related entities?
- Which method shall be used for reclaiming the tax?
- Will other tax types be affected by the judgment (e.g. other special taxes, certain regulations of local business tax)?

Based on the above, we recommend that those companies that paid a considerable amount of special retail tax should examine the case in more detail and prepare for the potential implications

## Tax audit focuses in 2014

We draw our Clients' attention to the fact that the Hungarian Tax Authority (hereinafter referred to as "HTA") published its brochure regarding the foreseeable focus areas of the 2014 tax audits on 18 February 2014. Based on the brochure, the HTA seemingly aims to further increase the audit activity. The brochure sets forth the criteria of the tax audit selection process, the main focus regarding the economic activities, industries and the objectives of the tax audits for 2014.

According to the brochure, the HTA will for the purposes of its risk assessment process specifically consider the circumstances of the seat, personnel changes, balance of taxes paid to and subsidies claimed from the Budget, and other networks of the taxpayer. In particular:

- the company uses seat provision services,
- the new member or managing director of the company has been concerned with company stacking or company crashing,
- the company repeatedly fails to fulfill its declaration obligations,
- the company is part of a supposedly fraudulent supply chain.

Tax registration and increased tax authority supervisory proceedings – that received significant attention last year – will remain a crucial part in the tax audit selection process.

Online till machines will have increased significance during the course of audits that aim at gathering

data. This is due to the fact that during this type of audit the HTA plans to monitor the installation of the till machines that are supposed to enable remote control. Information acquired from IT systems through data saving will remain a key component.

In addition to exploring supply chains and invoice circulation in tax types related to added value, pre-tax refund audits will remain the most significant regarding follow up audits of tax returns.

In corporate income tax, the following will remain crucial topics:

- audit of the adequacy of applicable transfer prices used between related parties, specifically in case of non-conventional price determining methods,
- legality of the application of tax base decreasing items regarding R&D activities,
- adequate return and payment regarding training fund contribution.

Audit of labor rental will have an emphasized role with regard to other taxes.

In addition to the above, the HTA determined the areas to be extensively audited based on economic activities:

- meat processing and preservation as well as grain industry in the agricultural sector,
- production of metal structures, building residential and non-residential buildings in the industrial sector,
- car repair services and car maintenance services as well as the retail trading of car components as trading activities;
- wholesale of sugar, sweets, vegetables and fruits,
- wholesale of living animals, meat and meat products,
- advertisement agent activities,
- labor rental,
- personal defense activities.

In addition to the focus areas for 2014, the brochure defines the primary targets of data gathering for audit purposes of the upcoming years. Such targets are restaurants, moving diners, engineering and technological consulting and rental of intellectual property.

In addition to tax audits, the HTA is responsible for customs duty audits. Within this area, the main focus will be on the following.

- verification of tariff classification and reported place of origin of products,
- verification of customs value and its definition,
- audit of duty free custom procedures,
- increased audit of the import of textile, clothing goods and footwear,
- audit of the merchants generating the highest import traffic,
- audit of export customs procedures.

It is also detailed in the brochure that the HTA is in possession of several tools other than the increased audit activity which increase the efficiency of the findings. Therefore, it is prudent from a client perspective to request professional assistance from the beginning of the audit procedure.

#### **Act concerning the tax implication pertaining to trusts**

The act on trusts and legislation of their activities has been proclaimed. The act comprehensively regulates the issues of trusts including taxation related questions in respect of asset assignment, asset management and asset disbursement. The provisions of the act bolster the purpose of the legislature, i.e. to ensure that the establishment of a trust does not have tax consequences that aggravate the functional use of the new legal institution. According to the new legislation – as a general rule – the acquiring of the assets by the trustee is not subject to gift tax while the acquiring of the assets by the (individual) beneficiary is exempt from personal income tax. The yield of the assets is taxed as dividend at the private individual. In addition, the managed assets are subject to both corporate income tax and local business tax.

### Change in residency legislation regarding settlers for investment purposes

The number of investors interested in Hungarian government bonds is constantly increasing. 298 new applicants applied for the program in the last two months of 2013 and the number of successful applicants increased to 430 by the end of the year. Residency legislation effective from 1 January 2014 may increase the number of investors interested in Hungarian residence bonds. It is a key factor whether the given investor is Hungarian resident or not regarding the taxation of investors having residential legal status.

According to the new legislation, for the purposes of 3. § point (3) of Act CXVII of 1995 on Personal Income Tax '*Non-resident private individual*' is an individual with residential legal status who falls under 35. § (1) point e) of Act II of 2007 on the Admission and Right of Residence of Third-Country Nationals provided that the individual resides less than 183 days on Hungarian territory – considering both the day of arrival and departure as a whole day – in any 12-month period.

The residency legislation effective as of 1 January 2014 brought favorable change for those individuals that apply for national permanent residence permits based on economic interest but do not intend to reside in Hungary.

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