Hungarian Group Taxation to Counterbalance the Tightening Transfer Pricing Documentation Rules

A new corporate tax grouping concept was introduced in Hungary as of 2019 with the aim of easing transfer pricing documentation burdens. This article highlights some of the peculiar features of the new Hungarian corporate group taxation rules and gives an overview of some of the practical aspects of the transfer pricing documentation rules implemented in Hungarian legislation as of 2018. The analysis focuses on the interrelationships between these transfer pricing rules and the new group taxation rules, and highlights their shortcomings and the opportunities they offer.

1. Introduction

The release of BEPS Actions 8-10 brought about substantial changes in a number of transfer pricing areas. Several of these changes were implemented immediately by Hungary at the end of 2017 by the Decree of the Ministry of National Economy 32/2017. The new documentation rules are to be applied to the 2018 tax year onward. With these new rules comes the dual concept of Master File and Local File with much expanded content. Taxpayers should ensure that all transfer pricing documentation is transformed into the new format by the end of May 2019. This represents a marked increase in the administrative burden for taxpayers. These changes can, however, be mitigated by forming a tax group for corporate income tax purposes under the new group taxation rules that were introduced as of 2019. This article gives an overview of some practical aspects of the transfer pricing documentation rules contained in Decree No. 32/2017 and their relationship with the new Hungarian group taxation rules. It also highlights some of the shortcomings of the rules, as well as the new opportunities they present.

2. New TP Documentation Requirements

The new TP documentation requirements are applicable to Local Files concerning the 2018 corporate income tax liability, and the years thereafter. The same rules apply to the new Master File, with the exception that the preparation deadline for this documentation can be extended until the end of 2019 if the reason for not preparing it earlier is due to different preparation deadlines as prescribed by legislation in the parent company’s country. TP documentation and the financial data on comparable entities should be updated annually. If data of commercial databases has been used in the comparability analysis, the database search has to be rerun every 3 years unless there is a substantial change in circumstances. The new documentation requirements closely follow Annexes I and II to chapter 5 of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines). The new TP documentation requirements, together with the annual update requirements, represent a fairly substantial increase in the administrative burden put on companies. An important question is therefore whether this increased burden can be avoided by using exemptions, such as the small enterprise exemption or the low-value-adding services simplification rules, or by utilizing the new corporate tax group regime.

3. Certain Exemptions

There are a number of exemptions when no Local File or Master File has to be created. The most important exemption for a multinational enterprise (MNE) is the advance pricing agreement (APA)-related exemption from the documentation liability. This exemption is applicable as long as the APA decision is in force and there have been no substantial changes in circumstance. An APA requires very detailed documentation that will be thoroughly scrutinized. Thus, MNEs do not have to update the TP documentation as long as the APA is valid. In this respect, the new corporate tax group rules described in section 4. bring a whole new range of possibilities for avoiding TP documentation obligations, at least for transactions within the corporate tax group.

Companies that recharge service costs or product purchase costs from third parties to related parties without markup do not need to prepare TP documentation either. In the case of recharging to more than one party, the allocation of the TP documentation burden can be avoided.

References

3. HU: Decree of the Ministry of National Economy 32/2017(X.8.), sec. 10 [hereinafter TP Decree].
4. Sec. 4.§(1) TP Decree.
5. Sec. 4.§(7) TP Decree.
8. Sec. 1.§(2)(b) TP Decree.
9. Sec. 1.§(2)(c) TP Decree.
cation method is not included in the exemption; its arm's length nature must still be proved.

As a general rule, small transactions (i.e. when the aggregate value of supplies under the same contract in one tax year does not exceed HUF 50 million (approximately EUR 158,000)) are exempt from the documentation obligation. It should be noted that these instances provide exemption from the documentation rules, but the arm's length nature of the transaction still has to be proved upon request. All in all, these exemptions are not relevant for MNEs in most cases.

In opposition to the OECD recommendations, the Hungarian simplification rules regarding low-value-adding services do not apply to companies whose main activity is to provide low-value-adding support services to the MNE group. Therefore, these rules do not really ease the administrative burden of MNE groups either.

4. Corporate Tax Group

In 2018, the parliament of Hungary introduced a new concept of a corporate tax group in the corporate income tax law. This is a special group tax regime, whereby a group constitutes a separate corporate taxpayer without eliminating the legal personality of the forming members for tax purposes. The separately established taxable bases of the group members are consolidated, but a number of rights and restrictions continue to apply to members individually. Overall, the Hungarian corporate tax group can be classified as a partial consolidation regime according to Da Silva's classification. The regimes that he distinguishes are group contribution, group relief, partial consolidation, and full consolidation.

A corporate tax group can be formed from closely related parties, when a taxpayer holds at least 75% of the voting rights in another taxpayer, or a person (domestic or foreign, legal or natural person) has at least 75% voting rights in the majority of the management is exercised from Hungary. Foreign permanent establishments do not participate in a group. Foreign permanent establishments do not participate in a group. Foreign permanent establishments do not participate in a group.

The regimes that he distinguishes are group contribution, group relief, partial consolidation, and full consolidation. Of the corporate income tax law in many respects. For transfer pricing purposes, the majority vote or the right to fire and hire the majority of the management is exercised from Hungary. Foreign permanent establishments do not participate in a group. Foreign permanent establishments do not participate in a group. Foreign permanent establishments do not participate in a group.

For calculating the majority voting rights, tax rules refer to the civil law concept of "majority influence", according to which voting rights shall be calculated in indirect situations in proportion to the indirect influence of the parent on the subsidiaries. The following example, also illustrated in Figure 1, demonstrates how these rules act together with the additional conditions laid down for corporate tax grouping in the corporate income tax law.

If a parent company (NL Co) holds 90% voting rights in an intermediate subsidiary (HU4 Co), which likewise holds 90% of the voting rights in another subsidiary (HU5 Co), in theory, both subsidiaries could form a corporate tax group, because the parent company will have 81% voting rights in the lower-tier subsidiary. Since the parent company is not resident in Hungary, it may not become a group member itself, but this will not prevent its Hungarian subsidiaries from forming a group. In theory, any Hungarian subsidiaries in which the parent has more than 75% of the voting rights could join the group even if this majority is the result of adding together the indirect voting rights of different intermediate subsidiaries. However, the rules also require the parent company to have at least 75% of the voting rights in the intermediate subsidiary in all branches of the ownership tree. Therefore, one of the lower-tier subsidiaries (HU3 Co) cannot join the group, because the ultimate parent company does not own the necessary voting rights in the intermediary company (HU1 Co), i.e. 75%. It is irrelevant that the ultimate parent company has, in fact, 80% of the combined voting rights.

Both definitions count the relationship in terms of voting rights, as opposed to the participation in registered capital. Therefore, diverting voting rights from ownership percentages needs to be carefully monitored. From the wording of the corporate income tax law, it is clear that the participants of a corporate tax group have to be taxpayers under the Hungarian corporate income tax law. This includes Hungarian registered business entities, European Companies (SEs) and European Cooperatives (SCs), Hungarian permanent establishments of foreign entities as well as Hungarian-resident foreign companies (where the management is exercised from Hungary). Foreign subsidiaries of Hungarian companies cannot participate in a group. Foreign permanent establishments do not participate in their own right, but as part of a Hungarian legal person. Such a definition will, in many cases, result in situations where only some of the Hungarian entities of a foreign multinational group can participate in the group taxation regime.

The rules also stipulate that when calculating the indirect influence, voting rights in an intermediate subsidiary should be counted as fully controlled (100%) if the parent has at least 75% of the voting rights in a subsidiary. In the example depicted in Figure 1, it means that, although the combined voting rights of the ultimate parent in a lower-tier subsidiary (HU6 Co) are only 56.25%, it should be...
calculated as 75% because it has 75% of the voting rights in the intermediary subsidiary (Lux Co).

As a result, only the Hungarian permanent establishment of the ultimate parent (PE in Hungary), and the Hungarian subsidiaries HU2 Co, HU4 Co, HU5 Co and HU6 Co could form a Hungarian corporate tax group.

5. Applicability of TP Rules to Corporate Tax Groups

The members of a corporate tax group should only apply transfer pricing rules in their dealings with each other if one phase of a transaction occurred prior to forming a group. Such a case can be construed, for example, if the reason for the transfer pricing adjustment is a capital contribution in kind, a merger or a capital reduction. Any such contributions or withdrawals should be at arm’s length or a transfer pricing adjustment will be required. As such a transaction is only recognized in the balance sheet (i.e. it has no immediate effect on the earnings), the other party may only make the correlative adjustment through the depreciation of the asset received as a capital contribution or as a repayment of capital. If the parties became members of the group before the entire correlative adjustment could be made, the adjustment must still be made.

A tax group can only be created with the permission of the tax authorities. Group forming requests can only be submitted from 1-20 November of the tax year in question, i.e. there is a very limited time frame available for taxpayers in each year to form a tax group. It also means that a tax group exists as of the beginning of a tax year.

Forming a group does not only lift the documentation rules; it removes all of the other TP requirements too. As a consequence, group members may be able to deal with each other on non-arm’s-length terms. Forming a group, however, does not mean that a group member has no TP documentation obligation at all. There may be Hungarian subsidiaries of the multinational group that are not included in the corporate tax group either because they are not eligible (no 75% voting rights) or because they did not opt to be so. In such a case, transactions within the multinational group but outside of the corporation tax group should be documented according to the general rules. Documentation requirements may also occur if a corporate tax group member acts as a parent or holding company for both group members and non-group members. Should this be the case, the holding company has to prepare the Master File regardless of its status in the corporate tax group and regardless of whether it has dealings with non-group members. Similarly, if a member leaves the tax group, transfer pricing rules should retroactively apply to all transactions that had an effect on the taxable base of the leaving member after it ceased to be a group member.

However, there is one aspect of the TP documentation requirements that is affected by group membership, this being that it is the representative of the group, registered with the tax authorities, who is liable to fulfil any transfer pricing obligations (and any other corporate tax obligation) of the group, including that of its members. This liability may involve receiving penalties even if it was another group member who should have prepared, for example, a Master File and failed to do so. All group members have joint and several liability for the tax obligations of the tax group. Therefore, the tax authorities may deal with the representative of the group alone. This system may make tax litigations more burdensome, as it is not the entity accused of not fulfilling its tax liability that can defend itself, but a third person; its group representative has to take up the defence on behalf of the group. As a result of the joint and several liability, the tax authorities will seek to satisfy their claim from the entire group.

18. Sec. 188(10) HICT
19. HU: Law No. 150 of 2017 on taxation procedures, sec. 114/A 4(2) [hereafter LTP].
20. Sec. 114/E §1 LTP.
and not only the group member who actually made the incorrect transfer price or supplied incomplete or inaccurate documentation.

Being a member of a corporate tax group can reduce the TP documentation requirements, but it does not eliminate them in respect of transactions concluded in non-membership periods and transactions with non-members. The obligation to prepare a Master File is also not eliminated if a tax group member acts as a parent for non-group members as well. There are major disadvantages to being a group member in the case of transfer pricing litigations due to the lack of possibilities of defending oneself, and the fact that tax recovery can be forced on the entire group.

6. No Arm’s Length Criterion?

As the tax group is seen as one taxpayer, the relevant transfer pricing provisions in the corporate income tax law provide that tax group members do not need to apply transfer pricing rules in their dealings with each other. In practice, however, there may be a number of tax situations when this is not doable, or it may lead to an artificial reduction of the group tax burden.

The compliance burden of a company does not decrease but actually increases by becoming a tax group member. The taxable base of the tax group is prepared in three steps. First, each member prepares its taxable base as if the group never existed. As a second step, the positive taxable bases are aggregated. Finally, the negative taxable bases of group members are deducted up to an amount of 50% of the total group tax base without taking the losses into consideration. Losses which may not be used up when the group tax base is created can be carried forward for 5 years. It is easy to see that the price of transactions between group members may affect their individual profitability. The legislation does not give any guidance on whether the transactions should take place at cost price, under the assumption that they are dealings with the same taxpayer, or whether they can or should contain a markup so that their taxable base reflects business reality. The lack of application of the arm’s length principle among group members makes it possible to optimize the corporate group tax burden in a way that a highly profitable member provides supplies at low prices to its loss-making fellow group member. It would also not be affected by the recapturing rules because the transaction would have taken place during group membership and it would have had no effect on future taxable bases. The only safeguard against such practice is presented by the general abuse-of-law rules.

The arm’s length criterion does not apply to a contribution in kind among group members. As a result, a tax group member will be able to establish or obtain ownership in another tax group member by contributing assets to its capital at book value. In such a situation, care should be taken that the receiving company does not leave the group prior to fully depreciating the asset received as a capital contribution, otherwise it may be affected by the recapturing rules. One may also argue in the case of a new establishment that a company first has to exist in order to join the group. It would be an interesting situation because the contributor has to make an upward adjustment as the recipient is not yet a group member, but the recipient cannot claim a downward adjustment after it joins the group. Although the new transfer pricing rules deal with the situation of transactions prior to becoming a group member, the wording restricts the special rules to transactions between parties where both parties become members of the group after the transaction.

Even though, in general, no arm’s length price is required in intra-group transactions between the corporate tax group members, there are special provisions when this is not the case. Group members shall apply the arm’s length price for calculating royalty fees for the purpose of the intellectual property (IP) box rules. Since half of the profit resulting from the licensing of qualifying IP is deductible from the corporate tax base, the tax code requires that group members use the arm’s length price in calculating the royalty fees. It is also mutatis mutandis applicable to research and development (R&D) cost allowances.

7. Tax Incentives

Tax incentives granted by way of tax credits represent an interesting dilemma. The tax group is seen as one single taxpayer for the purposes of such tax credits. Notwithstanding, the conditions of the tax incentive have to be fulfilled by one designated member and not by the entire group. In the case of an already existing tax incentive, the member who was originally entitled to the incentive has to continue to fulfill the conditions. The tax group may only continue the tax incentive of a designated group member if the group or one of its members qualifies as a legal successor. The group is entitled to use development tax incentives up to 80% of the proportionate positive taxable base allocated to the designated group member. This amount may not be identical to the amount that can be utilized should the company be a stand-alone taxpayer. For the sake of an example, let us say the group consists of two members: one making profits, the other making losses. The profit-making member is the designated member for tax incentive purposes. His entitlement will be limited to the proportionate positive tax base allocated to the member. He should be allocated 100% of the group tax base because he is the only profitable member. When calculating the group tax base, it also contains the losses but only up to 50% of the positive taxable bases. It is easy to see that prices diverted among the group members in order to favour the profitable taxpayer would increase.

21. Sec. 6.§(12) HCIT.
22. Sec. 17.§(15)-(18) HCIT.
23. A tax group is explicitly considered as one resident taxpayer according to sec. 2/A §(1) HCIT.
25. Sec. 6.§(13) HCIT.
26. Sec. 23.§(8)-(14) HCIT.
the maximum available amount of the tax credit. The tax payable is also allocated among the group members in proportion to their positive tax base.

There are also tax incentives that are granted as a reduction of the taxable base. As the taxable base of each group member is established separately first, transfer pricing within the tax group has no effect on taxable base incentives.

8. Corporate Tax Group and Cross-Border Situations

The Hungarian corporate tax group rules are solely limited to domestic situations and do not allow foreign resident taxpayers to participate. Therefore, it is important to examine the EU law aspects of the Hungarian corporate income tax law and its conformity with fundamental freedoms.

According to the jurisprudence of the European Court of Justice27 (hereinafter ECJ), EU law does not prevent an EU Member State from limiting the scope of its tax grouping regime and decline the accession of foreign resident taxpayers to it. Although such limitation would constitute a restriction to the freedom of establishment, the balanced allocation of the powers to tax among EU Member States, prevention of double use of losses and prevention of tax avoidance when taken together can justify the restriction of corporate tax group membership to domestic taxpayers.28 However, in the case of final losses, EU Member States should provide rules to exploit cross-border losses.29 Regardless of how remote the possibility of such a situation occurring is,30 no full EU compliance can be achieved without such rules. The Hungarian corporate tax rules do not contain any provisions on the utilization of ultimate cross-border losses, i.e. situations where the non-resident subsidiary has exhausted the possibilities available in its state of residence and there is no possibility for the foreign subsidiary’s losses to be taken into account in its state of residence.31 Therefore, it is reasonable to conclude that the Hungarian group taxation regime lacks, at this point, the necessary rules to comply with EU law. It would therefore be advisable to introduce special rules to allow the utilization of final losses with restrictions based on the ECJ case law.32

EU law does not require that EU Member States extend their group regimes for cross-border situations as a whole, but may do so in respect of specific elements of them. In the Groupe Steria case,33 the ECJ argued that the exclusion of foreign resident companies from special benefits, like the full exemption for received dividends, may not be justified by the overriding reasons of public interest. In the case of the Hungarian corporate tax group regime, the exemption from the preparation of TP documentation may be examined in the light of the aforementioned case. In the opinion of the authors, the limitation of this special provision solely to domestic situations is more comparable to foreign losses than to a full exemption of dividends received. Therefore, the balanced allocation of the powers to tax among EU Member States and the prevention of tax avoidance when considered together may justify the restriction.

The rules on corporate tax grouping allow Hungarian resident companies and Hungarian permanent establishments of foreign corporations to form a corporate tax group, without any restriction on the residency status of their intermediate connection. Thus, it is possible to form a corporate tax group between Hungarian subsidiaries of a foreign resident parent company, or even with its Hungarian permanent establishment. It is therefore reasonable to conclude that the group taxation rules, in this respect, are in line with ECJ jurisprudence.34

9. Transfer Pricing Adjustments and the Avoidance of Double Taxation

Group members should establish their taxable base separately. Therefore, double taxation on foreign-source income should also be avoided at an individual level. As foreign entities may not become group members, transfer pricing rules apply in all cross-border related-party transactions. According to the Hungarian rules, double taxation should be avoided on the net income.35 Net income is calculated by allocating both direct and indirect costs, and making taxable base adjustments to the foreign-source income. According to the wording of the relevant Hungarian provision,36 a transfer pricing adjustment may be considered as a taxable base adjustment directly allocated to the foreign-source income. Should this be the case, such an adjustment has an effect on the maximum foreign tax credit or the maximum amount of exempted income. As the Hungarian corporate income tax rate is as low as 9%, any increase to the tax credit ceiling creates a real gain.

Let us consider the situation of an intercompany loan at a below-market interest rate to a borrower resident in a country with a high interest withholding tax rate under its relevant double tax treaty. (Note that the 10% interest withholding tax rate recommended by the OECD Model37 would already be considered to be high because it results in an excess tax credit.) Withholding tax is levied on the (low amount of) interest paid and the Hungarian recipient

28. Da Silva, supra n. 11, at p. 316.
29. UK: ECJ, 13 Dec. 2005, Case C-446/03, Marks & Spencer plc v. David Halsey (Her Majesty’s Inspector of Taxes), ECJ Case Law IBFD.
30. UK: ECJ, 3 Feb. 2015, Case C-172/13, European Commission v. United Kingdom of Great Britain and Northern Ireland, ECJ Case Law IBFD.
31. Marks & Spencer (C-446/03), at para. 55.
32. Marks & Spencer II (C-172/13).
35. Sec. 28(8)(4) HCIT.
36. Id. and sec. 18(3)(1) HCIT.
37. OECD Income and Capital Model Convention and Commentary (21 Nov. 2017), Models IBFD.
increases its taxable base with a voluntary transfer pricing adjustment. As the voluntary adjustment is allocated to the foreign-source income, it increases the taxable base for the calculation of the hypothetical tax which presents the ceiling for tax credit calculations. Similarly, if there has been an upward adjustment directly related to the exempt foreign income, it should be “exempted” as well.

The above can be demonstrated in a simple numerical example where the intra-group interest rate on a loan to a foreign related party is 1%, while the arm’s length rate would be 5% and double taxation is eliminated by way of ordinary tax credit.

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<tr>
<th></th>
<th>Transfer price</th>
<th>Arm’s length price</th>
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</thead>
<tbody>
<tr>
<td>Interest rate</td>
<td>1%</td>
<td>5%</td>
</tr>
<tr>
<td>Interest income</td>
<td>1,000</td>
<td>5,000</td>
</tr>
<tr>
<td>Withholding tax (10%)</td>
<td>100</td>
<td>500</td>
</tr>
<tr>
<td>Earnings before taxation*</td>
<td>1,000</td>
<td>5,000</td>
</tr>
<tr>
<td>TP adjustment related to foreign source income</td>
<td>+4,000</td>
<td>0</td>
</tr>
<tr>
<td>Taxable base</td>
<td>5,000</td>
<td>5,000</td>
</tr>
<tr>
<td>Calculated tax (9%)</td>
<td>450</td>
<td>450</td>
</tr>
<tr>
<td>Maximum tax credit</td>
<td>100</td>
<td>450</td>
</tr>
<tr>
<td>HU tax payable</td>
<td>350</td>
<td>0</td>
</tr>
<tr>
<td>Overall tax burden</td>
<td>450</td>
<td>500</td>
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* Withholding tax is accounted for as income tax.

Currently, there is an ongoing discussion between taxpayers and the tax authorities whether the above interpretation is correct. The tax authorities argue that a transfer pricing adjustment is not related to a specific item of income but that it is an adjustment of the overall corporate profits. This argument is based on the fact that no transfer pricing adjustments are made in respect of withholding taxes and that the OECD Model\textsuperscript{38} regulates transfer pricing adjustments in a separate article, and not in each of the articles on different types of income. Taxpayers argue that, notwithstanding the international rules, the Hungarian corporate income tax law explicitly requires all taxable base amendments (including a transfer pricing adjustment) to be allocated to the foreign source income they directly relate to.

For corporate tax groups, the “per country, per income, per member” limitation together with the exclusion of foreign members from the tax group means that transfer pricing still represents withholding tax credit planning opportunities.

10. Conclusions

Decreasing the administrative burden by removing the need to prepare TP documentation within the corporate tax group was one of the explicit goals of the new group taxation regime. This goal, however, has only partially been achieved. Group members may still need to prepare a Master File for their non-group member subsidiaries and transfer pricing rules continue to apply for transactions outside the tax group. The corporate tax compliance of the tax group is a complex matter with an increased administrative burden, which may well counterbalance any transfer pricing simplifications. The joint and several liability of group members is probably the most threatening aspect of the new tax group regime, as tax recovery can be forced on the entire group. Due to the above issues and the very limited time frame for registration as a group, the authors expected that only a handful of tax groups would be formed in 2019. However, according to a press statement of the Minister of Finance, more than 200 group requests have been accepted in January 2019.