[JOINT COMMITTEE PRINT]

EXPLANATION OF PROPOSED INCOME TAX TREATY BETWEEN THE UNITED STATES AND THE HUNGARIAN PEOPLE'S REPUBLIC

PREPARED FOR THE USE OF THE

COMMITTEE ON FOREIGN RELATIONS

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

JUNE 4, 1979

U.S. GOVERNMENT PRINTING OFFICE

46-136 O WASHINGTON : 1979 JCS-20-79

CONTENTS

INTRODUCTION

This pamphlet provides an explanation of the proposed income tax treaty between the United States and the Hungarian People's Republic ("Hungary"). The proposed treaty was signed on February 12, 1979, and was amplified by an Exchange of Notes signed the same day. No similar treaty between the two countries is in force at the present time. The proposed treaty has been scheduled for a public hearing on June 6, 1979, by the Senate Committee on Foreign Relations.

The proposed treaty is similar to other recent U.S. income tax treaties and to the model income tax treaty of the Organization of Economic Cooperation and Development (OECD) in virtually all respects.

The first part of the pamphlet is a summary of the principal provisions of the proposed tax treaty. This is followed by a detailed, article-by-article explanation of the treaty.

I. SUMMARY

The principal purpose of the proposed income tax treaty between the United States and Hungary is to reduce or eliminate potential double taxation of income earned by citizens and residents of either country from sources within the other country. The proposed treaty is intended to promote closer economic cooperation between the two countries and to eliminate possible barriers to trade caused by overlapping taxing jurisdictions of the two countries.

As in other U.S. tax treaties, these objectives are principally achieved by each country agreeing to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other. For example, the treaty contains the standard tax treaty provision that neither country will tax the business income derived from sources within that country by residents of the other unless the business activities in the taxing country are substantial enough to constitute a branch or other permanent establishment or fixed base (*Article 7*). Similarly, the treaty contains the standard "commercial visitor" exemptions under which residents of one country performing personal services will not be required to file tax returns and pay tax in the other unless their contacts with the other exceed certain specified minimums (*Articles 13 through 18*). Also, the proposed treaty provides that interest, royalties, capital gains and certain other income derived by residents of either country from sources within the other are generally to be taxed only by the country of residence and not by the country of source (*Articles 10, 11, 12 and 19*), and that dividends received by residents of one country from sources within the other are to be taxed at reduced rates by the country of source (*Article 9*).

In situations where the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the treaty generally provides for the relief by the country of residence of the potential double taxation (*Article 20*) through a foreign tax credit (in the case of the United States) or an exemption (in the case of Hungary).

The treaty contains the standard provision (the "saving clause") contained in U.S. tax treaties that each country retains the right to tax its citizens and residents as if the treaty had not come into effect (Article 1). In addition, it contains the standard provision that the treaty will not be applied to deny any taxpayer any benefits he would be entitled to under the domestic law of either country or under any other agreement between the two countries (*Article 24*); that is, the treaty will only be applied to the benefit of taxpayers.

The treaty also contains standard nondiscrimination provisions and provides for exchanges of information and administrative cooperation between the tax authorities of the two countries to avoid double taxation and prevent fiscal evasion with respect to income taxes.

II. EXPLANATION OF PROPOSED TAX TREATY

A detailed, article-by-article explanation of the proposed income tax treaty between the United States and Hungary is presented below.

Article 1. Personal scope

The proposed treaty applies generally to residents of the United States and to residents of Hungary, with specific exceptions designated in other articles. This follows other U.S. income tax treaties and the OECD model income tax treaty.

The proposed treaty contains the "saving clause" contained in all U.S. income tax treaties which provides, with specified exceptions, that the treaty is not to affect the taxation by the United States of its citizens and residents or the taxation by Hungary of its citizens and residents. Residents for purposes of the treaty (and thus for purposes of the saving clause) include corporations and other entities as well as individuals (*Article 4. Fiscal domicile*). In the case of the United States, the saving clause also extends to former citizens. (Under section 877 of the Internal Revenue Code, an individual who gives up U.S. citizenship is subject to U.S. tax on his U.S.-source income as if he were still a U.S. citizen if one of his principal purposes in giving up U.S. citizenship was to avoid U.S. tax.)

Exceptions to the saving clause are provided for the benefits conferred by the articles dealing with pensions (*Article 15*), relief from double taxation (*Article 20*), nondiscrimination (*Article 21*), and mutual agreement procedures (*Article 22*); thus, the benefits of those articles will be conferred by each country on its own citizens and residents as well as the citizens and residents of the other. In addition, the benefits conferred by the articles dealing with the taxation of income received by government employees (*Article 16*), teachers (*Article 17*), and diplomatic and consular officials (*Article 24*) are to be provided by each country to its residents provided those residents are neither citizens of, nor have immigrant status in, that country.

Consequently, except for the exceptions to the saving clause set forth above, U.S. citizens and residents generally benefit under the treaty as the result of the agreement by Hungary to reduce its rate of tax on their income or exempt their income from tax rather than as the result of reductions in tax or exemptions by the United States. Even in this situation, if the tax which is foregone by Hungary could have otherwise been claimed in full by the U.S. taxpayers as a foreign tax credit, the real beneficiary of the reduction or elimination of the Hungarian tax would, as a practical matter, be the U.S. Treasury rather than the U.S. taxpayer. Similarly, except as noted above, Hungarian citizens and residents benefit under the treaty only to the extent that the United States agrees to reduce its tax on their income or to exempt their income from tax.

46-136 O - 79 - 2

Article 2. Taxes covered

In the case of the United States, the proposed treaty applies to the Federal income taxes imposed under the Internal Revenue Code and to the excise taxes imposed on insurance premiums paid to foreign insurers and with respect to private foundations. However, it does not apply to the accumulated earnings tax or the personal holding company tax. In the case of Hungary, the treaty applies to the general income tax, the income tax on intellectual activities, the profit tax, the profit tax on economic associations with foreign participation, the enterprises special tax, the levy on dividends and profit distributions of commercial companies, the profit tax on state-owned enterprises, and the contribution to communal development (but only to the extent that the contribution is required in respect of income taxes covered by the treaty).

The proposed treaty also contains a provision generally found in U.S. income tax treaties to the effect that it will apply to substantially similar taxes which either country may subsequently impose. Each country is obligated under the treaty to notify the other of any changes it makes in its tax laws and of any official published material concerning the treaty, including explanations, regulations, rulings, and judicial determinations.

Additionally, the nondiscrimination provisions (*Article 21*) of the treaty apply to all taxes of every kind imposed at the national, state, or local level by the United States or Hungary. The exchange of information provisions (*Article 23*) of the proposed treaty will also apply to all taxes of every kind imposed by the two countries at the national level.

Article 3. General definitions

Certain of the standard definitions found in most of our income tax treaties are contained in the proposed treaty.

Under the proposed treaty, the term "United States" when used in a geographical sense does not apply to Puerto Rico, the Virgin Islands, Guam or any other possession or territory of the United States.

A "national" of either country is defined to include both a citizen of that country and also any legal entity such as a corporation, trust, estate, partnership, or association which is established under the laws of that country. A "company" is defined as a corporation or other entity treated as a corporation for tax purposes. An enterprise of a country is defined as an enterprise carried on by a resident of that country. Although the treaty does not define the term "enterprise," it would have the same meaning that it has in other U.S. tax treaties—the trade or business activities undertaken by an individual, partnership, corporation, or other entity.

The proposed treaty also contains the standard provision that, unless the context otherwise requires or the competent authorities of the two countries establish a common meaning, any terms are to have the meaning which they have under the applicable tax laws of the country applying the treaty.

Article 4. Fiscal domicile

The benefits of the proposed treaty generally are available only to residents of the two countries. Under the treaty, a person (either an individual or an entity such as a corporation or partnership) is considered to be a resident of either country if, under the laws of that country, the person is subject to taxation by that country because it is the country of domicile, residence, citizenship, place of management, place of incorporation, or other criterion of similar nature. A person will not be considered to be a resident of a country if he is only taxable on his income from sources within that country or on his assets located in that country. A partnership, estate, or trust will be considered to be a resident of either country only to the extent that the income it derives is subject to tax, either in its hands or in the hands of its partners or beneficiaries, as the income of a resident of the country.

This provision of the proposed treaty is generally based on the fiscal domicile article of the OECD model tax treaty and is similar to the provisions found in other U.S. tax treaties. However, a significant difference between the definition of resident in this treaty and the definition in other recent U.S. income tax treaties, and consequently a significant difference in the coverage of the treaty, is that the term resident includes an individual who is subject to worldwide taxation on the basis of citizenship. As a result, U.S. citizens residing overseas (in countries other than Hungary) are entitled to the benefits of the treaty as U.S. residents. Since Hungary generally taxes on a residency basis rather than on a citizenship basis, this broadened definition of resident does not benefit citizens of Hungary who are not Hungarian residents. However, Hungary does tax certain of its nationals who work overseas for the Hungarian Government (or its instrumentalities), and a special rule is provided under which these individuals and their families are treated as residents of Hungary entitled to the benefits of the treaty.

A set of rules is provided to determine residence in the case of a person who, under the basic treaty definition, would be considered to be a resident of both countries (e.g., a U.S. citizen and resident in Hungary). In the case of a dual resident individual, the individual will be deemed for all purposes of the treaty to be a resident of the country in which he has his permanent home (where an individual dwells with his family), his center of vital interests (his closest economic and personal relations), his habitual abode, or his citizenship. If the residence of an individual cannot be determined by these tests, applied in the order stated, the competent authorities of the countries will settle the question by mutual agreement. In the case of a dual resident corporation which is created or organized under the laws of either country (or a political subdivision), the corporation will be treated as a resident of that country. In the case of a dual resident person, other than an individual or a corporation (e.g., a dual resident partnership, trust, or estate), the residence of the person and the mode of application of the treaty will be determined by the competent authorities.

Article 5. Definition of permanent establishment

The proposed treaty contains a definition of permanent establishment which follows the pattern of other recent U.S. income tax treaties and the OECD model tax treaty. The permanent establishment concept is one of the basic devices used in income tax treaties to avoid double taxation. Generally, a resident of one country is not taxable on its business profits by the other country unless those profits are attributable to a permanent establishment of the resident in the other country. In addition, the permanent establishment concept is used to determine whether the reduced rates of, or exemptions from, tax provided for dividends, interest, and royalties are applicable.

In general, a fixed place of business through which a resident of one country engages in business in the other country is considered a permanent establishment. This includes a place of management; a branch, an office; a factory; a workshop; or a mine, an oil or gas well, a quarry, or other place of extraction of natural resources. It also includes any building site, construction or installation project, or an installation or drilling rig or ship used for the exploration or development of natural resources, but only if the site, project, etc., lasts for more than 24 months.

This general rule is modified to provide that a fixed place of business which is only used for any or all of a number of specified activities will not constitute a permanent establishment. These activities include the use of facilities for storing, displaying, or delivering merchandise belonging to the resident; the maintenance of a stock of goods belonging to the resident for purposes of storage, display, delivery, or processing by another person; or the purchase of goods or merchandise, collection of information, or any other preparatory or auxiliary activities for the resident.

If a resident of one country maintains an agent in the other country who has, and regularly exercises, the authority to enter into contracts in that other country in the name of the resident, then the resident will be deemed to have a permanent establishment in the other country with respect to the activities which the agent undertakes on its behalf. This rule does not apply where the contracting authority is limited to those activities (described above) such as storage, display, or delivery of merchandise which are excepted from the definition of permanent establishment. The proposed treaty contains the usual provision that the agency rule will not apply if the agent is a broker, general commission agent, or other agent of independent status acting in the ordinary course of its business.

The determination of whether a resident of one country has a permanent establishment in the other country is to be made without regard to the fact that the resident may be related to a resident of the other country or to a person who engages in business in that other country.

Article 6. Income from immovable property (real property)

The proposed treaty provides that income from real property may be taxed in the country where the real property or natural resources are located. For purposes of the treaty, real property will generally have the meaning provided under the laws of the country where the property is located, but will in any case include property which is accessory to real property, livestock, and equipment used in agriculture and forestry, and rights to real property. Ships, boats, and aircraft will not be considered real property.

Income from real property includes income from the direct use or renting of the property. It also includes royalties and other payments in respect of the exploitation of natural resources (e.g., oil wells) and gains on the sale, exchange, or other disposition of the royalty rights or the underlying natural resource. It does not include interest on loans secured by real property. Under Article 12 (*Capital gains*), gains on the sale, exchange, or other disposition of the property may also be taxed by the country where the property is located.

Article 7. Business profits

Under the proposed treaty, business profits of an enterprise of one country are taxable in the other country only to the extent they are attributable to a permanent establishment in the other country through which the enterprise carries on business.

The business profits of a permanent establishment are determined on an arm's-length basis. Thus, there is to be attributed to it the business profits which would reasonably be expected to have been derived by it if it were an independent entity engaged in the same or similar activities under the same or similar conditions and dealing at arm's-length with the resident of which it is a permanent establishment.

In computing taxable business profits, deductions are allowed for all expenses, wherever incurred, which are incurred for purposes of the permanent establishment. These deductions include a reasonable allocation of executive and general administrative expenses, interest, and other expenses which are incurred for purposes of the enterprise as a whole (or for purposes of that part of the enterprise which includes the permanent establishment). Thus, for example, a U.S. company which has a branch office in Hungary but which has its head office in the United States will, in computing the Hungarian tax liability of the branch, be entitled to deduct a portion of the executive and general administrative expenses incurred in the United States by the head office for purposes of administering the Hungarian branch. Business profits will not be attributed to a permanent establishment merely by reason of the purchase of merchandise by the permanent establishment for the account of the enterprise, or by reason of the delivery to the permanent establishment of goods or merchandise for its use. Thus, where a permanent establishment purchases goods for its head office, the business profits attributed to the permanent establishment with respect to its other activities will not be increased by a profit element on its purchasing activities.

Where business profits include items of income which are dealt with separately in other articles of the treaty, those other articles, and not this business profits article, will govern the treatment of those items of income.

Article 8. Shipping and air transport

The proposed treaty provides that income which is derived by an enterprise of either country from the operation of ships and aircraft in international traffic shall be exempt from tax by the other country. International traffic means any transportation by ship or aircraft, except where the transportation is solely between places in the other country (*Article 3(1)(e). Definitions*). The exemption applies whether or not the ships or aircraft are registered in the first country.

The exemption for shipping and air transport profits applies to profits from the rental on a full or bare boat basis of ships or aircraft operated in international traffic if such rental profits are incidental to the actual operation of ships and aircraft in international traffic. (Rental on a full or bare boat basis refers to whether the ships or aircraft are leased fully equipped, manned and supplied or not.) Income from the operation in international traffic of ships or aircraft also includes income derived from the use, maintenance, or rental of containers, trailers for the inland transportation of containers, and other related equipment where the equipment is used to transport goods and merchandise.

The shipping and air transport exemption also applies where an enterprise has an agency in the other country for the transportation of goods or persons (e.g., an airline office), but the exemption only applies to the extent of activities directly connected with the business of shipping and aircraft transportation (including auxiliary activities).

Article 9. Dividends

Each country may tax dividends paid by its companies to shareholders resident in the other (i.e., they may impose a dividend withholding tax on shareholders resident in the other country), but the rate of tax may not exceed 15 percent if the beneficial owner is a resident of the other country. (In the absence of a treaty limitation, the statutory U.S. withholding tax rate on dividends paid by U.S. corporations to foreign shareholders is 30 percent.) The withholding tax rate is limited to 5 percent in the case of dividends paid to a company which directly or indirectly owns at least 10 percent of the voting stock of the company making the dividend distribution.

Neither country can tax dividends paid by companies of the other except insofar as (a) the dividends are paid to residents of the country imposing the tax, (b) the dividends are effectively connected with a permanent establishment or a fixed base in the taxing country, or (c) at least 50 percent of the company's gross income was attributable to a permanent establishment in the taxing country. In this last situation, however, the tax can be imposed only to the extent the dividends are paid out of the profits derived from the permanent establishment and, in addition, the rate of tax on the taxable portion is limited to 15 percent or 5 percent under the rules (described above) applicable to dividends paid by companies of the taxing country. As set forth in the Exchange of Notes, this last exception does not apply to Hungary because Hungary does not tax dividends paid for by foreign corporations regardless of the extent to which the dividends were derived from Hungarian source profits of the distributing foreign corporation. The United States, however, does impose its withholding tax on the U.S.-source portion of dividends distributed to foreign shareholders by foreign corporations which derive more than 50 percent of their gross income for the preceding 3-year period from U.S. sources. This last exception permits the United States to continue to do so.

The reduced rates of tax on dividends will apply unless the recipient has a permanent establishment (or fixed base in the case of an individual performing independent personal services) in the source country and the dividends are effectively connected with the permanent establishment (or fixed base). Dividends effectively connected with a permanent establishment are to be taxed as business profits (*Article 8*). Dividends effectively connected with a fixed base are to be taxed as income from the performance of independent personal services (*Article 13*).

Article 10. Interest

Interest derived by a resident of one country from sources within the other country is generally exempt from tax by the source country. (In the absence of a treaty limitation, the United States generally imposes a 30-percent withholding tax on interest paid by U.S. debtors—other than banks—to foreign lenders.)

The exemption from tax on interest will apply unless the recipient has a permanent establishment or fixed base in the source country and the interest is effectively connected with the permanent establishment or fixed base. In that event, the interest will be taxed as business profits (*Article 7*) or income from the performance of independent personal services (*Article 13*).

The proposed treaty defines interest as income from debt claims of every kind, whether or not secured and whether or not carrying a right to participate in profits. In particular, it includes income from government securities and from bonds or debentures, including premiums or prizes attaching to bonds or debentures.

Article 11. Royalties

Under the proposed treaty, royalties derived by a resident of one country from sources within the other are exempt from tax by the source country. (In the absence of a treaty limitation, the United States generally imposes a 30-percent withholding tax on royalties paid to foreigners not engaged in a U.S. business.) Royalties are defined for this purpose as payments of any kind received as consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work, including films, radio or television tapes, any patents, trade marks, designs or models, plans, secret formula or processes, or any other similar rights or property. Royalties also include payments for information concerning industrial, commercial, or scientific experience (e.g., "knowhow"). However, this article does not apply to mineral royalties (which are covered by *Article 6*).

The exemption does not apply where the recipient is an enterprise with a permanent establishment in the source country or an individual performing personal services in an independent capacity through a fixed base in the source country, and the royalties are effectively connected with the permanent establishment or fixed base. In that event the royalties will be taxed as business profits (*Article 7*) or income from the performance of independent personal services (*Article 13*).

Article 12. Capital gains

The proposed treaty generally provides that capital gains derived by a resident of one country will be exempt from tax by the source country. Under the Code, capital gains derived from U.S. sources by foreign investors are generally exempt from U.S. tax.

The exemption does not apply in two situations, and in those situations the gains may be taxed by both countries (with relief from double taxation provided pursuant to *Article 20*). First, gains from the sale or exchange of real property may be taxed in the country where the property is located. Second, gains on the sale or exchange of property which forms a part of the business property of a permanent establishment or a fixed base (including gains on the disposition of the permanent establishment or the fixed base itself) may be taxed in the country where the permanent establishment or fixed base is located. This second exception does not apply to gains from the sale or exchange of ships, aircraft or containers operated by an enterprise of the other country in international traffic; such gains are only taxable by the country of residence.

Article 13. Independent personal services

Under the proposed treaty, income from the performance of independent personal services (i.e., services performed as an independent contractor, not as an employee) in one country by a resident of the other country is exempt from tax in the country where the services are performed, unless (1) the person performing the personal service is present in the country where the services are performed for 183 or more days during the taxable year or (2) the individual has a fixed base regularly available to him in that country for the purpose of performing the services. In the second situation, the source country can only tax that portion of the individual's income which is attributable to the fixed base. Independent services include independent scientific, literary, artistic, educational or teaching activities as well as activities of physicians, lawyers, engineers, architects, dentists, artistes, athletes and accountants.

Article 14. Dependent personal services

Under the proposed treaty, income from services performed as an employee in one country (the source country) by a resident of the other country will not be taxable in the source country if three requirements are met: (1) the individual is present in the source country for less than 183 days during the taxable year; (2) his employer is not a resident of the source country; and (3) the compensation is not borne by a permanent establishment or fixed base of the employer in the source country.

Compensation derived by an employee aboard a ship or aircraft operated by a resident of one country in international traffic is exempt from tax by the other country, provided that the compensation is in respect of employment as a member of the regular complement of the ship or aircraft.

This article does not apply to pensions and social security payments (*Article 15*) or to compensation as a government employee (*Article 16*).

Article 15. Pensions

Under the proposed treaty, private pensions (and other similar compensation for past services) beneficially derived by residents of either country are exempt from tax in the other country, regardless of the source of pensions.

Social security payments and other public pensions paid by either country to a resident of the other (or to U.S. citizens) are only taxable by the country making payments. This rule does not apply in the case of pensions which are paid to resident nationals of one country attributable to services performed by that individual to government entities of the other. (*Article 16(2) (b). Governmental service*).

Article 16. Governmental service

Under the proposed treaty, compensation paid by one country, its political subdivisions or local authorities, to an individual for labor or personal services performed for the paying governmental entity is exempt from tax by the other country. However, this exemption does not apply if the services are performed in the other country and the individual is a national of that country or did not become a resident of that country solely for the purpose of performing the service. In that situation, the compensation is only taxable by the country where the services are performed. Thus, an individual performing services for a Hungarian governmental entity ordinarily will only be taxable by Hungary. However, if he performs the services in the United States and is a U.S. citizen, or is a U.S. resident whose reasons for becoming a U.S. resident were not solely to work for that Hungarian governmental agency, he will be taxable by the United States.

Pensions paid for services to a governmental entity of either country will generally only be taxable by that country. However, if the recipient is a resident national of the other country, the pension will only be taxable by that other country.

The governmental services rules do not apply in situations where the compensation or pensions are paid in connection with any business carried on by any governmental entity of either country. In such situations, the provisions applicable to the private sector apply: Articles 13 (*Independent personal services*), 14 (*Dependent personal services*), and 15 (*Pensions*).

Article 17. Teachers

The proposed treaty provides that if a teacher or researcher who is a resident of one country is invited to teach or engage in research in the other, he will be exempt from tax by the host country on income from teaching or engaging in research if he is present in that country for a period not expected to exceed 2 years. The exemption only applies if the individual comes to the other country primarily for the purpose of teaching or engaging in research pursuant to an invitation of the host country (or political subdivision or local authority) or a recognized educational institution in the host country. It is not to apply with respect to income from research which is undertaken primarily for the private benefit of a specific person or persons.

If the teacher or researcher remains in the other country for a period exceeding 2 years, the exemption only applies to income earned during the 2-year period. The exemption does not apply if the individual is a citizen of, or acquires immigrant status in, the host country (*Article 1(3)*).

Article 18. Students and trainees

Under the proposed treaty, a resident of one country who becomes a full-time student, apprentice, or business trainee in the other country will generally be exempt from tax in the host country on payments from abroad used for maintenance, education, or training.

A full-time student, apprentice or business trainee who qualifies for the exemption from tax by the host country may instead elect under the treaty to be treated for tax purposes as a resident of the host country. The election applies for the entire period that the individual is a full-time student, apprentice, or business trainee, and it may not be revoked except with the consent of the competent authority of the host country. The purpose of the election is to permit foreign students, apprentices, and business trainees present in the United States to qualify for benefits such as the standard deduction (the zero bracket amount), and for the dependency deductions (if applicable). For example, for U.S. tax purposes nonresident aliens are limited to one personal deduction and they are not permitted to claim the standard deduction or the dependency deduction. By electing to be taxed as U.S. residents, they may claim these deductions but, as a consequence, they are subject to U.S. tax on their worldwide income. This election would generally be advantageous for those foreign students, apprentices, and business trainees who do not have any substantial income from sources without the United States.

Article 19. All other income

Any item of income, regardless of its source, which is derived by a resident of either country and which is not dealt with in one of the other articles of the treaty will be taxable only by the country of residence. However, such an item of income which is received by a resident of one country who is a citizen of the other may be taxed by both countries (*Article 1. Personal scope*), subject to a foreign tax credit for taxes paid to the other if the other country is the country of source (*Article 20. Relief from double taxation*). Items covered by this article would include, for example, annuities, alimony, child support, and certain income from the rental of personal property.

Article 20. Relief from double taxation

United States

Under the proposed treaty, the United States agrees to provide its citizens and residents with a foreign tax credit against their U.S. income tax for the appropriate amount of taxes paid to Hungary. The credit allowed for U.S. tax purposes is in accordance with the provisions and subject to the limitations of U.S. law applicable to the year in question. Under present law, the United States only allows a credit for foreign income taxes (sec. 901 of the Internal Revenue Code), or foreign taxes imposed in lieu of income taxes (Code sec. 903), and the credit is limited to the amount of the pre-credit U.S. tax which is attributable to foreign source income (Code secs. 904 and 907).

The proposed treaty also provides that a deemed-paid foreign tax credit will be made available to a U.S. corporation with respect to dividends from a Hungarian corporation in which it owns, directly or indirectly, at least 10 percent of the voting stock. In this case, a credit will be allowed for the Hungarian tax paid by the Hungarian corporation on the earnings out of which the dividend is paid. A deemed-paid foreign tax credit satisfying the treaty requirements is presently provided under the Internal Revenue Code (sec. 902).

This article provides that all the Hungarian taxes covered by the treaty (*Article 2. Taxes covered*) are to be considered to be income taxes for purposes of the U.S. foreign tax credit. Accordingly, all the Hungarian taxes covered by the treaty will be eligible for the U.S. foreign tax credit. These taxes would probably be creditable for U.S. tax purposes in the absence of the proposed treaty.

Hungary

The treaty generally provides for the relief by Hungary of double taxation of income received by its residents which is taxable under the treaty by the United States through the use of an exemption with progression. Hungary, like the United States and most other countries, has a progressive rate structure for its income tax (i.e., the tax rate becomes higher as taxable income increases). Under the exemption with progression, the exempt income is not subject to Hungarian tax, but it is taken into account in determining the effective rate on the resident's other income which is subject to tax. (By increasing the income taken into account, the effective rate becomes higher because of the progressive rate structure.)

With the exception of dividend income for which a foreign tax credit is allowed (described below), the exemption is available with respect to income derived by the Hungarian residents which under the treaty may be taxed by the United States (other than income which under the treaty may be taxed by the United States solely because the Hungarian resident receiving the income is also a citizen of the United States). Income eligible for the exclusion would include, for example, income from U.S. real property, business profits attributable to a U.S. permanent establishment, or compensation for personal services performed in an independent capacity through a U.S. fixed base. The treaty exemption is also available with respect to income from sources within the United States which would not be taxable by the United States under the treaty but for the fact the recipient is a U.S. citizen. This would include U.S.-source interest and royalties received by U.S. citizens resident in Hungary.

A Hungarian foreign tax credit rather than the exemption with progression will be provided under the treaty with respect to dividends received by Hungarian residents from U.S. companies where the dividends qualify for the reduced 15-percent or 5-percent treaty rate for the U.S. withholding tax (*Article 9*). Although Hungary does not have a statutory foreign tax credit, the treaty provides that such dividends from U.S. companies will be taxable by Hungary and that the Hungarian residents will be entitled to reduce their Hungarian tax by the 5-percent or 15-percent U.S. withholding tax imposed on the dividends. It was necessary to provide a credit in this situation rather than an exemption because the U.S. withholding tax rate under the treaty is substantially lower than the regular income tax rates of both countries. Therefore, an exemption would have more than offset any potential double taxation of the dividends.

Consequently, the only income received by a U.S. citizen resident in Hungary which would not qualify for either the exemption from, or the credit against, the Hungarian tax pursuant to this provision would be non-U.S.-source income. There would not be double taxation in this situation, however, because the Hungarian tax could be claimed as a foreign tax credit against the U.S. tax on that foreign source income.

Article 21. Nondiscrimination

The proposed treaty contains a comprehensive nondiscrimination provision relating to all taxes of every kind imposed at the national, state, or local level. It is similar to provisions which have been embodied in other recent U.S. income tax treaties.

Under this provision, neither country can discriminate by imposing more burdensome taxes (or other requirements connected with taxes) on citizens of the other country than it imposes on its own citizens who are in the same circumstances. For this purpose, citizens taxable on their worldwide income are not to be considered to be in the same circumstances as citizens who are not. Thus, for example, the United States would not be required to tax in the same way a U.S. citizen and a Hungarian citizen, neither of whom are residents of the United States, because the U.S. citizen is taxed by the United States on his worldwide income while the Hungary citizen is not. This provision does not, however, require either country to grant to residents of the other country the personal allowances, reliefs, or deductions for taxation purposes on account of personal status or family responsibilities which it grants to its own residents.

Similarly, neither country may tax a permanent establishment of an enterprise of the other country less favorably than it taxes its own enterprises carrying on the same activities. In determining the taxable income of an enterprise of either country, both countries are required to allow the enterprise to deduct interest, royalties, and other disbursements paid by the enterprise to residents of the other country under the same conditions that they allow deductions for such amounts paid to residents of the same country as the enterprise. Similarly, for purposes of determining the taxable capital of an enterprise of one country, debts owed to residents of the other country are to be deductible under the same conditions as if they were owed to residents of the same country as the enterprise. The nondiscrimination provision also applies to corporations of one country which are owned by residents of the other country.

Articles 22 and 23. Administrative provisions

The proposed treaty contains various administrative provisions generally along the lines of the provisions contained in other U.S. tax treaties. In general, the proposed treaty provides—

(1) for consultation and negotiation between the tax authorities of the two countries to resolve differences arising in the application of the proposed treaty and also to resolve claims by taxpayers that they are being subjected to taxation contrary to the terms of proposed treaty; and

(2) for the exchange between the countries of information pertinent to carrying out the provisions of the proposed treaty and of the domestic laws of the countries concerning taxes covered by the proposed treaty.

Article 24. Diplomatic and consular officials; Domestic laws and other treaties

The proposed treaty contains the rule found in other U.S. tax treaties that its provisions are not to affect the taxation privileges of diplomatic and consular officials under the general rules of international law or the provisions of special agreements.

The proposed treaty also contains the rule found in other U.S. tax treaties that its provisions will not restrict in any manner any exclusion, exemption, deduction, credit or other allowance otherwise accorded by the domestic laws of either country or any other agreement between the two countries. In other words, the treaty (other than the exchange of information provisions) can only be applied to the benefit of taxpayers of the two countries, and the taxing authorities cannot apply it to increase a taxpayer's tax liability.

Article 25. Entry into force

The proposed treaty will enter into force as soon as the United States and Hungary notify each other that their constitutional requirements for ratification have been met (in the case of the United States, upon its presentation of an instrument of ratification). With respect to withholding taxes withheld at source, it will become effective to income paid or credited on or before the first day of the second month following the date on which it enters into force. This would apply to dividends (*Article 9*), interest (*Article 10*), royalties (*Article 11*), and annuities and other fixed and determinable annual or periodic income which is not specifically covered by any article (*Article 19*). With respect to all other taxes, it will become effective for taxable years beginning on or after January 1 of the year following the date on which the proposed treaty comes into force.

Article 26. Termination

The proposed treaty will continue in force indefinitely, but either country may terminate it at any time after 5 years from its entry into force by giving at least 6 months' prior notice through diplomatic channels. If terminated, the termination will be effective with respect to income of taxable years beginning (or, in the case of withholding taxes, payments of income made) on or after January 1 next following the expiration of the 6-month period.

Exchange of Notes

In an exchange of identical letters signed together with the treaty, the two countries set forth certain agreements concerning the application of certain provisions of the treaty. The interpretations and understanding set forth in the Notes have the same force and effect as if they were contained in articles of the treaty.

First, although the dividend article (*Article 9(5)(c)*) would permit it, Hungary will not impose a tax on dividends paid to U.S. shareholders by corporations deriving more than 50 percent of their profits from Hungary in situations where the distributing corporation is not resident in Hungary. The United States imposes its withholding tax on dividends paid by foreign corporations to foreign investors where the distributing corporation derives more than 50 percent of its income from the United States during the 3-year period preceding the distribution. Under the treaty, the United States may continue to tax dividends paid by Hungarian corporations in such situations.

Second, where a resident of one country carries on business through a permanent establishment in the other, income (other than income from real property) will be taxed as business profits (*Article 7*) rather than other income (*Article 19*) if the right or property in respect of which the income is paid is effectively connected with the permanent establishment. Similarly, where a resident of one country performs independent personal services through a fixed base in the other, income (other than income from real property) will be taxed as independent personal services income (*Article 13*) rather than other income if the right or property in respect of which the income is paid is effectively connected with the fixed base. The consequences of this understanding is that the income in these situations will be taxed by the country of the permanent establishment or fixed base rather than only by the country of residence.

Third, the Notes recognize the right of each country to apply the provisions of its internal law to distribute, apportion, or allocate income, deductions, credits, and allowances between related enterprises in order to reflect properly their arm's-length profit in situations where the dealings between the related enterprises involve conditions different from those that would have been made between independent enterprises. In addition, the Notes also provide that the internal law of each country may be applied to limit the exemption provided in the treaty for interest (*Article 10*) and royalties (*Article 11*) so that it only applies to the extent that the interest or royalty does not exceed the arm's-length amount that would have been paid between unrelated parties. Thus, the treaty does not in any way limit the authority of the Internal Revenue Service to allocate or apportion income, deductions, credits or allowances between related parties under section 482 of the Internal Revenue Code in situations where it determines that the allocation is necessary in order to prevent the evasion of taxes or clearly to reflect the income of the related parties. This authority is not limited by the treaty even where the allocation is between related parties which are not enterprises or where the related parties have not had dealings with each other.

Finally, the Notes set forth an agreement, similar to provisions in other recent U.S. income tax treaties, that each country will assist the other in collecting taxes imposed by the other country to the extent necessary to insure that the treaty benefits are only enjoyed by persons entitled to them. This agreement does not obligate either country to carry out administrative measures which are of a different nature from those used in the collection of its own tax or measures which would be contrary to its sovereignty, security, or public policy.