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wts TAX LEGAL CONSULTING

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Dear Readers,

Growing globalisation means **the significance of international employment is increasing**. As an employer, you also need to **comply with the national laws** valid in the country of the posting.

Last week, during the event organised by the **German-Hungarian Chamber of Industry and Commerce** in Budapest, we had a chance to deliver three presentations on the most important **labour and tax laws affecting you with regard to the posting of employees**.

- Employee postings from the perspective of **German tax law**
- Information on Hungarian **labour law**
- Hungarian regulations on the taxation of **foreigners**

The photos of the event and the **presentations** are available at the following **link**:
http://wtsklient.hu/en/2017/02/17/duihk/

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Expected changes to foreign investments after the corporate tax rate

> "Thanks to these three most significant allowances alone, even before 2017 it was possible to lower the effective corporate tax rate of a large corporation to 2-8%."

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The 2017 **tax change** that **triggered the biggest reaction** among companies was the introduction of the uniform **9% corporate tax rate**. It is worth checking out **how foreign investors respond** to this change, and how this decision by the government will affect their Hungarian investments.

Corporate tax rate cut may favour large corporations

Those foreign investors whose Hungarian subsidiaries have a corporate tax base of less than HUF 500 million will experience a minor, 1 percentage point decrease when preparing their 2017 corporate tax returns, similar to local SMEs. For them, the corporate tax rate cut is mainly psychological in nature. **Large corporations whose tax bases are multiples of the HUF 500 million mark that enjoyed the favourable 10% tax rate so far stand to win** much more with this reduction in corporate tax.

This seemingly favourable situation is nuanced by two factors in the case of large corporations operating in Hungary.

1. Corporate tax base and corporate tax allowances

One factor is that Act LXXXI of 1996 on Corporate and Dividend Tax defines significant corporate tax base and corporate tax allowances not only for SMEs, but also for large corporations that carry out major projects or significant research and development activities.

» **Development reserve**

Companies may allocate a reserve that can be taken into account as a disallowed item for tax purposes, up to 50% of their pre-tax profits, but no more than HUF 500 million. The development reserve allocated in this way can be used to buy tangible assets. In the case of tangible assets acquired from the development reserve, no depreciation can be claimed in corporate tax up to the amount of the development reserve used. In such cases, **depreciation** is essentially **charged earlier**. The amount of the development reserve can be used for projects within four years.

» **Double deductibility of direct research and development costs**

Another significant opportunity for lowering tax bases is that pre-tax profits can be decreased by the direct cost of research and development performed in the fiscal year in connection with the business activity, or in other words, the depreciation charged to an amount recognised as the capitalised value of experimental development may be used to decrease pre-tax profit. Thus **the pre-tax profit may actually be decreased twice, with the costs of research and development or with the depreciation charged to the capitalised value**.

» **80% corporate tax allowance**

The lower corporate tax achieved by decreasing the tax base can be further reduced with a direct tax allowance if a large corporation carries out a project with a value higher than HUF 3 billion (HUF 1 billion in the administrative territory of the beneficiary municipality, or HUF 100 million in certain industries), and fulfils certain additional conditions regarding future employment. In this case, an 80% corporate tax allowance applies for the fiscal year when the investment was commissioned, and in the following nine fiscal years.

Thanks to these three most significant allowances alone, **even before 2017 it was possible to lower the effective corporate tax rate of a large corporation to 2-8%, which would have been 15-18% without the allowances**. With an unchanged tax base or tax allowance, these companies can calculate with a uniform tax rate of 9% from 2017, thus their tax burden will be almost halved, dropping to 1-4%. However, the corporate tax saved in this way only makes up 1-4% of their tax base, or 1-2% of their pre-tax profit at most.

2. Business tax that exceeds corporate tax several fold

The fact that foreign companies **take local business tax into account when calculating their "effective tax rate"** further mitigates the effect of the tax-cutting measure. Since the local business tax base is several times the size of the corporate tax base (net sales revenue can only be reduced by material costs and mediated services), the seemingly innocent 2% tax can reach 6-10% of profit after tax. If we calculate with 6% only, the effective tax rate including corporate and business tax will be around 7-8%. Compared to the 8-12% of previous years, this represents a much smaller saving than the decrease of the 10 and 19% rates to the uniform 9% would imply.

Taxation conditions improving overall

Despite all this, the introduction of the 9% corporate tax rate points in the right direction, and together with the 5 percentage point decrease in the social contribution tax imposed on employees it could **make Hungary a more appealing destination for investment**. However, the gradual convergence of the local business tax base to the corporate tax base remains to be solved.

What can a dividend in Hungary be paid from?

The following should be taken into account when making a dividend decision:

- category of balance sheet profit no longer exists
- dividend accounted for as of the date of the decision
- calculation of amount available for a dividend payment has changed
- dividend payment limit has changed

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At the beginning of the year, when annual reports are prepared, there is one members' meeting or general meeting after another and the owners define the amount of any dividend for the previous year. We have all become used to the Hungarian phenomenon that an annual report is prepared before the decision on the dividend, then another report is prepared after the members' or general meeting including the dividend resolution, which defines the amount of the dividend for the previous year.

From this year, the dividend is included in the annual report for the year when the decision is made

Many will likely be surprised in Hungary that this year the situation is different, and finally, because of amendments to the Accounting Act effective from 1 January 2016, any dividend must be included in the annual report for the year the decision was made, in line with IFRS rules.

The last row of the income statement of 2016 annual reports is **profit after tax**; the category of balance sheet profit has been cancelled. From 2016, any dividend is accounted for as of the **date of the dividend decision**. Thus, a dividend determined by a subsidiary or associated company in 2017 for 2016 is not included in the parent company's 2016 annual report. The 2016 annual report does not include the amount of the dividend defined by the parent company or the owners of the company in 2017 for 2016 either.

The dividend payable will decrease the retained earnings directly when the owners become liable for payment, while any dividend received (due) will still increase income from financial transactions as of when the dividend receivable is set. In Hungary this obviously changes the calculation of the **amount available for a dividend payment**, i.e. the free retained earnings supplemented with the profit after tax for the previous financial year can be used for a dividend payment; the sum of any dividend received (due) not yet included in the annual report for the previous financial year but accounted for before the balance sheet preparation date (i.e. included in a resolution by the subsidiary or associated company) increases the amount.

Dividend payment limit also changed

The **dividend payment limit** has also changed: the retained earnings supplemented with the profit after tax for the previous financial year may only be paid as a dividend if the amount of equity less the allocated reserve and any positive valuation reserve will not fall below the registered capital after the dividend payment. Naturally, the amount of any dividend received (due) and accounted for before the balance sheet preparation date can also be included in the amount of the equity.

The new dividend calculation requirements apply to the calculation of the amount available for any interim dividend too. However, the rule that an **interim dividend** can only be defined and paid based on an interim balance sheet or an annual report dated no earlier than six months has not changed.

Interim dividends could only be paid in the reporting year so far, primarily because the dividend was booked back to the balance sheet date of the reporting year. However, since the dividend is included in the books as of the date of the decision, there is no legal or accounting obstacle preventing payment of an interim dividend after the end of the reporting year but before the decision on the dividend is made.

In addition to the above, the change in the accounting of a dividend also affects **undercapitalisation calculations** since the dividend only decreases the equity underlying the calculations from the date of the dividend decision, not from the beginning of the year.

Review and reconsider

It is worth reviewing and reconsidering the **calculation** of the **bonuses and premiums** for managers and employees if these amounts used to depend on balance sheet profit. If a company has a **bank loan**, it is definitely necessary to review the limits (covenants) included in the loan contract along with the required equity ratios in light of the fact that from the 2016 financial year, equity as of the balance sheet date will include any dividend received and payable with a one-year delay compared to previous years.

Cooperative procedure – new customer-friendly NAV concept

After the risk analysis, the Hungarian tax authority:

- may launch either a **cooperative procedure** or an inspection, or indicate the possibility of a crime
- asks the taxpayer during the cooperative procedure to conduct a **self-revision**, or initiates dialogue with the taxpayer to remedy the errors
- **may order an inspection of the taxpayer** if the cooperative procedure is unsuccessful

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For a long time now the government has talked about developing a customer-friendly, service-providing tax authority. The "dream NAV" for company managers differentiates between good and bad taxpayers in Hungary like the good fairy, while directing citizens and companies lost in the forest of taxation rules back onto the right path, with some kind words and understanding instead of NAV inspections or tax penalties. Below we look at what can actually come out of this during a cooperative procedure.

Brief summary of cooperative procedure

Both companies and tax consultants have long since lobbied for the tax authority not to launch inspections immediately when it detects a risk, but instead attempt to encourage taxpayers to interpret tax rules correctly and eliminate administrative errors through dialogue and cooperation, like a service provider.

The **cooperative procedure**, a new element of the **customer-friendly NAV** concept, is presumably the result of these efforts. However, some aspects of the system is not completely new.

The previous framework ensured by procedural law also provides an opportunity for a softer procedure. In such cases, the Hungarian tax authority does not examine tax returns and related documents with an inspection aimed at subsequently reviewing tax returns, but rather with a less stringent inspection focusing on the settlement of tax liabilities.

As opposed to the subsequent review of tax returns, also referred to as reviews of individual tax types, the great advantage of the softer procedure is that after any inspection is launched, it is still possible for taxpayers to correct any errors or shortcomings through a self-revision, paying a self-revision charge that is much lower than the tax penalty or default charge that can be levied as a result of an inspection.

This NAV procedure gives us one last chance to take the necessary measures to avoid an inspection as well as serious sanctions. So it is well worth preparing for disputes with the tax authority, or even to request the assistance of an expert in the various tax procedures, such as WTS Klient.

Government agencies now understand that it is much easier to remedy some violations of the law or other anomalies through dialogue with taxpayers, without conducting formal inspections. This is what is now called the cooperative procedure.

How can you fall under the cooperative procedure in Hungary?

The NAV's selection process and the decision as to which taxpayers it will focus on remain an internal procedure for them, and are essentially decided on during **risk analyses**.

In such cases, the tax authority checks the data available (such as mandatory data supplied, tax return data).

The exact details of these evaluations are not public, but it is presumably marked differences and logical contradictions that may focus the tax authority's attention on individual companies.

After the risk analysis and assessing the weight and nature of the risks identified, the tax authority decides whether to

» launch a **cooperative procedure**,
» select the taxpayer for **inspection**,
» contact the investigative authority of the NAV **indicating a possible crime**.

What happens in the cooperative procedure?

During a cooperative procedure, the Hungarian tax authority

» makes a direct request to the taxpayer to conduct a **self-revision** (presumably in cases when an issue can be judged easily based on data in the system), or
» **contacts the taxpayer** to remedy the detected errors and shortcomings together, using the professional support of the tax authority.

Participation in the cooperative procedure is voluntary, companies can decide for themselves whether to avail of the opportunity offered by the NAV. Passing up on it would not be very wise, however, because on the one hand, no sanctions can be applied on violations of law identified and resolved during the procedure, while on the other hand, if the cooperative procedure is not successful, the tax authority can resort to a proper **inspection** at any time.

Similar to all human and business relationships, the key to the success of dialogue between the NAV and taxpayers is **mutual trust**. This cannot be earned just by creating the legal framework for dialogue through the cooperative procedure, what is also needed is sustained and consistent tax authority practice. If companies and private individuals see tax inspectors striving to find genuine solutions within the framework of the cooperative procedure, **taking their role of service provider seriously**, and not just falling under the spell of numbers and figures, then they too will likely search for opportunities to present problems to the NAV in an open and transparent way.

Services of the WTS Klient:

» Tax consulting
» Financial advisory
» Legal consulting
» Accounting
» Payroll

Should you have any questions regarding the above or any other professional issues, please do not hesitate to get in touch with your WTS advisor or use any of the contact details below.

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