



The impact of the changes in the tax and duties regime on the activities of real estate development and sales companies

Due to the high property transfer duties, it was previously more expedient for real estate development and sales companies not to sell larger real estate properties developed or kept for sale as an asset, but the sale of shares of the property holding company, even one specifically created by way of de-merger. The legislative changes promulgated on 8 July 2009 in Act LXXVII of 2009 on the “Amendments aimed at the transformation of the allocation system of public charges” which is the subject of our present newsletter, will have a fundamental impact on this business structure.

The international taxation rules applicable to profits from the sale of real property and real property holdings

The Model Convention, designed to offer a uniform treatment of the most general issues of international double taxation and elaborated by the OECD on income and capital taxation, grants the power to levy taxes on income from real property to the state in which the income-generating property is situated. For the avoidance of difficulties of interpretation, the law of the state in which the given real property is located must be applied for the definition of real property assets. The Model Convention also allows, as an exemption from the generally applicable rule of paying capital gain taxes in the country where the entity earning the income is resident, that the capital gain earned on the sale of shares can be subject to taxation in the state in which these real properties are located, provided that more than 50% of the value of such shares is based directly or indirectly on real estate assets located in this other country

Hungary extends its right of taxation from 1 January 2010

The Hungarian tax regime has not used this option so far. Thus, if the purchase and sale of a target company whose only assets were real properties took place between two foreign entities, then this transaction was not subject to property transfer duties, and it did not give rise to an income tax payment obligation either, despite the fact that the purchase of the target company took place in order to acquire the real property in Hungary held by that company. The above amendment will enforce Hungary’s right to levy taxes on such transactions from 1 January 2010, and thus extend both the group of tax subjects and the tax base.

Tax payment obligations of shareholders of a company holding real property

Definitions

In the act on corporate tax and dividend tax (CIT), the concept of “property-holding company” is introduced, which is adopted by the act on personal income tax (PIT):

- A taxpayer and its affiliated enterprises holding real property in Hungary, if
1. in the balance sheet of the given group the value of real properties in Hungary relative to the total asset value exceeds 75%, and
 2. a member (shareholder) of them is established abroad on at least one day of the tax year, and we have no treaty for the avoidance of double taxation with the country of establishment or the treaty allows the taxation of the capital gain in Hungary.

The rules above are not applicable to companies listed on a recognized stock exchange.

The role of the treaties concluded for the avoidance of double taxation

On the basis of the above, in case of the alienation or withdrawal of shares by a shareholder in a property-holding company and in case of a private person shareholder, the income generated by way of the lending of the share can only be subject to taxation in Hungary, if there is no treaty with the country where the shareholder is tax resident or the treaty allows the taxation of such income. In accordance with the data provided in the reasons to the law, out of the 65 treaties in effect, 44 do not contain such special rules for the shareholders of property-holding companies; these are generally the oldest concluded treaties. The list of countries with which we have such treaties includes those having some of the most important investments in Hungary, e.g. Austria, Cyprus, Germany, Great Britain, Italy, Spain and the USA. At the same time, the abovementioned provisions are included in the treaties with some of the countries active in real estate investments, including France, Israel and Ireland. The applicable rules may vary from treaty to treaty; for example, some only allow taxation in case of direct, while others also in case of indirect ownership, and they use different methods for the avoidance of double taxation. A case-by-case consideration of the tax residency and evaluation of other data on the given company group is necessary to determine the tax obligation.

Tax payment obligation of a foreign entity

If the tax obligation does exist, the tax obligation of the shareholder (foreign entity) of the property-holding company on the capital gain realized on the alienation or withdrawal of the share will arise on the day of the alienation or capital reduction. The tax base will be the difference of the consideration and the acquisition value, less documented costs, provided that this is a positive amount, i.e. the shareholder realized a capital gain. It will also be deemed as alienation if the shareholder uses its share to make an in-kind contribution or transfers the share without consideration. In case of sale to affiliated enterprise and transfer without consideration, the tax base is the usual market price, while in case of capital reduction, it is the value of the assets given in exchange for the withdrawn shares. The tax rate is identical with the general corporate income tax, i.e. 19% as of 1 January 2010.

Tax payment obligation of a foreign private person

Beginning from next year, if a foreign private individual shareholder of a property-holding company transfers, lends or withdraws from such company his/her share for consideration, such income will be deemed to have been generated domestically. If such income is taxable in Hungary either for lack of, or under the relevant provisions of a treaty, then (despite the fact that the revenue is determined in accordance with the general rules applicable to real properties), to determine the taxable income the rules applicable to the determination of income from securities lending, capital gains or from withdrawal from enterprises must be used. This means that the income cannot be reduced in proportion to the length of time elapsed since the acquisition, but a 25% withholding tax must be paid for the entire amount.

Deadline for the tax payment by shareholder: 20 November

Under the new provisions of the act on the rules of taxation, shareholders of property-holding companies who have tax-payment obligations in Hungary do not have to file and make tax advance payments, and they can perform their obligations for the determination, payment and filing of taxes until 20 November of the subsequent tax year. If the shareholder was unable to meet its tax payment obligations due to the failure of the property-holding company notifying the tax authority, then the company has joint and several liabilities for the payment of tax imposed on the shareholder.

Real property-holdings can also be registered shares

In the course of the drafting the new legislation, the original plan was to remove property-holding companies from the concept of registered shares, similarly to controlled companies. Finally, this restriction is not included in the act, in the interest of encouraging holding structures in countries having favourable taxation regimes to return to Hungary and to extend this benefit also to the real estate sector. Thus, from a corporate tax point of view, the capital gain realized on stakes of at least 30% will continue to have a neutral effect that the shareholder notified to the tax authority within 30 days of their acquisition and held for a minimum of one year; profits will decrease, while losses will increase the tax base.

Special notification obligations of property-holding companies

Data supply to affiliated enterprises on the proportions of real properties to total assets

For the determination of the proportion of real properties to the total asset value, the taxpayer is required to inform its affiliated enterprises holding real properties in Hungary within 60 days after the deadline for the filing of the corporate tax returns, which generally means the end of July. With a view to the fact that the determination of the proportions must be based on the market price, this implies also that the assets would have to be valued by the companies at market price annually.

Notification of the tax authority

If the group is considered as a property-holding company, as defined in the act, all shareholders also should be considered as such, and each taxpayer concerned is required to notify the tax authority of this fact annually, by the 90th day after the deadline for the filing of the corporate tax returns. In this notification, the tax subject must declare whether or not it qualifies as a property-holding company under the definition of the CIT. The taxpayer must also declare whether foreign shareholders of the company alienated their shares in the course of the previous

tax year. If such event did take place, then the taxpayer has a data supply obligation including the time of the alienation, the nominal value of the share, as well as the country of tax residency of the shareholder. This latter data is to be reported on the basis of a declaration by the foreign shareholder.

Tax authority obligation to publish

By 30 September of each year – or in case of a different deadline for the filing of the tax returns, within 120 days of such other deadline – the tax authority will publish on its website the names, registered seats and tax numbers of the notified property-holding companies.

Changing rules applicable to duties

General reduction of the rates

As a result of the amendment of the act on duties, the general rate of transfer duty charged on property purchase and sale will be significantly reduced, effective 1 January 2010, from 10 to 4 percent, and in case of transactions over a value of HUF 1 billion to 2 percent, with the maximum amount of payable duty being HUF 200 million per property. In case of residential properties, the reduced, 2 percent rate will remain applicable up to a value of HUF 4 million, with the general rate of 4 percent, instead of the earlier 6% to be used for the amount over the above limit.

Acquisition of shares in property holding companies will be also subject to duties

At the same time, the transfer duty obligation charged on property purchase and sale will be extended also to the acquisition of shares/quota in a company holding real property in Hungary. The concept of a company owning real property is not defined in this act, and no reference is made to a definition given in another law either, which means that this provision is applicable regardless of the value of properties in proportion to the total value of assets. The obligation for the payment of duties arises if the acquiring person or entity, either alone or together with his/her close relatives or with companies in which they have majority ownership interest or with affiliated enterprises, acquires at least 75% of the shares of a company owning property in Hungary. Since the treaties for the avoidance of double taxation do not cover duties, the obligation of foreign and Hungarian shareholders to pay duty is enforced in the same way.

The base of the duty

The base of the duty is the market value of the properties owned by the company falling on their ownership interest, in the time when the group of affiliated shareholders reach 75% ownership interest. The base of the duty can be reduced by the proportionate part of the value that was acquired before 10 January 2010 or that came into the possession of the taxpayer by way of inheritance or as a gift. Also free from the obligation to pay the duty is the market value proportionate to such business share that was acquired after 1 January 2010 with an obligation to pay duty on the purchase or that was duty-free under any legal title permitted by the law. The affiliated shareholders will pay the duty calculated on the basis of their ownership interests as the base of the duty.

Reporting obligation

Upon reaching 75 % stake in a company holding real property, the shareholder whose acquisition of shares caused the group of affiliated shareholders to reach the 75% limit will have the obligation to report this fact to the tax authority. This

Control data

shareholder, however, will be responsible for reporting the data of all affiliated shareholders concerned because, after reaching the 75% limit, all of the affiliated shareholders exercising joint control over the company will have an obligation to pay the property transfer duty.

The court of register and the notaries will provide the tax authorities with control data for the purpose of checking the payment of duties. The court of register will report to the tax authority if any shareholder of the companies registered by it obtained qualified control, or became the sole owner in a company, or a change occurred in the proportion of ownership interest. Within 45 days of the deadline for filing tax returns with respect to property tax, the notaries will provide the tax authorities with data on the shareholders of foreign organisations owning properties with a market value of HUF 500 million and above, as well as the ownership proportions in these properties. In case of taxation based on territory, the reporting obligation is applicable in case of buildings over 1000 m² and plots over 10,000 m².

General duty-exemption for company transformations abolished

Previously, another cost-saving method for the transfer of real property assets was if it took place in the framework of a company transformation, de-merger and/or merger. Under the new rules, the duty-free status can subsequently only be used in case of preferential transformation as stipulated in the corporate tax act; i.e. in case they do not involve a change in the ownership structure by virtue of the fact that the earlier shareholders acquire proportionate shares also in the resulting company. The duty exemption in the future, however, will be extended to the acquisition of property by way of preferential exchange or shares.

Changes in the rules applicable to duties facilitating the sale and financing of real properties

Supporting real property financial leasing arrangements

Lessors of real properties in the framework of financial leasing arrangements will pay a reduced, 2% duty after 1 January 2010 when acquiring property for the above purpose, provided that at least 50% of their revenue in the previous year was generated from financial leasing activity. (Previously half of the revenue of the enterprises had to be realized from the financial leasing activity of real estates only.)

Deadlines that can be extended upon requests filed

The approved tax package also contains temporary relief measures, which can be used to mitigate the unfavourable effects of the financial crisis in the short term. In case of a property was acquired and filed for the determination of duty between 1 October 2004 and 31 May 2009, the owner can request that the duty-free period available for the construction of a residential property be extended from 4 to 6 years. It can also be requested that the 2 years available for re-sale and renting out in the framework of financial leasing period set as the condition of the reduced duty rates be extended to 4 years. The deadline for the submission of these applications is 31 January 2010 in case the original deadline expired between 1 October 2008 and 15 January 2010, or the original deadline otherwise. If the amount of the duty plus late charges due to a payment deadline that

Temporary exemption – sale and leaseback

expired prior to the entry into effect of the amending act (9 July 2009) has already been paid, but the extension of the deadline is now requested, then the late charges will be repaid by the tax authority.

With a view to the difficulties of obtaining financing from banks, it was also made possible to buy properties duty-free in the period between the entry into force of the act (9 July 2009) and 31 December 2012 for the purpose of sale and leaseback transactions. This rule is applicable if the property was owned by the lessee until the conclusion of the lease contract, the sale took place merely for the purpose of ensuring the financing, and the ownership title reverts to the lessee at the end of the lease period.

The elimination of the cultural contribution

From 1 January 2010

Another favourable change for real estate developers is that the obligation for the payment of the cultural contribution will be abolished from 1 January 2010.

Should you have any question concerning the topics discussed in this Newsletter, we are pleased to be at your service.

Szmicsek Sándor
Tax Partner
+36-1-429-3010
s.szmicsek@mazars.hu

Dr. Fekete Zsuzsa
Director – Transaction Services
+36-1- 885-0279
Zsuzsa.Fekete@mazars.hu

Mazars Kft.
1074 Budapest, Rákóczi út 70-72.

This Newsletter is for the purpose of general information only. The information provided herein cannot substitute professional consultation, and it should not be used as a basis for any decision or act without prior consultation with your advisor.