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highlights

Transfer pricing records - Recently, the tax authority has been examining not just the existence of transfer pricing documentation, but its content too, and so particular emphasis should be devoted to this area. Our newsletter contains a short summary of the expected changes in the MoF decree governing the preparation of transfer pricing records.

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Transfer pricing records – likely changes in regulations

Recently, the tax authority has been examining not just the existence of transfer pricing documentation in detail but also that the content is appropriate, and so particular emphasis should be placed on this area. Below is a short summary of the expected changes in the MoF decree governing the preparation of transfer pricing records.

According to the draft law signed by the Minister of Economy which has been on the government's website since March, changes are likely in several areas in Decree 22/2009. (X.16.) PM on transfer pricing records.

must be compiled per contract

One significant change compared to the previous legislation is that transfer pricing records must be compiled per contract (previously it was for each controlled transaction), even if several controlled transactions take place based on one contract. For lack of a contract, however, transfer pricing records must be prepared for each controlled transaction.

According to the draft law, transfer pricing documentation does not have to be prepared from the tax year a request is submitted in advance to the tax authority for the assessment of arm's length prices until the last day of the tax year in which the tax authority decision is valid. However, please note that this exemption is subject to the circumstances set forth in the decision prevailing unchanged until the end of said period.

According to the amendment there is also no obligation to prepare documentation when passing on services/products not associated with the core activity to related companies for an unchanged sum, provided that the supplier of the service or product is not related to the taxpayer (foreign entity) or the party bearing the costs. However, if the value of the service or product is passed on to more than one related company, then the taxpayer has to substantiate the arm's length nature of the price applied.

HUF 50 million limit

The draft law also states that when examining the HUF 50 million limit providing exemption from the obligation to keep records on arm's length prices, only the value of supplies in the tax year must be taken into account. This provides significant relief compared to the previous regulation, given that when assessing the HUF 50 million threshold it is no longer necessary to consider the service and product supplies from the contract date until the end of the tax year. If the contractual value is not denominated in HUF, the foreign exchange rate of the National Bank of Hungary valid on the contracting date must be applied when examining the HUF 50 million threshold for exemption from preparing transfer pricing documentation, and when examining the HUF 150 million threshold for "low added value" services within the group.

the arm's length mark-up is between 3% and 10%

Additionally, the draft law states that the arm's length mark-up is the mark-up applied at the related party affected by the controlled transaction, but one which is no less than 3% and no more than 10% (when preparing records on low added value services within the group, where the same types of service must be considered together per tax year).

According to one of the most important and practical amendments, when using public databases on comparable companies the steps followed must be very detailed and defined, while both quantitative and qualitative filters must be applied.

Registration of property renting – tax authority is watching

Property renting is, by default, exempt from VAT, but taxpayers can make a preliminary decision to opt for it being taxable. It is crucial to get the timing right when informing the tax authority, as failure to meet the registration obligation can result in taxpayers having to delve deep into their pockets, as demonstrated by the following court case which serves as a good case study.

find out whether the lessor has indeed opted for VAT

It is a common error that tenant companies do not bother to find out whether the lessor has indeed opted for VAT with the tax authority on the renting activity. And it is in cases like these that the recipients of the invoices on the rental fee discover, during a tax inspection, that they illegally deducted the VAT. The unlawfully charged VAT can be claimed back from the issuer of the invoice, but the recipient of the invoices will be the one facing a tax penalty potentially running into several millions of forints.

invoice issuer can also be hit with tax penalty

According to the following ruling from the Curia summarised below, it is also clear that the issuer of the invoice can expect a hefty tax penalty if the notification was not made at the proper time.

First of all, let's look at the facts:

- In the first quarter of 2010 the tax authority conducted a pre-remittance review at a taxpayer for VAT.
- The taxpayer began its activity on 26 May 2009, and its main profile was the renting and operating of own and leased property.
- After being registered, the taxpayer acquired business premises on 9 July 2009, which it then leased out based on a rental contract dated 28 September 2009.
- The inspectors found that the taxpayer only generated revenue from property renting, but the taxpayer did not notify the tax authority of the option to make this taxable, and so the taxpayer could not deduct any VAT on purchases. Following the tax inspection the amount of VAT reclaimable by the taxpayer was modified to HUF 0, and resulted in a tax penalty from the tax authority.

According to the taxpayer, it only became clear to them on 17 September 2009 that the business premises in question were to be rented out, and the notification was sent on the same day. However, the inspectors did not accept this argument, stating that the company designated the rental of owned and leased property as its main profile when founded, and so in their opinion **the taxpayer should have made a statement on the option for taxation upon the registration of the company, regardless of whether the taxpayer had any property at that time or not**.

The tax authority also found that on the form submitted on 17 September 2009 the taxpayer made a declaration with retroactive effect to 26 May 2009 that in the case of property renting it chose to make the activity subject to VAT, as opposed to being exempt. The declaration was previously rejected by the competent office of the tax authority, stating that it is not possible to make this taxation choice at a subsequent date. Consequently, in 2009 the taxpayer should only have invoiced the renting of the business premises without VAT. The tax authority also noted that in 2009 the taxpayer did not submit a declaration stating it wished to opt for VAT in 2010 with regard to its property renting activity. The taxpayer did submit a modification form on 14 June 2010, in which it opted for VAT with retroactive effect to 28 September 2009, but the tax authority rejected this declaration and so the taxpayer should have invoiced its renting activity without VAT in 2010 as well.

it is not possible to choose the proper method of taxation at a later date

The case made it all the way to the Curia. In its ruling, the Curia emphasised that the Act on the Rules of Taxation does not make it possible to make up at a later date for failing to choose the proper method of taxation, and to make notifications with retroactive effect.

The tax authority won the case, while the taxpayer won some valuable (and expensive) experience, essentially, that the tax authority does not accept statements made in connection with property renting that are submitted with retroactive effect. If renting is included among the scope of activities when a company is established, it is advisable to submit notification of the taxation choice at this time, even if the company does not yet have any property.

Penalty, or clean bill of health?

A labour inspection is never a "red-letter day" for any employer, but with careful administration and adhering to the basic rules of the Hungarian Labour Code it is possible to avoid being hit with fines.

first half of 2013: focusing on activities supporting services second half of 2013: the retail sector

The inspectors from the National Labour Office primarily select the companies to review based on their inspection plan. According to the plan published for 2013, in the first half of this year the Office will be focusing on activities supporting services, while in the following six months the emphasis will switch to the retail sector. In many cases the labour inspectors visit employers without prior notification, which is primarily designed to ensure the inspection can be conducted safely and successfully. Such inspections are most likely in the construction industry, shopping centres and hospitality industry, but it is not unknown for inspectors to appear at companies located in office buildings too.

complex inspection on the basis of notification from the public

One other common factor triggering official inspections is a notification or complaint from the public, which implies a complex and comprehensive labour inspection. This type of inspection generally starts with anonymous information that the Office always has to follow up on.

Two inspectors are generally in attendance, and they identify themselves with photographic ID before starting the inspection.

During the process, labour inspectors principally focus on examining compliance with the rules of the Hungarian Labour Code, and so they request registrations, employment contracts and attendance sheets; furthermore, they can interview employees as witnesses who have to respond to questions about their employment relationship. Experience shows that the inspectors focus on the following areas:

- do employees believe they are registered at the company?
- have the employees received an employment contract and a job description?
- what are their gross salaries?
- how many hours do they work each day?
- how do they complete the attendance sheet?
- does the employer tend to order overtime, if so, when and in what form?
- is the overtime compensated?
- can employees take their holiday entitlement?
- do the employees receive a salary slip?

Employers can provide evidence for all these questions for both employees and the inspectors based on good administration.

registration obligation T1041

According to the current regulations, employment relationships must be registered with the tax authority on form T1041 before the employment begins, but by the latest on the first day of the social security relationship. A copy of the data provided and of the confirmation of receipt must be given to the employees, naturally with the employees verifying receipt of these documents with their signature. This way the employer can easily prove that employees were informed about the registration.

employment contract in two copies

Two copies must be prepared of employment contracts, the main purpose here being that both signatories to the contract each receive an original copy.

attendance sheets must be kept on an hourly basis

Attendance sheets must be kept on an hourly basis. Many companies do not indicate the number of hours worked on a given day with a number on the attendance sheets, but with an "X". However, this does not reveal when the employee arrived at the workplace on the given day and when they left, so any overtime cannot be determined either. According to the new Hungarian Labour Code, an employee normally working 8 hours per day can be compelled to work overtime of 4 hours per day, 8 hours per week and no more than 32 hours per month, bearing in mind the annual limit on overtime which is 250 hours. This extra work must be instructed in writing if so requested by the employee; verbal agreement is also possible, but written instructions provide precise evidence for both parties in the event of an inspection. According to the rules of the Hungarian Labour Code, overtime must always be compensated.

annual limit on overtime: 250 hours

holiday

Records of working hours also reveal whether employees can take their holiday entitlement. The general rule is that normal holiday leave must be used up in the given year, and this must be recorded on both the attendance sheet and the holiday consent form. If employees are unable to take out all of their annual holiday entitlement, then from 1 January 2013 and based on agreement between the parties the employer may allow the employee to use one third of the leave by the end of the following year based on Act I of 2012.

salary slips handed over by 10th of the month

Salary slips must be handed over to all employees by the 10th working day of the month following the given month, with the employee signing to verify receipt. This proves that the employer complied with the rules.

If the employer adheres to the important requirements as outlined above during day-to-day operations, the inspectors of the National Labour Office will likely have nothing to object to during an inspection. Despite this, it is possible for employers to make mistakes during their everyday routines, and these may be discovered during an inspection. Nevertheless, for first-time infringements by small and medium-sized enterprises the Office only issues a warning or sets a deadline for the problem to be rectified.

If the labour inspectors reveal shortcomings or errors during the inspection that entail a fine or penalty – e.g. repeated breaches of the rules above, risk to life or health or the violation of rules regarding the protection of those under the age of 18 – such can range from thirty thousand forints to twenty million forints based on Section 6/A of the Act on Labour Inspections.

This means it is advisable for employers to inspect their labour documentation and review the circumstances of individual employment relationships to ensure that a possible labour inspection does indeed end with a decision to raise no objections (i.e. no employment-related irregularities are found).

Do Hungarians working abroad also have to pay taxes in Hungary?

In recent years, many Hungarian citizens have moved abroad to work. Those going to work abroad are advised to get information about the taxation implications, as in many cases they may be subject to taxation in Hungary, despite working in another country.

A portion of income earned in Hungary has to be paid to the budget in the form of taxes. Those working abroad may find themselves in a special position with regard to taxation: **they may be subject to taxation both in Hungary and in the country where they work**. In order to avoid and regulate this situation (double taxation), many countries sign bilateral conventions. Hungary currently has valid and effective conventions for the avoidance of double taxation with more than 70 states (you can find out which states Hungary has concluded such conventions with and which legal regulations contain the details thereof on the website of the National Tax and Customs Administration.)

conventions for the avoidance of double taxation

determining residence for tax purposes

Just like foreign legal systems, the Hungarian legal system also uses the term **residence for tax purposes**. Typically, both international conventions and Hungarian legislation assign the taxation for incomes earned by private persons to the country of residence (with exceptions for certain types of income). Residence has to be determined on the basis of Hungarian legislation, taking into consideration that if Hungary has signed a convention with the state in question the provisions of the convention override national regulations. Let's take a look at an example for both cases.

In the first example, a Hungarian citizen works in Germany in 2012. Since his family is in Hungary, he regularly travels back to Hungary to see them; his family and other relations are mainly in Hungary. As the two countries have signed a convention for the avoidance of double taxation, in addition to national legal regulations, **the provisions of the convention have to be considered when determining residence for taxation purposes**. To determine a private individual's tax residence for a given tax year, the relevant factors must be considered in the order stated in the convention. It must be examined where the private person had his **place of permanent residence**, his **centre of vital interests** (e.g. family, work, bank account), his **usual place of residence**, and in which state he possesses **citizenship**. As a last resort, if these are not sufficient to make a decision, the **tax authorities of the states concerned will consult in order to find a solution**.

examining place of permanent residence, centre of vital interests

Essentially, income from employment (non-independent activity) is subject to taxation at the individual's place of residence. Since the Hungarian citizen in the example has a place of permanent residence in both states, his tax residence cannot be determined at the first stage. According to the guidance provided by the convention, the next step is to examine where the employee's centre of vital interests is. Since the family of the person in the example lives in Hungary, he travels home regularly to see them and his relations are mainly in Hungary, he can thus be considered a Hungarian resident in 2012. **For certain types of income (e.g. interest and dividends) determining the place of residence is sufficient to decide where taxes have to be paid**. However, in the case of income from employment (non-independent activity), **further circumstances have to be examined as well**. If the place of work is not identical with the country of residence, income may be subject to taxation in the country where the work is performed as well, if the person in questions works in the other country **for a period of more than 183 days**, or his **salary is paid from there**, or **costs related to paying the salary are borne by a branch in that state**. Since the person in the example stays in Germany for a period of more than 183 days, his salary is subject to taxation in Germany as well, despite the fact that he qualifies as a Hungarian resident for tax purposes (i.e. his interest and dividend income is subject to taxation in Hungary). In this case, the countries concerned avoid double taxation in accordance with the provisions of the convention by exempting income taxable in one state from taxation in the other state (which means, in practice, that the salary received for activities in Germany will be tax-exempt in Hungary). In addition to all this, when determining taxation the latest OECD guidelines state that it must also be examined which country's employer qualifies as the **real employer**.

working for a period of more than 183 days

real employer

In the second example, a Hungarian citizen is employed in Bolivia (a non-convention state) and earns income from employment (non-independent activity) there. Pursuant to Hungarian regulations, a Hungarian citizen normally qualifies as a **domestic resident**. Domestic residents' tax liabilities cover all their income. Therefore, the **income of the private individual in the example is subject to taxation in Hungary**. Double taxation may occur in the absence of a convention, but taxes payable in Hungary can be reduced by **90% of taxes paid for income abroad** – up to a maximum of the amount of taxes payable in Hungary. Thus the private individual can set off 90% of taxes paid in Bolivia against his tax liability in Hungary.

can be reduced by 90% of taxes paid for income abroad

be careful as regards registering and deregistering

Please note that anyone working abroad should be very careful as regards **registering and deregistering** with the authorities. For example, failure to deregister at the residents' registry office may be important not only in taxation matters, but may also result in social security payment obligations. The examples above broadly describe the issue of determining tax residence, but in many cases, establishing residence can require an in-depth examination and is only possible with full knowledge of all circumstances of the specific case.

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