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Rules relating to controlled foreign corporations set to change

As part of the usual year-end tax law amendments, but approved in a separate procedure, the corporate tax and personal income tax rules relating to controlled foreign corporations have changed with effect from 1 January 2017. This summary covers the most important changes.

About the rules in general

The Personal Income Tax Act and the Corporate Tax Act contain special rules for Hungarian taxable persons who are in an ownership relationship with what are officially defined as "controlled foreign corporations" (CFCs), but commonly referred to simply as "offshore companies". The gist of the regulations is that the so-called capital income (dividend, capital gains, earnings withdrawn from the business) received from such foreign companies by Hungarian-domiciled private individuals and companies is liable for taxation at a higher rate than normal.

For private individuals this means that instead of the 15% PIT + 14% healthcare contribution (capped at HUF 450,000 p.a.), such capital income incurs a 15% PIT + 27% (22% from 2017) uncapped healthcare contribution. For companies, on the other hand, the most important tax disadvantage is that the dividend paid by CFCs doesn't enjoy the corporate tax exemption applied in the case of "normal" dividend. Another disadvantage is that shareholdings acquired in CFCs cannot be reported to the tax authority; in other words, if a Hungarian corporate owner sells its share in the CFC, it will incur a tax liability on the profit from the sale. In certain cases, further, the CFC's profit is taxable at the Hungarian private individual or company that is the CFC's ultimate owner even if the foreign company has not paid out its profit to shareholders in the form of dividends.

Until the recently approved amendment, the rules relating to CFCs were also applied in the system of personal income tax. The Personal Income Tax Act also applied the category of "legal entities domiciled in low tax countries". This meant that for the purposes of personal income tax there were two terms to take into consideration, even if these definitions did govern similar classes of companies.

Changes affecting private individuals

The recently passed amendment of the Personal Income Tax Act introduces changes that are beneficial to taxpayers. From 2017, the anti-offshore legislation applicable to private individuals will be based exclusively on the category of "legal entities domiciled in low tax

countries", and will no longer extend to CFCs as defined in the Corporate Tax Act. So in the future, ownership of a foreign company will only have negative tax implications for a Hungarian private individual if the company operates in a country that hasn't concluded a double taxation treaty with Hungary, and where the rate of corporate tax levied is below the Hungarian rate of 9%. This means that, in practice, tax disadvantages will only arise in the case of companies operating in tax havens (e.g. Seychelles, BVI, Panama, Belize) in future. If a private individual has a stake in a Maltese, Cypriot, Hong-Kong, Singaporean or even a Dubai-registered company, then – because we have tax treaties with these countries – the capital income derived from these will be taxed at the low, 15% rate, without the need to investigate the activity or taxation of the foreign company in question.

Particularly problematic in the legislation that has just been replaced were foreign holding companies, since in certain cases these could be classified as CFCs even if they were operating in a country (e.g. The Netherlands or Luxembourg) where the corporate tax rate was higher than the Hungarian tax rate. Indeed, these companies were generally profitable without paying corporate tax, which is one of the cases in which CFC status may be established. The new legislation makes this, too, a thing of the past.

And finally, the possibility of taxing private individuals on profit that hasn't been distributed is to end: a private individual will now only be liable to pay tax on the profit of a foreign company once it has actually been paid out to him or her as dividends.

How do the changes affect Hungarian companies?

With effect from 2017, the definition of CFC status has changed in several respects in the Corporate Tax Act, but the related unfavourable tax implications have essentially remained. Determining whether a foreign company is classed as a CFC will continue to necessitate a complex investigation, which must be performed in several steps. In the first step of the investigation, it is no longer important to determine where the majority of the foreign company's revenues come from or whether a Hungarian private individual holds a stake of at least 10% in it; instead the emphasis will be on whether a Hungarian company directly or indirectly holds a stake of at least 50% in the foreign company.

If this condition is met, then a second test, simply worded but difficult to carry out in practice, must be performed: does the actual foreign corporate tax liability of the foreign entity equal at least half the foreign company's hypothetical corporate tax liability calculated in accordance with the Hungarian tax rules? The third condition, which relates to whether the foreign company has an actual economic presence, remains albeit in slightly modified form: a foreign company may be exempted from CFC status if it can prove that it is engaged in genuine economic activity in the country of its incorporation.

What does this mean in practice?

First of all, in future, Hungarian companies directly or indirectly owned by foreign private individuals will also have to consider whether their foreign investments are not perhaps classified as CFCs.

Secondly, if a Hungarian company has a stake of more than 50% in a foreign company, and the latter company is unable to prove that it is engaged in genuine economic activity, then the situation as regards fulfilment of the condition relating to the actual tax liability must be monitored continuously. This is because even for a company incorporated in a country with a high tax burden, it may turn out that, due to differences between the accounting or tax rules of the two countries, the foreign company's tax liability under the Hungarian rules would exceed twice the actual tax liability of the foreign company, and thus it is classed as a CFC. And there's no need to spell out just how many practical issues and difficulties are involved in calculating the tax liability, under Hungarian rules, of companies that keep their accounts, and pay tax, in accordance with the foreign rules.

Retrospective effect

The law that came into effect in January also introduces a special transitional provision. According to this, with regard to earlier tax years for which the limitation period has not expired, the taxpayer may choose whether to meet its tax obligation relating to CFCs or companies domiciled in low tax countries in accordance with the old rules, or with the new rules that took effect in January. While this provision could also be interpreted as a kind of amnesty (because if someone hasn't declared tax on income derived from its CFC, but based on the new rules such a tax liability would not have existed in the first place, then it can effectively free itself from the old tax liability), practical questions nevertheless arise here too. It is uncertain, for example, what the law means by "choice". In the course of a tax inspection, is it enough for the taxable person to just cite the fact that it applies the 2017 rules to its tax liability from before 2017, or does this choice have to be officially registered in advance?