

AN ALERT FROM THE BDO INTERNATIONAL TAX PRACTICE

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► SUBJECT

UNITED STATES AND HUNGARY SIGN A NEW INCOME TAX TREATY

► ISSUE

The United States and Chile signed a new income tax treaty (“Treaty”) on February 4, 2010.

► AFFECTING

Taxpayers with cross-border activities between the United States and Hungary.

► EFFECTIVE DATE

Once approved by the United States Senate, the Treaty will enter into force on the date of the exchange of instruments of ratification. The new treaty provisions will enter into force on the following dates:

- Concerning taxes withheld at source—for amounts paid or credited on or after the first day of the second month next following the date on which the new treaty enters into force; and
- Concerning other taxes—for tax periods beginning on or after the first day of January next following the date on which the new treaty enters into force.

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► DETAILS

On February 4, 2010, the Treasury Department announced a new income tax treaty between the United States and Hungary, replacing the existing 1979 treaty which no longer reflects current policies.¹ The Treaty is designed to ensure that only residents of the United States and Hungary may enjoy its benefits. The texts of the new Treaty and a diplomatic note, also dated February 4, 2010, have been released and can be located at www.treas.gov/offices/tax-policy/library/HungaryTreaty2010.pdf and www.treas.gov/offices/tax-policy/library/HungaryNote2010.pdf, respectively.

The Treaty includes a comprehensive Limitation on Benefits (“LOB”) provision that is consistent with more recent United States tax treaties. It also includes an exemption from withholding tax on dividends paid to pension funds. However, the Treaty retains the existing withholding tax exemption on cross-border interest and royalty payments, along with the previous reduction in withholding taxes on cross-border dividend payments.

The Treaty generally did not change the withholding tax rates under the existing treaty. Unlike a number of other recent treaties or protocols, this Treaty does not provide for a zero-percent withholding tax for certain parent-subsidary dividends.

WITHHOLDING TAXES

Dividends- The general withholding tax rate for dividends continues to be 15 percent, with a further reduced rate of five percent when the beneficial owner is a company that holds directly at least ten percent of the voting stock of the company paying the dividend. The five-percent rate generally does not apply to a dividend paid by a regulated investment company (“RIC”) or a real estate investment trust (“REIT”).

Whereas RIC dividends should always benefit from the 15-percent rate, the dividends paid by a REIT must meet additional requirements in order to qualify. Unlike recent treaties with other European countries, the new Hungarian treaty does not contain an exemption for certain parent-subsidary dividends.

Interest- Interest is exempt from source-country withholding taxation, except that contingent interest is generally subject to a withholding tax of 15 percent. Interest that qualifies as an excess inclusion with respect to a REMIC residual interest may be taxed in accordance with domestic laws.

Royalties- Royalties are exempt from source-country taxation.

LIMITATION ON BENEFITS

Hungary has been a tax-efficient portal to the United States for foreign investors because the existing treaty did not contain an LOB provision. The Treaty includes a modern LOB clause, which may deny treaty benefits to Hungarian entities that are ultimately owned by residents of other countries. Also included in the LOB is a triangular provision intended to limit a resident company’s ability to receive the benefits of the Treaty for income derived through a permanent establishment located in a (low-tax) country other than the United States or Hungary. Under the existing treaty, any Hungarian company that is a resident for treaty purposes could have claimed the benefits of the treaty,

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¹ Convention between the Government of The United States of America and the Government of The Republic of Hungary for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, dated February 4, 2010.

regardless of the country of residence of its ultimate shareholders. In order for a Hungarian (or United States) company to be eligible for benefits under the Treaty, it will have to meet one of the following tests contained in the LOB article:

Publicly traded company test- Either the company or its ultimate parent is publicly traded on a recognized stock exchange.

Ownership and base erosion test- The majority of the company's stock is owned by other qualified persons (*e.g.*, individual residents of Hungary) and less than 50 percent of the company's gross income is paid to residents of other States in the form of deductible payments (*e.g.*, interest).

Active trade or business test- The company (including "connected persons") has an active trade or business in the state of residence and income for which treaty benefits are desired must be derived in connection with or incidental to that trade or business.

Derivative benefits test- At least 95 percent of the company's shares (by vote and value), are held, directly or indirectly, by seven or fewer residents of countries subject to the North American Free Trade Agreement, the European Union, or the European Free Trade Association (Note that the Treaty permits only a maximum number of seven individuals; however, the corresponding diplomatic note suggests that there can be up to ten equivalent beneficiaries.). With respect to dividends, interest and royalties, the equivalent beneficiaries would have to be entitled to the same tax rate under their applicable Convention as the resident company.

Headquarters company test- The company must supervise and administer a group of companies which must be engaged in active businesses in at least five countries and must also meet various other requirements. Financing services alone will not suffice to qualify as a headquarters company.

► RECOMMENDATION

Any planning under the prior United States-Hungary Treaty should be reviewed for any changes that may be required to continue claiming treaty benefits. The addition of the LOB provisions may require some planning to allow for continued treaty benefits.

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