



Investment in Hungary

KPMG HUNGÁRIA Kft.

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Preface

Investment in Hungary is one of a series of booklets published by KPMG to provide information to those considering investing or doing business in various countries. This publication has been prepared by KPMG in Hungary to assist those contemplating investment or commencing operations in Hungary or working in Hungary. KPMG in Hungary provides audit, tax and advisory services for Hungarian and multinational companies, government entities and inward investors.

The information in this booklet is of a general nature and should be used only as a guide for preliminary planning purposes. Because of the continually changing legislative environment, the complexity of Hungarian corporate, tax and social laws and regulations and the steadily evolving nature of the Hungarian economy, comprehensive professional advice and assistance should always be obtained before implementing any plan to invest or work in to Hungary. KPMG and its several hundred professionals in Hungary can render such assistance and would be pleased to provide more detailed information on matters discussed in this publication.

Every care has been taken to ensure that the information presented in this sixth edition is correct and accurate in relation to legislation coming into effect from 1 January 2004.

Revised sixth edition

Budapest, August 2004

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Chapter 1

General Information

Geography and Climate

Hungary is located in the Carpathian Basin of Central Europe, within easy reach of Western Europe. It covers 93,000 square kilometers (36,000 square miles). About two thirds of its territory is flat and lies less than 200 meters above sea level. The highest peak, Kékesteto, rises to a height of 1,015 meters.

Hungary has two important rivers, which also serve as waterways - the Danube and the Tisza - and three major lakes - Balaton, Velence and Fertő. The greater part of Fertő belongs to Austria. Lake Balaton, (with a surface area of 598 square kilometers) and its surroundings are a popular destination for both Hungarian and foreign tourists. In addition to rivers and lakes, the country is rich in thermal and medicinal waters and springs. The continental climate, the high annual sunshine hours and the quality of the soil ensure favorable conditions for agriculture.

A truly Central European country, Hungary has borders with Austria, Croatia, Romania, Serbia and Montenegro, Slovakia, Slovenia, and Ukraine. Hungary is expected to join the Schengen accord in 2007, taking full responsibility for EU borders.

Population and Language

Hungary has a population of approximately 10 million. Population density is about 100 persons per square kilometer. This population is expected to decline as a result of the low birth rate and the high death rate, which are respectively amongst the lowest and highest in Europe. The capital, Budapest, has approximately 2 million inhabitants. The population of the other 10 major cities ranges from 100,000 to 200,000 people.

The official language is Hungarian, but English and German are also used frequently. used for business.

Infrastructure

The transportation infrastructure is currently undergoing a major reconstruction. In government-supported projects additional highways are being built, while the widely used, state-owned domestic railway system is also under reconstruction.

Hungary has an extensive road system, centered around Budapest, with highways extending in most directions. Public transport in Budapest is well developed and consists of a comprehensive network of trams, buses, a subway system and railways.

Ferihegy airport handles in excess of 3 million passengers annually. Major Hungarian cities have also reopened and modernized their airports, a sign of an increasing importance of domestic air services.

The telecommunications sector in Hungary has gone through a major development. The fixed-line market became open to competition in 2002, although alternative service providers still have to use the lines of the former monopoly holder MATAV and pay fees, as building parallel networks in the comparatively small domestic market would not appear profitable.

Hungary also has a highly developed mobile telecom market, while Internet penetration is growing steadily with broadband services giving a new impulse in the past years.

Labor Force

The Hungarian labor force is highly skilled and highly educated, particularly in engineering, IT, pharmacy, economics, mathematics and physics. Around two-thirds of the work force has completed some form of secondary, technical or vocational schooling. Foreign investments of the recent decade also brought know-how and technology into the country, thus increasing the productivity of the labor force considerably.

The unemployment rate is slightly below 6 percent currently, lower than the European Union average. The unemployment rate is higher in the eastern and southern regions and lower in the central and western areas.

Wages still lag behind those of Western Europe. The minimum wage is currently HUF 53 thousand per month, approximately EUR 210 per month.

The Political System

Hungary has been stable politically since its transformation process began in 1989. The originally large number of political parties has consolidated, and only four parties successfully met the minimum 5 percent threshold to get into the Hungarian Parliament

during the latest elections in 2002. The political arena is currently bipolar - the conservative right consists of two parties, the Viktor Orbán-led FIDESZ-MPSz and the Hungarian Democrats (MDF) currently in opposition, whilst the socialist-liberal pole includes the Hungarian Socialist Party (MSZP) and Alliance of Free Democrats (SZDSZ), also forming the current coalition government. The next general elections are due to take place in 2006.

The President is the head of state. He is elected by Parliament and serves a largely figurehead function. Parliament is the dominant source of power in Hungary and is comprised of elected representatives in a single chamber. The government is comprised of the Prime Minister and his ministers. The Prime Minister is elected by a simple majority of the members of Parliament.

International Memberships

Hungary has been a member of the United Nations and some of its associated institutions (ILO, UNESCO, FAO, WHO, etc.) since 1955.

Hungary became a member of the IMF, the World Bank and the IFC (International Finance Corporation) in 1982. Additionally, Hungary is a signatory to the GATT (General Agreement on Tariffs and Trade), a member of the WTO (World Trade Organization) and of the OECD, as well as of the International Bank for Reconstruction and Development (IBRD), the World Intellectual Property Organization (WIPO) and the Central European Free Trade Association (CEFTA).

Hungary became a member of NATO in 1999, and a member of the European Union on 1 May 2004.

Hungary and EU accession

On May 1, 2004 Hungary became a full member of the European Union.

Ten years earlier, in 1994, Hungary was the first from the Central and Eastern European countries to apply for EU membership. The negotiation process was launched in 1998 and since then Hungary has met the economic requirements of the accession and brought its legal system fully in line with the acquis of the EU.

All the laws that may potentially concern foreign investors have already been brought into line with the EU regulations, with the exception of certain environmental protection issues.

With the EU's financial assistance, Hungary aspires to close the gap between its level of development as a new member country and the EU average. The Hungarian government

has been working on the establishment of the physical and legal infrastructure, which will enable the country to most effectively channel the EU sources, as well as to complement these sources with domestic funds.

The Economy

The table below presents leading indicators of the Hungarian economy from 2003 to 2006

	2003(c)	2004(c)	2005(c)	2006(c)
Real GDP growth (%)	2.9	3.3	3.9	4.1
Consumer Price inflation (av; %)	4.7	7.5	4.7	4
Budget balance (% of GDP)	5.9	5.3	4.4	3.9
Current-account balance (% of GDP)	-8.9	-7.3	-5.8	-6.2
Unemployment rate (%)	5.6	5.4	5.2	5.1
Short-term deposit rate (av; %)	7.1	10	6.5	5.8
Exchange rate Ft: (av)	253.5	256.3	262.0	255.0
Exchange rate Ft: US\$ (av)	224.3	197.1	190.2	196.2

Source: EIU

Hungary has seen a successful transformation from a centrally planned economy to a free, fast-growing and robust market economy in the past 15 years.

A successful privatization process has now been completed in most sectors, bringing foreign strategic investors as well as know-how, technology and best international practice into the country. As a result, the private sector accounts for over 80 percent of GDP today.

Hungary has made significant progress in recent years in creating sustained economic growth - the growth rate exceeding four percent in each of the years between 1997-2000. Through the downturn in the global economy in the past years, Hungary achieved a GDP growth of 3.8 percent in 2001, 3.4 percent in 2002, and 2.9 percent in 2003. But growth is recovering once again and the GDP is expected to expand by 3.5 percent in 2004 - about double the rate of the EU average.

In order to give further impetus to economic growth and to enhance competitiveness the Hungarian government introduced the National Development Plan, a medium term economic policy program. It is to provide about EUR 4 billion between 2004 and 2006 for the development of economic competitiveness, human resources and regional development, as well as environmental protection and infrastructure development programs. Over 60 percent of the planned budget is expected from EU funds, with the government financing the remaining EUR 1.5 billion.

Inflation has declined continuously over the past years - from about 30 percent in the mid-90s the inflation rate fell to 4.7 percent in 2003. Further decrease is predicted for the coming years, although the rate will be partly dependent on government decisions, as energy and infrastructure costs are mostly subject to official price regulation.

Foreign Investment in Hungary

Since 1989, all Hungarian governments have enacted laws and treaties to attract foreign direct investments into Hungary. The capital stock of FDI reached almost EUR 30 billion by the end of 2003, thus becoming a driving force of the economic transformation.

With EU accession, Hungary has been required to stop offering tax holidays for major foreign investments. Nevertheless, the current government has introduced new investment incentives that are compatible with EU rules.

A business friendly environment with a well-developed legal framework, a benign corporate tax system, a relatively low paid, well-educated workforce, and a favorable geographical location continues to encourage foreign direct investment (FDI). Due to the highly skilled labor force in Hungary, particularly in sectors with high added value, a significant proportion of the incoming FDI is considered to be high-tech and much has been in the form of greenfield investments.

The largest part (almost 50 percent) of the total FDI has been in the manufacturing industry, with most preferred segments being the automotive industry and its supplier industries, the chemical and food industries and the production of electronic and electric machinery products.

Almost 75 percent of the total FDI inflow has come from the USA, Germany, the Netherlands, Austria and France. Further major investments have come from Japan, Belgium and Italy.

Chapter 2

Foreign Investment in Hungary

The Hungarian Act on Foreign Investment specifies that investments by non-residents enjoy full legal protection and security. Additional protection for foreign investors is guaranteed by bilateral treaties in force.

Foundation of New Companies or Acquisition of Shares in Existing Companies by Foreign Investors

Foreign individuals and legal entities may found new companies or acquire shares in existing companies in Hungary. Companies, which are wholly or partly foreign owned, can, in practice, operate in all business areas. Where the chosen activity requires a permit (e.g. for banking activity) the same rules apply regardless of whether the owners of the entity are resident in Hungary or abroad.

Returns payable to Foreign Investors

There are no legal restrictions on the payment of returns on investments (e.g. dividends, interest, repayment of loans) to foreign shareholders. This provides important protection to foreign investors. However, dividends are subject to withholding taxes. The tax system and current tax rates are discussed in the taxation chapter.

Branches and Representative Offices

A foreign company may establish a registered company branch or a representative office in Hungary. Neither a branch nor a representative office is treated as a legal entity.

Representative offices are relatively easy to administer and their activities may be stopped immediately without consequence or requiring deregistration.

Branches

Non-residents can conduct business in Hungary through branches registered with the Hungarian Court of Registration.

After registration, branches can carry out most business activities in Hungary without limitation: the branch cannot pursue representation activity on behalf of its founder. Naturally, the same business licenses must be obtained as are required for Hungarian legal entities.

The assets required for the operation of the branch must be provided by the non-resident entity and the non-resident entity has an unlimited obligation for the liabilities of its Hungarian branch. The branch must keep its books in accordance with Hungarian accounting law, and prepare annual financial statements and have these audited by a Registered Auditor.

The acquisition of real estate by a branch is subject to the Act on Acquisition of Real Estate by Non-Residents, similarly to any other non-resident company. In all other respects, the same rules are applied to branches as apply to resident legal entities (e.g. they are subject to Hungarian VAT, corporate income tax, local taxes etc.).

Representative Offices

Certain activities of a non-resident entity may also be conducted through a representative office, which can be used to provide information concerning the non-resident's products and services and to a limited extent to assist the non-resident entity in the conclusion of contracts. Tax consequences should be carefully considered.

Representative offices must be registered at the Hungarian Court of Registration. A representative office of a non-resident company is permitted to assist in the preparation of contracts and to supply advertising services on behalf of the entity it represents. They are not allowed to engage in any other kind of commercial activity. In particular, representative offices of foreign law firms may not provide legal services or legal consulting services.

Although the accounting for Hungarian representative offices is not governed by Hungarian accounting legislation, most of the rules (e.g. double-entry bookkeeping, valuation rules etc.) should be followed by these entities if they are subject to Hungarian corporate income taxes. For example, acting as an agent for a non-resident may subject a representative office to Hungarian corporate income taxes.

In other respects, the same rules apply to representative offices as apply to other domestic business entities. For example, the employment of foreign or Hungarian employees results in the same administrative, personal tax and social security obligations as for Hungarian corporations or branches.

Chapter 3

Company Law

The primary legislation governing the form and regulation of companies is Act CXLIV of 1997 on Business Associations (the Companies Act), which came into effect on 16 June 1998. This Act is the successor to Act VI of 1988, which had already brought Hungarian company law substantially into conformity with European Union company regulations.

Most of the types of companies and the associated regulations found in Hungary are similar to those used in European Union countries.

Five possible legal forms of business association are listed in the Companies Act:

- Unlimited Partnership (Közkereseti Társaság - Kkt.)
- Limited Partnership (Betéti Társaság - Bt.)
- Joint Company (Közös Vállalat - Kv.)
- Limited Liability Company (Korlátolt Felelősségű Társaság - Kft.)
- Company Limited by Shares (Részvénytársaság - Rt.)

The Kkt. and Bt. forms have elements, which resemble partnerships in some ways but not to such an extent that they would be treated as such in all EU countries. The other three are clearly recognized as legal entities. Notwithstanding this, all these forms are taxed at the level of the entity.

In practice, most foreign investors are likely to form or take a financial interest in either a limited liability companies (Kft.) or a company limited by shares (Rt.). These legal entity forms correspond to the company forms most commonly used by businesses in the European Union.

Foreign parties may found or become shareholders in a Kft. or Rt. if they are either a company under their domestic law or if they are individuals.

Specific rules applicable to Kft.'s and Rt.'s are discussed below following a summary of the rules applicable to all types of business associations, including the Kkt. and Bt.

Rules applicable to all Types of Business Associations

Articles of Association

An initial step in funding a business venture is the preparation of written Articles of Association (or Deed of Foundation), which must be signed by all members (or their authorized representatives holding a power of attorney). An attorney or notary public must countersign this document.

The Articles must contain:

- the name, the company form and the registered office of the company;
- the name, the company form and the registered office (address) of the founders;
- the scope of the company's activities;
- the registered capital of the company, and the method (cash or in-kind) and date of contribution by the founder;
- authorities for signing on behalf of the company;
- name and address of executive officers;
- term of the company, if it was established for a definite period;
- other matters required by the Companies Act for the different forms of business associations.

The value of any in-kind contribution cannot exceed the valuation approved by the statutory auditor of the company. A member providing an in-kind contribution remains liable for five years to the company that their contribution was not worth less than the value stated in the Articles of Association.

Single-member Companies

A company may have a single member. The share capital of a company founded by a single-member must be paid up in full prior to submission of the application for registration.

The single-shareholder has to make decisions on the issues falling within the authority of the general meeting in writing, and must inform the executive officers of these.

Pre- company Status

A new business association may begin to operate (e.g. enter into contracts, etc) from the date of the countersignature of the Articles of Association. However the business association will not be able to pursue any activities requiring a license until the Court of Registration has registered it since licenses are only granted to registered companies. Until it is registered, the business association has a special interim legal status as a

'pre-company'. This status has to be indicated on all company documents.

The rules applicable for the business association to be established apply to its pre-company, with the following exceptions:

- generally, no changes may take place in the members of the pre-company;
- the articles of association may not be altered, except to make corrections ordered by the court of registration;
- legal proceedings for the exclusion of a member may not be initiated;
- no resolution may be made on termination of the entity without a legal successor, or transformation into any other business association or into a non-profit company.

If the application for registration of a new business association is refused, the business association may not acquire further rights or assume new obligations, and must terminate its operations. The members (shareholders) are liable for debts arising from the undertakings of the executive officers up to the proposed registered share capital. The executives are personally liable for debts exceeding the proposed registered share capital.

Registration

The foundation of a business association must be reported to the Court of Registration within 30 days of the countersignature of the Articles of Association. The Court must also be notified of any change in the registered data within 30 days of each change. If the court does not respond within a specific period of time, the registration is deemed to have occurred at the end of that period.

Business associations are deemed to be established as of the date of their entry into the register of companies. The pre-company status ends as of the date of registration.

Directors

A director of a company must be an individual. It is not possible for a company to be a director. An individual may be a director of a maximum of three different companies at any one time.

Directors are elected by the Members' Meeting (General Assembly) for a fixed term, which cannot exceed five years. Officers may be re-elected or recalled at any time by the General Assembly.

Supervisory Board

A Supervisory Board is comprised of non-executive directors.

A supervisory board must be established by:

- all Rts.;
- a Kft., if the registered capital exceeds 50 million HUF;
- any company, if it has more than 200 employees.

The Articles of Association may assign authority to the supervisory board to elect and remove the executive directors, establish their remuneration and approve particular transactions.

Auditor

A statutory auditor is required to be appointed by:

- an Rt.;
- a Kft., if the registered capital exceeds 50 million HUF, or if there is only one registered owner;

In order to be appointed as an auditor, the individual person or audit company must be registered in the list of registered accountants.

The auditor must be named in the Articles of Association and can be appointed for a period not exceeding five years. The auditor can be re-appointed following the end of his term of office.

The company must have any report it is required to prepare to comply with the Accounting Act examined by the auditor (not just its annual financial statements). Generally, the company's members may not make a decision to approve any report prepared pursuant to the Accounting Act in the absence of a written opinion from the auditor. Further, the auditor is expected to review all substantial business reports submitted to the members' meeting and report whether they contain correct data and comply with the law.

The auditor is entitled to inspect all books and records of the company and to request information from all executive officers, supervisory board members and employees.

The auditor must safeguard the confidentiality of information he obtains about the affairs of the company.

A member (shareholder) of the company may not be an auditor. Executive officers, supervisory board members, their close relatives and employees of the company may not be elected as the auditor of a company until at least three years after termination of their position.

The auditor must take part in meetings of the company's members. If required, the auditor may be invited to attend meetings of the executive board or the supervisory board with a right of consultation, or the auditor himself may initiate his attendance at such meetings. In this latter case, the auditor's request may only be refused in exceptional cases.

If the auditor verifies or otherwise learns that a significant loss of the company's net equity is probable (such that net equity is or will be less than 66 percent of an Rt.'s or less than 50 percent of a Kft.'s registered capital), he must request that a members' meeting be convened.

If the company's members'/shareholders' meeting is not convened, or that meeting fails to take the decisions necessary to ensure that the position will be rectified, the auditor must inform the Court of Registration.

Termination of Business Associations

The business association shall terminate:

- if the period of time set forth in the Articles of Association expires or any other condition of termination is realized;
- if it resolves its termination without a legal successor;
- if it resolves its termination with legal succession (transformation);
- if the number of its members declines to one person, unless otherwise allowed by the provisions on the individual forms of business associations (Kft. and Rt.);
- upon being declared terminated by the Court of Registration;
- on other conditions depending on the actual form of the company.

Business associations are deemed terminated upon cancellation from the company register.

If a company ceases to exist without a legal successor, a "final account" must be prepared, except when a winding-up procedure has been initiated due to insolvency. In this case, a liquidation procedure is followed in accordance with Act IL of 1991 on Bankruptcy, Liquidation and Final Account.

The closing balance is to be made by the liquidator(s), who can be appointed from the executive officers of the company, or the liquidator can be any private individual. Members representing one tenth of the votes or any creditor of the company may ask the court to appoint others as liquidators.

Transformation of Business Associations

Transformation can result from a change from one corporate form to another (e.g. a Kft. can re-register as an Rt., or vice versa), or from corporate reorganizations such as mergers and demergers. These can take a variety of different forms:

- Merger (consolidation, acquisition, merger)
- Demerger (division into two or more new companies, separation of part of the activities into a new company)

Compulsory Transformation

If a business association's equity shown in its annual report is less than the minimum capital required for its form of business association for two consecutive years, then the business association should be required to reregister as a different form of business association unless the members of the business association provide the necessary equity within a period of three months after the approval of the annual report for the second year.

The new form of business association chosen must be one for which the entity meets the minimum registered capital requirement or for which the Companies Act does not specify a minimum registered capital.

Liability of members of Business Associations

From 1 January 2004 Hungary has introduced a procedure whereby the 'corporate veil' (limited liability) can be lifted in certain circumstances. If the corporation cannot be found at its officially registered seat and its directors cannot be traced to their office addresses, the court can demand that the shareholders provide information on where the corporation can be found within 60 days. Failure to comply with this may result in the loss of limited liability status and recourse to 50 percent or 70 percent shareholders can be sought. This may be used as a mechanism to recover debts from customers that have failed to honor payment obligations and can no longer be traced.

Limited Liability Company (Kft.)

The Limited Liability Company is a very popular form of company for small or medium-sized businesses in Europe. The Hungarian Kft. form is very close to the German and Austrian GmbH (Gesellschaft mit beschränkter Haftung) and similar to the British Ltd (private company limited by shares). It is possible to establish a single-owner Kft. The Kft. form is the most common company form for wholly owned subsidiaries.

Formation of a Kft.

In addition to the items mentioned above as rules applicable for all types of business associations, a Kft.'s Articles of Association must include the following:

- the registered capital and each member's stake therein;
- if part of the cash contribution is unpaid, the method and date of payment;
- questions relating to voting rights;
- the name of the first managing directors(s);
- the method of signature in the firm's name;

- if appointment of a supervisory board and/or an auditor is compulsory, the names of the first persons so appointed;
- the procedures to be followed if a members' meeting does not have a quorum and must be reconvened.

Capital Structure

The capital of the company is comprised of the capital contributions of the individual members, which can be contributions in cash and in kind.

Contributions in kind constituting a part of the subscribed capital may be any marketable object or intellectual work of pecuniary value, or any right representing pecuniary value. Only those objects, intellectual works or rights, which can be subject to foreclosure and which can be transferred by the business association without the consent of a third party, may be taken into account as contributions in kind. The amount of initial capital may not be less than 3 million HUF. At foundation, at least 30 percent of the initial capital or 1 million HUF must be contributed in cash.

Each member has an identified percentage share of the total capital and a single share may be owned by more than one person. A share cannot be less than 100,000 HUF and it has to be exactly divisible by 10,000.

The company may only be registered if, prior to the submission of the application for registration,

- contributions in kind have been made available to the company in full, and
- at least half of each contribution in cash, and 1million HUF in total, has been deposited into the company's bank account.

The remaining part of the cash contribution must be made within one year of the registration. In case of a single-owner Kft., the value of the whole share must be made available at the foundation of the company.

Members' Meeting

The supreme body of a Kft. is the Members' Meeting, which must be held at least once a year.

The following falls within the exclusive authority of the members' meeting:

- all of the annual financial statements of the company, including the decision on the appropriation of after-tax profits;
- decisions on the payment of additional capital contributions and the repayment of capital;
- decisions to pay interim dividends;
- consent for the division of business shares, and approval for the withdrawal of shares;
- resolutions initiating the exclusion of a member;
- decisions on the repurchase of shares by the company, and the sale of these to members;

- election and removal of the managing director, and the establishment of his or her remuneration, as well as the exercise of employer's rights if the managing director is an employee of the company;
- election and removal of supervisory board members, and the establishment of their remuneration;
- election and removal of the auditor;
- approval to conclude contracts which take place between the company and one of its members, its managing director or their close relatives;
- enforcement of indemnification claims against members responsible for the foundation of the company, managing directors or supervisory board members;
- the decision on termination without legal successor or transformation of the company;
- alteration of the Articles of Association;
- all issues which are assigned to the members' meeting by law or by the Articles of Association.

A simple majority is required to approve members' resolutions at the meeting, unless the Companies Act or the Articles of Association provide otherwise.

The members' meeting has a quorum if at least half of the registered capital or the majority of the eligible votes are represented, unless the Articles of Association stipulate a higher rate of participation. Unless otherwise provided by the Articles of Association, if the members' meeting did not have a quorum, any reconvened members' meetings called as a result of this shall have a quorum for the issues of the original agenda regardless of the percentage of the capital or voting rights represented by those present.

If the balance sheet discloses that accumulated losses are equivalent to at least one-half of the registered capital or the company's equity has fallen below 3 million HUF or the company has gone bankrupt, the managing director is obliged to call an extraordinary meeting to deal with the situation.

Managing Directors

The administration of the company's affairs and representation of the company is carried out by the managing director (or directors).

Company Limited by Shares (Rt.)

A company limited by shares is the other popular corporate form for medium-sized or larger companies all over Europe. The Hungarian Rt. is very similar in form to the German and Austrian AG (Aktiengesellschaft) and similar to the British PLC (Public Limited Company).

An Rt. may be a private company or a public company. An Rt. is a private company if its shares are not issued publicly. An Rt. is a public company if at least some of its shares are issued to the public.

The share capital of an Rt. must not be less than twenty million HUF. At foundation, contributions in cash must be at least 50 percent of the share capital or ten million HUF.

Shares and Shareholders' Rights

Shares are securities embodying membership rights and can be bearer shares or registered shares.

Different classes of shares can be issued, such as ordinary shares, preference shares, employees' shares, interest-bearing shares and reconvertible shares.

All shareholders are entitled to participate, to request information and to make comments at members' meetings. Shareholders are entitled to make proposals and, if they hold shares with voting rights, to vote.

Shareholders are entitled to dividends voted by the members' meeting proportionately to the face value of their shares.

No dividends may be paid if as a consequence, the equity of the company limited by shares will be less than the minimum required share capital of an Rt.

General Meeting

The supreme body of a company limited by shares is the general meeting of shareholders.

Actions which fall within the exclusive competence of the general meeting include:

- establishment and alteration of the Deed of Foundation (Articles of Association);
- decisions to change of the form of the company;
- decisions on transformation or termination without legal successor of the company;
- the election and removal of members of the board of directors, members of the supervisory board and the auditor, and the establishment of their remuneration;
- approval of the Annual Report, including the decision on the appropriation of after-tax profits;
- decisions to pay interim dividends;
- decisions on the acquisition of own shares;
- decisions to change the type of the shares;
- decisions to convert the printed shares to non-certificated shares;
- decisions to modify the rights attached to different series of shares, and the share types and share classes;
- decision to issue convertible bonds;

- decision to increase or reduce the share capital;
- decision to exclude the execution of preferential prescription right;
- all issues which are assigned to the general meeting by law or by the Deed of Foundation.

The general meeting must be convened as frequently as required in the Deed of Foundation, but at least once every year. If so required, extraordinary general meetings may be held at any time.

The general meeting is generally called by the board of directors.

The general meeting has a quorum if shareholders representing more than half of the votes are present, unless the Deed of Foundation stipulates a higher rate of participation.

If the general meeting does not have a quorum, any reconvened general meetings will have a quorum for the issues on the original agenda irrespective of the number of those present.

Board of Directors

An Rt. must have a Supervisory Board and a Board of Directors (except that the Deed of Foundation of a private Rt. may provide that there will be no board of directors and that the rights of the board of directors are to be exercised by a general director.)

The Supervisory Board supervises the management of the company. The supervisory board may request information from the executive directors and officers, and may inspect the books of the company.

The board of directors is responsible for the management of the Rt.

The board of directors must consist of at least three and at most eleven members who must be natural persons. The board of directors elects its chairman from among its members.

The board of directors must exercise its rights and perform its duties as an independent body. The rules of procedure approved by the board of directors will provide for the allocation of tasks and responsibilities among the members of the board of directors.

The board of directors must ensure that the books of the company are kept according to the accounting law.

The board of directors must prepare reports on the management, the financial situation and the business policy of the company at regular intervals (at least once every year for the general meeting, and at least once every three months for the supervisory board).

The board of directors is responsible for preparing the Annual Report presented to the General Meeting and for presenting a proposal on the appropriation of after-tax profits.

The members of the board of directors participate in the general meeting of the company with a right of consultation.

Increase of Share Capital

The share capital may be increased

- by the issue of new shares;
- to the extent that assets exceed share capital;
- by the issue of employees' shares;
- by the conversion of convertible bonds.

New shares or bonds may be issued publicly or privately.

The Deed of Foundation may authorize the board of directors to issue new share capital up to a defined maximum limit. Such authorization may be valid for a period of up to five years and for a share capital increase of up to 25 percent, and is renewable.

Reduction of Share Capital

The general meeting may decide to reduce the share capital and, in certain cases, is obliged to reduce the share capital. The share capital may not be reduced below the minimum registered capital (20 million HUF).

If the reduction of share capital is not possible because the share capital of the company would fall below the minimum registered capital required, the general meeting must pass a resolution to transform the company into another form of business association, or to terminate the company.

In any share capital decrease, any own shares held by the company must be withdrawn first.

In respect of printed share certificates, the share capital reduction may be implemented:

- by exchanging the shares;
- by stamping the shares;
- by reducing the number of shares according to the procedure set forth in the deed of foundation.

Termination of Companies Limited by Shares

The general meeting of an Rt. may decide to terminate the company by a majority of three-quarters of the votes.

The assets of an Rt. undergoing voluntary dissolution may not be distributed until after the company's registration is cancelled.

In the event of termination of an Rt. without legal successor, the assets remaining after the satisfaction of creditors must be distributed among shareholders on the basis of payments and contributions in kind actually provided, and in proportion to the face value of their shares. If the company has issued shares with preferred rights on a liquidation, the rights granted by such shares must be taken into account when distributing the assets of the company.

Acquisition of an Influencing Interest in Business Associations

Members hold a “significant interest” if they control more than 25 percent of the votes in a company.

Members hold a “majority interest” if they control more than 50 percent of the votes in a company.

Members hold a “controlling interest” if they control more than three-quarters of the votes in a company.

The existence of any of these “influencing interests” must be reported to the Court of Registration by the party holding the interest within 30 days.

Prior to reporting an influencing interest to the court of registration, the party holding such interest may exercise its voting rights only to the extent to which its participation is not subject to the disclosure obligation.

Chapter 4

Working in Hungary

Working Permission

Foreign persons can usually be employed in Hungary only if they hold a valid stay visa or residence permit and work permit.

Stay visas: Foreign persons who want to enter Hungary to work must apply for a stay visa unless there is an agreement between Hungary and the relevant country. The stay visa is issued for one year. A stay visa is granted by any Hungarian embassy in the home country of the applicant.

Residence permits: If the foreigner intends to work in Hungary and the stay visa has expired, a residence permit is required. The person must register and apply for a residence permit at the relevant police station for the place of residence. The registration procedure is subject to a fee.

Work permits: An application must be submitted by the employer to the relevant local Labor Centre prior to applying for a stay visa. Chief executives (including managing directors, general managers, board members of an Rt., members of the supervisory board, head of the Hungarian representation office and of the Hungarian branch office) appearing in the Company's documents filed with the Registration Court are not subject to work permit requirements. The required data and documents must be contained in the application. The work permit is granted for a maximum period of one year but may be extended.

An employee may begin to work in Hungary only after having received all the necessary permits.

Employment Law

The basic elements of employment contracts are regulated by the Hungarian Labor Code, which is broadly similar to employment law in European Union countries.

The Law provides a basis for organized labor negotiations with trade unions or other representatives of employees (e.g. works councils). An employer may enter into only one collective agreement at a time. Notwithstanding this, more than one collective agreement may have effect on the employer (e.g. collective agreements of industrial branches or regions). A contract of employment may not contradict the Labor Code or any collective agreement in force. A contract of employment can provide more benefits for the employee than those required by the Labor Code or a collective agreement.

Important minimum-provisions in connection with salaries include:

- The salary, the place of work and the field of work must be stated in the employment contract. (Every employee must have an employment contract).
Upon conclusion of the employment contract the employer is obliged to notify the employee of
 - a) the basic work hours,
 - b) the other component elements of the remuneration,
 - c) the date of payment of salaries,
 - d) the date of commencement of the employment,
 - e) the amount of paid leave and the procedures for allocating and determining such leave, and
 - f) the rules governing the periods of notice to be observed by the employer and the employee should their contract or employment relationship be terminated, and
 - g) whether a collective agreement applies to the employee.
- There is a national minimum wage. As of January 2004 the minimum gross monthly wage is HUF 53,000.

Taxation

For taxes on dependent/independent personal services please refer to Chapter 6.

Chapter 5

Accounting and Auditing

Introduction

Hungarian accounting regulations and the annual reporting requirements for companies are set out in Act C of 2000 on Accounting (“the Act”). The Act also establishes rules for independent auditing. There are additional Acts and government decrees which affect accounting in specific industries such as banking and insurance.

The current Act replaces an earlier Act as part of the legal harmonization process preparatory to EU Accession. The Act and its predecessor, the 1991 Act, draw on the Fourth, Seventh and Eighth Directives of the Council of the European Union. These Directives regulate, respectively: the financial statements of limited liability corporations; the basic rules pertaining to the preparation of consolidated financial statements; and the appointment and qualification of persons responsible for statutory audits. The acts and decrees dealing with banking are based upon the European Union Bank Accounting Directive.

The requirements of the Act extend to all business organizations, including branches of foreign organizations but not representative offices.

Accounting Principles

The Act incorporates accounting assumptions and principles, which are, in the main, the same as those approved by the International Accounting Standards Board (“IASB”). However, while some companies find it possible to report the same profits under Hungarian Accounting Law (“HAL”) and International Financial Reporting Standards (“IFRS”), there can be significant differences between financial statements prepared in accordance with HAL and financial statements prepared in accordance with IFRS. Some of these differences arise due to different recognition and measurement principles but normally most result from different presentational and disclosure requirements.

The Act adopts basic principles such as going concern, accruals, consistency and prudence. It requires annual financial statements to be prepared on the assumption that the entity will be a going concern. The principles of substance over form and materiality were first introduced in 1997 and have been increasingly invoked by preparers of accounts and auditors as these concepts have become more familiar. Effective from 1 January 2001 departure from the provisions of the Act is allowed when it is necessary to achieve a fair presentation.

There are differences in presentation from IFRS since the Act sets out detailed rules governing the recording and reporting of different categories of income, expenditure, assets and liabilities under HAL. Amongst other requirements, the Act requires transactions and balances to be evaluated individually and presented gross (to ensure completeness of reporting). This means that certain items presented net under IFRS are grossed up in the Hungarian balance sheet and profit and loss account. Also, the Act defines in detail the conditions, which give rise to a requirement to restate prior year financial statements and mandates that any such prior year adjustments are presented in a separate third column supplementing the current and previously reported prior year financial statements. The net result is that some figures presented in Hungarian financial statements can have a different meaning from those most non-Hungarian readers would expect.

The Ministry of Finance, which is responsible for accounting and auditing regulation, is also responsible for taxation and fiscal matters, and corporate liability to taxation is still closely dependent on the recording of financial transactions in accordance with the detailed accounting rules set out in the Act.

Company bookkeepers are usually concerned to book accounting transactions in the way expected by the tax authority and to have the supporting documentation, which a tax authority auditor may be expected to request.

Accounting and Bookkeeping

It is important to appreciate that the Act regulates day-to-day bookkeeping as well as annual accounting. It requires, amongst other matters, that:

- The accounting records of business organizations are kept in accordance with the principles and rules laid down in the Act.
- This requirement does not preclude the use of accounting and reporting systems developed and/or held outside Hungary (e.g. in shared service centers). However such systems must be capable of presenting accounting information in accordance with the Act and prime ledgers and accounting documents must be made available promptly in Hungary if requested for Tax Authority audits.
- The accounting records are generally closed off at 31 December each year. However, subsidiaries and branches of foreign entities can account to the balance sheet date of the foreign entity, if this is not December 31.

- The accounting records are kept in the Hungarian language.
- All businesses (other than school cooperatives and unincorporated organizations with net sales not exceeding HUF 50 million in two consecutive years) and budgetary organizations (that is, organizations whose finances form part of the government's annual budget) must maintain double-entry books of account.
- After 1 January 2004 single-entry bookkeeping is allowed only for a limited group of not-for-profit organizations.
- There is a standard chart of accounts comprising 9 prescribed classes of account and a memorandum class (Class 0):
 - Classes 1-4 are the balance sheet accounts. The asset accounts are in Classes 1-3 and Class 4 includes the equity, specific provisions and liabilities accounts.
 - Costs are recorded in accounts in classes 5 and 8 and revenues are recorded in the class 9 accounts.
 - Classes 6 and 7 may be used to account for direct and indirect costs. Their use is not mandatory, however, each entity is free to decide whether and how to use these classes of account.

There is flexibility to choose specific account headings to suit the business's needs within each class of the accounts.

- Descriptions of the accounting policies and the chart of accounts must be prepared. (These documents are usually among the first documents tax auditors look for to understand the entity's accounting policies and procedures.)
- Financial transactions should only be recorded in the books if they are supported by reality and can be verified. In practice this means that bookkeepers expect to receive authorized supporting documentation before booking entries. It also means that they are sometimes reluctant to book accruals, estimates or provisions unless there is strong supporting evidence to substantiate these.

This last feature has implications for timely recording, for the preparation of reliable interim and management accounts, and for the ability to prepare annual statutory accounts reporting the same results as are shown in accounts prepared in accordance with IFRS or parent company reporting rules. Many subsidiaries of multinational companies find it possible to book accruals at each month end and to report the same figures to their parent company as they do for local statutory purposes at year end but some incoming investors may be surprised by incomplete accruals and provisions, particularly in interim period financial statements and management accounts.

Financial Reporting

All economic organizations must issue a financial report following the end of each business year. The report is the responsibility of the entity and its authorized representatives. The form of report required is determined by the size of the organization and, in some cases, its method of bookkeeping. There are three different kinds of report:

- Annual Report
- Simplified Annual Report
- Consolidated Annual Report

So called “pre-companies” (companies whose articles of association have been signed but which have not been registered by the Court of Registration) must prepare and publish a separate financial report covering the period from their date of formation until incorporation. For this case, the period end date is the date of incorporation.

Annual Report

A company which meets two of the three criteria detailed below in two consecutive years is required to prepare an Annual Report.

- total assets at year-end of at least HUF 150 million;
- annual net sales of at least HUF 300 million;
- an average of more than 50 employees in the year.

The Annual Report consists of a balance sheet, profit and loss account, supplement (including a summary of accounting policies applied, notes to the accounts and a cash flow statement). A business report must also be prepared. The balance sheet and profit and loss account must each be prepared according to a prescribed structure and detail, in the Hungarian language and in thousands of Forints.

The balance sheet and profit and loss account must be based on, and supported by, bookkeeping records. Comparative figures must be shown.

The prescribed format for the balance sheet follows the format of the Fourth Directive of the European Union. As in the European Union, companies have a choice of profit and loss account format between a total cost model and a cost of sales model. The Act permits companies to adopt the model, which the company considers to be the most appropriate to the nature of its business.

The Supplement includes additional information necessary to give a true and fair view of the financial position and results of the business. This includes explanations of the accounting policies applied in the accounts and the cash flow statement.

The Business Report provides a commentary by management on the financial position presented in the accounts.

Simplified Annual Report

Companies which operate a double-entry bookkeeping system but which do not meet the size criteria referred to above are only required to produce a simplified annual report. This consists of a balance sheet and a profit and loss account simplified to show only certain headings and a simplified Supplement (for example, this need not include a cash flow statement).

Consolidated Annual Report

In addition to their separate accounts, companies having a majority holding or exercising significant control over subsidiaries must prepare a consolidated annual report if they have met two of the following criteria during the preceding two years:

- Total unconsolidated assets exceed 2,700 million HUF,
- Total unconsolidated sales revenue exceeds 4,000 million HUF; or
- Total number of employees of the group exceeds 250.

Financial institutions, insurance companies, listed companies and other companies whose shares are licensed to be traded, must file consolidated annual reports regardless of whether or not they meet any of the above criteria. Consolidated accounts should present a true and fair view of the group's transactions with third parties. To this end, all inter-company transactions and balances are eliminated.

The consolidated annual report consists of a consolidated balance sheet, profit and loss account and supplement. A consolidated business report must also be prepared. A parent company which is itself a subsidiary of a Hungarian company (or a Company resident in an EU member state after EU Accession) which is obliged to prepare a consolidated annual report under the Act or the applicable EU requirements (and has included the parent company and its subsidiaries in its own consolidated annual report) is not required to prepare a consolidated annual report.

Effective from business years beginning on or after 1 January 2005, listed companies must, while other companies may, prepare and present their consolidated financial statements in accordance with IFRS.

A company which does not meet the consolidation criteria and has a majority holding, significant holding or mutual participation in another company must record its investments at cost less impairment and account for dividends received as income. In the balance sheet, such investments are valued at the lower of cost and market value. Any write down in the value of the investment is shown under financial expenses in the income statement.

Accounting Rules

Accounting Convention

Transactions are normally recorded at historical cost. Inflation accounting is not permitted. General revaluations of assets are only permitted in exceptional circumstances (such as on merger or the transformation of a company from a Kft to an Rt).

Contributions in kind are recorded at valuation.

Foreign Currency Translation

Transactions denominated in foreign currency must usually be recorded at the exchange rate ruling on the day of the transaction. Differences between these amounts and the subsequent cash settlement must be recorded as financial expense or financial income.

Any balances denominated in foreign currency at year-end are valued at the year-end rate. The unrealized foreign exchange gains and losses deriving from the year-end valuations are netted. The net f/x gain or loss is recognized in the profit and loss account.

There are special rules for unrealized losses on foreign currency loans taken out for the purpose of acquiring fixed assets. The loan amount must be reported in the balance sheet at the current year-end rate but the unrealized loss can be deferred and taken to the profit and loss account in annual installments over the useful life of the related assets. (On partial or full repayment of the loan previously deferred unrealized losses corresponding to repayment amounts become realized and must be charged to the profit and loss account immediately.)

Fixed Assets

Tangible and some intangible fixed assets may be recorded at cost less depreciation and impairment or revalued amount. If revaluation is applied, it is not required to revalue all the assets within the same class. Assets under construction, bonds and other securities held as income earning investments, goodwill, capitalized foundation, restructuring and development costs may not be revalued. The revalued amount of assets must be reviewed annually.

If assets are revalued upwards, the revaluation surplus must be recognized directly in equity and presented separately as a revaluation reserve. Subsequent adjustments in the revaluation surplus are charged directly against the revaluation reserve; the depreciation charge recognized in the profit and loss account is based on the historical cost.

If assets are revalued downwards below the carrying amount, the revaluation deficit must be recorded in the profit and loss account as exceptional depreciation.

Most assets (other than land and works of art) must be depreciated or amortized over their expected useful lives, as determined by management. If there has been a permanent diminution in value of a fixed asset (including securities and shares) as at the Closing Date for the preparation of the balance sheet, additional depreciation should be charged to reflect the revaluation of the asset to its market value. Permanent means in evidence for at least one year. If the market value has been significantly less than the book value for at least one year, then a write down must be made. Impairment losses must be reversed if no longer appropriate due to a subsequent increase in market value.

Assets purchased under finance leases must be capitalized. However the definition of a finance lease is much more restricted under HAL than under IFRS and most lease agreements in Hungary are structured as operating leases for HAL purposes.

Development expenses and foundation or reorganization expenses are not required, but permitted to be capitalized and written off over a period of up to five years. Recognition criteria for capitalization of development costs are less restrictive than under IFRS.

Goodwill must be written off over a period of not less than five years. If the period is longer than five years this must be disclosed in the supplement to the accounts.

Inventory

Inventory is valued at the lower of cost or realizable value. Cost can be calculated on a first in, first out basis or on average cost. Inventories must be written down to market value in the case of loss in value but provisions, as distinct from write-downs (e.g. for slow moving goods) are not permitted. Write-offs must be reversed if no longer appropriate due to a subsequent increase in market value.

Securities

Long-term securities (held for investment or trading purposes) should be valued at cost unless the market value has decreased significantly below cost for at least one year at the date of preparation of the balance sheet. Securities with a maturity of not more than one year (short-term securities) should be valued at cost unless it is expected that the face value will not be repaid by the issuer.

Export Subsidies

Any export subsidies due may only be recorded as income when claimed, not when receivable.

Capital

A special non-distributable reserve must be separated within the equity for certain capitalized costs and future liabilities. Dividends can be paid only if the total equity, excluding the non-distributable reserve, after the dividend payment exceeds or equals the registered capital. Minority interests are disclosed separately as part of equity.

Liabilities

Liabilities may only be recorded if they are supported by invoices, contracts or other appropriate documentation.

Provisions

As noted above, formally, provisions cannot be made against inventory (although write downs are permitted).

Provisions are required to be made against specified kinds of liabilities: legally enforceable guarantees (such as warranties), early retirement pensions and severance payments. It is also possible to record provisions against other losses that are likely or probable to occur and can be estimated with reasonable certainty.

Profit and Loss Account Presentation

The principle of completeness (grossing up) means that some related items are presented separately in the profit and loss account. For example, the proceeds of fixed asset disposals and the write back of the prior year impairment of assets are reported under Other Income whereas the book value of fixed assets disposed of and the full amount of the write down required at the current year end are reported under Other Expenses.

Dividends approved after the balance sheet date (at the annual general meeting or members' meeting) should be recognized as liabilities on the balance sheet date and presented on the face of the income statement as a deduction from profit for the year.

Extraordinary Items

The definition of extraordinary profits and losses is broader under HAL than IFRS. For an item to be extraordinary for IFRS it must be unusual in amount and kind and not expected to recur frequently. Under HAL, even immaterial and recurring amounts should be reported as extraordinary if they are outside the normal course of business.

Extraordinary items include development grants, the value attributable to assets received as gifts and purchases / sales of treasury shares. Further, the grossing up principle means that elements of a single transaction are sometimes reported separately under extraordinary profits and extraordinary losses. For example, the sale of treasury shares will result in the presentation of an extraordinary loss (the book value of the shares sold) and an extraordinary profit (the proceeds of the sale), rather than simply the net profit.

Prior Year Material Errors

Significant errors detected from prior years must be adjusted directly against the retained earnings and presented in a separate column of the financial statements. The amount which is considered significant can be decided by the company but cannot be more than 2 percent of the total assets for the year in question or HUF 500 million (if this is less than 2 percent). This amount could be below what is considered material under IFRS. There are detailed rules defining what is a significant error and how the calculation of the total of significant errors is to be made. Errors increasing and decreasing profits cannot be netted in arriving at this total.

Fair valuation

Fair valuation of financial instruments and hedge accounting may be applied optionally from 2003. If fair valuation is applied, the classification of financial instruments and the recognition and measurement requirements are similar to that of IAS 32 and IAS 39.

Disclosure

The disclosure requirements in Hungary are less extensive than under IFRS. Under HAL there is no requirement to disclose earnings per share or segment information in the financial statements.

Consolidated Financial Statements

Deferred tax provided in consolidated financial statements represents the difference between the total tax charge in the individual companies' financial statements and the tax charge in the group financial statements after eliminating the effect of inter company transactions (which is not the same as deferred tax under IFRS).

Filing Requirements

All legal entities, which are registered in the Trade Register, and maintain double or single-entry books, must file their Annual Report, Simplified Annual Report with the Court of Registration within 150 days after the balance sheet date. The managing director of the entity must sign the Report. It should contain the auditor's report, where an audit is required, as well as the proposal or resolution pertaining to the utilization of the after-tax profit. The business report need not be filed but must be available for inspection at the registrant's own head office.

Consolidated Annual Reports must be filed within 180 days after the balance sheet date. Many Hungarian companies still tend to publicize their company results and regard the preparation and issuance of their consolidated accounts as less important.

Under Budapest Stock Exchange rules, Companies listed on the Exchange must issue their preliminary unaudited announcement within 45 days of the year-end, the audited separate and consolidated financial statements within 120 days of the year-end.

Publication

All entities keeping double-entry books are required to publish their annual report (excluding the business report) and the auditor's report. However there is no requirement to publish this information in any newspaper. The requirement must be satisfied by filing the information at the Company Information Office of the Ministry of Justice (in addition to filing the same information with the Court of Registration).

Auditing

The general rule is that all companies required to keep double entry books, including branch offices of foreign companies, must appoint independent auditors. Auditors are normally appointed on incorporation and subsequently at the general meeting at which the previous year's accounts are approved.

There are exemptions for small companies. Companies with less than HUF 5 million average annual sales over the past two years (pro-rata annual sales in the first accounting year) do not have to appoint an auditor and companies with average annual sales of HUF 5 to HUF 50 million do not have to appoint an auditor provided that their annual financial statements are prepared by a qualified bookkeeper or accountant. Once a company has appointed an auditor, it cannot subsequently cease to have an audit even if its sales are less than HUF 50 million. There is no audit exemption for branches of foreign companies; these must always be audited.

The independent auditor must be an individual or an accounting firm registered at the Chamber of Hungarian Auditors ("Registered Auditor"). If an accounting firm has been appointed as auditor, an individual Registered Auditor from the firm must be nominated as the responsible auditor and the audit report must be signed by this individual.

Only certain individuals and firms are authorized to sign audit reports on banks, member firms of the Budapest Stock Exchange ("BSE") or companies listed on the BSE. KPMG Hungária Kft. is a Registered Auditor and holds the necessary qualifications.

Under the Act, the purpose of an audit is to establish that the annual report (or simplified report) has been drawn up in accordance with the Act and provides a true and fair view of the financial position and results of operations of the entity in accordance with HAL.

An auditor is entitled to request the company to provide facts and information in the course of an audit. Auditors have a duty of confidentiality with respect to the facts and information that they become aware of in the course of their duties. The auditor is required to draw attention to any breaches of the law or other matters detrimental to the company's present situation or prospects (including losses of share capital, for which special rules apply) and may initiate the convening of meetings of management or shareholders if the circumstances justify this. The auditor must attend the general meeting of a company limited by shares.

Registered Auditors and the Chamber of Auditors are regulated under Act XV of 1997. The Chamber of Auditors has had certain responsibilities delegated to it by the Ministry of Finance. To become an individual Registered Auditor it is necessary to have at least three years relevant work experience and to pass exams set by the Chamber. The Chamber of Auditors is also responsible for auditing standards and has adopted International Standards on Auditing ("ISA"). Individual Standards were introduced over a three-year period (1999 to 2001) and all auditors are expected to comply fully with ISA (adapted as necessary to deal with particular local issues) from 1 January 2001.

Other Matters

Specific rules and legislation apply to certain types of entities.

Banking and other financial institutions are legislated for under Act CXII of 1996 on Financial Institutions and Financial Institutional Activities and associated rules and regulations. Special accounting rules require banks to establish a risk reserve to cover the risks associated with off balance sheet commitments and contingencies. Other risks such as lending risk, country risk and investment risk should be considered in the valuation of the related assets at the balance sheet date (i.e. any specific provisions should be reflected in the reported value of the asset)

Insurance companies are legislated for under Act XCVI of 1995 on Insurance Companies and Insurance Activities.

Brokerage firms are regulated by Act CXX of 2001 on Capital Markets. Brokerage firms must also meet the requirements of several sets of rules and regulations established by the BSE.

Chapter 6

Taxation

Introduction

Personal income tax and VAT were introduced into the Hungarian tax system in 1988.

This was a first step in a long process of tax reform. The next major step, undertaken in 1991, was the modernization of the corporate income tax system.

In 1993, the VAT legislation was further modified to conform, at least in principle, to the VAT systems used in the European Union.

1995 witnessed the introduction of a two-tier corporate tax system, comprised of a standard rate and a supplementary tax. New legislation, which came into force in 1997, left the standard rate untouched while replacing the supplementary tax with a withholding tax.

With Hungary's accession into the European Union, several changes have been implemented in the Hungarian tax legislation during the past few years to comply with the EU tax directives (e.g. parent-subsidiary directive, mergers directive, sixth VAT directive).

The current, significant taxes and levies imposed in Hungary are:

- Corporate Tax
- Personal Income Tax
- Value Added Tax
- Customs Duties
- Excise Duties
- Property Transfer Tax
- Local Taxes
- Social Security Levy
- Contribution to the Rehabilitation Fund
- Contribution to the Vocational Training Fund
- Contribution to the Cultural Fund

- Death, Gift and Inheritance Taxes
- Environmental Protection Levy
- Innovation Contribution
- Energy Tax

Corporate Tax

The basic principles for the taxation of business profits are detailed in the Corporate Tax Act. The taxable income of Hungarian companies is subject to corporate tax at a rate of 16 percent as of 1 January 2004. Based on the amended plans of the government, a further reduction of the tax rate might be enacted in the future. A 4 percent rate applies to offshore companies from 1 January 2004. (See Chapter 7).

The 20 percent withholding tax on dividend payments is deducted and remitted by the Hungarian paying corporation on behalf of the recipient at the time dividend payments are made. However, no withholding tax is to be withheld when dividends are payable to other Hungarian corporations. This means that the dividend may flow through any number of Hungarian corporations on a tax-free basis. The withholding tax will be levied only once when the dividend ultimately reaches a Hungarian tax resident individual or a foreign shareholder.

Foreign shareholders may reclaim the difference between the tax withheld and the dividend rate provided for in a relevant double tax treaty. Alternatively, special procedural rules allow the use of reduced treaty rates at the time of paying the dividend.

The rules of the EU parent-subsidiary directive have been implemented in the Hungarian tax legislation. Based on these regulations, dividends distributed by Hungarian companies to shareholders located in the EU might be exempted from withholding tax following Hungary's EU accession if the shareholder holds at least 25 percent of the shares of the Hungarian company for at least two years on a continuous basis. Nevertheless, if a third party gives a guarantee to the tax authority at the time of the dividend payment, the two year holding period may also be completed subsequent to the payment.

The following table sets out as an example the rates of tax applicable in 2004 to corporate profits and dividends (if it is paid e.g. to a US company, or resident of another similar treaty country outside the EU which qualifies for the reduced 5 percent withholding tax rate):

	Tax rate	Tax (HUF)	Income (HUF)
Taxable income			100,000
Corporate tax	16%	16,000	
Balance of undistributed income available for distribution as gross dividend			84,000
Tax charged on dividend payable to the company (treaty rate 5%)	5%	4,200	
Total tax charged on distributed income		20,200	
Net distributed profits			79,800

Determination of Taxable Income

The basis of assessment is the profit shown in the financial statements of the taxable entity, as adjusted by various additions and deductions required under the Corporate Tax Act.

- The Act provides special rules, among others, for the handling of:
- Non-business expenses
- Depreciation
- Bad debts written off
- Thin capitalization
- Research and Development expenses
- Transfer pricing
- Intercompany interest; stock-exchange gains; royalties
- Local business tax
- Loss carryforwards
- Intercompany interest; stock-exchange gains; royalties

Non-Business Expenses

In general, expenses considered to be for non-business purposes are not recognized for tax purposes. The tax legislation provides a list of various costs and expenditures that are not seen as incurred in the interest of the business, and hence, not deductible. Examples include interest disallowed under thin capitalization rules and certain entertainment expenses.

All services exceeding HUF 200,000 must be documented in writing, the nature of service must be determined and the business purpose must be proven. This means that the expense must be incurred in the usual business activities of the company in order to be deductible.

Depreciation

No depreciation is allowed on assets that have not been put into use or are still considered to be part of construction-in-progress.

Since 1997, the Tax Law dealing with Deductions stated that the depreciation allowed would be limited to the lower of the rates stated in the Corporate Tax Act or the amount of depreciation charged in the Financial Statements in accordance with the provisions of The Act on Accounting. However, effective as of 1 January 2001, the corporate tax depreciation rates must be used to determine the allowable deduction for tax purposes.

The Act on Accounting relates depreciation rates to the expected useful life of the asset. In view of the importance of correctly classifying assets based on the official guidelines, the exact text is quoted: "the absolute amount of depreciation shall be planned with regard to the expected use of the individual asset, its duration arising therefrom, its physical wearing out and moral obsolescence, as well as to the circumstances typical of the entrepreneurial activity concerned". It can be seen that the criteria include not only physical life but also useful economic life.

The following table sets out most of the current maximum rates, for corporate tax purposes:

Machinery and equipment	14.5%
Computers	33%
Vehicles	20%
Buildings	2% / 3% / 6% (Depending on type)
Intangibles	Accounting Life
Leased assets:	
Leased Buildings	5%
Equipment in leased buildings and other leased tangible assets	30%

There have been some incentives introduced in the CIT law as of 1 January 2003, which allow faster tax depreciation regarding the following assets:

- 50 percent depreciation can be claimed on general IT machinery and on equipment exclusively serving motion picture and video production.
- Taxpayers can claim 50 percent depreciation in connection with brand new tangible assets that are acquired or produced in 2003 or 2004 and which would otherwise be subject to a 33 or 14.5 percent rate; the same rules apply to intangible properties purchased or produced in 2003 or 2004, and to the capitalized value of experimental development.
- As of 1 January 2003, the concept of development reserve was introduced. This entitles the taxpayer to decrease its pre-tax profits by up to 25 percent (with an upper limit of HUF 500 million), provided that, it capitalizes investment equaling or exceeding the amount of the development reserve within four years of recognizing such reserves.

Subsequent to the capitalization of the invested assets, the tax book value of the assets must be decreased by the amount of the development reserve. This is because the tax depreciation of the relevant assets is already accounted for when recognizing the development reserve itself.

It is important to note that the amount of development reserve limits the dividend payment potential of the taxpayer, as it is accounted for through a transfer from profit reserves.

Debts Written down

Hungarian Accounting Law requires a write down to be made for doubtful debts, however the tax-deductible amounts are limited to a percentage based on the age of the debt:

90 - 180 days overdue	2%
181 - 360 days overdue	5%
Over 360 days overdue	25%

In addition, write-offs are tax deductible only in the tax year when they are booked. Such provisions should be added back to the tax base of the subsequent tax year, to be replaced by that year's provision.

Thin Capitalization

New legislation was initiated in 2001 that changed not only the debt to equity ratio for thin capitalization calculation purposes to 3:1 but also the definition of what debt instruments are included in the calculation. The revised definition indicates that interest on loan instruments payable on all of the taxpayer's non-trade and non-financial institution creditors is included when calculating the ratio. Thus, the thin capitalization rules include interest on loans granted by both related and unrelated parties and also extend to bonds and other loan securities issued exclusively to one party (i.e. closed securities). The thin capitalization rules provide an exemption for loans made through banking institutions.

R&D expenses

Generally, a double deduction can be claimed for R&D expenses. Nevertheless, there is only a single deduction for R&D activities supported with governmental subsidies to the extent of the subsidies.

Transfer Pricing

Transfer pricing rules allow the tax authorities to adjust taxable profits where transactions between related parties are not at arm's length. The current legislation prescribes not only the methods applicable for determining a fair market price but also the way in which these must be applied. The taxpayer may calculate the fair market price using any alternative method, provided they can prove that the market price cannot be determined by the methods included in the Act, and the alternative method suits the purpose. OECD transfer pricing principles are generally accepted in Hungary.

Based on recently introduced rules, taxpayers are obliged to produce detailed transfer pricing documentation (transitional rules apply for transaction entered into between 1 September 2003 and 31 December 2004). This documentation should be prepared by the deadline for the submission of the annual corporate income tax return of the company. Nevertheless, these records do not have to be filled with the tax return itself but must be available at the time of tax authority investigations.

Loss Carryforwards

Under the new legislation effective from 1 January 2004 losses can be carried forward without time limitation. However, should the taxpayer have tax losses for two consecutive years, then the taxpayer should apply for a tax authority permission. The tax authority grants such permissions if the taxpayer can prove that the losses were incurred in the normal course of business.

For companies formed before 16 June 1998 the start up losses of the first year of operations and the next two years could be carried forward indefinitely. Companies formed since 16 June 1998 with no predecessors may now carry forward losses incurred in the year of establishment and in the three subsequent years thereafter for an unlimited period of time.

In the event of transformation, a legal successor is permitted to use the losses of a predecessor. If the net revenue of the company in the fifth tax year following the year of commencement does not exceed 50 percent of the sum of costs and expenses for the specific year, a loss carryforward will be available only with the permission of the tax authorities. This permission is granted if the losses result from external unavoidable events (force majeure).

No loss carryforward is available for financial institutions.

Intercompany interest; stock-exchange gains; royalties

As of 1 January 2003, the following changes have been implemented in the Hungarian corporate income tax law (these rules do not apply to offshore companies - see Chapter 7):

- The taxpayer can decrease its pre-tax profits by 50 percent of royalties accrued and gains realized on stock exchanges.
- The taxpayer can generally deduct 50 percent of net intercompany interest receivable.

The above deductions are limited to a maximum 50 percent of profit before tax.

Local Business Tax

Under the new rules effective as of 1 January 2004, companies can decrease their positive pre-tax profits (i.e. a tax loss cannot be created or augmented) by 25 percent of the amount of local business tax payable (see also on page 48) in addition to the ordinary 100 percent deduction.

Non - Resident Companies

Branches and Permanent Establishments

Non-residents are in most cases able to conduct business in Hungary through branches registered with the Hungarian Court of registration, if they do not want to establish a Hungarian registered company. If some conditions are fulfilled, foreign companies may engage in expert activities, management, construction, repair, sport, performance and education activities without establishing a branch.

Hungarian branches are treated as any other corporate income taxpayer. Accordingly, profit transfers from the branch to the headquarters are considered as dividends and are liable to withholding tax on dividends or other payments, which are subject to Hungarian withholding tax. No withholding tax on such payment is necessary if the applicable double tax treaty has deemed it as a non-dividend payment (applicable in most cases with notable exceptions being France and Canada).

Withholding Tax

As of 1 January 2004 most payments by Hungarian companies are exempt from any withholding taxes irrespective of the residence of the recipient party. The only exception is the taxation of dividends distributed by Hungarian companies to foreign shareholders or branch profit repatriations. Nevertheless, dividends distributed to companies located in the EU subsequent to Hungary's EU accession might be exempted from withholding tax under the Parent-Subsidiary directive, as implemented into the Hungarian legislation.

Relief from Tax

Foreign Tax Credit

A domestic tax credit system is available for corporations in order to avoid double taxation on foreign - source income other than dividends. Hungarian tax treaties apply either the exemption or the credit method to prevent double taxation.

Reduction of Withholding Taxes

Hungary has concluded a comprehensive network of bilateral tax treaties for the avoidance of double taxation, based mainly on the OECD Model Convention. Among other things, these treaties set reduced rates of withholding taxes in respect of dividends, royalties and interest income. For a listing of the existing treaties, see Appendix A. Nevertheless, for royalties and interest paid from Hungary, domestic legislation gives unilateral exemption irrespective of the double tax treaties.

Tax Incentives

As a result of Hungary's EU accession, the intervention of the state in the private sector has had to be limited.

Tax Allowance for Small and Medium-sized Enterprises (effective as of 1 January 2001)

Small and medium sized companies, as defined by the Act on Small and Medium Size Companies and on their Subvention, may apply for a tax incentive with regard to the interest payable on loans borrowed from a financial institution for the purpose of purchasing or manufacturing tangible assets (including a second loan obtained to refinance an existing one). The company must qualify as a small or medium sized company on the last day of the tax year when the loan contract is entered into and the contract must have been entered into on or after 1 January 2004.

The tax incentive equals 40 percent of the interest paid on the loan in a tax year.

Tax Incentives Related to Investments started after 31 December 2002

The Ministry of Finance grants tax incentives for a maximum 10-year period for the following investments started after 31 December 2002, which are executed within the framework of the development program published by the government.

- 1) For investments of at least HUF 3 billion present value or in case of investments in certain special regions in value of at least HUF 1 billion present value, which meet any of the following requirements during the four years following the first year in which the tax allowance is utilized:

- the average number of persons employed should be at least 100 (50 in certain special regions), or
 - the taxpayer's annual wage costs should be increased by at least six hundred times the minimum wage calculated for the tax year (three hundred times in certain special regions), or
 - at least 30 percent of the supplier liabilities of the taxpayer should be towards small and medium-sized enterprises.
- 2) For investments of at least HUF 100 million at present value for:
- projects bringing an existing food facility producing foodstuffs of animal origin into compliance with the requirements laid down in legal regulation concerning food hygiene,
 - independent environmental protection or rehabilitation projects,
 - broadband Internet service projects,
 - motion picture and video production.
- 3) For investments creating new jobs for the initial year and the following five years if the project in question is for the creation of a new facility, the expansion of an existing one, or involving a significant improvement in the product that is manufactured or in production technology. This allowance can be utilized if certain additional conditions are met. For example - at least 20 percent of the total workforce hired for the new jobs created under the development program are "first-time employees".

For eligibility for the tax allowance the Ministry of Finance shall grant an authorization in a decree. The decision must be adopted within 60 days from the date when the application was submitted or when re-submitted. This deadline may be extended once, by a maximum of 60 days. If the Ministry of Finance does not reject the application within the prescribed time limit, it shall be subject to the legal consequences and applicable as if it had been approved, in which case the taxpayer shall be entitled to the tax allowance.

The benefit of this incentive is a tax relief of up to 80 percent of the tax liability, however in total no more than a certain percentage of the capital invested (depending on the particular industry).

Taxation of Individuals

Personal Income Tax

Residence

Under Hungarian domestic law, individuals with Hungarian citizenship (with the exception of dual citizens without a permanent or habitual residence in Hungary) and foreign nationals with a valid permanent residency permit and stateless persons are treated as residents. In case of other natural persons, the residence status can be determined firstly by permanent residence, secondly by the center of vital interests and thirdly by habitual abode. Individuals are considered to have a habitual abode in Hungary if they stay in the country for more than 183 days (including the date of arrival and the date of departure) during a calendar year.

There is no codified test for the application of the 183 days but in practice it is understood to be a physical presence test. In case of doubt, an individual is responsible for proving that his/her stay did not exceed 183 days.

Non-resident individuals are subject to income tax on their Hungarian source income under the same rules as residents. For tax purposes Hungary means the territory of the country. Income from a foreign employment exercised in Hungary will be treated as Hungarian source income. Hungarian resident individuals are subject to individual income tax on their worldwide income.

Income derived from Hungarian sources is in particular:

- Income derived from employment with a domestic employer;
- Income derived from a legal relationship where the party that orders the work is resident in Hungary;
- Income from activities exercised in Hungary; and
- Income from assets (any property value) situated in Hungary.

Income

Individuals are subject to tax on a progressive basis on the aggregate amount derived from different types of income unless the income is specified as non-aggregated income (e.g. dividends) that is taxed separately at flat rates (see below). Income is defined as “any increase in wealth or value obtained in any manner and form”.

Income of directors, regardless of whether they carry out their function as employees or not, is taxed as employment income. The term ‘director’ is not defined under the income tax law.

Rates

The individual income tax is levied on the aggregate taxable base according to a progressive scale. There is a three level tax table for 2004, as illustrated below. Tax on employment income from a Hungarian employer is withheld at source by the employer.

Annual taxable income HUF Tax payable	
0 - 800,000	18%
800,001 - 1,500,000	144,000 + 26% on excess over 800,000
Over 1,500,001	326,000 + 38% on excess over 1,500,000

Flat rates applicable to certain types of income are as follows:

- 0% on interest income from saving deposits
- 20% or 35% on dividends (depending on ownership)
- 20% on certain capital gains and gains on trading options and futures
- 20% on gains from the alienation of immovable property
- 20% on advance dividends
- 38% on small sums
- 44% on the value of benefits provided in kind (payable by the provider).

Taxation of Certain Specific Benefits

- Housing provided by a Hungarian entity both in cash and in kind is taxed as a part of employment income if supported by an employment contract. In case of foreign employees, who are only seconded to Hungary and do not possess an employment contract with a Hungarian entity, housing should be treated as a non-taxable benefit in kind.
- Company cars used for private purposes are taxed according to separate rules. This tax is based on the value, the age of the car and when it was placed into service. The tax is due and payable monthly by the Hungarian company provider.
- Relocation services provided by the employer are exempt. All allowances are taxed as cash benefits. Reimbursement of home leave expenses of family members is taxed as a cash benefit. Education allowances are services provided in kind and are taxed according to the general rules. Professional training of employees is treated as tax exempt fringe benefits.
- Should the interest charged on an employee loan be less than the Hungarian National Bank prime rate plus 5 percentage points - or the standard market rate if the payer is able to prove that the standard market rate is lower- then the difference between the amounts of the actual interest charged and what should have been charged using the actual prime rate plus 5 percentage points; (the prime rate was 11.00 percent as of August 2004), are taxable as a fringe benefit. Salary advance payments exceeding 5 times the minimum wage are treated as below market rate loans.

- Business travel and accommodation expenses are treated as exempt fringe benefits if properly documented with invoices. If the invoices do not name the employer (i.e. the actual payer of the expense), or if invoices are not provided to the employer, the costs reimbursed by the company are treated as other income of the individual.
- Meals are taxed as fringe benefits.
- Certain life insurance premiums paid by the employer for the benefit of an employee are exempt. Lunch vouchers up to a very low amount are exempt.
- Any value of property or benefit received from a person other than a foreign private person to whom no domestic tax law applies, must be treated under the same category as defined by the payer. For example, if the foreign payer treats the benefit as employment income, then it shall be the same for Hungarian taxation purposes. The recipient is personally liable for declaring and paying the taxes on these benefits to the Hungarian tax authority.

Exemptions

Various types of income are exempt under the tax legislation. These include:

- interest income such as income from savings deposits, securities and gains from any transaction concluded in the Hungarian stock exchange and, since Hungary's EU accession, gains from any transaction concluded on a recognized stock exchange of another Member State
- gains from dwellings if proceeds from such are used for purchasing a new primary home (unless such new home is subsequently disposed of within five years);
- income from the disposal of real estate if the real estate was purchased 15 years prior to the sale;
- capital gains on certain publicly traded bonds;
- certain housing subsidies;
- the part of the taxpayer's salary which is paid as membership fees to a trade union;
- educational, health and social welfare benefits in kind, insurance compensation, compensation for meals and work clothes provided by the employer;
- certain scholarships.

Deductions

In general, expenses incurred for the purpose of pursuing business activity are deductible in order to determine the taxable base of income from independent activities. Tax legislation provides individuals with two options for the deduction of such expenses: either the deduction of actual expenses or a deduction of an allowance of 10 percent of gross revenues. Increased allowances are available for small- entrepreneurs.

No expense deductions from employment income are allowed. Foreign mortgage and other interest are not deductible, nor are contributions to foreign pension or insurance schemes.

Relief From Tax

Foreign Tax Credit

Under domestic law, a tax credit system is available for individuals to avoid double taxation on income received from abroad. In order to obtain such tax credit the income must fall under the category of aggregated income and not be one of the types, which are taxable at a special flat rate, as indicated earlier.

Under its double tax treaties, Hungary usually gives relief by way of exemption by progression. This means that the income taxed abroad does not form part of taxable income, though it is included in the taxable base in order to determine the tax rate applicable to the taxpayer's remaining income. The wording of each double tax treaty should be considered, however.

Other Tax Credits

Allowances and other deductions from taxable income are granted in the form of tax credits.

The most important tax credits are as follows:

- 30 percent but up to a maximum HUF 100,000 (HUF 130,000 if the private individual reaches the retirement age before 1 January 2020) of contributions paid by the individual or its employer either to Hungarian voluntary private pension schemes (first type of voluntary schemes), or to voluntary private health funds and voluntary private aid funds (second types of voluntary schemes). In aggregate if both types of voluntary schemes are contributed to, the maximum amount which can be deducted from taxable income is HUF 120,000 (HUF 150,000 if the private individual reaches the retirement age before 1 January 2020);
- 25 percent but up to a maximum HUF 50,000 of income from intellectual property;
- 40 percent but up to a maximum HUF 120,000 of income used for paying back housing related loans if annual gross income is below HUF 3,400,000;
- 30 percent but up to a maximum HUF 60,000 of the tuition paid by day student/teacher at a accredited university;
- 30 percent but up to a maximum HUF 60,000 of the sum paid for adult education;
- 50 percent but up to a maximum HUF 60,000 of costs of computer and computer accessories obtained within the framework of tender hosted by the Ministry, applicable if the annual gross income is less than HUF 3,400,000; and
- 30 percent but up to a maximum HUF 50,000 or 100,000 of payments to charities for specific purposes.

Social Security Contributions

Hungary has one of the highest levels of social security contribution in Europe.

In addition, there is a fixed health care charge of a maximum HUF 3,450 per month/per employee. An 11 percent health care charge is due on a broad range of receipts including:

- remuneration and benefits-in-kind not subject to the 29 percent social security contribution noted below;
- preferred rates of interest on loans;
- company-owned or leased automobiles (computed at not 11 percent but 25 percent of the company car tax); and
- miscellaneous income (including interest on loans between individuals, special income from capital, third party contributions to the voluntary pension plans, payments of insurance premiums, etc.).

The pension system is now a three-pillar system consisting of a mandatory public scheme, a private scheme and a voluntary scheme. Individuals must contribute to the public scheme (8.5 percent) and may contribute to the private and voluntary schemes.

Employees may choose to pay 0.5 percent to the public scheme and 8 percent to the private scheme. Additional contributions of 1.5 percent may be made to the private fund. Hungarian citizens may also contribute to voluntary private pension funds, which make up the third pillar.

A summary of 2004 employer and employee contribution rates is as follows:

Employers	Pension and Health Insurance	Unemployment	Total
(required to pay a contribution calculated on the basis of the wages and salaries of their employees)	29%	3%	32%
Employees			
(the contribution is withheld from their salaries or wages by the employer)	12.5%	1%	13.5%

The health insurance contributions payable by employees have been changed to 4 percent. The remaining 8.5 percent comprises pension contributions, and as discussed above, are generally divided into those made into the Social Security system (0.5 percent) and those made into private pension funds (8 percent). For 2004, the ceiling for the payment of contributions under the state pension scheme and under the private schemes is HUF 5,307,000 for individuals. Tax credits are available as mentioned above.

Social security contributions are mandatory for Hungarian employees, foreign employees employed by Hungarian entities, foreign employees under certain Social Security Totalization Agreement provisions and in certain other cases, including employment by another EU company. Employees not otherwise subject to but wishing to benefit from the Hungarian social security system are allowed to contribute.

Gift and Inheritance Duties

Hungarians and foreign persons who inherit property in Hungary are liable to pay inheritance duty. The applicable rate of the inheritance duty depends on the relationship between the decedent and the beneficiary (in case of close relatives of the decedent the applicable rates are 11 percent, 15 percent, 21 percent according to a progressive scale depending on the value of the property inherited). In case of real estate, the rates are 2.5 percent, 6 percent or 11 percent.

The applicable rates of gift duty are almost the same as the rates of inheritance duty (11 percent, 18 percent, 21 percent in case of close relatives), however, they are higher in the case of real estate (5 percent, 8 percent or 12 percent).

There are exemptions from inheritance and gift duties, for example: inheritance / acquisition of ownership (ownership share) of a plot of land suitable for the construction of a residential house, and rights of pecuniary value in respect of such real property, if the beneficiary builds a residential house on such inherited / acquired real property within four years of the definitive delivery of the estate is exempt from inheritance / gift duty.

Indirect Taxes

Value Added Tax

The Hungarian VAT has been increasingly harmonized with the EU Sixth Directive. VAT applies to all natural persons, legal entities and associations of individuals and partnerships, which supply goods or services on a regular basis or business-like manner for profit. Foreign entities performing VATable business activities in Hungary are obliged to register for VAT and fulfill their VAT obligations under the Hungarian legislation.

VAT is levied on supplies of goods and services performed in Hungary, on intra-Community acquisitions and on importation of goods (for VAT purposes the territory of Hungary includes the customs free and transit zones as well as bonded warehouses). The VAT tax base covers not only tangible goods and services, but also intangibles. Certain kinds of goods and services are exempt from VAT.

Generally, the Hungarian VAT law applies the destination principle to cross-border transactions. Therefore, exports of goods, certain services and intra-Community supplies of goods are zero-rated. In other words, these transactions are not subject to Hungarian

VAT. The supplier of such transactions being a VAT registrant can claim input tax credits to recover the VAT paid on its own business related purchases.

There are three VAT rates:

- 25 percent - is the general rate and is applied to most products and services;
- 15 percent - is the reduced rate and is applied to certain products and services (basic consumer goods, newspapers, transportation, etc.);
- 5 percent - the five percent reduced rate is largely restricted to books and basic medicines.

The basis of assessment is the sale value of the goods or services although an adjustment is possible if the sale value is significantly below market price. In the case of importation of products, the basis of assessment is the value for customs duty, increased by the amounts of stamp duties and other tax related payment obligations. Foreign currency values are determined by the exchange rates quoted by the National Bank of Hungary.

In connection with intra-Community transactions, administrative obligations, such as Intrastat and EC Sale List filings, exist. Taxpayers are obliged to submit Intrastat returns monthly, if the value of their dispatches of goods or arrivals of goods exceeds the annual threshold determined by the Statistical Office. Taxpayers should submit EC Sales Lists quarterly as part of the VAT return on intra-Community supply and acquisition of goods.

The purchaser may assume the seller's obligation to issue an invoice based on a prior written agreement (self-billing) between the parties. The parties have joint and several liability for the obligations by law.

The following conditions have to be met in order to issue an invoice electronically: 1) the authenticity of origin; 2) the inviolability of the content; 3) the legibility of the document should be secured by certified electronic signature and time-stamp (or by delivery to the client through the so-called electronic data exchange system (EDI)).

In the case of import of goods and certain services acquired abroad, the importer must self-assess VAT on the amounts charged to it. The most important services that must be treated as "imported services" if the supplier has no Hungarian VAT registration are as follows:

- 1) If the purchaser is a Hungarian resident
 - hiring out of movable tangible property;
 - transfer and assignments of copyrights, licenses, trade marks and similar rights;
 - advertising services;
 - consultancy, legal, accounting, tax, IT, translating, engineering services;
 - data processing;
 - banking, financial and insurance services;
 - the supply of personnel;
 - telecommunication services;
 - radio and television broadcasting;
 - electronically supplied services.

- 2) If the services are physically carried out in Hungary
 - cultural, artistic, scientific, educational, sport or similar activities;
 - ancillary services related to transportation of goods (such as loading, warehousing);
 - work on movable tangible property;
 - product related advisory services.
- 3) Services connected with immovable property located in Hungary.

For imported goods, imported services and intra-Community acquisitions, companies should report VAT payable in one reporting period. However, companies providing taxable goods or services may deduct the input VAT in the same reporting period thus resulting in no actual VAT payable on that transaction.

The taxpayers are obliged to keep a register to show and control the basis of assessment and the taxes paid for five years.

VAT Refund for Non-Residents

Non-resident taxpayers from countries that have concluded bilateral agreements for the avoidance of double taxation on VAT (see Appendix B), and also from all EU Member States may obtain a VAT refund under certain circumstances.

Customs Duties

Exporting to and from Hungary

Hungary belongs to the customs union of the European Union (EU). Customs duties are payable on most goods imported across the EU external frontier, but do not apply to goods in free circulation moving across internal EU boundaries. All references to imports are to imports from outside the EU.

Import procedures

General procedures

All goods must be declared to the Customs Authorities (“Customs”) at import. Often this is undertaken by an agent, but the accuracy of the declaration remains the ultimate responsibility of the importer. The value, classification and origin of the goods and the purpose for which they are being imported will determine whether and how much duty is payable.

The classification and valuation of imported goods is a highly complex area governed by international agreements entered into by the Commission of the EU on behalf of its Member States.

Valuation

There are six methods of valuation. The first and simplest is the transaction method, which is based on the price paid or payable for the goods. Certain costs, such as freight and insurance, must be added to this price. The transaction method cannot be used, for example, where there is no sale, or where the relationship between the parties influences the sale price - in such cases the remaining five methods must be considered in strict order.

Classification

The Hungarian tariff is based on the international Harmonized System (HS) used by most of the industrialized nations of the world. This classifies all goods of international commerce so that each article is classified in one place, and one place only, within the tariff. Classification determines the rate of duty applicable to imported goods and whether any special preferential treatment is available.

Origin

The origin of imported goods and the route they take to the EU have considerable influence on their liability to duty. If they originate in, and are directly consigned from a country, which has a preference agreement with the EU, the duty rate is reduced or eliminated altogether. The EU has such agreements with other country groupings such as EFTA (European Free Trade Association - now within the European Economic Area), ACP (African, Caribbean and Pacific states), OCT (Overseas Countries and Territories), Mashraq and Maghreb. Suspension of the full rate of duty may be available from specified countries at certain times of the year on particular goods. Similarly a quota may be in force, which allows predetermined quantities of goods of certain tariff headings to be imported at lower than full rates of duty.

Charges at importation

Customs duties are mainly charged on the value of goods, although many agricultural products are also liable to specific duties, assessed according to weight or quantity, under the Common Agricultural Policy of the EU. A few items are subject to compound duties - i.e. a mixture of value-based and specific duties. The rate and type of duty applicable to an item is determined by its classification.

VAT is also charged at importation as if it were a customs duty. Any VAT paid at import may be recovered as input tax providing the importer is registered for VAT and the goods are for use in its taxable business activities. Evidence of VAT paid in this way is the VAT statement issued by Customs direct to the importer of the goods every month in the case of traders with deferred payment facilities. In other cases the invoice from the customs clearance agent is acceptable.

The acquisition of goods into Hungary from other EU Member States by a person registered for VAT in Hungary is known as an intra-community acquisition. A person

making an intra-community acquisition in Hungary is required to self-account for Hungarian VAT on their VAT return at the rate of VAT applicable to the goods by reference to the consideration paid. Provided the goods are acquired for a taxable purpose that person may make a simultaneous matching deduction on their VAT return for the VAT arising on the intra-Community acquisition.

Anti dumping duties are levied on specific goods imported from a particular country, or even a particular company, and are designed to protect EU industry from unfair foreign competition.

Once all import duties have been paid, goods are in free circulation in the EU and may pass to any other EU member state without further payment of customs duty.

Customs duty relief

A number of relieves are available in respect of imported goods: because they will not permanently enter the economic life of the community; or because they have already borne duty in the EU; or because they are imported for a specific non-dutiable purpose such as medical or research use, or for testing.

Two of the most common relieves are:

- Inward Processing Relief (IPR) - where goods are imported from outside the EU for processing and re-export, duty may be waived at import or refunded at export.
- Outward Processing Relief (OPR) - where goods are temporarily exported outside the EU for processing, a proportion of the import duty is waived on their return.

In order to take advantage of most custom relieves, authorization must be obtained in advance from Customs.

Export procedures

As with imports, goods must be declared to Customs at export. The same form is used, but generally fewer details are required (unless the goods being exported are under Customs control for duty relief purposes).

From a VAT perspective the export of goods to a destination outside the EU can be zero-rated provided the exporter could produce the necessary evidence of export.

For goods destined to other EU Member States the supply may be zero rated for VAT purposes provided the customer's VAT number is quoted on the sales invoice and evidence of "export" is retained. Zero rating for VAT purposes does not apply for "exports" of goods to customers in other EU Member States who are not registered for VAT. In such circumstances the supplier may be required to register for VAT in the Member State to which the goods are supplied dependent on the level of sales to that state.

Excise Duties

The legislation follows the concepts laid down in the relevant EU legislation and the new excise law was ratified by the Hungarian Parliament in November 2003 and became effective on 1 May 2004.

Excise duty is charged on a variety of goods including alcohol, tobacco products, motor vehicles, hydrocarbon oils and their derivatives, and goods containing any of these products. Excise duty is usually related to weight or quantity rather than to value.

The general foundation of the excise tax requires that the tax liability be computed at the time the excisable goods enter the country or when produced in Hungary.

Other Taxes and Duties

Motor Vehicle Tax

The operators of road vehicles (cars, trucks, etc.) are subject to a differential annual tax payment based on the weight of the vehicle. The current rate is HUF 1,200 per 100 kilos. Motorcars with a catalytic converter enjoy tax allowance between 20 and 50 percent.

Registration Fees and Stamp Duties

There are a number of types of fees and duties that may also apply to business associations. The registration fee at the Court of Registration amounts to HUF 600,000 for public limited liability companies and HUF 80,000 for other legal entities. In the case of registration of a branch, the fee is HUF 250,000.

Property Transfer Tax

Individuals and legal entities are subject to property transfer tax levied on the transfer price of Hungarian real estate or any rights related to such property. The tax is payable by the transferee and is levied on the market value of the property transferred at the following rates:

- 2 percent for apartments and houses on the first HUF 4 million of their value and 6 percent on the remaining value;
- 10 percent for all other real estate properties;
- 2 percent on commercial real estate if the buyer is a property trading company (with specific requirements);
- No tax on transfer of securities.

Local Taxes

There are a number of local taxes, which may be imposed at the discretion of the various local authorities:

Property Taxes

A property tax can be imposed on a company each year. For buildings, the tax is based on square meters (maximum HUF 900 per m² per year) or on the market value of the building (maximum 3 percent). Similarly for land, the tax is based on square meters (maximum HUF 200 per m² per year) or on the market value of the land (maximum 3 percent).

Community Tax

This tax is based on the number of employees, and may be imposed at a maximum rate of HUF 2,000 per employee/per year.

Local Business Tax

Enterprises pay local business tax on all business performed on a permanent or temporary basis in municipal areas. This tax is based on net income and is therefore payable any time a corporation has revenues. The base of this tax is an enterprise's gross sales revenue less cost of goods acquired for resale and the value of mediated services and subcontractors' fees. Material costs are also fully deductible. The maximum rate of tax is 2 percent of the tax base, which can be lower depending on the particular municipal area where the company is undertaking its business. Service providers get very limited relief and are required to compute their local tax based almost wholly on gross revenues. Furthermore 50 percent of financial income increases the local business tax base.

Since the national law provides no minimum levy, it is up to each municipality to determine whether it will impose this tax and if so, the rate it will charge. Therefore, it may be increasingly important to operate in municipalities that offer the lowest rates.

Offshore companies (see chapter 7) are exempt from the local business tax.

Contribution to the Rehabilitation Fund

This fund provides assistance to disabled employees. Disabled people should comprise a minimum of 5 percent of an employee's headcount. Any employer not meeting this criteria is obliged to pay a contribution of HUF 117,600/per disabled person employed per annum in 2004. The contribution is not levied if the total number of employees does not exceed 20.

Contribution to the Vocational Training Fund

Employers are required to contribute to this fund, which supports various vocational schools in Hungary. The contribution is at a rate of 1.5 percent of the total annual wages.

Contribution to the Cultural Fund

Retailers of certain listed products (films, magazines, construction etc.) and providers of certain services (such as video-rentals and advertisements) are obliged to pay contributions to the cultural fund. The basis of payment is a percentage of the net sales revenue (excluding VAT). The rates vary from 0.2 percent to 25 percent depending on the particular product or service provided. This provision is currently under consideration and may be subject to change.

According to the Act on the Program of the National Cultural Fund, the constructors of flats and other buildings with a value exceeding HUF 120 million is obliged to pay contributions to the Cultural Fund of 0.2 percent of the investment value. The investor should include in the subcontractor agreement whether or not the total value of investment will exceed HUF 120 million. Where the investment value exceeds HUF 120 million, the investor must notify the constructor in writing that the building to be built is subject to cultural contribution. In case of failure to notify, the cultural contribution is borne by the investor.

Environmental Protection Levy

This single-stage tax is imposed on the domestic manufacturer, importer or intra-Community acquirer of certain listed products, which in the opinion of the government could prove to be harmful to the environment.

These products include:

- fuels and other crude oil products;
- rubber tires;
- cooling equipment and refrigerants;
- wrapping materials;
- batteries;
- thinners and solvents;
- commercial printed papers.

As of 1 January 2005, the government intends to levy environmental charge also on electronic and electric equipment as well as vehicles, while the environmental charge on thinners and solvents is expected to be abolished.

The amount of levy is specifically set out for each type of product and is generally computed as an amount per kilogram of product.

Innovation Contribution

- A new contribution as of 2004, innovation contribution is payable by every entity subject to the Act on Accounting.
- The base of the contribution is equal to the local business tax base.
- The applicable tax rate is 0.2 percent in 2004, 0.25 percent in 2005 and 0.3 percent in 2006.
- The annual amount of innovation contribution payable can be reduced by the cost of R &D activity carried out by the taxpayer itself (state subsidies received for this purpose are excluded).
- The tax return is to be filed by the last day of the fifth month following the actual year.
- Quarterly advance payments are due by 20th of the subsequent month.

Energy Tax

The energy tax will be payable based on megawatts for electricity and on gigajoules for natural gas. The rate of energy tax is defined as 186Ft/MWh for electricity, and 56Ft/GJ for natural gas. This tax is related to national and administrative institutions and energy-intensive producer sectors. Tax must be paid by:

- public utility providers selling energy to public utility consumers;
- energy traders selling energy to eligible consumers;
- eligible consumers purchasing energy in Hungary directly from the producers or importing energy into Hungary;
- producers, which generate energy for their own use (with some exceptions); and public utility providers, energy traders and distributors, which purchase energy for their own use, except if this purchasing is in order to compensate the loss of network.

The tax liability arises on the day of performance as defined by the VAT law or on the day of customs clearance or on the day of private utilization respectively.

This tax falls under the responsibility of the Customs Authority.

Chapter 7

Offshore Companies

Rules currently in Effect

Under the Hungarian offshore legislation, qualifying companies receive very favorable tax benefits.

Several criteria must be met to qualify:

- the company must be registered in Hungary;
- the company must be 100 percent foreign-owned and involved exclusively in trading or the provision of services (other than public financial services) outside of Hungary;
- neither the company, nor its immediate owners may have any direct or indirect interest in any other Hungarian business or maintain a representative office in Hungary;
- the company must employ Hungarian lawyers in domestic legal issues and Hungarian registered accountants to perform statutory audits; and
- the majority of the company's Board of Directors and employees must be Hungarian tax residents.

The offshore company's profits are taxed at a rate of only 4 percent from 1 January 2004. Please note that the tax rate was increased from the previous rate of 3 percent. The combination of this very low tax rate with Hungary's extensive network of double tax treaties (see Appendix A) enables non-resident businesses to effectively minimize their overall tax liabilities, and makes Hungary a favorable jurisdiction in which to undertake certain types of activities.

The same rules apply to these companies, in relation to the employment of foreign or Hungarian employees etc., as apply for other Hungarian companies. However, offshore companies are exempt from local business tax (which is levied locally on other Hungarian companies at up to 2 percent of adjusted gross revenues).

Offshore companies must pay corporate income tax advances similarly to other Hungarian companies. The amount of advance payable is based on the tax liability of the

previous year. The advances are payable monthly if the previous year's tax liability is over HUF 5 million, otherwise the advances are due quarterly. The advances are due by the 20th of the month following the respective quarter/month. In addition, the advances paid during the year must equal at least 90 percent of the tax liability for the current year by the 20th of December.

Offshore companies are not exempt entities under VAT regulations, but services provided by the offshore company are usually outside the scope of VAT or VAT exempt. Thus, no VAT charge on these services arises. For example, according to VAT regulations, issuance of loans and acceptance of deposits will be considered VAT exempt "financing activities" and will not be subject to VAT.

It should be noted that the definition of "financing activities" for VAT is different from other definitions for "financing services." Typically, an offshore company's activities will be considered "financing" for VAT purposes but will not be considered "financing" according to corporate offshore regulations.

For Hungarian VAT purposes, an offshore company must not perform activities if the place of supply is situated in Hungary under Section 15 of the Hungarian VAT Act and therefore its activities would normally be outside the scope of Hungarian VAT. However, because offshore companies are subject to Hungarian VAT (i.e. non-exempt entities), it could happen that, in the case of imported services (i.e. non-exempt activities), an offshore company may have to pay Hungarian VAT. (For VAT on imported services see chapter 6.)

This input VAT can be deductible, but only to the extent that the activity performed is taxable. In the case of VAT exempt activities (e.g. financing), any input VAT connected to this activity is not deductible. Additionally, the tax authorities will not repay reclaimed Hungarian VAT if the taxable income of the company does not exceed HUF 4 million or if the input VAT on assets purchased does not exceed HUF 200,000. There are also additional requirements for monthly VAT declarations.

Effective as of 1 January 2002, offshore status is determined at the time of establishment and not at the time of court registration. Thus, offshore companies will be automatically eligible for foreign-exchange non-resident status and may maintain their books in foreign currency without notifying the Hungarian National Bank. This change allows offshore companies to keep their books in foreign currency from the date of establishment and eliminates any need to change the operational currency after registration.

In line with the changes to foreign exchange legislation, the restrictions concerning the use of Hungarian bank accounts and payments from petty cash have been cancelled as of 1 January 2002. Offshore companies are allowed to transfer payments to directors, supervisory board members, employees and professional service providers from any bank account, whether Hungarian or foreign. Maintenance expenses may be paid from non-Hungarian bank accounts as well. The payments may also be made from petty cash.

Future Changes

From 1 January 2003 new offshore companies cannot be established in Hungary. However existing offshore companies are allowed to continue their operation under the favorable offshore regime until 31 December 2005. As of 1 January 2006 the offshore companies will lose their offshore status, but they can operate as normal Hungarian entities.

In addition to the above, offshore companies can retain their foreign currency accounting status after 31 December 2005. Since offshore companies will lose their offshore status from 1 January 2006, the profits of former offshore companies will be taxed at the general CIT rate (16 percent in 2004) and they will not enjoy local business tax exemption after that time. Nevertheless, the following rules can still significantly lower the tax burden of former offshore companies if they continue their current main activities (intra-group financing, collecting royalties).

- The general corporate income tax rate might be lowered according to the current plans of the government;
- Subsequent to losing their offshore status, companies could enjoy the following incentives (already detailed in Chapter 6.):
- The taxpayer can exempt 50 percent of royalties and gains realized on stock exchanges for corporate tax purposes.
- The taxpayer can exempt 50 percent of the net intercompany interest receivable (unless the payer has made an election not to add back 50 percent of net intercompany interest payable)
- Even though former offshore companies will be subject to local business tax, (See chapter 6), should the company realize only interest income, only 50 percent of the interest income would be subject to local business tax.

Taking into consideration the above - and applying 16 percent corporate income tax rate, the effective tax burden can be reduced to 8-9 percent if the company is used exclusively as an intercompany financing or royalty-collecting vehicle.

Chapter 8

Property Investments by Foreign Investors

Introduction

Interest in property investment in Hungary has grown sharply in recent years. We describe the main tax issues involved with the acquisition and use of property below.

Possible Forms of Investment

- Use of a Hungarian subsidiary of a foreign company.
- Use of a Hungarian branch office of a foreign company. The Branch Offices Act effective from 1 January 1998 means that foreign-registered enterprises can only do business in Hungary via branch offices. This restriction on forms of doing business also refers to foreign entities' direct property investments in Hungary.
- Direct investment by foreign individuals.

Acquiring Property

Real estate

General Overview

Up until 1989, the fundamental concept of real estate ownership in Hungary was that all land belonged to the state - apart from a relatively small proportion of privately owned property and land owned by local co-operatives - and companies could only obtain a right to use land.

In the 1990s, the interest of foreign investors and the number of foreign owned property investment companies both increased rapidly, particularly in Budapest and in certain

cities in the Western part of Hungary. These investors have been attracted by the demand for modern office, retail and industrial premises and for real estate in general. Prices have risen rapidly.

The following real estate opportunities exist for foreign investors:

- the acquisition of real estate by a foreign owned Hungarian legal entity or a foreign legal entity.
- the acquisition of real estate by non-resident individuals.
- long-term rentals.

Acquisition of Real Estate by a Business Venture

A business venture may acquire ownership and other real estate rights, except for agricultural land and protected natural areas, provided that this falls within the scope of its business activity as defined in its Articles of Association.

Business ventures can acquire real estate in two ways:

- if it is provided by an investor as an in-kind contribution
- if it is purchased by the business venture.

Properties in Hungary are registered in the land register, which is open to the public, and anyone can purchase an official copy of information in the register.

Companies, which own properties in Hungary are generally allowed unrestricted use of their property and may sell it, utilize it (e.g. rent it) or take out loans secured on it (e.g. to mortgage it) or sell rights associated to it.

Acquisition of Real Estate by Non-Residents

According to the Act on Acquisition of Real Estate by Non-residents, non-resident individuals may acquire Hungarian real estate (excluding arable land and natural areas) provided they obtain a permit granted by the local director of the regional public administration office. No permit is needed if the acquisition occurs through succession.

The permit may be issued if the acquisition does not infringe any local or public interests. The director shall request a statement by the mayor of the local council in respect of this. If the permit is denied, the decision can be appealed in court.

Long Term Rental

Non-residents are allowed to rent apartments or houses in Hungary. During the rental period the tenant will have exclusive use of the property and is considered as a "quasi-owner".

Restrictions on Acquisition of Certain Land

No foreign party, whether a private individual or company, may acquire title or any other right to Hungarian arable land or nature reserves. This same restriction applies to acquisitions by Hungarian subsidiaries of foreign investors.

Foreign legal or natural persons may only acquire title to property not classified as arable land or nature reserves (henceforth “property”) with an acquisition permit, unless the property is inherited. Permits are issued by the head of the relevant county administration. However, land acquisitions carried out by certain foreign legal entities are not subject to such a permit if the acquisition is carried out on behalf of their Hungarian branch.

Transfer Tax Issues Involved with Acquisition

Those acquiring property are required to pay a property transfer tax of 10 percent of the commercial value of the property. This duty is reduced to 2 percent for enterprises whose main core activity is trading in real estate (effective from 1999, such property must be sold by the enterprise within 2 years of acquisition); for residential property the duty is 2 percent for the first HUF 4 million of commercial value, and 6 percent thereafter.

For further details on taxation of Real Estate please refer to Chapter 6.

Foreign Exchange Regulations

As of June 2001, the Hungarian Forint received “hard currency” status and foreign exchange regulations changed. Property acquisitions may now be paid for in any currency, whether Hungarian Forint or foreign currency.

Rules on Existing Properties (Sale or Use of Properties)

Tax Regulations

VAT

The use by foreign parties of any Hungarian property is liable for VAT reporting (but not necessarily VAT payment - see below for exemptions), except for the non-commercial sale of an individual's property. Investors must thus register for VAT in Hungary and issue VAT invoices when selling or renting/leasing property.

Vendors are not liable to pay VAT on certain real estate transactions (treated as exempt) including the rental of residential property or the sale of residential property for the second or subsequent time after its construction. However, the vendors are not entitled to reclaim any VAT charged to them in connection with these activities.

Based on the rules effective as of 1 January 2004, the rental of non-residential properties is exempt from VAT under the general rules. Under these rules rental fees are VAT exempt, meaning that the input VAT incurred in connection with the rented property cannot be deducted. Nevertheless, taxpayers may opt for a VATable status at the beginning of the tax year regarding the rental of non-residential properties.

VAT is payable at the general rate of 25 percent on the use (sale or rental) of all other properties, which are not considered exempt.

Tax may be charged on property (building tax, land tax, local business tax and community tax) please refer to Chapter 6.

Income Taxes and Dividend Tax

The rules governing the taxation of income from the use or sale of property in Hungary is analyzed below. However, where a double tax treaty exists, the terms of that treaty would override the Hungarian tax provisions in any cases where the two might contradict.

Foreign Individuals

Foreign individuals are taxed at 20 percent on income from the sale of property in Hungary. The documented costs of acquiring and developing the property allowed by Hungarian law may be deducted from the income from the sale. If the acquisition cost of the property cannot be determined, the tax base is automatically 25 percent of income. Tax can be reclaimed on any income from a property sale used by the seller or a close relative to buy or to secure title to residential property within the period allowed by law after the date on which the income was acquired.

Hungarian Subsidiaries of Foreign Companies

Subsidiaries are liable for corporation tax under the general rules as described in the general information section. Corporation tax is thus currently 16 percent of taxable income, which is the profit before tax calculated using the rules of the Act on Accounting adjusted for reconciling items under the Act on Corporation Tax.

The income of investors selling property is the selling price of the property. The accounting amount recorded as the value of the tangible asset may be included in the cost of sales figure.

If the selling price exceeds the book value, the difference is defined as profit and is subject to 16 percent corporation tax. The income calculations are based on nominal, historical forint figures; there are no rules for relief for inflationary gain.

The buyer must register the property at the Land Registry Office and depreciation is tax-deductible each year. The amount of depreciation is governed by the rules discussed below. If the vendor and buyer of the property are related parties, particular care must be taken to set a price, which is at arm's length.

Book depreciation on property is limited for tax purposes to rates recognized under the Act on Corporation Tax. The maximum tax-deductible depreciation on industrial buildings and buildings with long useful lives is 2 percent, while rental properties can be depreciated at a preferential rate of 5 percent. When calculating book depreciation, it is important to ensure that it corresponds to the anticipated useful life of the property and to the company's accounting policy.

Under the Act on Corporation Tax, 20 percent withholding tax must be deducted from dividends paid abroad by Hungarian companies unless paid to an EU resident parent whose holding in the payer meets certain conditions. The paying agent is not required to assess or deduct tax on any part of a dividend used by a foreign recipient to increase the registered capital of a Hungarian operational company or to form a new Hungarian company.

If tax is deducted from a foreign shareholder at a higher rate than that allowed for under an applicable double tax treaty, the foreign recipient may reclaim the difference. Alternatively, special procedural rules allow the use of the reduced treaty rates already at the time of paying the dividend.

The provisions of the EU parent-subsidiary directive have broadly been implemented into the Hungarian tax legislation. Based on these regulations, dividends distributed by Hungarian companies to shareholders located in the EU may be exempt from withholding tax if the shareholder holds at least 25 percent of the shares of the Hungarian company for at least two years on a continuous basis. Nevertheless, if a third party gives a guarantee to the tax authority at the time of the dividend payment, the two year holding period might also be completed subsequent to the payment.

Capital gains derived from the alienation of real estate are taxed as ordinary business income.

Branch Offices of Foreign Enterprises

The general rules on taxation of Hungarian branch offices state that such offices of foreign enterprises are treated identically to Hungarian-registered companies unless otherwise stipulated in an act of law or by a government decree issued pursuant to such a law. One such stipulation is the restriction on property acquisition mentioned above.

Thus, branch offices are treated like domestic companies for corporation tax purposes. Business performed at branch offices is taxed in the same way as that performed by legal entities. Accordingly, branch offices must assess and pay tax on their taxable profits. However where a double tax treaty applies, it may be possible to apply somewhat different principles to the determination of a branch's tax base.

Foreign-registered enterprises owning a branch office, as defined in the Act on Corporation Tax, may only withdraw the branch office profits in the form of a dividend. However, according to the practice of the Hungarian Ministry of Finance, in the case of

an applicable tax treaty between Hungary and the country of the foreign company's residence, no dividend withholding tax is payable. This exemption does not apply to some states such as France and Canada since these have specific paragraphs covering withholding tax on branch distributions but even in these cases, the preferential withholding tax rates prescribed by the treaties may be applied together with the parent-subsidiary directive rules in case of recipients seated in the EU.

Since business activity can only be carried on through a branch or a subsidiary, and since income related to real estate is deemed to create a permanent establishment, the registration of a branch is obligatory.

Transfers of Ownership of Property Holding Companies

There is no specific Hungarian legislation regulating companies the core activity of which is the ownership or use of property. General corporate legislation applies to these companies.

Property sales affected by way of transferring shares in a property holding company (rather than selling the property itself) are not subject to either transfer stamp duty or VAT.

The sale by a foreign entity of a holding in a Hungarian company is not liable to Hungarian corporation tax. A foreign individual is liable to 20 percent Hungarian personal income tax on the gain from selling the holding, but this could be reduced or eliminated by an applicable tax treaty.

Hungarian companies or branch offices selling property must book the selling price of the investment as income, reduced by the book value of that investment. If the company being sold has incurred a loss that decreases the value of the investment, the Hungarian investor may deduct this loss for tax purposes only when the investment is sold, regardless of whether loss in value on the investment has been booked for accounting purposes.

Appendix A

Income Tax Treaties and Withholding Tax Rates

Income	Dividends (%)	Minimum Holding	Interest (%)	Royalties (%)
Non-treaty Rates	20	-	0	0
Country:				
Albania	5/10	25	0	0
Australia	15	-	0	0
Austria (EU)	10	-	0	0
Belgium (EU)	10	-	0	0
Brazil	15	-	0	0
Bulgaria	10	-	0	0
Canada	10/15	25	0	0
China	10	-	0	0
Croatia	5/10	25	0	0
Cyprus (EU)	5/15	25	0	0
Czech Rep. (EU)	5/15	25	0	0
Denmark (EU)	5/15	25	0	0
Egypt	15/20	25	0	0
Finland (EU)	5/15	25	0	0
France (EU)	5/15	25	0	0
Germany (EU)	5/15	25	0	0

Income	Dividends (%)	Minimum Holding	Interest (%)	Royalties (%)
Greece (EU)	10	-	0	0
India	15	10	0	0
Indonesia	15	-	0	0
Ireland (EU)	5/15	10	0	0
Israel	5/15	10	0	0
Italy (EU)	10	-	0	0
Japan	10	-	0	0
Kazakhstan	5/15	25	0	0
Korea	5/10	25	0	0
Kuwait	0	-	0	0
Luxembourg (EU)	5/15	25	0	0
Malaysia	10	-	0	0
Malta (EU)	5/15	25	0	0
Mongolia	5/15	25	0	0
Moldova	5/15	25	0	0
Morocco	12	-	0	0
Netherlands (EU)	5/15	25	0	0
Norway	10	-	0	0
Pakistan	15/20	25	0	0
Philippines	15/20	25	0	0
Poland (EU)	10	-	0	0
Portugal (EU)	10/15	25	0	0
Romania	5/15	40	0	0
Russia	10	-	0	0
Singapore	5/10	25	0	0
Slovakia (EU)	5/15	25	0	0
South Africa	5/15	25	0	0

Income	Dividends (%)	Minimum Holding	Interest (%)	Royalties (%)
Spain (EU)	5/15	25	0	0
Sweden (EU)	5/15	25	0	0
Switzerland	10	-	0	0
Thailand	15/20	25	0	0
Tunisia	-	-	0	0
Turkey	10/15	25	0	0
UK (EU)	5/15	25	0	0
Uruguay	15	-	0	0
US	5/15	10	0	0
Ukraine	5/15	25	0	0
Vietnam	10	-	0	0
Yugoslavia	10	-	0	0

** (EU): EU Parent-Subsidiary Directive enacted legislation may bring the rate to 0 percent provided certain ownership conditions are met.*

Please note that the above table does not describe any special treatment applicable to certain interest payments. In addition, it does not describe the criteria for differentiating between withholding tax rates where more than one rate is available (e.g. the withholding tax rates on dividends may depend on minimum ownership or voting rights).

Appendix B

Treaties Concluded by Hungary in Order to Avoid Double Taxation on VAT

Austria

Belgium

Denmark

Finland

France

Germany

Italy

Netherlands

Liechtenstein

Luxembourg

United Kingdom and Northern Ireland

Slovenia

Spain

Sweden

Switzerland

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