Business Advice Series Part Four: Ten typical mistakes investors make in Hungary

Hungary’s tax man: demanding and unforgiving

In the previous installments of this series we have dealt with preliminary questions: what sort of things do you bear in mind before setting up business in Hungary (whether it be a greenfield investment or buying into an existing company.) In this article, we will assume these first hurdles have been successfully jumped. Now is when the real work starts: the day-to-day management of business. It is very important at this point to be prudent, especially as regards taxation.

Various dangers threaten on the tax front: one of them is that each kind of tax has its own wiles. Indeed, joining the EU eliminated several national anomalies - for instance in sales tax laws - but the better part of the power to regulate taxation is still in the hands of the states. This is also the case for procedural law. Another hazard is that the short-term sanctions for a late or erroneous tax declaration are significantly tougher in Hungary than they are in other EU member states. Deadlines for tax declarations - for instance, income tax - are tighter here, and interest and penalties on late payment are considerably higher. Making mistakes can be very painful.
Before we dive into some of the thorny problems that arise at this point in a company’s life, I would again advise that when it comes to complex business affairs, one should always resort to the services of professional consultants.
In any case, if there are any doubts, the only sure way of proceeding is to obtain a binding statement from the tax office concerning a planned business configuration. The tax reform of 2004 has made this somewhat easier. As opposed to past practices, now not only can you have individual contracts inspected for their tax implications, but also template contracts which can be used many times.
It would be impossible to answer all possible questions on taxes and their procedures in the scope of this article, so we will single out three “evergreens.” First sales tax; then company tax, with an eye toward its relationship with “permanent establishments” and transfer pricing; and finally income tax, especially of foreign executives.

Sales tax

Next to income tax, sales tax is the most important source of state revenue in most countries. Merely because of the huge sums involved, tax authorities monitor it with an eagle eye. And the deadline for transferring sales tax to the tax office is very tight. Hungary’s very high - many would say too high - 25% sales tax puts it at the top of the EU.
Companies responsible for transferring sales tax to the tax office have very different deadlines to keep. Companies transferring more that a million forints a year in sales tax do not pay it quarterly, but monthly. Those obliged to pay monthly can opt for fortnightly payment. If the sales tax does not get paid in time, a hefty late fee applies. An erroneous declaration is subject to a penalty of 50% of the unpaid taxes, and the interest due is double the rate of the Hungarian National Bank’s base rate. And new sources of peril were added when Hungary’s sales tax system was harmonised with EU requirements.

Company tax

As regards company tax: all entrepreneurs doing short-term business in Hungary who have intentionally not set up a Hungarian company for the purpose, should be extremely vigilant against establishing what, for tax purposes, qualifies as a “permanent establishment.” Any permanent facility through which the activities of the company are partially or fully carried out constitutes such a permanent establishment. This is quite apparent in the case of a branch office, an agency, or a manufacturing plant, but even a simple construction site, if it remains in place for more than 12 months - or according to some double taxation treaties even less - qualifies as a permanent establishment, and makes the company liable for 16% company tax.
Many investors notice that this rate is incredibly low, tempting them into indiscriminately shifting production from companies abroad to Hungarian subsidiaries. That presents yet another possible source of tax troubles in the challenging realm of transfer pricing. Since September 1, 2003 all related parties have to present documentation of the prices they charge one another for products and services, and of the methods used to arrive at these prices.
The Hungarian tax authorities have been instructed to inspect all of this documentation. The prices charged between related parties must bear comparison with the prices charged between independent third-party companies. These measures are meant to insure that companies do not engage in practices such as a parent company extracting the profits of a Hungarian subsidiary through excessive service charges, at the expense of the Hungarian tax authorities, or - and this is how we got onto this subject - creating artificial profits in the “tax paradise” Hungary, and in this case bilking the tax authorities of the country where the parent company is headquartered.

Income tax
Income tax is an area in which particular caution should be exercised. A foreign executive who spends more than 183 days in one year in Hungary, is under certain conditions obliged to declare his entire personal income in Hungary (i.e. even the remunerations received outside of Hungary). At least that is the way it works according to the majority of double-taxation treaties. As part of Hungary’s integration in the EU, departments were created within the tax office that compare and verify personal tax information from various EU member countries. The day is fast approaching when international business people will not be able to play shell games with their income anymore. So, the rules that apply to the company and the shareholders also apply to the executives.
When it comes to matters of taxation, you just cannot be too careful.

The ‘Business Advice Series’ points out the recurrent pitfalls of doing business in Hungary and gives advice aimed at making your business more successful.