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SME INFO HU

TERMINATION OF CONVENTION FOR AVOIDANCE OF DOUBLE TAXATION BETWEEN USA AND HUNGARY

The purpose of SME INFO is to provide general information and to draw the attention to the current changes in law which we believe to be important for the business operation of our clients. It is not a replacement for careful review of the acts and rules, and the consultation with your tax advisor.

The termination of 49/1979 (XII.6) Convention between the Government of the People's Republic of Hungary and the Government of the United States of America for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income[1] took place on 8 July 2022.[2]

Under the rules governing international conventions, the Convention may be applied until 31 December 2023. Hereby we summarise the tax consequences of the termination and present the tax measures introduced by the Hungarian government..

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As the topic is complex and concerns international taxation, we do not aim to provide comprehensive information but present only the Hungarian regulatory side, focusing on the Hungarian tax residents' aspects. Our aim is to provide information that will help to decide whether you should seek further advice to ensure that you are not adversely affected for tax purposes by the termination of the Convention.

However, please note that only certain types of income and their tax implications are presented in this summary. There may be different types of income not covered herein, but still be concerned.

The provisions of the Convention shall expire after 1 January 2024, therefore the Hungarian rules modification will enter into force from 1 January 2024.

A. PRIVATE INDIVIDUALS

The taxation of individuals is strongly influenced by their tax residence. An individual who is resident in Hungary for tax purposes meets his tax obligations on his worldwide income (Hungarian income plus income from anywhere in the world) in Hungary, under Hungarian tax rules. Since the United States is known to apply withholding tax, but Hungary does not at present, the absence of the Convention basically affects, in tax terms, those Hungarian tax residents who earn income from the United States and on which the payer is required to deduct withholding tax.

The following describes the tax rules applicable from 1 January 2024 for a Hungarian tax resident private individual who receives income (dividend, interest) or realise investment gain from a US resident corporation (institution).

While we do not wish to discuss the US rules, one thing that needs to be mentioned in order to better understand the rules described below is the US approach to dividend and interest income before and after the Convention.

During the period covered by the Convention, i.e., until December 31, 2023, the United States could not deduct withholding tax on interest, while in the case of dividends, the US had the right to tax this type of income to a limited extent, but this was only a right that could be waived by US domestic tax rules. However, even if they wished to tax dividends paid by the US company, the tax could not exceed 15% of the gross dividend.

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(1) 49/1979 (XII.6) Convention between the government of the Hungarian People's Republic and the government of the United States of America for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income.

(2) https://nav.gov.hu/ado/szja/az-amerikai-egyesult-allamok-es-magyarorszag-kozotti-kettos-adoztatas-elkeruleserol-szolo-egyezmeny-alkalmazhatosaga

With the termination of the Convention, the US withholding tax will become automatic, rising to a general of 30% for both dividends and interest income (and other passive income), meaning that the US is expected to deduct 30% of the income paid at source.

1 Personal Income Tax (PIT)

1.1 Dividend income

As regards the Hungarian legislation, there will be no change in the taxation of dividend income.

The current PIT Act defines income from dividends (or dividend advances) as income in full. The definition of dividend also includes „income qualifying as a dividend under the law of a foreign state", so dividends under the law of the US are taxed under this title in Hungary. The current PIT Act allows for a limited offset of tax paid abroad against the Hungarian tax liability, but the US withholding tax cannot reduce the Hungarian tax to zero; a 5% tax rate is payable in Hungary in any case.

This regulation will look similar from Hungarian side even after the termination of the Convention. However, what will change—see point 1.4—is that only in the case of income earned abroad (not in the case of income earned domestically!) will it be possible to offset the tax paid in the place of aquisition of income. So, an important point of analysis will be whether the dividend received qualifies as foreign source income and, thus, whether the above 5% tax rate will apply instead of the standard 15% PIT.

In addition, the social contribution tax will be (and has been) levied on the dividend, according to the wording of the regulation, on the „part taxable in Hungary.".

1.2 Interest income [3]

The current PIT Act classifies interest payments made by a resident of a country with which Hungary does not have a double taxation convention in force as other income. Other income is part of the consolidated tax base, and therefore social contribution tax (in addition to PIT) is payable on other income.

Under the amendment, an addition is made to the relevant part of the tax law on other income, the purpose of which is to exclude interest payments from persons resident in OECD member states from the list of countries

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(3) Act CXVII of 1995 – on Personal Income Tax 28.§ (12)

without a double tax treaty. Since the US is an OECD member state, thus the absence of a convention does not automatically imply for a Hungarian individual, if a US resident pays him interest, to tax this interest as other income. In this case, this type of interest income will presumably be treated as separately taxable interest income, which is more favourable because it is not subject to social conrtibution tax.

1.3 Income from Controlled Capital Market Transactions [4]

The definition of Controlled Capital Market Transactions (CCMT) under the current PIT Act requires, as one of the conditions, that the investment service provider conducting the transactions must be established in an EEA Member State or in a state with which Hungary has a double taxation treaty.

The CCMT requirement will also apply, as amended, if the investment service provider is operating in and supervised by a financial market of an OECD member state and, as mentioned above, the US is an OECD member state. Thus, income from the US will remain subject to the CCMT, which means that it will continue to be possible to offset profitable and unprofitable transactions and to place these investments in a Long-term Investment Account and income earned under this title will continue to be exempt from the social contribution tax payment.

1.4 Amendment to the law on offsetting tax paid abroad [5]

The rules on the calculation of tax offsetting were also amended due to the termination of the Convention. According to this, the place of acquisition of income would be an important criterion and would allow for the crediting of tax paid abroad (in the place of acquisition of income) when determining Hungarian tax liability in the case of the foreign place of acquisition of income, but not in the case of the domestic place of income acquisition. The place where the income is earned is defined in the PIT Act by income title (e.g.: interest, dividends, income withdrawn from the enterprise, etc.), so a thorough examination of these becomes crucial when determining Hungarian tax liability.

2 Social Security

The termination of the Convention, which will come into force in 2024, will have a tax type of disadvantage for those concerned. Under the US-Hungarian Social Security Agreement concluded in 2015 and also promulgated in

§ (4) Act CXVII of 1995 – on Personal Income Tax 67/A.§ (3)
(5) Act CXVII of 1995 – on Personal Income Tax 8.§ (2)

Hungary, which will not be terminated, social security issues can be settled in the two contracting states.

However, it is another matter that, in the absence of a tax treaty, the determination of tax liabilities (where to tax, offsetting options, etc.) and social security obligations may be different for the same income.

3 Social contribution tax (SCT)

SCT is closely linked to the personal income tax system. The amendments to the PIT Act related to the recent termination of the US-Hungarian tax treaty have, for the most part, regulated the points where the absence of the treaty would also potentially impose an extra SCT payment obligation. Thanks to these modifications, except for the payment of the SCT on dividends, US source income of individuals may be exempt from the extra SCT payment.

B. COMPANIES

1 Corporate income tax (CIT)[6]

For companies, the termination of the US-Hungary treaty will be disadvantageous in different ways than for individuals. Since the persons defined in the conventions are understood to include not only private individuals, but companies as well, the Hungarian crediting of the tax paid abroad—in corporate tax—may be questionable in companies' case.

Although the Hungarian CIT has already addressed the avoidance of double taxation for non-Convention countries since 2003, during the application of the imputation method the limitations of the law must nevertheless be taken into account.

In addition, permanent establishment is a difficult issue to get around in corporate taxation, and the address of this issue has been aided by the double taxation conventions (and the OECD Model Convention interpretations). It is questionable for which activities a Hungarian company will and will not be considered having a permanent establishment under US rules in the absence of a treaty.

§ (6) Act LXXXI of 1996. – on Corporate Tax and Dividend Tax 28.§