# Tax law implications for the eastern EU enlargement - The case of Hungary

***Topic 6:* The accession of ten new EU member states as of 1 May 2004 means that the EU Treaty's freedom of movement provisions will from that date on also apply to these countries.**

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It is of particular importance to be competitive for a country like Hungary, going to accede to the European Union. It has been important for the country to modernize its tax system, in line with completing the transition into a modern market economy. In the context of EC harmonization, the main issues for discussion are
- adjustment of national legislation to the „acquis communautaire" in the fiscal law area; and
- adoption of the lessons to be drawn from the work of interpretation performed by the EC Court of Justice so far.

In the following, the Hungarian direct tax law practice will be reviewed with regard to the above considerations. The paper is structured as to three major topics:
- streamlining the national tax system and fiscal state aid issues;
- the implementation of the corporate tax harmonization directives; and
- the problems of non-restriction and non-discrimination.

### 1. Streamlining the Hungarian direct tax system

In the Keck and Mithouard case (C-267/91 and C-268/91),[1] it is held by the ECJ that the application to products from other Member States of national provisions restricting or prohibiting certain selling arrangements is not such as to hinder directly or indirectly, actually or potentially, trade between Member States, so long as those provisions apply to all relevant traders operating within the national territory and so long as they affect in the same manner, in law and in fact, the marketing of domestic products and of those from other Member States. In the light of this judgment, the Hungarian fiscal law measures seem to be consistent with the EC Treaty so long as they do not discriminate against foreign taxpayers or the marketing of non-Hungarian products. The Hungarian direct tax system has been to date streamlined to the extent that fiscal incentives, although applicable to a wide scope of capital income, are available without regard to whether income is derived by Hungarian or non-Hungarian (corporate or individual) taxpayers. This is a tax policy that favours economic stabilisation over equity considerations. A kind of the consumption-oriented income tax policy has been necessarily introduced in order to attract foreign capital. One can hope that the conflict between efficiency and equity will be in the long run reconciled in the light of the fiscal climate friendly to investors. It will then be possible on a higher level of welfare to revisit equity issues.

The Hungarian fiscal law background effective from 1 January 2004 on is favourable in many respects of which the following can be highlighted:
- there is a flat corporate tax rate of no higher than16 percent;
- income derived by foreign enterprises (without a permanent establishment) in Hungary is not taxable in Hungary at all [Sec. 3 (2) of Corporate Tax Act],[2] except for the taxation dividends;[3]
- the dividends derived by foreign enterprises in Hungary may still be shielded by the Hungarian law consistent with the Parent & Sub Directive; furthermore, the corporate or income tax on the capital gains derived from qualifying mergers may be deferred due to the Hungarian implementation of the Merger Directive; and
- losses (as regulated by Section 17 of Corporate Tax Act) can be carried forward without time limitation (although the loss carry forward is subject to the tax authority's approval where the sales receipts of a corporate taxpayer do not exceed within a financial year at least half of the expenses or where losses have been recorded in two subsequent financial years); and
- qualifying interest income (including the return on deep discount bonds and investment certificates that are publicly traded) and the capital gains realized through qualifying stock exchange transactions are exempt from individual income tax.[4]

Furthermore:
- locked-up reserves may be made for implementing capital projects (putting into operation of tangible assets acquired or manufactured; the assets received in exchange for interests in companies must be taken out of consideration) free

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[1] ECR (1993), p. I-06097.

[2] Act LXXXI of 1996 on corporation and dividend tax, as amended.

[3] Due to the unilateral exemption from Hungarian tax of income, not attributable to a permanent establishment, derived in Hungary by foreign enterprises, the requirements envisaged by the Council Directive 2003/49 EC on the tax exemption of inter-company interest and royalty payments (OJ L 157, 26.06.2003, p. 49.) will be fulfilled in Hungary without explicit implementing measures.

[4] Although the Council Directive 2003/48 on the taxation of savings (OJ L 157, 26.06.2003, p. 38.) has not yet taken into effect, Hungary will be bound to it. The Hungarian law is not prejudiced, however, to the extent that Hungary will not have opted out of the exchange of information system. Accordingly, Hungary will not be required to apply a minimum rate of withholding tax on the interest income paid to non-Hungarians.

of corporate tax up to the lower of HUF 500 million[5] or 25 percent of pre-tax profits; these reserves must be used for implementing capital projects in the fourth year following the year of making locked-up reserves at the latest [Sec. 7 (1)(f) of Corporate Tax Act in conjunction with Section 7 (15) of Corporate Tax Act];

- 100 percent – or in respect of corporate taxpayers operating within the seat of a Hungarian-registered academic institution 300 percent -- (although no more than HUF 50 million per annum) of R+D costs – except for the subsidies received and the payments made for the use of R+D services ordered from other businesses -- may reduce the tax base in addition to the R+D costs accounted for in the taxpayer's books; where a taxpayer capitalizes the results of experimental development activities, the amounts of depreciation may reduce the tax base in addition to the expenses of depreciation made in the books [Sec. 7 (1)(t) and Sec. 7 (17)].
- half of the capital gains derived from (Hungarian or non-Hungarian) qualifying stock exchanges, recognized by the Hungarian Capital Markets Act, by other than financial institutions, investment enterprises, insurance corporations or venture capital corporations is free of corporate tax [Sec. 7 (1)(e)]; and
- half of the royalties received from Hungary or from abroad is free of corporate tax [Sec. 7 (1)(s)].

The new Hungarian development tax relief (as provided for by Section 22B and applicable since 2003) differs from the earlier Sec. 21 investment relief (to be phased out). First of all, under the new scheme, no operating aid is granted because the law addresses specific investment projects. The development tax relief may be considered by the Commission to be compatible with the common market because it is state aid intended to promote economic development of particular areas, and it is in proportion to, and targeted at, the aims sought. The new scheme is dubious only because it is not sure that relief measures do not leave room for the government's discretionary treatment of taxpayers.[6]

As a result of the accession negotiations, under Annex X (6) to the Accession Treaty, the scope of the Hungarian investment relief (as regulated by Sec. 21 of Corporate Tax Act) has drastically been reduced. In addition, a series of investment relief has been phased out. The project must have started after 31 December 1996 and no later than 31 December 2002. The relief is available in 2005 for the last time. Following the day of EU accession, the percentage of allowance is subject to limitations in accordance with the EU state aid rules, provided that the operation of the taxpayer affect the trade with a Member State. Moreover, under Annex X (6) to the Accession Treaty, as of 31 December 2007, local tax relief cannot be granted but to small businesses as defined by the law.

A corporation resides both for company law and tax purposes in Hungary on the grounds that it derives its legal status from Hungarian law. The effective place of management is disregarded both for company law and tax purposes. Therefore, foreign companies effectively managed from Hungary cannot be caught by the Hungarian legal or tax jurisdiction in any way. In the absence of a Hungarian national law doctrine of the real seat, the tie-breaker test for businesses as provided for by a double tax convention is for the time being on the Hungarian side inactive.

The recognition of the broad approach to the residence of companies can be strengthened in the European scene by the Überseering judgment (C-208/00)[7] which – as part of the „acquis communautaire" -- will be inadvertently guiding for Hungary soon. Here -- in a moving-in situation --, in contrast to the Daily Mail decision (related to a moving-out situation) -- the right of establishment has been redefined, including the right of a company to pick up the residence of another Member State on the grounds of the transfer of the effective place of management thereto, while not losing the identity of the Member State in which it has been incorporated. It is not precluded that the host country Revenue invokes the enlarged scope of the right of establishment. Legitimate concerns may arise from the possible arbitrage in tax jurisdictions, as explicitly mentioned in the ECJ reasoning [in Centros, (C-212/97)].[8]

**2. Comparability with the Merger Directive and the Parent & Subsidiary Directive**

Under the Merger Directive (90/434 EEC)[9], taxpayers are entitled to treat the fiscal attributes of the businesses affected by mergers based on continuity, i.e., fiscal attributes such as operating losses, registered capital

[5] Equivalent to € 1,945,525, based on the exchange rate of HUF 257 equal to EUR 1 as subscribed by the National Bank of Hungary on 1 March 2004.

[6] Para 33 of Commission notice on the application of the State aid rules to measures relating to direct business taxation, OJ C 384, 10.12.1998, p. 3.

[7] ECR (2002), p. I-09919. Where a company formed in accordance with the law of a Member State (`A') in which it has its registered office is deemed, under the law of another Member State (`B'), to have moved its actual centre of administration to Member State B, Articles 43 EC and 48 EC preclude Member State B from denying the company legal capacity and, consequently, the capacity to bring legal proceedings before its national courts for the purpose of enforcing rights under a contract with a company established in Member State B.

[8] ECR (1999), p. I-01459. Given that the right to form a company in accordance with the law of a Member State and to set up branches in other Member States is inherent in the exercise, in a single market, of the freedom of establishment guaranteed by the Treaty, the fact that a national of a Member State who wishes to set up a company chooses to form it in the Member State whose rules of company law seem to him the least restrictive and to set up branches in other Member States cannot, in itself, constitute an abuse of the right of establishment.

[9] OJ L 225, 20.08.1990, p. 1.

losses, or tax deductible provisions may be taken over by a legal successor company from a legal predecessor company. In Hungary, new rules on roll-over relief have been introduced for domestic mergers as of 1 January 2003. They will apply to European-wide mergers from the date of accession. The definitions of qualifying mergers (as provided for by Article 2 of the Merger Directive) have been taken over in Hungary literally.[10]

The major considerations of approximating the Hungarian law to the Merger Directive can be summarised as follows:
- Capital gains realised during a legal merger are taxable both with the shareholders and the legal predecessor company. Taxable gains may, however, be deferred.
- Capital gains realised at the time when in-kind contributions are made in exchange for shares may be treated non-realised for fiscal purposes, namely, there is deferral for tax, provided that there is no step-up with the acquiring company in the registered book-value of the tangible and intangible assets contributed [Sec. 16 (12)-(14) of Corporate Tax Act]. This is also the case about an exchange of shares [Sec. 7 (1)(h) of Corporate Tax Act in conjunction with Sec. 8 (1)(t) of Corporate Tax Act]. The bonus shares received by corporate recipients -- as a result of the capitalisation of freely-available profit or capital reserves -- are deemed to be dividends received under Hungarian tax law, exempt from corporate tax, so the question of tax liability cannot be raised either.

Under the Parent and Subsidiary Directive (90/435 EEC),[11] outbound dividends (dividends paid) must be exempt from withholding tax while inbound dividends (dividends received) must enjoy either participation exemption or indirect credit, depending on the domestic rules that must not be of discriminatory nature. Hungary has brought her law into line with the directive in the instance that these rules will take into effect upon the accession. From that date on, dividend tax will not be levied on Hungarian source distribution to companies meeting the requirements as provided for by the directive [Sec. 27 (5)-(7) of Corporate Tax Act]. The inbound dividend requirement (that tax relief must be applicable to dividends without regard to whether they have been received from domestic or foreign sources) is met because of the liberal Hungarian participation exemption system. The directive's definition (in Article 2) of qualifying companies has been inserted into the Hungarian law literally [Sec. 4 (32a) of Corporate Tax Act].

The differences between Hungarian fiscal law and its Community counterpart with regard to the Parent & Subsidiary Directive will remain in the instances as follows:
- in Hungary, there is no minimum participation requirement, nor is there any minimum holding period requirement under corporate taxation in respect of inbound dividends; thus the dividends derived by Hungarian companies from inside or outside Hungary are, without limitation, covered in Hungary by the participation exemption except for the dividends paid by controlled foreign corporations;
- in the context of outbound dividends, invoking the option offered by the directive, the Hungarian law provides for the requirement of a 25 percent minimum capital and a two-year minimum holding period to be respected by qualifying EU resident enterprises deriving dividends in Hungary [Sec. 27 (3) of Corporate Tax Act];
- it is still doubtful if the distinction between domestic and foreign corporate taxpayers in respect of outbound dividends is consistent with the Community law (to the extent that the above requirements do not apply to Hungarian companies receiving dividends); and
- the current Hungarian law, suggesting retrospective interpretation in respect of outbound dividends (in individual cases, the above statutory requirements shall have been fully met until the time when dividends are declared), seems to contravene the Denkavit judgment (C-283/94, C-291/94 and C-292/94);[12] the harshness in the Hungarian law is alleviated by the provision that even if a foreign enterprise fails to show that the above statutory requirements have been fulfilled at the time when dividends are declared, the tax shall not be withheld, provided that the payment of the tax liability will be by a third party guaranteed;
- the Hungarian definition of the qualifying EU resident enterprises seems to be contradictory to the Directive to the extent that public companies do not qualify for the relief unless they have issued registered shares.

### 3. Tax treatment of losses

It is worth making remarks on the Hungarian tax law on losses, effective from 2004 onwards, that has become quite generous. The major considerations of a possible anti-abuse policy must be borne in mind, however. Particular attention must be given to the following:
- No loss carry over may be recognized for tax purposes in respect of profits subject to low tax only. For example, the use of tax relief available for the losses sustained in the holding of shares, in respect of which no tax was payable on

[10] For legal mergers, see Sec. 4 (23a) of Corporate Tax Act, for asset mergers, see Sec. 4 (23b) of Corporate Tax Act, for the exchange of shares, see Sec. 4 (23c) of Corporate Tax Act.
[11] OJ L 225, 20.08.1990, p. 6.
[12] ECR (1996), p. I-05163. Article 3 (2) of Directive 90/435 introduces an option to derogate from the obligation to grant the exemption which, as such, must be strictly interpreted; it cannot therefore be interpreted as authorizing a Member State to make that exemption subject to the condition that, at the moment when the profits are distributed, the parent company should have had the required holding in the capital of its subsidiary for a period at least equal to that which the Member State has laid down pursuant to the option which it is recognized as having.

the dividends received due to the application of a kind of the participation exemption system, can be challenged. Also, the losses or expenses sustained in a low-tax country cannot be recognized unless they are justified. Although there are no explicit prohibitory rules in Hungary that would apply in the above instances, abusive schemes can be attacked, based, for example, to the principle, that corporate taxpayers are prevented from double-dip (from double benefits established on the same facts).
- Anti-trafficking rules prescribe that loss carry over may be precluded where upon legal mergers there are significant changes in the ownership structure of affected taxpayers or in the company profile (the former is relevant in Hungary to 1999-2000 losses, the latter is indifferent in Hungary).
- Due to income basket limitation, particular losses may only be carried over in respect of the same type of profits (this does not apply currently in Hungary).
- Loss carry over from legal predecessors to legal successors may be precluded where mergers are mainly motivated by tax savings (explicitly covered by the new Hungarian law).
Under the Hungarian tax law effective from this year on, it is plainly required in certain cases to substantiate a merger by showing sound and prudent business practices. In this context, the term of „valid commercial reasons" as suggested by the Merger Directive, and discussed in the Leur-Bloem case (C-28/95) before the ECJ,[13] is of particular importance even if Article 11 (1) of the directive has not been explicitly introduced in Hungary.

Although there is no harmonised Community law that would require consistency in treating the losses of subsequent financial years (e.g., by providing for loss recapture rules), the Hungarian law cannot be considered as sufficient in this respect at any rate. Namely, under Hungarian law
- in a treaty-situation, in FY 1 the losses of a foreign branch may likely be deducted (based on the national law) in the absence of a statutory consistency requirement while in FY 2 the gains of the foreign branch can be exempted (based on the respective treaty law) and the losses utilised earlier need not be recaptured;
- in a non-treaty situation, in FY 1 the losses of a foreign branch can be deducted (based on the national law) while in FY 2 foreign tax credit (based on the national law) need not be adjusted because of the losses utilised earlier;
- no AMID-related (C-141/99) situation[14] can occur because under the effective Hungarian law it is not obligatory immediately to utilise the losses as long as they are available, and
- since no fiscal consolidation (whether effectuated purely domestically or across the border) has been introduced to date in Hungary, there is no legal basis at all for the cross-border consolidation of losses.

### 4. Non-restriction and non-discrimination issues

The current Hungarian direct tax system has achieved a very low level of tax burden while it is not fraught with the artificial calculation of the tax base, with ring-fencing or similar harmful tax competition measures. Importantly, the effective tax rules on thin capitalisation rules or on the participation exemption available for corporate taxpayers do not distinguish between investments, whether made within or outside Hungary or whether effectuated by Hungarian or foreign resident creditors. This way, neither Lankhorst-Hohorst-typed (C-324/00),[15] nor Bosal-related (C-168/01)[16] problems can occur in Hungarian law. Apparently, in Hungarian fiscal law there are no features that would lead to the restriction on the right of establishment to be exercised by enterprises resident in another Member State or by Hungarian enterprises outside Hungary. The Halliburton-like problem (C-1/93)[17] does not exist either because there is no relief in Hungarian law from the 10 percent duty on the acquisition of immovable property in return for compensation in terms of the contribution of immovable property in exchange for shares. Further on, as the

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[13] ECR (1997), p. I-04161. Under Article 11(1)(a) of the directive, the Member States may stipulate that the fact that the planned operation is not carried out for valid commercial reasons constitutes a presumption of tax evasion or tax avoidance; it is for the Member States, observing the principle of proportionality, to determine the internal procedures necessary for this purpose.

[14] ECR (2000), p. I-11619. Article 52 of the EC Treaty (now, after amendment, Article 43 EC) precludes legislation of a Member State under which a company incorporated under national law, having its seat in that Member State, may, for the purposes of corporation tax, deduct a loss incurred the previous year from the taxable profit for the current year only on the condition that that loss was not capable of being set off against the profit made during that same previous year by one of its permanent establishments situated in another Member State, when the loss, although set off, cannot be deducted from taxable income in either of the Member States concerned, whereas it would be deductible if the establishments of that company were situated exclusively in the Member State in which it has its seat.

[15] ECR (2002), p. I-11779. The fiscal restriction on interest paid by subsidiary companies to their parent companies in return for loan capital is prohibited to the extent that a difference in treatment is made between resident subsidiary companies according to the seat of their parent company.

[16] Not yet reported. The EC Treaty precludes a national provision which, when determining the tax on the profits of a parent company established in one Member State, makes the deductibility of costs in connection with that company's holding in the capital of a subsidiary established in another Member State subject to the condition that such costs be indirectly instrumental in making profits which are taxable in the Member State where the parent company is established.

[17] ECR (1994), p. I-01137. Articles 52 and 58 of the Treaty preclude the law of a Member State from restricting exemption from the tax on transactions relating to immovable property, which is normally payable in connection with a reorganization within a group of companies only to cases where the company liable for tax acquires immovable property from a company constituted under national law, and refusing to grant such relief where the transferor is a company constituted under the law of another Member State.

fiscal law problem of consortia does not exist in Hungarian law, the ICI case (C-264/96)[18] is not relevant to Hungary either.

Notably, the indirect costs incurred by the permanent establishments (including the branches) of foreign enterprises cannot be recognized for Hungarian corporate tax purposes but in proportion to the volume of the Hungarian operation and such taxpayers can be subject to a few other particular tax law provisions (e.g., at least five percent of the income derived from the services negotiated from a foreign part of the foreign enterprise shall be recognized as taxable income). Nevertheless these distinctive tax rules cannot be considered as discriminatory against foreign enterprises or rather they can be justified by the technical difficulties of the calculation of taxable profits.

The international tax policy issues based on the territoriality principle [appearing, e.g., in the Schumacker case(C-279/93)][19] are relevant to Hungary like in many other Member States. In compliance with the continental tradition, the Hungarian treaty policy is also established on the capital import neutrality principle (in connection with the grant of the exemption of foreign-earned active income from domestic tax). Similarly to the current Hungarian corporate tax law, the effective Hungarian individual income tax law does not contain (with minor exceptions) discriminatory rules either. Interestingly, qualifying family allowances, scholarships and similar income are subject to zero percent income tax, no matter whether they are granted based on the Hungarian law or on the law of a Member State of the European Economic Area [Sec. 3 (72)(m) of Income Tax Act].[20] Furthermore, where the income which is derived by a taxpayer resident in an EEA Member State, and would be subject to progressive tax under Hungarian law, is exempt from tax in an EEA Member State, it is also exempt from Hungarian tax [Sec. 3 (72)(n) of Income Tax Act]. The consequences of the Schumacker decision has already been properly concluded by the Hungarian legislator last year while introducing Section 1A applicable as of the date of the EU accession (accordingly, the active income of individuals, reaching at least 75 percent of total income, with restricted tax liability must not be subject to Hungarian tax that would be more burdensome than the Hungarian tax that falls in comparable cases on individuals with unrestricted tax liability). Because of the operation of Section 1A, the fiscal cohesion principle as defended by Belgium in the Bachmann case (C-204/90),[21] cannot likely be maintained in Hungarian law.

In Hungarian law, it is not likely that problems in the application of the non-restriction principle can occur like in the Groot (C-385/00) case.[22] Under Hungarian income tax law, there are no tax deduction opportunities but in very exceptional cases (payment of fees for interest safeguarding organizations, 30 percent of standard daily allowances received for assignment to work abroad). Tax exemptions and allowances are available, however, mainly subject to their domestic exploitation. In the almost total absence of individual income tax deduction, no problem of discrimination seems to occur in respect of the Gerritse (C-234/01)[23] decision either. Foreign resident individuals earning income in Hungary from independent personal services have access to tax deduction in the same way as Hungarian resident individuals while they are subject to progressive tax in Hungary.

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[18] ECR (1998), p. I-04695. Article 52 of the Treaty precludes legislation of a Member State which, in the case of companies established in that State belonging to a consortium through which they control a holding company, by means of which they exercise their right to freedom of establishment in order to set up subsidiaries in other Member States, makes a particular form of tax relief subject to the requirement that the holding company's business consist wholly or mainly in the holding of shares in subsidiaries that are established in the Member State concerned.

[19] ECR (1995), p. I-00225. Article 48 of the Treaty must be interpreted as precluding the application of rules of a Member State under which a worker who is a national of, and resides in, another Member State and is employed in the first State is taxed more heavily than a worker who resides in the first State and performs the same work there when the national of the second State obtains his income entirely or almost exclusively from the work performed in the first State and does not receive in the second State sufficient income to be subject to taxation there in a manner enabling his personal and family circumstances to be taken into account. See also the 94/79 EC Commission Recommendation (OJ L 39, 10.02.1994, p. 22) reflecting the Schumacker decision.

[20] Act CXVII of 1995 on personal income tax, as amended.

[21] ECR (1992), p. I-00249. Legislation of a Member State which makes the deductibility of sickness and invalidity insurance contributions or pension and life assurance contributions conditional on those contributions being paid in that State is contrary to Articles 48 and 59 of the Treaty; however, that condition may be justified by the need to safeguard the cohesion of the applicable tax system.

[22] ECR (2002), p. I-11819. The aim of the rules governing the calculation of the exemption is to distribute the allowances relating to a taxpayer's personal and family circumstances over his total income; it follows that those allowances are deducted from the tax payable in the Netherlands only in proportion to the income received by the taxpayer in that Member State. Article 48 of the EC Treaty precludes rules such as those at issue in the main proceedings whereby a taxpayer forfeits, in the calculation of the income tax payable by him in his State of residence, part of the tax-free amount of that income and of his personal tax advantages because, during the year in question, he also received income in another Member State which was taxed in that State without his personal and family circumstances being taken into account.

[23] ECR (2003), p. I-05933. Article 59 of the EC Treaty (now, after amendment, Article 49 EC) and Article 60 of the EC Treaty (now Article 50 EC) preclude a national provision such as that at issue in the main proceedings which, as a general rule, takes into account gross income when taxing non-residents, without deducting business expenses, whereas residents are taxed on their net income, after deduction of those expenses. However, those articles of the Treaty do not preclude that same provision in so far as, as a general rule, it subjects the income of non-residents to a definitive tax at the uniform rate of 25 percent, deducted at source, whilst the income of residents is taxed according to a progressive table including a tax-free allowance, provided that the rate of 25 percent is not higher than that which would actually be applied to the person concerned, in accordance with the progressive table, in respect of net income increased by an amount corresponding to the tax-free allowance.

Relief opportunities can be reviewed as to whether they are problematic for the purpose of the non-restriction principle. No issues of discrimination or restriction can be raised in the instances as follows:
- the pension income derived from the national compulsory social insurance fund, from a private pension fund or from a voluntary mutual pension fund are exempt from Hungarian tax, no matter that these investment vehicles operate in Hungary or abroad [Sec. 3 (23)(m) of Income Tax Act in conjunction with Sec. 7 (1)(m) of Income Tax Act];
- the contribution paid by the employer on behalf of the employee to a private pension fund or a voluntary mutual insurance fund is exempt from Hungarian tax up to the limit as determined by the law, no matter the employer operates in Hungary or abroad [Sec. 7 (1)(k) in conjunction with Sec. 3 (14) and 3 (22)];
- foreign tax credit is available up to 90 percent of the tax paid abroad where the overall limitation ratio is simply calculated, based on the domestic tax falling on foreign earned income, and neither foreign income nor total income is adjusted for the purpose of applying foreign tax credit;
- the wages tax credit (available for low wages only) is available irrespective of whether the labour income is derived from Hungarian or foreign employment relationship [Sec. 3 (21) in conjunction with Sec. 33];
- 30 percent credit is available for the fees paid for voluntary mutual insurance funds up to HUF 120,000 or HUF 150,000 per annum (depending on, how old the beneficiary is), no matter that these investment vehicles operate in Hungary or abroad.

In contrast to the above, the Hungarian law is restrictive in the instances as follows:
- 30 percent of tuition fees is available paid up to HUF 60,000 per annum, provided, however, that the higher education institution is registered in Hungary as such;
- apparently, housing benefits (within certain limits) are strictly connected with the acquisition of inland residential homes;[24]
- apparently, disabled persons' allowances and family allowances, based on the number of dependants, are available for Hungarian citizens only;
- 30 percent of donations (35 percent of durable donations), made for public benefit organizations, registered exclusively in Hungary as such, may be credited up to HUF 50,000 per annum and, in respect of donations made for priority public benefit organizations, up to HUF 100,000 per annum;[25] and
- 20 percent of life insurance premiums and 30 percent of the increase in the life insurance premiums, paid to Hungarian-registered insurance corporations only, may be credited up to HUF 100,000 per annum.

Certain items of capital income are worth discussing for the purpose of the applicability of the non-restriction principle. Where interest income falls within the definitions and limits provided in the Income Tax Act, the income is taxed separately at zero percent [Sec. 65 (4)]. The definitions and limits of interest for these purposes [Sec. 65 (1)] can be summarised as follows (interest on non-banking loans are not discussed here):
(i) interest on savings deposits, savings notes and foreign exchange deposits, governed in all cases by Hungarian or non-Hungarian law (the interest payments made by Hungarian or non-Hungarian credit institutions uniformly fall within the authority of the term of interest subject to zero-rated income tax);
(ii) the yield on debt securities, publicly issued and traded in Hungary or elsewhere (the yield includes capital gains achieved from deep-discount bonds upon the admission or the disposition of securities);
(iii) the capital gains derived from equity securities, publicly traded in the Budapest stock exchange or in the stock exchange operating in a Member State, as recognized by the Hungarian Capital Markets Act; and
(iv) the yield on investment certificates, admitted and traded in Hungary publicly by Hungarian fund managers or by foreign fund managers operating in Hungary (the yield includes the capital gains achieved upon the admission or disposition of certificates as well).[26]

Where interest income does not fall within the definitions above, or exceeds the limits prescribed therein, it is treated as „other income", and added in full to the consolidated tax base. As it can be seen, tax relief is in the first three cases not subject to whether the investment vehicles used operate in Hungary or abroad. This is not true in case (iv) where no tax relief is available unless investment certificates are governed by the Hungarian law.

The issue of employee shares (or employee business quotas) in Hungary is based on the Companies Act and may be financed by profit reserves or capital reserves of the corporation which is the employer running an employee stock option programme. It may occur that part of the market value of employee shares (or employee business quotas) is paid by employees themselves. The fraction of the financial value of employee shares not paid is

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24 These provisions may contravene the free movement of capital at least. See Svensson and Gustavsson, C-484/93, ECR (1995), p. I-3955: It is not compatible with Article 67 of the Treaty for a Member State to make the grant of a housing benefit, in particular an interest rate subsidy, subject to the requirement that the loans intended to finance the construction, acquisition or improvement of the housing which is to benefit from the subsidy have been obtained from a credit institution approved in that Member State, which implies that it must be established there.

25 Similarly, Hungarian corporate taxpayers may deduct the expenses of donation up to 25 percent of their accounting profit per annum, provided that grants are made to Hungarian-registered beneficiaries.

26 The income derived from investment certificates in cases other than mentioned here is subject in full to normal progressive tax: the tax may be levied separately on the fractions of interest, dividends or capital gains, as carved out from the yield on investment certificates.

considered as employment income subject in full to progressive tax. The tax on the income derived can, however, be deferred [Sec. 77A (2)(d)]. This means that this income is not taxable upon the grant of shares (or business quotas). Instead, tax is payable – based on the original acquisition value – upon disposal only [Sec. 77A (5)]. The same rule applies to the bonus shares received by existing shareholders [Sec. 77A (2)(b)] and the capital gains derived from the appreciation of shares during a legal merger [Sec. 77A (2)(c)]. In the latter case, the taxpayer can enjoy another relief as well. Namely, he or she is allowed to increase for the purpose of calculating the tax base the acquisition value by half of the nominal value of the employee shares (or employee business quotas) received [Sec. 77A (6)]. Notably, the tax deferral in the above cases and the relief that the tax base upon disposal may be reduced are extended to foreign companies residing in one of the EU Member States (equivalent to the Article 2 definition of the Merger Directive) – and not operating in low-tax jurisdictions -- in cases where foreign companies release employee shares equivalent to those issued by a Hungarian corporation. The Merger Directive is implemented by Section 77A (7) in terms of the acquisition of the capital gains arising from the exchange of shares.

**5. Concluding remarks**

The reform of the Hungarian legal and tax system, which was launched at the end of the eighties as part of the transition from a centrally planned economy to a modern market economy, has been complete. Due to Hungary's desire to join the European Union, much of this legislative fine-tuning has involved aligning the Hungarian laws to their counterparts in the European Union. To date, the Hungarian courts and tax authorities have made nevertheless very few attempts to interpret and use the harmonized Community law or the ECJ law in their reasoning in proceedings. Moreover, the Hungarian tax legislation is in a need of more stability. More legal certainty is also needed in practice where dubious cross-border tax planning schemes have not been addressed by more elaborate legal regulation or by means of guiding judgments.