EXPLANATION OF PROPOSED INCOME TAX TREATY BETWEEN THE UNITED STATES AND HUNGARY

Scheduled for a Hearing
Before the
COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

On June 7, 2011

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, describes the proposed income tax treaty between the United States and Hungary (the "proposed treaty"). The proposed treaty was signed on February 4, 2010, and is accompanied by official understandings implemented by an exchange of diplomatic notes (collectively the "diplomatic notes") carried out on that same day. The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed treaty for June 7, 2011.[2]

Part I of the pamphlet provides a summary of the proposed treaty. Part II provides a brief overview of U.S. tax laws relating to international trade and investment and of U.S. income tax treaties in general. Part III contains a brief overview of Hungary's tax laws. Part IV provides a discussion of investment and trade flows between the United States and Hungary. Part V contains an article-by-article explanation of the proposed treaty. Part VI contains a discussion of issues relating to the proposed treaty.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty Between the United States and Hungary* (JCX-32-11), May 20, 2011. References to "the Code" are to the U.S. Internal Revenue Code of 1986, as amended. This document is available on the internet at http://www.jct.gov/.

[2] For a copy of the proposed treaty, see Senate Treaty Doc. 111-7.

I. SUMMARY

The principal purposes of the proposed treaty are to reduce or eliminate double taxation of income earned by residents of each country from sources within the other country, and to prevent avoidance or evasion of the taxes of the two countries. The proposed treaty also is intended to promote close economic cooperation between the two countries and to eliminate possible barriers to trade and investment caused by overlapping taxing jurisdictions of the two countries. As in other U.S. tax treaties, these objectives principally are achieved through each country's agreement to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other country.

For example, the proposed treaty contains provisions under which each country generally agrees not to tax business income derived from sources within that country by residents of the other country unless the business activities in the taxing country are substantial enough to constitute a permanent establishment (Article 7). Similarly, the proposed treaty contains certain exemptions under which residents of one country performing personal services in the other country will not be required to pay tax in the other country unless their contact with the other country exceeds specified minimums (Articles 14 and 16). The proposed treaty also provides that pensions and other similar remuneration paid to a resident of one country may be taxed only by that country and only at the time and to the extent that a pension distribution is made (Article 17).

The proposed treaty provides that dividends and certain gains derived by a resident of one country from sources within the other country generally may be taxed by both countries (Articles 10 and 13); however, the rate of tax that the source country may impose on a resident of the other country on dividends may be limited by the proposed treaty. The proposed treaty provides that, subject to certain rules and exceptions, interest and most types of royalties derived by a resident of one country from sources within the other country may be taxed only by the residence country (Articles 11 and 12). Notwithstanding this general rule, the source country may impose tax on certain interest in an amount not to exceed 15 percent of the gross amount of such interest.

In situations in which the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the proposed treaty generally provides for relief from the potential double taxation through the allowance by the country of residence of a tax credit for certain foreign taxes paid to the other country (Article 23).

The proposed treaty contains the standard provision (the "saving clause") included in U.S. tax treaties pursuant to which each country retains the right to tax its residents and citizens as if the treaty had not come into effect (Article 1). In addition, the proposed treaty contains the standard provision providing that the treaty may not be applied to deny any taxpayer any benefits to which the taxpayer would be entitled under the domestic law of a country or under any other agreement between the two countries (Article 1).

The proposed treaty (Articles 19 and 20) generally provides that students, business trainees, teachers, professors, and researchers visiting the other treaty country are exempt from host country taxation on certain types of payments received.

The proposed treaty provides authority for the two countries to resolve disputes (Article 25) and exchange information (Article 26) in order to carry out the provisions of the proposed treaty.

The proposed treaty also contains a detailed limitation-on-benefits provision that reflects the anti-treaty-shopping provisions included in the United States Model Income Tax Convention of November 15, 2006 (the "U.S. Model treaty") and more recent U.S. income tax treaties. The new rules are intended to prevent the inappropriate use of the treaty by third-country residents (Article 22).

The provisions of the proposed treaty will have effect generally on or after the first day of January following the date that the proposed treaty enters into force. However, with respect to withholding taxes (principally dividends, interest and royalties), the proposed treaty has effect for amounts paid or credited on or after the first day of the second month following the date on which the proposed treaty enters into force.

The proposed treaty replaces the existing treaty (signed in 1979). The rules of the proposed treaty generally are similar to rules of recent U.S. income tax treaties, the U.S Model treaty,[3] and the 2010 Model Convention on Income and on Capital of the Organisation for Economic Cooperation and Development (the "OECD Model treaty"). However, the proposed treaty contains certain substantive deviations from these treaties and models. These deviations are noted throughout the explanation of the proposed treaty in Part V of this pamphlet.

[3] For a comparison of the U.S. Model treaty with its 1996 predecessor, *see* Joint Committee on Taxation, *Comparison of the United States Model Income Tax Convention of September 20, 1996 with the United States Model Income Tax Convention of November 15, 2006* (JCX-27-07), May 8, 2007.

II. OVERVIEW OF U.S. TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND U.S. TAX TREATIES

This overview briefly describes certain U.S. tax rules relating to foreign income and foreign persons that apply in the absence of a U.S. tax treaty. This overview also discusses the general objectives of U.S. tax treaties and describes some of the modifications to U.S. tax rules made by treaties.

A. U.S. Tax Rules

The United States taxes U.S. citizens, residents, and corporations on their worldwide income, whether derived in the United States or abroad. The United States generally taxes nonresident alien individuals and foreign corporations on all of their income that is effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "effectively connected income"). The United States also taxes nonresident alien individuals and foreign corporations on certain U.S.-source income that is not effectively connected with a U.S. trade or business.

Income of a nonresident alien individual or foreign corporation that is effectively connected with the conduct of a trade or business in the United States generally is subject to U.S. tax in the same manner and at the same rates as income of a U.S. person. Deductions are allowed to the extent that they are related to effectively connected income. A foreign corporation also is subject to a flat 30-percent branch profits tax on its "dividend equivalent amount," which is a measure of the effectively connected earnings and profits of the corporation that are removed in any year from the conduct of its U.S. trade or business. In addition, a foreign corporation is subject to a flat 30-percent branch-level excess interest tax on the excess of the amount of interest that is deducted by the foreign corporation in computing its effectively connected income over the amount of interest that is paid by its U.S. trade or business.

U.S.-source fixed or determinable annual or periodical income of a nonresident alien individual or foreign corporation (including, for example, interest, dividends, rents, royalties, salaries, and annuities) that is not effectively connected with the conduct of a U.S. trade or business is subject to U.S. tax at a rate of 30 percent of the gross amount paid. Certain insurance premiums earned by a nonresident alien individual or foreign corporation are subject to U.S. tax at a rate of one or four percent of the premiums. These taxes generally are collected through withholding. Certain payments of U.S.-source income paid to foreign financial institutions and other foreign entities are also subject to withholding tax at a rate of 30 percent unless the foreign financial institution or foreign entity is compliant with specific reporting requirements.

Specific statutory exemptions from the 30-percent withholding tax are provided. For example, certain original issue discount and certain interest on deposits with banks or savings institutions are exempt from the 30-percent withholding tax. An exemption also is provided for certain interest paid on portfolio debt obligations. In addition, income of a foreign government or international organization from investments in U.S. securities is exempt from U.S. tax.

U.S.-source capital gains of a nonresident alien individual or a foreign corporation that are not effectively connected with a U.S. trade or business generally are exempt from U.S. tax, with two exceptions: (1) gains realized by a nonresident alien individual who is present in the United States for at least 183 days during the taxable year, and (2) certain gains from the disposition of interests in U.S. real property.

Rules are provided for the determination of the source of income. For example, interest and dividends paid by a U.S. resident or by a U.S. corporation generally are considered U.S.-source income. Conversely, dividends and interest paid by a foreign corporation generally are treated as foreign-source income. Notwithstanding this general rule that dividends and interest are sourced based upon the residence of the taxpayer making such a payment, special rules may apply in limited circumstances to treat as foreign source certain amounts paid by a U.S. resident taxpayer and treat as U.S. source certain amounts paid by a foreign resident taxpayer.[4] Rents and royalties paid for the use of property in the United States are considered U.S.-source income.

Because the United States taxes U.S. citizens, residents, and corporations on their worldwide income, double taxation of income can arise when income earned abroad by a U.S. person is taxed by the country in which the income is earned and also by the United States. The United States seeks to mitigate this double taxation generally by allowing U.S. persons to credit foreign income taxes paid against the U.S. tax imposed on their foreign-source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax liability on U.S.-source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets only the U.S. tax on foreign-source income. The foreign tax credit limitation generally is computed on a worldwide basis (as opposed to a "per-country" basis). The limitation is applied separately for certain classifications of income. In addition, a special limitation applies to credits for foreign taxes imposed on foreign oil and gas extraction income and foreign oil related income.

For foreign tax credit purposes, a U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and receives a dividend from the foreign corporation (or is otherwise required to include in its income earnings of the foreign corporation) is deemed to have paid a portion of the foreign income taxes paid by the foreign corporation on its accumulated earnings. The taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid and its foreign tax credit limitation calculations for the year in which the dividend is received.

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[4] For tax years beginning before January 1, 2011, all (or a portion) of a payment of interest by a resident alien individual or domestic corporation was treated as foreign source if such individual or corporation met an 80-percent foreign business requirement. Although this provision was generally repealed for tax years beginning after December 31, 2010, other rules still apply to treat certain payments of interest by a foreign bank branch or foreign thrift branch of a domestic corporation or partnership as foreign source. Similarly, several rules apply to treat as U.S. source certain payments made by a foreign resident. For example, certain interest paid by a foreign corporation that is engaged in a U.S. trade or business at any time during its taxable year or has income deemed effectively connected with a U.S. trade or business during such year is treated as U.S. source.

B. U.S. Tax Treaties

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. Another related objective of U.S. tax treaties is the removal of the barriers to trade, capital flows, and commercial travel that may be caused by overlapping tax jurisdictions and by the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal. To a large extent, the treaty provisions designed to carry out these objectives supplement U.S. tax law provisions having the same objectives; treaty provisions modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty partner.

The objective of limiting double taxation generally is accomplished in treaties through the agreement of each country to limit, in specified situations, its right to tax income earned within its territory by residents of the other country. For the most part, the various rate reductions and exemptions agreed to by the country in which income is derived (the "source country") in treaties are premised on the assumption that the country of residence of the taxpayer deriving the income (the "residence country") may tax the income at levels comparable to those imposed by the source country on its residents. Treaties also provide for the elimination of double taxation by requiring the residence country to allow a credit for taxes that the source country retains the right to impose under the treaty. In addition, in the case of certain types of income, treaties may provide for exemption by the residence country of income taxed by the source country.

Treaties define the term "resident" so that an individual or corporation generally will not be subject to tax as a resident by both of the countries. Treaties generally provide that neither country may tax business income derived by residents of the other country unless the business activities in the taxing jurisdiction are substantial enough to constitute a permanent establishment or fixed base in that jurisdiction. Treaties also contain commercial visitation exemptions under which individual residents of one country performing personal services in the other are not required to pay tax in that other country unless their contacts exceed certain specified minimums (for example, presence for a set number of days or earnings in excess of a specified amount). Treaties address the taxation of passive income such as dividends, interest, and royalties from sources within one country derived by residents of the other country either by providing that the income is taxed only in the recipient's country of residence or by reducing the rate of the source country's withholding tax imposed on the income. In this regard, the United States agrees in its tax treaties to reduce its 30-percent withholding tax (or, in the case of some income, to eliminate it entirely) in return for reciprocal treatment by its treaty partner. In particular, under the U.S. Model treaty and many U.S. tax treaties, source-country taxation of most payments of interest and royalties is eliminated, and, although not provided for in the U.S. Model treaty, many recent U.S. treaties forbid the source country from imposing withholding tax on dividends paid by an 80-percent owned subsidiary to a parent corporation organized in the other treaty country.

In its treaties, the United States, as a matter of policy, generally retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect. The United States also provides in its treaties that it allows a credit against U.S. tax for income taxes paid to the treaty partners, subject to the various limitations of U.S. law.

The objective of preventing tax avoidance and evasion generally is accomplished in treaties by the agreement of each country to exchange tax-related information. Treaties generally provide for the exchange of information between the tax authorities of the two countries when the information is necessary for carrying out provisions of the treaty or of their domestic tax laws. The obligation to exchange information under the treaties typically does not require either country to carry out measures contrary to its laws or administrative practices or to supply information that is not obtainable under its laws or in the normal course of its administration or that would reveal trade secrets or other information the disclosure of which would be contrary to public policy. Several recent treaties and protocols provide that, notwithstanding the general treaty principle that treaty countries are not required to take any actions at variance with their domestic laws, a treaty country may not refuse to provide information requested by the other treaty country simply because the requested information is maintained by a financial institution, nominee, or person acting in an agency or fiduciary capacity. This provision thus explicitly overrides bank secrecy rules of the requested treaty country. The Internal Revenue Service (the "IRS") and the treaty partner's tax authorities also can request specific tax information from a treaty partner. These requests can include information to be used in criminal investigations or prosecutions.

Administrative cooperation between countries is enhanced further under treaties by the inclusion of a "competent authority" mechanism to resolve double taxation problems arising in individual cases and, more generally, to facilitate consultation between tax officials of the two governments. Several recent treaties also provide for mandatory arbitration of disputes that the competent authorities are unable to resolve by mutual agreement.

Treaties generally provide that neither country may subject nationals of the other country (or permanent establishments of enterprises of the other country) to taxation more burdensome than the tax it imposes on its own nationals (or on its own enterprises). Similarly, in general, neither treaty country may discriminate against enterprises owned by residents of the other country.

At times, residents of countries that do not have income tax treaties with the United States attempt to use a treaty between the United States and another country to avoid U.S. tax. To prevent third-country residents from obtaining treaty benefits intended for treaty country residents only, treaties generally contain "anti-treaty shopping" provisions designed to limit treaty benefits to bona fide residents of the two countries.

III. OVERVIEW OF TAXATION IN HUNGARY[5]

A. National Income Taxes

Overview

Hungary imposes a national income tax on individuals and corporations. In addition, Hungarian municipalities may impose a business tax at a rate of up to two percent on sole proprietors and corporate taxpayers that have their legal seat or permanent establishment located in the municipality. The Hungarian tax year is the calendar year, although corporate taxpayers may elect a fiscal year under the accounting law in certain circumstances. If such an election is made, the fiscal year also applies for corporate income tax purposes. Hungarian tax law includes a general anti-avoidance provision that allows tax authorities to disregard the form of a transaction in favor of its actual substance. An abuse of law doctrine also exists that permits tax authorities to look at all relevant facts and circumstances to assess tax liabilities resulting from transactions determined to have the sole purpose of avoiding the tax law.

Individuals

Individuals resident in Hungary are generally subject to tax on their worldwide income. An individual is generally considered a resident if he or she is (1) a Hungarian citizen, (2) a foreign citizen with a Hungarian residence permit, (3) a citizen of a country in the European Economic Area other than Hungary that spends more than 183 days in Hungary in a calendar year, (4) a foreign citizen with a permanent home exclusively in Hungary, or (5) a foreign citizen with no permanent home in Hungary, or with a permanent home in another country in addition to a permanent home in Hungary, if (a) the person's center of vital interests is in Hungary, or (b) if the person's center of vital interests cannot be determined, his or her habitual abode is in Hungary (for example, he or she spends more than 183 days in Hungary in a calendar year).

Gross income is divided between the consolidated tax base (for example, employment income, including benefits in kind, and income from independent personal services) and separately taxable income (for example, dividends, interest, and capital gains). There is a gross up of employment income to reflect social security or health care contributions made by employers. In 2011, the gross up is 27 percent, while in 2012 the gross up is reduced to 13.5 percent. Starting in 2013, the gross up is eliminated. Tax-exempt income includes pension income, certain scholarships, and certain allocations for childcare. In general, an employee may not deduct expenses related to his or her work, although reimbursements of substantiated expenses are exempt from tax. All income (including grossed-up employment income) is taxed at a flat 16 percent rate.

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[5] The information in this section relates to foreign law and is based on the staff of the Joint Committee on Taxation's review of publicly available secondary sources, including in large part Antal Gábor, International Bureau of Fiscal Documentation, IBFD European Taxation Database, Hungary (hereinafter IBFD Hungary, Country Survey), available at http://checkpoint.riag.com (last accessed May 2, 2011). The description is intended to serve as a general overview; it may not be fully accurate in all respects, as many details have been omitted and simplifying generalizations made for ease of exposition.

Business income is generally treated as income from independent personal services and included in the consolidated tax base. Unlike with employment income, deductions are generally allowed for expenses associated with the business income. Certain business income of sole proprietors is treated as entrepreneurial income and taxed under a separate regime. Amounts withdrawn from a business qualifying for this separate regime and used to compensate the entrepreneur for his or her personal services are taxed as part of the consolidated tax base and not under the separate regime. Under the entrepreneurial income tax regime, tax is imposed at a 10-percent rate on the first HUF 500 million ($2,403,164) of income, and at a 19-percent rate on any excess.[6] Taxable income is calculated as the difference between gross income and related expenses, including amounts paid to the entrepreneur for his or her personal services. Losses may not be carried back, but may be carried forward indefinitely. Instead of deducting actual expenses, entrepreneurs who are not employed and whose income does not exceed HUF 15 million ($72,095), or HUF 100 million ($480,633) in the case of retail traders, may elect to determine their gross income by taking a notional deduction for expenses that varies from 40 to 94 percent of gross income depending on the type of activity in which the entrepreneur engages. An entrepreneurial dividend tax is also payable. As an alternative to the entrepreneurial income tax regime, entrepreneurs may elect the application of a simplified tax regime available for small businesses, which is described in more detail below.

Capital gains from the disposition of property are generally taxable at the flat 16-percent rate noted above. A reduced rate of 10 percent applies to capital gains realized on the disposition of certain investments held for more than three years. Exemptions exist for capital gains realized on the disposition of certain investments held for more than five years as well as real property the proceeds of which are used to purchase retirement property for the seller or his or her relatives.

Tax relief is provided in the form of allowances and credits. For example, the tax base is reduced by a family allowance equal to HUF 62,500 ($300) per child per month for families with one or two dependent children and HUF 206,250 ($991) per child per month for families with three or more dependent children. Additional relief is provided in the form of a wage tax credit equal to 16 percent of salary, with the credit capped at HUF 12,100 ($58) per month. The credit is available in full for annual incomes of up to HUF 2.75 million ($13,217), with a decreased amount available for incomes of up to HUF 3.96 million ($19,033).

Corporations

Corporations resident in Hungary are generally subject to a corporate tax on their worldwide income. An entity is considered a resident of Hungary for corporate income tax purposes if it is incorporated under Hungarian law or has its place of management in Hungary. Partnerships are treated as corporations for tax purposes. The corporate income tax is imposed at a 10-percent rate on the first HUF 500 million ($2,403,164) of income, and at a 19-percent rate on any excess. Beginning in 2013, the corporate tax rate will be a flat 10 percent on all income.

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[6] Except where otherwise indicated, the quoted tax rates and threshold amounts apply in 2011. U.S. dollar equivalents were calculated using the currency rate for January 1, 2011, according to OANDA's FX Converter, available at http://www.oanda.com.

Special surtaxes at varied rates apply for 2011 and 2012 to activities in the energy, retail, telecommunications, and financial sectors.

In general, taxable income is determined by making certain adjustments to the pretax profits shown on a corporation's financial statements prepared in accordance with the accounting rules. Under those rules, all expenses directly related to the operation of the business, including compensation, interest, depreciation, amortization, and royalties, are generally deductible. However, certain expenses such as dividends, interest in excess of thin-capitalization limits, and certain fines and penalties are not deductible. If a corporation does not make a profit, it must pay a minimum corporate tax unless it files a form showing its cost structure. The minimum corporate tax equals two percent of the corporation's gross revenue. Losses may not be carried back, but a taxpayer may elect to carry forward losses indefinitely and use them to offset future income. Capital gains are generally included in income, but gains from the disposal of stock in certain subsidiaries in which the corporation has owned at least a 30-percent interest for one year are exempt. Capital losses may be deducted in the same manner as ordinary losses. Dividends, as well as 50 percent of royalties, received by corporations are exempt from tax.

An elective simplified tax regime is available for small businesses, defined as those with annual revenue not in excess of HUF 25 million ($120,158). This simplified regime is available to limited liability companies, general and limited partnerships, sole proprietors, and certain other business forms. The business must be owned exclusively by individuals and may not own an interest in any corporation (except publicly traded shares). Under the regime, the business is taxed at a flat 30-percent rate on its annual revenue in lieu of having to pay the corporate income tax, the personal income tax, and the value added tax ("VAT"). Thus, individual owners of businesses that elect this regime are exempt from tax on any dividends received from the business.

B. International Aspects

<u>Individuals</u>

Individuals who are residents of Hungary are generally taxed on their worldwide income. Nonresidents are subject to tax only on certain Hungarian-source income, including business profits derived from a permanent establishment in Hungary, income derived from employment and independent personal services performed in Hungary, and income from the use of real and intangible property in Hungary. A final withholding tax applies to dividends at a rate of 16 percent. There is generally no withholding tax applicable to interest and royalties paid to a nonresident individual.

<u>Corporations</u>

Corporations resident in Hungary are generally taxed on their worldwide income. Nonresident corporations are generally subject to tax only upon income derived through a branch or permanent establishment in Hungary. The taxable income of a branch or permanent establishment is calculated in the same manner as a resident corporation. Thus, the first HUF 500 million ($2,403,164) taxable income is currently taxed at a rate of 10 percent, with amounts above that limit taxed at a 19-percent rate. Beginning January 1, 2013, the tax rate will be a flat 10 percent on all income.

In addition, nonresident corporations without branches or permanent establishments in Hungary may be subject to tax on certain Hungarian-source income if they own Hungarian real estate holding companies. A Hungarian real estate holding company is any nonpublicly traded resident corporation or nonresident corporation with a branch or permanent establishment in Hungary if more than 75 percent of its assets consist of Hungarian real estate.

Hungarian-source dividends paid to nonresident corporations are not subject to withholding tax. Similarly, there is no withholding tax on Hungarian-source interest and royalties paid to nonresident corporations.

In general, dividends received by a Hungarian corporation from a foreign subsidiary are not taxable. However, dividends received from controlled foreign corporations are taxable. In addition, payments to controlled foreign corporations are generally not deductible. A foreign corporation is a controlled foreign corporation if (1) a 10-percent or greater interest in the corporation is held, directly or indirectly, by at least one Hungarian resident individual for more than half the days of the taxable year, (2) the corporation's effective corporate tax rate in its jurisdiction of residence is less than 10 percent, and (3) the corporation (a) is resident in a country that is not a member of the European Union or the OECD and that has not entered into a tax treaty with Hungary, or (b) does not have a real economic presence in its country of residence.

<u>Transfer pricing</u>

The transfer pricing rules generally follow OECD guidelines and require that transactions between related parties must occur at arm's-length prices.

Relief from double taxation

In general, double taxation relief is provided in the form of a tax credit available for foreign taxes paid on foreign-source income. The tax credit is limited to 90 percent of the foreign taxes paid and may not exceed the Hungarian tax liability.

C. Other Taxes

Inheritance and gift taxes

Hungary imposes a tax on the transfer of property located in Hungary pursuant to an estate, a legacy or will, an acquisition of a legal share of an estate, and donation in the event of death. The tax also applies to moveable property (and rights with respect to moveable property) located outside Hungary that is inherited by a Hungarian resident, but only when no inheritance tax is imposed abroad. The rate of tax varies depending on whether the recipient is a spouse, sibling, or other individual. The rate also varies depending on the value of the property received and whether that property is residential property (or rights with respect to residential property) or other property. The total variation is between 2.5 percent and 40 percent. Exemptions are available for persons who are descendants or ascendants of the deceased.

A tax is imposed on gifts of real property (and rights with respect to real property) located in Hungary. The tax also applies to gifts of moveable property (and rights with respect to moveable property) worth more than HUF 150,000 ($721) if the physical transfer occurs in Hungary. The tax is imposed at rates that vary between five percent and 40 percent using the same considerations as above. Exemptions are available for persons who are descendants or ascendants of the donor.

Social security taxes

Employers are required to pay a social security tax at a 27-percent rate on employees' gross wages (including benefits in kind), which is used to fund pension and health insurance programs. In addition, employers must pay a tax equal to 1.5 percent of employees' gross wages to fund a vocational training fund. A health care tax is imposed on payers of income that is not subject to the social security tax, with the rate of tax being either 14 percent or 27 percent depending on the type of income.

Employees must also pay social security taxes. In general, employees must pay a health insurance tax equal to 7.5 percent of their wages and a pension insurance tax equal to 10 percent of their wages. The employee's pension contribution base is capped at HUF 7.665 million ($36,841) per year.

Indirect taxes

Hungary imposes a VAT on the supply (including importation) of goods and services on a regular basis for profit. Small businesses, defined as those with an annual revenue less than HUF 5 million ($24,032) may elect to be exempt from accounting for VAT. The VAT is levied at each stage of the economic chain on the total consideration received (excluding the VAT) by the supplier, with either a deduction by the supplier or a refund by the tax authorities for the VAT paid by the supplier on purchases of goods and services. The generally applicable rate is 25 percent, while reduced rates of five and 18 percent apply to certain goods and services, including books, pharmaceuticals, food, and hotel services. Exemptions exist for transactions relating to financial services, health care services, rental of real property, and education. In addition, exported goods and services are exempt from the VAT.

There is a tax on the transfer of real property (and rights with respect to real property) by the transferee. The basic rate is four percent on the first HUF 1 billion ($4,806,329) of fair market value, capped at HUF 200 million ($961,266) per real estate asset. Exemptions and special rates are available for certain transactions.

IV. THE UNITED STATES AND HUNGARY: CROSS-BORDER INVESTMENT AND TRADE

A. Introduction

A principal rationale for negotiating tax treaties is to improve the business climate for businesses in one country that aspire to sell goods and services to customers in the other country and to improve the investment climate for investors in one country who aspire to own assets in the other country. Clarifying the application of the two nations' income tax laws makes more certain the tax burden that arises from different transactions, but may also increase or decrease that burden. If there is, or where there is the potential to be, substantial cross-border trade or investment, changes in the tax structure applicable to the income from trade and investment have the potential to alter future flows of trade and investment. Therefore, in reviewing the proposed treaty it may be beneficial to examine the cross-border trade and investment between the United States and Hungary. Whether measured by trade in goods or services or by direct and non-direct cross-border investment, the United States and Hungary engage in significant cross-border activity. The income from cross-border trade and investment generally is subject to income tax in either the United States or Hungary and in many cases the income is subject both to gross basis withholding taxes in the source country and net basis income tax in the residence country (before possible elimination of one country's tax under the proposed treaty).

B. Overview of International Transactions Between the United States and Hungary

Cross-border trade

The current account consists of three primary components: trade in goods; trade in services; and payment of income on assets invested abroad. While detail regarding the balance of payments between the United States and Hungary is not publicly available, one can document the value of trade between the United States and Hungary. In 2009, the United States exported $1.2 billion of merchandise to Hungary and imported $2.2 billion in merchandise from Hungary. This made Hungary the United States' 68th largest merchandise export destination and the 57th largest source of imported merchandise.[7]

Trade in services includes: transportation of goods; travel by persons and passenger fares; professional services such as management consulting, architecture, engineering, and legal services; financial services; insurance services; computer and information services; and film and television tape rentals. Also included in receipts for services are the returns from investments in intangible assets in the form of royalties and license fees. In 2005, U.S. parent businesses received approximately $67 million in royalty and license fees from their affiliates in Hungary. In 2005, U.S. affiliates paid a negligible amount in royalties and license fees to their parents in Hungary.[8]

Cross-border investment

Income from foreign assets is categorized as income from "direct investments" and income from "non-direct investments." Direct investment constitutes assets over which the owner has direct control. The U.S. Department of Commerce defines an investment as direct when a single person owns or controls, directly or indirectly, at least 10 percent of the voting securities of a corporate enterprise or the equivalent interest in an unincorporated business. Often the income that crosses borders from direct investments is in the form of dividends from a subsidiary to a parent corporation, although interest on loans between such related corporations is another source of income from a direct investment. In non-direct investments the investor generally does not have control over the assets that underlie the financial claims. Non-direct investments consist mostly of holdings of corporate equities and corporate and government bonds, generally referred to as "portfolio investments," and bank deposits and loans. Hence, the income from non-direct investments generally is interest or dividends.

In 2008, U.S. persons held direct investments in Hungary valued at $7.7 billion on a historic cost basis[9] and persons from Hungary held direct investments in the United States valued

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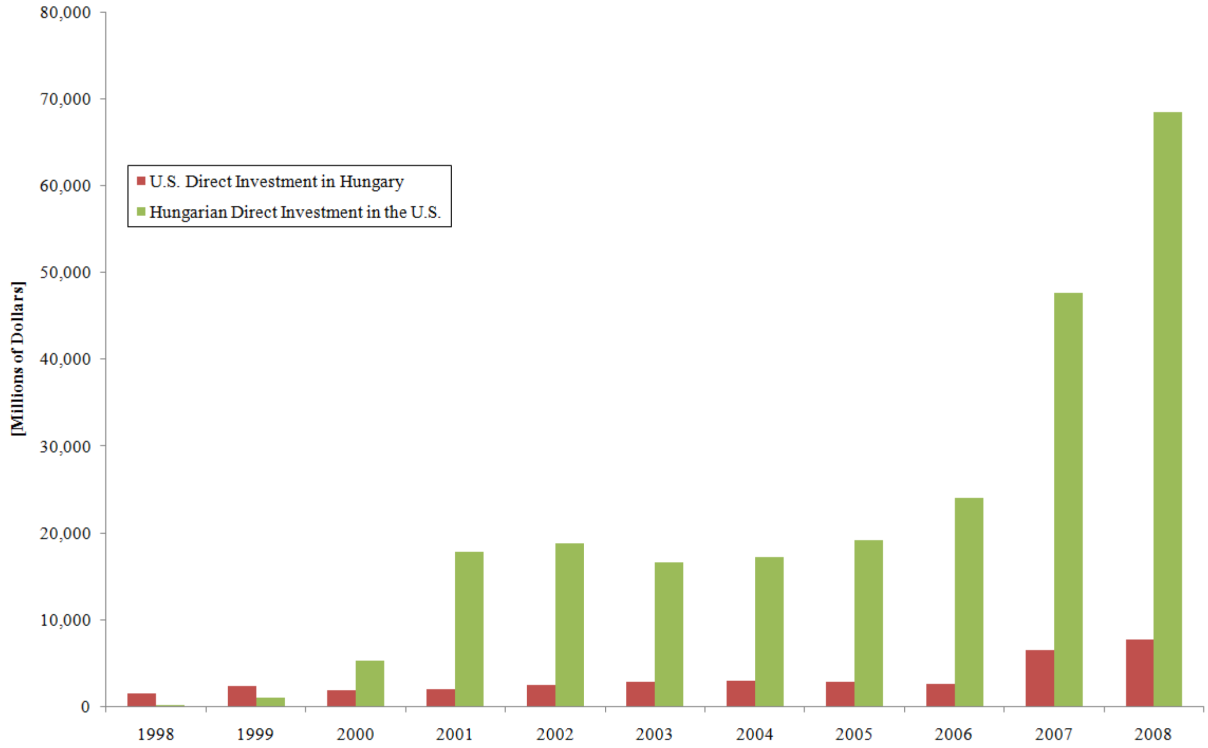
[7] Bureau of Economic Analysis, U.S. Department of Commerce, "U.S. International Trade in Goods and Services, Annual Revision for 2009," June 10, 2010.

[8] Bureau of Economic Analysis, U.S. Department of Commerce, "International Economic Accounts," www.bea.gov/international, February 2010.

[9] The Bureau of Economic Analysis prepares detailed estimates of direct investment by country and industry on an historical cost basis only. Thus, the estimates reported reflect price levels of earlier periods. For

at $68.4 billion.[10] Figure 1, below, documents the value in U.S. direct investment in Hungary and direct investment by Hungarians in the United States on an historical cost basis at year-end for 1998 through 2008.

Figure 1. Value of U.S. Direct Investment in Hungary and Hungarian Direct Investment in the U.S. on an Historical Cost Basis, 1998-2008 [Millions of Dollars]



Source: Bureau of Economic Analysis, U.S. Department of Commerce, February 2011.

U.S. direct investments in Hungary produced approximately $1.2 billion in income to U.S. persons in 2007. Hungarian direct investments in the United States produced approximately $2.1 billion in income to Hungarian persons in 2007. Figure 2, below, details income from U.S. direct investments in Hungary and direct investments by Hungarians in the United States for the period 1998-2008. Measured in real (inflation-adjusted) dollars, income earned by U.S. persons from direct investments in Hungary has increased since 1998. Over the same period, direct investments in the U.S. have also produced increasing income for Hungarian persons.

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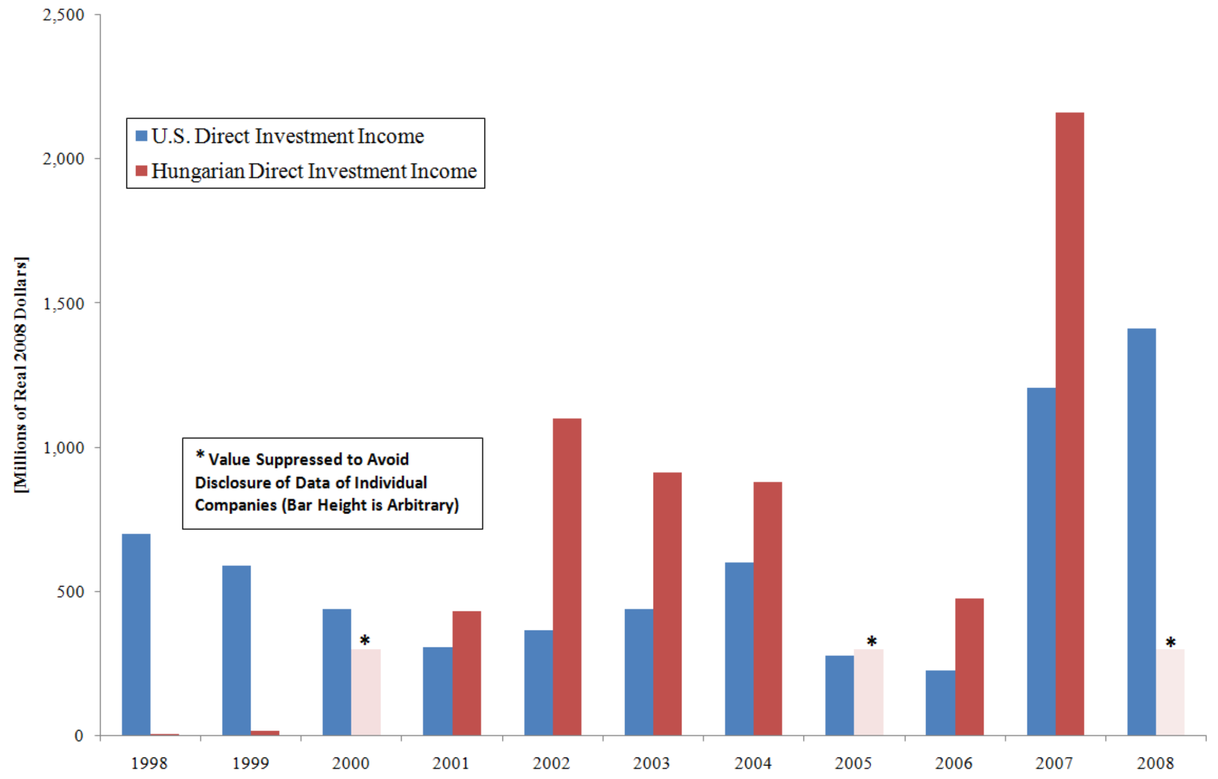
estimates of aggregate direct investment the Bureau of Economic Analysis also produces current-cost and market value estimates.

[10] Jeffrey Lowe, "Direct Investment 2007-2009: Detailed Historical-Cost Positions and Related Capital and Income Flows," vol. 90, *Survey of Current Business,* September 2010.

Figure 2.-Income From U.S. Direct Investments in Hungary and Hungarian Direct Investments in the U.S., 1998-2008
[Millions of Real 2008 Dollars]



Source: Bureau of Economic Analysis, U.S. Department of Commerce, February 2011.

The data presented above do not report the amount of U.S. or Hungarian portfolio investments or holdings of stocks and bonds (including holdings of U.S. government securities). The Bureau of Economic Analysis generally reports portfolio holdings by country only for the several largest portfolio investment countries.

C. Income Taxes and Withholding Taxes on Cross-Border Income Flows

The data presented above report the amount of direct investment in Hungary by U.S. persons and the amount of direct investment in the United States by Hungarian persons. Data from tax returns reflect the magnitude of cross-border investment and trade and income flows reported above.[11] U.S. corporations, including U.S. parent companies of Hungarian controlled foreign corporations, reported the receipt of $396 million of dividends from Hungary corporations in 2006.[12] Of the $396 million in dividends reported, approximately $29 million reflected the grossed-up value of net dividends to account for deemed taxes paid to Hungary. U.S. corporations recognized about $569.9 million in taxable income originating in Hungary, including the dividend amounts just cited. This income was subject to an average Hungarian corporate income tax rate of approximately 5.8 percent (after allowing for apportionment and allocation of certain expenses incurred in the United States).

Data for withholding taxes from 2007 show that the United States collected approximately $56.1 million through withholding of taxes on payments to Hungary.[13] Data on withholding taxes may not be an accurate indicator of cross-border investment and income flows, however, because a taxpayer can often control the amount and timing of tax paid, and since withholding tax is only paid when dividends are repatriated to the home country.

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[11] The data reported below are classified according to the geographical location of the direct payor and may not capture the full extent of tiered activity.

[12] Nuria E. McGrath, "Corporate Foreign Tax Credit, 2006," *Statistics of Income Bulletin*, Summer 2010, pp. 118-171.

[13] Scott Lutrell, "Foreign Recipients of U.S. Income, 2007," *Statistics of Income Bulletin*, Winter 2010, pp. 115-128.

D. Analyzing the Economic Effects of Income Tax Treaties

Tax treaties often change both the amount and timing of income taxes and the country (source or residence) that has priority to impose such taxes. If the tax treaty changes increase the after-tax return to cross-border trade and investment, or to particular forms of trade or investment, in the long run there could be significant economic effects. Generally, to the extent a treaty reduces barriers to capital and labor mobility, more efficient use of resources results and economic growth in both countries is enhanced, although there may be negative transitional effects occurring in specific industries or geographic regions. On the other hand, tax treaties may also lead to tax base erosion if they create new opportunities for tax arbitrage. Tax treaties also often increase and improve information sharing between tax authorities. Improvements in information sharing and the limitation on benefits provision should reduce the potential for outright evasion of U.S. and Hungary income tax liabilities.

Generally, a treaty-based reduction in withholding rates directly reduces U.S. tax collections in the near term on payments from the United States to foreign persons, but increases U.S. tax collections on payments from foreign persons to the United States because of the reduction in foreign taxes that are potentially creditable against the U.S. income tax. To the extent that the withholding rate reduction encourages more income flows between the treaty parties, this initial dampening of collections on payments to foreign persons and related decrease in foreign tax credits begins to reverse. The proposed treaty's reductions in dividend withholding rates will reduce U.S. withholding tax collections on dividend payments from the United States to Hungary. Over the longer term, the withholding tax rate changes coupled with other changes in the proposed treaty are likely to cause small revenue increases in later years as capital flows increase and from improved allocation of capital.

However, this simple analysis is incomplete. A complete analysis of a withholding change, or any other change in a treaty, would account for both tax and nontax related factors, such as portfolio capital needs in the affected countries, and the corresponding relation between current and financial accounts. The potential for future growth in each country is also an important determinant of cross-border investment decisions. In sum, even in the short run, the larger macroeconomic outlook, compared to treaty modifications, is likely to be a more important determinant of future cross-border income and investment flows and the related tax collections.

V. EXPLANATION OF PROPOSED TREATY

Article 1. General Scope

In general

The general scope article describes the persons who may claim the benefits of the proposed treaty. It also includes a "saving clause" provision similar to provisions found in most U.S. income tax treaties, and a special rule for fiscally transparent entities similar to that found in the U.S. Model treaty.

Who may claim treaty benefits

Paragraph 1 provides that the proposed treaty generally applies only to residents of the United States and to residents of Hungary. The determination of whether a person is a resident of the United States or Hungary is made under Article 4 (Resident) of the treaty. Certain provisions are applicable to persons who may not be residents of either treaty country. For example, paragraph 1 of Article 24 (Non-Discrimination) applies to nationals of the treaty countries. Under Article 26 (Exchange of Information), information may be exchanged with respect to residents of third states.

Relationship to U.S. law and other agreements

Paragraph 2 states the generally accepted relationships both between the proposed treaty and domestic law and between the proposed treaty and other agreements to which the United States and Hungary are parties. It provides that the proposed treaty generally does not restrict any benefit accorded by internal law or by any other agreement between the United States and Hungary. Consequently, the proposed treaty may not increase the tax burden of a resident of either the United States or Hungary beyond that determined under internal law.

Under the principles of paragraph 2, a taxpayer's U.S. tax liability need not be determined under the proposed treaty if the Code would produce a more favorable result. The Technical Explanation[14] states, however, that a taxpayer may not choose among the provisions of the Code and the proposed treaty in an inconsistent manner to minimize U.S. tax. The Technical Explanation includes an example illustrating this rule. In the example, a resident of Hungary has three separate businesses in the United States. One is a profitable permanent establishment and the other two are trades or businesses that would earn taxable income (or loss) under the Code but that do not meet the permanent establishment threshold tests of the proposed treaty. One is profitable and the other incurs a loss. Under the proposed treaty, the income of the permanent establishment is taxable in the United States, and both the income and loss of the other two businesses are ignored. Under the Code, all three would be subject to tax, but the loss would

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[14] Department of the Treasury Technical Explanation of the Convention Between the Government of the United States of America and the Government of the Republic of Hungary for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (hereinafter referred to as the "Technical Explanation").

offset the income of the two profitable ventures. The Technical Explanation states that the taxpayer may not invoke the proposed treaty to exclude the income of the profitable trade or business and invoke the Code to claim the loss of the loss trade or business against the income of the permanent establishment. However, if the taxpayer invokes the Code for the taxation of all three ventures, that taxpayer would not be precluded from invoking the proposed treaty in respect of, for example, any dividend income from the United States that is not effectively connected with any of the taxpayer's business activities in the United States.

Paragraph 3 of the proposed treaty specifically relates to non-discrimination obligations of the treaty countries under the General Agreement on Trade in Services (the "GATS"). The provisions of paragraph 3 are an exception to the rule provided in paragraph 2 under which the proposed treaty may not restrict any benefit accorded by any other agreement between the United States and Hungary.

Paragraph 3 provides that, unless the competent authorities determine that a taxation measure is not within the scope of Article 24 (Non-Discrimination) of the proposed treaty, the national treatment obligations of the GATS do not apply to that measure. Further, for purposes of paragraph 3 of Article 22 (Consultation) of the GATS, any question arising as to the interpretation or application of the proposed treaty, including whether a taxation measure is within the scope of the proposed treaty, is determined exclusively in accordance with the provisions of Article 25 (Mutual Agreement Procedure) of the proposed treaty. According to the Technical Explanation, the result under paragraph 3 of the proposed treaty is that paragraph 3 of Article 22 (Consultation) of the GATS may not be used to bring a dispute before the World Trade Organization unless the competent authorities of both treaty countries have determined that the relevant taxation measure is not within the scope of Article 24 (Non-Discrimination) of the proposed treaty.

Paragraph 3 provides that the term "measure" means a law, regulation, rule, procedure, decision, administrative action, or any similar provision or action.

Saving clause

Like all U.S. income tax treaties and the U.S. Model treaty, the proposed treaty includes a "saving clause" in paragraph 4. Under this clause, with specific exceptions described below, the proposed treaty does not affect the taxation by either treaty country of its residents and citizens. By reason of this saving clause, subject to the exceptions described below, either treaty country may continue to tax its residents and its citizens who are residents of the other treaty country as if the treaty were not in force.

Paragraph 4 generally also allows the United States to tax, in accordance with the laws of either treaty country, a former citizen or former long-term resident for a period of ten years following the loss of citizenship or long-term resident status.

The United States defines "long-term resident" as an individual (other than a U.S. citizen) who was a lawful permanent resident of the United States in at least eight of the 15 taxable years ending with the taxable year in which the individual ceased to be a long-term resident. An individual is not treated as a lawful permanent resident for any taxable year in which the individual is treated as a resident of Hungary under the proposed treaty, or as a resident of any country other than the United States under the provisions of any other tax treaty of the United States, and, in either case, the individual does not waive the benefits of the relevant treaty.

Section 877 of the Code provides special rules for the imposition of tax on certain individuals who expatriate (that is, U.S. citizens and long-term residents who relinquish their citizenship or cease to be long-term residents) before June 17, 2008. Under section 877, those taxpayers are subject to U.S. tax for a period of ten years on both their U.S.-source income (including deemed U.S.-source income), and their foreign-source income that is effectively connected with the conduct of a trade or business within the United States.

For any individual who expatriates on or after June 17, 2008, the Heroes Earnings Assistance and Relief Tax Act of 2008,[15] replaces section 877 with the mark-to-market regime provided in section 877A. In general, taxpayers who expatriate are treated as having sold all of their property on the day before the expatriation date for its fair market value.[16] However, at a taxpayer's election, the time for payment of additional tax attributable to any gain so recognized (but not realized) may be deferred until the taxpayer actually disposes of property deemed sold.[17] This election may be made only if the taxpayer irrevocably waives any right under any U.S. treaty that would preclude assessment or collection of the tax deferred by reason of the election.[18]

The proposed treaty's ten-year grant of taxing jurisdiction to the treaty country from which an individual has expatriated corresponds with the ten-year rule in section 877. However, for any individual who expatriates on or after June 17, 2008, section 877A requires the payment of tax after the ten-year period if that individual elects to defer payment of the section 877A tax and sells property after the ten-year period. In this circumstance, the individual will have been required, as a condition of making the election under section 877A, to waive the benefits of the proposed treaty's ten-year rule.

Paragraph 5 contains exceptions to the saving clause. The referenced provisions are intended to provide benefits to citizens and residents even if those benefits do not exist under internal law. Paragraph 5 thus preserves these benefits for citizens and residents of the treaty countries. Exceptions to the saving clause are provided for the following benefits conferred by the proposed treaty: the allowance of correlative adjustments when the profits of an associated enterprise are adjusted by the other country (Article 9, paragraph 2); exemption from source or resident state taxation for certain pension distributions and social security payments (Article 17, paragraphs 1(b), 2, and 3); relief from double taxation through the provision of a foreign tax credit or an exemption for income earned in the other state (Article 23); protection of residents

[15] Pub. L. No. 110-245, sec. 301 (June 17, 2008).

[16] Sec. 877A(a)(1).

[17] Sec. 877A(b)(1).

[18] Sec. 877A(b)(5).

and nationals of one country from discriminatory tax treatment in the other country (Article 24); and benefits under the mutual agreement procedures of the proposed treaty (Article 25).

The saving clause also does not apply to certain benefits conferred by the United States or Hungary upon individuals who are not citizens of, and have not been admitted for permanent residence in, the United States or Hungary. Under this set of exceptions to the saving clause, the specified treaty benefits are available to, for example, a citizen of Hungary who spends enough time in the United States to be taxed as a U.S. resident but who has not acquired U.S. permanent residence status (that is, does not hold a "green card"). The benefits that are covered under this set of exceptions are exemptions from host country taxation for certain income for government service (Article 18), certain income received by visiting students and trainees or professors and teachers (Articles 19 and 20), and certain income received by members of diplomatic missions and consular posts (Article 27).

Fiscally transparent entities

The proposed treaty contains special rules for fiscally transparent entities that are identical to those in the U.S. Model treaty. Under these rules, as explained in the Technical Explanation, income derived through an entity that is fiscally transparent under the laws of either treaty country is considered to be the income of a resident of one of the treaty countries only to the extent that the income is subject to tax in that country as the income of a resident. For example, if a Hungarian company pays interest to an entity that is treated as fiscally transparent for U.S. tax purposes, the interest will be considered to be derived by a resident of the United States only to the extent that U.S. tax laws treat one or more U.S. residents (whose status as U.S. residents is determined under U.S. tax laws) as deriving the interest income for U.S. tax purposes.

The Technical Explanation states that these rules for income derived through fiscally transparent entities apply in circumstances in which an entity is organized in the United States or Hungary. The Technical Explanation also states that these rules apply even if an entity organized in one treaty country is viewed differently under the tax laws of the other treaty country. As an example, the Technical Explanation states that income from U.S. sources received by an entity organized under the laws of the United States, which is treated for Hungarian tax purposes as a corporation and is owned by a Hungarian shareholder who is a Hungarian resident for Hungarian tax purposes, is not considered derived by the shareholder of that corporation even if, under the tax laws of the United States, the entity is treated as fiscally transparent. Rather, for purposes of the proposed treaty, the income is treated as derived by the U.S. entity.

The Technical Explanation generally defines fiscally transparent entities as entities that are not subject to tax at the entity level. Entities are not considered fiscally transparent if the entity tax may be relieved under an integrated system. For example, in the United States, a partnership, common investment trust under Code section 584, grantor trust, or limited liability company ("LLC") that is treated for tax purposes as a partnership or disregarded entity, is considered a fiscally transparent entity.

The Technical Explanation also states that the treatment of fiscally transparent entities is not an exception to the saving clause. As a result, a treaty country is not precluded from taxing an entity that is treated as a resident of that country under its tax laws. For example, if a U.S. LLC with Hungarian members elects to be taxed as a corporation for U.S. tax purposes, the United States will tax that LLC on its worldwide income on a net basis, without regard to whether Hungary views the LLC as fiscally transparent.

According to the diplomatic notes, the rules for fiscally transparent entities do not apply in respect of income received by an entity organized in a third country.

Article 2. Taxes Covered

The proposed treaty applies to all taxes on income irrespective of the manner in which they are levied, including taxes on gains from the alienation of property and on the total amounts of wages or salaries paid by enterprises, but excluding social security and unemployment taxes. In the case of Hungary, the proposed treaty applies to the personal income tax, the corporate tax, and the surtax. In the case of the United States, the proposed treaty applies to the Federal income taxes imposed by the Code (but excluding social security and unemployment taxes) and to the Federal excise taxes imposed with respect to private foundations.

The proposed treaty also applies to any taxes that are identical or substantially similar to the taxes described in the preceding paragraph and that are imposed after the signing of the proposed treaty in addition to or in place of existing taxes. This provision generally is found in U.S. income tax treaties. The proposed treaty obligates the competent authority of each treaty country to notify the competent authority of the other treaty country of any significant changes in its internal taxation laws.

Article 3. General Definitions

This article provides definitions of a number of terms for purposes of the proposed treaty. Certain of the standard definitions found in most U.S. income tax treaties are included in the article.

The article sets forth the geographical scope of the proposed treaty with respect to Hungary and the United States. In the case of Hungary, it encompasses the territory of the Republic of Hungary. In the case of the United States, it encompasses the United States of America, including the States and the District of Columbia, and the territorial sea thereof. It also includes the sea bed and the subsoil of the submarine areas adjacent to the territorial sea, over which the United States exercises sovereign rights in accordance with international law. The term does not include Puerto Rico, the Virgin Islands, Guam, or any other U.S. possession or territory.

The term "person" includes an individual, an estate, a trust, a partnership, a company, and any other body of persons.

The term "company" means a body corporate or any entity treated as a body corporate for tax purposes. The diplomatic notes state that the treaty countries understand that partnerships (betéti társaság, közkereseti társaság) established in Hungary are taxed by Hungary as corporations and therefore fall within the definition of "company."

The terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean, respectively, an enterprise carried on by a resident of one of the treaty countries and an enterprise carried on by a resident of the other treaty country. An enterprise of a Contracting State also includes an enterprise carried on by a resident of a treaty country through an entity that is treated as fiscally transparent in that treaty country.

The term "enterprise" applies to the carrying on of any business. The Technical Explanation clarifies that an enterprise of a treaty country need not be carried on in that country.

The terms "a Contracting State" and "the other Contracting State" mean the United States or Hungary, as the context requires.

The term "business" is not defined, but the proposed treaty provides that the term includes the performance of professional services and other activities of an independent character. According to the Technical Explanation, this provision is intended to clarify that income from the performance of professional services or other activities of an independent character is dealt with under Article 7 (Business Profits) and not Article 21 (Other Income).

The term "international traffic" means any transport by a ship or aircraft except when such transport is solely between places within a treaty country. This definition is applicable principally in the context of Article 8 (Shipping and Air Transport).

The article designates the "competent authorities" for Hungary and the United States. In the case of Hungary, the competent authority is the Minister of Finance or his authorized representative. The U.S. competent authority is the Secretary of the Treasury or his delegate. According to the Technical Explanation, the Secretary of the Treasury has delegated the competent authority function to the Commissioner of Internal Revenue, who in turn has delegated the authority to the Deputy Commissioner (International) Large Business and International ("LB&I").

The term "national" as applied to one of the two treaty countries means (1) an individual who possesses nationality of that treaty country, and (2) any legal person, partnership, association, or other entity deriving its status as such from the laws of that treaty country. This term is relevant for purposes of Articles 18 (Government Service) and 24 (Non-Discrimination). The diplomatic notes provide that, in the case of the United States, nationality includes citizenship.

The term "pension fund" means any person established in a treaty country that (1) is generally exempt from income taxation in that country and (2) operates principally to administer or provide pension or retirement benefits or to earn income for the benefit of one or more such persons.

Terms that are not defined in the proposed treaty are covered in paragraph 2. Paragraph 2 provides that in the application of the proposed treaty, any term not defined in the proposed treaty will have the meaning that it has under the law of the country whose tax is being applied, unless the context requires otherwise or the competent authorities have agreed on a different meaning under Article 24 (Mutual Agreement Procedure). If the term is defined under both the tax and non-tax laws of a treaty country, the definition in the tax law prevails.

Article 4. Resident

The assignment of a country of residence is important because the benefits of the proposed treaty generally are available only to a resident of one of the treaty countries as that term is defined in the proposed treaty. Issues arising because of dual residency, including situations of double taxation, may be avoided by the assignment of one treaty country as the country of residence when under the internal laws of the treaty countries a person is a resident of both countries.

Internal taxation rules

United States

Under U.S. law, the residence of an individual is important because a resident alien, like a U.S. citizen, is taxed on his or her worldwide income, while a nonresident alien is taxed only on certain U.S.-source income and on income that is effectively connected with a U.S. trade or business. An individual who spends sufficient time in the United States in any year or over a three-year period generally is treated as a U.S. resident. A permanent resident for immigration purposes (that is, a "green card" holder) also is treated as a U.S. resident.

Under U.S. law, a company is taxed on its worldwide income if it is a "domestic corporation." A domestic corporation is one that is created or organized in the United States or under the laws of the United States, a State, or the District of Columbia.

Hungary

An individual is generally considered a resident if he or she is (1) a Hungarian citizen, (2) a foreign citizen with a Hungarian residence permit, (3) a citizen of a country in the European Economic Area other than Hungary that spends more than 183 days in Hungary in a calendar year, (4) a foreign citizen with a permanent home exclusively in Hungary, or (5) a foreign citizen with no permanent home in Hungary, or with a permanent home in another country in addition to a permanent home in Hungary, if (a) the person's center of vital interests is in Hungary, or (b) if the person's center of vital interests cannot be determined, his or her habitual abode is in Hungary (for example, he or she spends more than 183 days in Hungary in a calendar year).

A company is considered to be resident in Hungary for corporate income tax purposes if either (1) it is incorporated in Hungary, or (2) has its place of management in Hungary.

Proposed treaty rules

Article 4 of the proposed treaty provides rules to determine whether a person is a resident of the United States or Hungary under the proposed treaty. The rules generally are consistent with the rules of the U.S. Model treaty.

The proposed treaty generally defines "resident of a Contracting State" to mean any person who, under the laws of that treaty country, is liable to tax therein by reason of the person's domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature. The term does not include any person who is liable for tax in that treaty country only on income from sources in that country or on profits attributable to a permanent establishment in that country. Accordingly, although not explicitly stated in the proposed treaty, an enterprise of Hungary with a permanent establishment in the United States does not become a resident of the United States as a result of its U.S. permanent establishment. Such an enterprise generally is liable to tax by the United States only on income attributable to its U.S. permanent establishment, not on its worldwide income.

The proposed treaty makes explicit the generally understood practice of including in the definition of "resident of a Contracting State" the two treaty countries and any political subdivisions or local authorities of those countries.

The proposed treaty provides a special rule to treat as residents of a treaty country certain legal entities that generally are exempt from tax in that country. The provision applies to a pension fund established in that state. In addition, the provision applies to an organization that is a resident of a treaty country under its laws and is established exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes.

The proposed treaty provides a series of tie-breaker rules to determine residence in the case of an individual who, under the basic residence definition, would be considered to be a resident of both countries. These tie-breaker rules are to be applied in the order in which they are described below. Under these rules, an individual is deemed to be a resident of the country in which he or she has a permanent home available. If the individual has a permanent home in both countries, the individual's residence is deemed to be the country with which his or her personal and economic relations are closer (that is, the individual's "center of vital interests"). If it cannot be determined in which country the individual has his or her center of vital interests, or if the individual does not have a permanent home available in either country, the individual is deemed to be a resident of the country in which he or she has a habitual abode. If the individual has a habitual abode in both countries or in neither country, the individual is deemed to be a resident of the country of which he or she is a national. If the individual is a national of both countries or of neither country, the competent authorities of the countries will endeavor to settle the question of residence by mutual agreement.

The proposed treaty also provides a tie-breaker rule for persons other than individuals (e.g., companies, trusts, or estates). If, under the general residence rules described above, a person other than an individual is a resident of both countries, the proposed treaty requires the competent authorities to endeavor to settle the issue of residence by mutual agreement. If the competent authorities are unable to reach mutual agreement, then that person will not be entitled to claim any benefits provided by the proposed treaty, except those provided by Article 24 (Non-Discrimination) and by Article 25 (Mutual Agreement Procedure).

A dual-resident company also may be treated as a resident of a treaty country for purposes other than obtaining benefits under the proposed treaty. For example, according to the Technical Explanation, if a dual-resident company pays a U.S.-source dividend to a resident of

Hungary, the tax on the dividend is limited to the treaty rate because the treaty reduction is a benefit of the resident of Hungary, not a benefit of the dual resident company. Moreover, information related to the dual-resident company may be exchanged because Article 26 (Exchange of Information) is not limited to residents of the treaty countries.

Fiscally transparent entities

The residence treatment of items of income, profit, or gain derived through fiscally transparent entities is addressed in paragraph 6 of Article 1 (General Scope) of the proposed treaty.

Article 5. Permanent Establishment

The proposed treaty contains a definition of the term "permanent establishment" that generally follows the language of other recent U.S. income tax treaties, the U.S. Model treaty, and the OECD Model treaty.

The permanent establishment concept is one of the basic devices used in income tax treaties to limit the taxing jurisdiction of the host country and thus to mitigate double taxation. Generally, an enterprise that is a resident of one country is not taxable by the other country on its business profits 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 apply, or whether those items of income will be taxed as business profits.

In general, under the proposed treaty, a permanent establishment is a fixed place of business in which the business of an enterprise is wholly or partly carried on. A permanent establishment includes a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry, or other place of extraction of natural resources. It also includes a building site or a construction or assembly project if the site or project lasts for more than 12 months, and includes an installation used for the exploration of natural resources if the activity continues in the treaty country for more than 12 months. The Technical Explanation states that the 12-month test applies separately to each individual site or project, with a series of contracts or projects that are interdependent both commercially and geographically treated as a single project. The Technical Explanation further states that if the 12-month threshold is exceeded, the site or project constitutes a permanent establishment as of the first day that work in the country began.

The proposed treaty provides that the following activities of a preparatory or auxiliary character are deemed not to constitute a permanent establishment: (1) the use of facilities solely for storing, displaying, or delivering goods or merchandise belonging to the enterprise; (2) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for storage, display, or delivery or solely for processing by another enterprise; and (3) the maintenance of a fixed place of business solely for the purchase of goods or merchandise or for the collection of information for the enterprise. The proposed treaty also provides that the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character does not constitute a permanent establishment. The proposed treaty further provides that a combination of these activities will not give rise to a permanent establishment if the combination results in an overall activity that is of a preparatory or auxiliary character.

Under the proposed treaty, if a person, other than an independent agent, is acting in a treaty country on behalf of an enterprise of the other country and has, and habitually exercises in such first country, the authority to conclude contracts in the name of such enterprise, the enterprise is deemed to have a permanent establishment in the first country in respect of any activities undertaken for that enterprise. This rule does not apply in cases in which the activities are limited to the activities described in the preceding paragraph that would not give rise to a permanent establishment if carried on by the enterprise through a fixed place of business. The Technical Explanation states that the language "in the name of that enterprise," which also appears in the OECD Model treaty, is intended to have the same meaning as "binding on the enterprise" found in the U.S. Model treaty. Both phrases are intended to encompass persons who have sufficient authority to bind the enterprise's participation in the business activity in the treaty country.

No permanent establishment is deemed to arise under the proposed treaty if the agent is a broker, general commission agent, or any other agent of independent status, provided that the agent is acting in the ordinary course of its business. The Technical Explanation states that whether an enterprise and an agent are independent is a factual determination, and that the relevant factors in making this determination include: (1) the extent to which the agent operates on the basis of instructions from the principal; (2) the extent to which the agent bears business risk; and (3) whether the agent has an exclusive or nearly exclusive relationship with the principal.

The proposed treaty provides that the fact that a company that is a resident of one country controls or is controlled by a company that is a resident of the other country or that carries on business in the other country does not cause either company to be a permanent establishment of the other. The Technical Explanation clarifies that, consistent with the U.S. Model treaty, such control is not taken into account in determining whether either company has a permanent establishment in the other treaty country.

Article 6. Income from Immovable Property (Real Property)

This article covers income from immovable property (real property). The rules governing gains from the sale of immovable property (real property) are included in Article 13 (Capital Gains). Under the proposed treaty, income derived by a resident of one country from immovable property (real property) situated in the other country may be taxed in that other country. This rule and, in general, the other rules of this article are consistent with the rules in the U.S. and OECD Model treaties.

The term "immovable property (real property)" generally has the meaning that it has under the law of the country in which the property in question is situated. According to the Technical Explanation, in the case of the United States, the term "real property" has the meaning given to it by Treas. Reg. section 1.897-1(b). The proposed treaty provides, however, that regardless of internal law definitions, immovable property (real property) also includes property accessory to immovable property (real property), including livestock and equipment used in agriculture and forestry; rights to which the provisions of general law respecting landed property apply; usufruct of immovable property (real property); and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources, and other natural resources. Ships, boats, and aircraft are not regarded as immovable property (real property).

The proposed treaty specifies that the country in which the property is situated also may tax income derived from the direct use, letting, or use in any other form of immovable property (real property). The rules permitting source-country taxation of income from immovable property (real property) also apply to the income from immovable property (real property) of an enterprise. However, the rules do not apply if the beneficial owner of the income, resident in one treaty country, has a permanent establishment in the other treaty country through which the beneficial owner carries on a business and the income from the immovable property (real property) is effectively connected with that permanent establishment. In such case, the provisions of Article 7 (Business Profits) apply.

The proposed treaty does not grant an exclusive taxing right to the country where the property is located; such country is merely given the primary right to tax. The proposed treaty also does not impose any limitation in terms of the rate or form of tax such country may impose. Furthermore, the proposed treaty provides that a taxpayer may elect to be taxed on a net basis in the country in which the real property is situated. By making this election, a taxpayer generally is able to obtain the same treatment in the country where the real (immovable) property is situated regardless of whether the income is treated as business profits attributable to a permanent establishment or income from real (immovable) property. This election is binding for the taxable year of the election and for any subsequent taxable years unless the competent authority of the country in which the property is situated agrees to terminate the election. The Technical Explanation notes that, in the United States, revocation will be granted in accordance with the provisions of Treas. Reg. section 1.871-10(d)(2).

Article 7. Business Profits

Internal taxation rules

United States

U.S. law distinguishes between the U.S. business income and the other U.S. income of a nonresident alien or foreign corporation. A nonresident alien or foreign corporation is subject to a flat 30-percent rate (or lower treaty rate) of tax on certain U.S. source income if that income is not effectively connected with the conduct of a trade or business within the United States. The regular individual or corporate rates apply to income (from any source) that is effectively connected with the conduct of a trade or business within the United States. The performance of personal services within the United States may constitute a trade or business within the United States.

The treatment of income as effectively connected with a U.S. trade or business depends upon whether the source of the income is U.S. or foreign. In general, U.S. source periodic income (such as interest, dividends, rents, and wages) and U.S. source capital gains are effectively connected with the conduct of a trade or business within the United States if the asset generating the income is used in (or held for use in) the conduct of the trade or business or if the activities of the trade or business are a material factor in the realization of the income. All other U.S. source income of a person engaged in a trade or business in the United States is treated as effectively connected with the conduct of a trade or business in the United States (under what is referred to as a "force of attraction" rule).

The income of a nonresident alien individual from the performance of personal services within the United States is excluded from U.S.-source income, and therefore is not taxed by the United States in the absence of a U.S. trade or business, if the following criteria are met: (1) the individual is not in the United States for over 90 days during the taxable year; (2) the compensation does not exceed $3,000; and (3) the services are performed as an employee of, or under a contract with, a foreign person not engaged in a trade or business in the United States, or are performed for a foreign office or place of business of a U.S. person.

Foreign source income generally is effectively connected income only if the foreign person has an office or other fixed place of business in the United States and the income is attributable to that place of business. In those circumstances, only three types of foreign source income are considered to be effectively connected income: rents and royalties for the use of certain intangible property derived from the active conduct of a U.S. business; certain dividends and interest either derived in the active conduct of a banking, financing or similar business in the United States or received by a corporation the principal business of which is trading in stocks or securities for its own account; and certain sales income attributable to a U.S. sales office. Special rules apply for purposes of determining the foreign source income that is effectively connected with a U.S. business of an insurance company.

Any income or gain of a foreign person for any taxable year that is attributable to a transaction in another year is treated as effectively connected with the conduct of a U.S. trade or business if it would have been so treated had it been taken into account in that other year (section 864(c)(6)). In addition, if any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States, the determination of whether any income or gain attributable to a sale or exchange of that property occurring within ten years after the cessation of business is effectively connected with the conduct of a trade or business within the United States is made as if the sale or exchange occurred immediately before the cessation of business (section 864(c)(7)).

Hungary

Nonresident corporations are generally subject to tax only upon income derived through a branch or permanent establishment in Hungary. The taxable income of a branch or permanent establishment is calculated in the same manner as a resident corporation. Thus, the first HUF 500 million ($2.4 million) taxable income is currently taxed at a rate of 10 percent, with amounts above that limit taxed at a 19-percent rate. Beginning January 1, 2013, the tax rate will be a flat 10 percent on all income.

Nonresident corporations without branches or permanent establishments in Hungary may be subject to tax on certain Hungarian-source income if they own Hungarian real estate holding companies. A Hungarian real estate holding company is any nonpublicly traded resident corporation or nonresident corporation with a branch or permanent establishment in Hungary if more than 75 percent of its assets consist of Hungarian real estate.

Hungarian-source dividends paid to nonresident corporations are not subject to withholding tax. Similarly, there is no withholding tax on Hungarian-source interest and royalties paid to nonresident corporations.

Nonresident individuals are subject to tax only on certain Hungarian-source income, including business profits derived from a permanent establishment in Hungary, income derived from employment and independent personal services performed in Hungary, and income from the use or real and intangible property in Hungary. A final withholding tax applies to dividends at a rate of 16 percent. There is generally no withholding tax applicable to interest and royalties paid to a nonresident individual.

<u>Proposed treaty limitations on internal law</u>

Under the proposed treaty, business profits of an enterprise of a treaty country may be taxed in the other treaty country only to the extent that they are attributable to a permanent establishment in that other country through which the enterprise carries on business. This rule is one of the basic treaty limitations on a country's right to tax income of a resident of the other country. The rule is similar to the rules found in the U.S. and OECD Model treaties.

Although the proposed treaty does not provide a definition of the term "business profits," the Technical Explanation states that the term is intended to cover income derived from any trade or business. The term "business profits" includes income attributable to notional principal contracts and other financial instruments to the extent that the income is attributable to a trade or business of dealing in such instruments or is otherwise related to a trade or business (as in the case of a notional principal contract entered into for the purpose of hedging currency risk arising from an active trade or business). Any other income derived from financial instruments is, according to the Technical Explanation, addressed in Article 21 (Other Income) unless it is specifically governed by another article.

The term "business profits" also includes income from the rental of tangible personal property, unless the property consists of aircraft, ships or containers, income from which is governed by Article 8 (Shipping and Air Transport). Thus, a treaty country resident's rental income may be taxed (on a net basis) by the other treaty country only if the income is attributable to a permanent establishment that the resident maintains in the other treaty country. The Technical Explanation provides that income from rental of tangible personal property not derived in connection with a trade or business is governed by Article 21 (Other Income).

As a result of the definitions of "enterprise" and "business" in Article 3, the definition of business profits includes income from independent personal services, which, like the U.S. and OECD Model treaties, is not addressed in a separate article. The inclusion in business profits of income of an enterprise from personal services is consistent with the long-standing U.S. position that an enterprise's personal services income is business profits. Accordingly, a consulting firm resident in one treaty country whose employees or partners perform services in the other treaty country through a permanent establishment may be taxed in that other country under Article 7, not under Article 14 (Income from Employment), because Article 14 applies only to income of employees.

The proposed treaty provides rules for the attribution of business profits to a permanent establishment. Under these rules, the treaty countries attribute to a permanent establishment the business profits that the permanent establishment might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment. For this purpose, the business profits to be attributed to the permanent establishment include only the profits derived from the assets used, risks assumed, and activities performed by the permanent establishment.

The Technical Explanation states that the concept of "attributable to" is an alternative to the analogous but somewhat different effectively connected income concept of Code section 864(c). According to the Technical Explanation, the amount of income attributable to a permanent establishment may, depending on the circumstances, be greater or less than the amount of income that would be treated as effectively connected with the conduct of a U.S. trade or business under the Code. The Technical Explanation states that a financial institution's use of internal dealings to allocate income within an enterprise may produce results under Article 7 that are significantly different from the results under the Code's effectively connected income rules. As an example, the Technical Explanation states that income from interbranch notional principal contracts may be taken into account under Article 7 even though those transactions may be ignored under U.S. domestic law.

The diplomatic notes describe the treaty countries' understanding that the principles of the OECD Transfer Pricing Guidelines apply in determining the profits attributable to a permanent establishment. Consequently, according to the Technical Explanation, any of the principles of the OECD guidelines, including the profits methods, may be used so long as those methods are applied in accordance with the guidelines. The Technical Explanation states, however, that the availability of the OECD guidelines does not create legal obligations or other tax consequences that would result if transactions had independent legal significance.

The proposed treaty provides that in computing taxable business profits of a permanent establishment, deductions are allowed for expenses, wherever incurred, that are for the purposes of the permanent establishment. These deductions include executive and general administrative expenses so incurred. The Technical Explanation states that deductions are allowed regardless of which accounting unit of the enterprise books the expenses, so long as the expenses are incurred for the purposes of the permanent establishment (including for the purposes of the enterprise as a whole or that part of the enterprise that includes the permanent establishment). This rule permits a treaty country to apply the type of expense allocation rules provided by U.S. law (such as in Treas. Reg. sections 1.861-8 and 1.882-5). However, the proposed treaty does not permit a deduction for expenses charged to a permanent establishment by another unit of the enterprise.

Like the U.S. and OECD Model treaties, the proposed treaty provides that business profits are not attributed to a permanent establishment merely by reason of the purchase of goods or merchandise by the permanent establishment for the enterprise of which it is a part. According to the Technical Explanation, this rule applies only to an office that performs functions in addition to purchasing because purchasing does not by itself give rise to a permanent establishment under Article 5 (Permanent Establishment) to which income can be attributed. When it applies, the rule provides that business profits may be attributable to a permanent establishment for its non-purchasing activities (sales activities, for example), but not for its purchasing activities.

The proposed treaty requires that the determination of the business profits of a permanent establishment be made using the same method year by year unless there is good and sufficient reason to the contrary. The Technical Explanation states that this rule limits the ability of both the treaty country and the enterprise to change accounting methods to be applied to the permanent establishment.

Where business profits include items of income that are dealt with separately in other articles of the proposed treaty, those other articles, and not the business profits article, generally govern the treatment of those items of income. Thus, for example, the taxation of dividends is determined under the rules of Article 10 (Dividends), and not by the rules of Article 7, except as specifically provided in Article 10 (that is, when dividends are attributable to a permanent establishment).

The proposed treaty provides that, for purposes of the taxation of business profits, income may be attributable to a permanent establishment (and therefore may be taxable in the source country) even if the payment of the income is deferred until after the permanent establishment has ceased to exist. This rule incorporates into the proposed treaty the rule of section 864(c)(6) described in the summary of U.S. internal law above. This rule applies for purposes of the rules for business profits under this article, dividends (Article 10, paragraph 6), interest (Article 11, paragraph 4), royalties (Article 12, paragraph 3), gains (Article 13, paragraph 5) and other income (Article 21, paragraph 2).

The Technical Explanation notes that Article 7 is subject to the saving clause of paragraph 4 of Article 1 (General Scope). Thus, if a U.S. citizen who is a resident of Hungary derives business profits from the United States that are not attributable to a permanent establishment in the United States, the United States may, subject to the special foreign tax credit rules of paragraph 4 of Article 23 (Relief from Double Taxation), tax those profits, notwithstanding that paragraph 1 of this article would exempt the income from U.S. tax.

The Technical Explanation further notes that Article 7 is subject to Article 22 (Limitation on Benefits). Consequently, a Hungarian enterprise with income that is effectively connected to a U.S. trade or business is not entitled to the benefits of Article 7 unless the resident carrying on the enterprise qualifies for those benefits under Article 22.

Article 8. Shipping and Air Transport

This article covers income from the operation of ships and aircraft in international traffic. The rules governing income from the disposition of ships, aircraft, and containers are in paragraphs 6 and 7 of Article 13 (Capital Gains).

The United States generally taxes the U.S.-source income of a foreign person from the operation of ships or aircraft to or from the United States. An exemption from U.S. tax is provided if the income is earned by a corporation or nonresident alien individual organized or resident in a foreign country that grants an equivalent exemption to U.S. corporations and residents. Under the present treaty, Hungary is considered to grant an equivalent exemption.[19]

The proposed treaty provides that profits of an enterprise of one treaty country from the operation of ships or aircraft in international traffic are taxable only in that country. Paragraph 6 of Article 7 (Business Profits) provides that if profits include items of income that are described in both Article 7 and other articles of the proposed treaty, including this article, the provisions of those other articles are not affected by the provisions of Article 7. The rules of this article, therefore, are not affected by the general rule of Article 7 that profits attributable to a permanent establishment that an enterprise of a treaty country has in the other treaty country may be taxed in the other treaty country. Consequently, the profits of an enterprise of a treaty country from the operation of ships or aircraft in international traffic may not be taxed in the other treaty country even if the enterprise has a permanent establishment in that other treaty country.

"International traffic" is defined in Article 3(1)(f) (General Definitions) as any transport by a ship or aircraft, except when the transport is solely between places in a treaty country.

The proposed treaty includes a nonexclusive list of items that constitute profits from the operation of ships or aircraft in international traffic. That list includes profits derived from the rental of ships or aircraft on a full basis (i.e., rental with crew, whether on a time or voyage basis). The list also includes profits from the rental of ships or aircraft on a bareboat basis (i.e., without crew), whether the ships or aircraft are operated in international traffic by the lessee or the rental income is incidental to the lessor's other profits from the operation of ships or aircraft in international traffic.

The proposed treaty provides that profits of an enterprise from the inland transport of property or passengers within either treaty country are treated as profits from the operation of ships or aircraft in international traffic (and, therefore are governed by this article) if the transport is undertaken as part of international traffic. Thus, according to the Technical Explanation, if a U.S. enterprise contracts to carry property from Hungary to a U.S. city and as part of that contract transports the property by truck from its point of origin to an airport in Hungary (or contracts with a trucking company to carry the property to the airport), the income earned by the U.S. enterprise from the overland leg of the transport is taxable only in the United States. Similarly, the Technical Explanation states that this article also applies to all income derived from a contract for the international transport of goods even if the goods are transported

[19] See Rev. Rul. 2008-17, 2008-1 C.B. 626.

to the port by a lighter (a barge used in loading and unloading ships), and not by the vessel that carries the goods in international waters.

The proposed treaty provides that profits of an enterprise of a treaty country from the use, maintenance, or rental of containers (including trailers, barges, and related equipment for the transport of containers) used in international traffic are taxable only in that treaty country. According to the Technical Explanation, this exclusive residence country taxation applies even if the enterprise is not engaged in the operation of ships or aircraft in international traffic and even if the enterprise has a permanent establishment in the other treaty country.

As under the U.S. Model treaty, the shipping and air transport provisions of the proposed treaty apply to profits from participation in a pool, a joint business, or an international operating agency. These arrangements are common methods of cooperation among international shipping and air transport companies.

The Technical Explanation notes that this article is subject to the saving clause of paragraph 4 of Article 1 (General Scope). Consequently, if a U.S. citizen who is a resident of Hungary derives profits from the operation of ships or aircraft in international traffic, the United States may tax those profits as part of the citizen's worldwide income (subject to the proposed treaty's foreign tax credit rules). The benefit of exclusive residence country taxation is available to an enterprise of a treaty country only if that enterprise satisfies the limitation on benefits requirements of Article 22.

Article 9. Associated Enterprises

The proposed treaty, like most other U.S. tax treaties, contains an arm's-length pricing provision. The proposed treaty recognizes the right of each country to make an allocation of profits to an enterprise of that country in the case of transactions between related enterprises, if conditions are made or imposed between the two enterprises in their commercial or financial relations that differ from those that would be made between independent enterprises. In such a case, a country may allocate to such an enterprise the profits that it would have accrued but for the conditions so imposed. This treatment is consistent with the U.S. Model and OECD Model treaties.

For purposes of the proposed treaty, an enterprise of one country is related to an enterprise of the other country if one of the enterprises participates directly or indirectly in the management, control, or capital of the other enterprise. Enterprises are also related if the same persons participate directly or indirectly in the enterprises' management, control, or capital.

Under the proposed treaty, when a redetermination of tax liability has been made by one country under the provisions of this article, and the other country agrees with that redetermination, then that other country will make an appropriate adjustment to the amount of tax paid in that country on the redetermined income. In making such adjustment, due regard is to be given to other provisions of the proposed treaty. The proposed treaty's saving clause retaining full taxing jurisdiction in the country of residence or citizenship does not apply in the case of such adjustments. Accordingly, internal statute of limitations provisions do not prevent the allowance of appropriate correlative adjustments. However, the Technical Explanation states that statutory or procedural limitations cannot be overridden to impose additional tax because paragraph 2 of Article 1 (General Scope) provides that the proposed treaty cannot restrict any statutory benefit.

Article 10. Dividends

Overview

The dividends article of the proposed treaty generally allows full residence-country taxation and limited source-country taxation of dividends. The proposed treaty includes a generally applicable maximum rate of withholding at source of 15 percent and a reduced five-percent maximum rate for dividends received by a company owning at least 10 percent of the dividend-paying company. A zero rate of withholding tax generally applies to dividends received by pension funds if the dividends are not derived from the trade or business by the pension fund or through an associated enterprise. Special rules apply to dividends received from regulated investment companies ("RICs") and real estate investment trusts ("REITs"). The provisions in this article are generally consistent with the U.S. and OECD model treaties, although the proposed treaty does not provide the complete exemption from withholding tax for certain direct dividends as is found in a number of recent U.S. tax treaties and protocols.

Internal taxation rules

United States

The United States generally imposes a 30-percent tax on the gross amount of U.S.-source dividends paid to nonresident alien individuals and foreign corporations. The 30-percent tax does not apply if the foreign recipient is engaged in a trade or business in the United States and the dividends are effectively connected with that trade or business. In that case, the foreign recipient is subject to U.S. tax on the dividends on a net basis at graduated rates in the same manner in which a U.S. person would be taxed.

Under U.S. law, the term "dividend" generally means any distribution of property made by a corporation to its shareholders from current or accumulated earnings and profits.

In general, corporations are not entitled under U.S. law to a deduction for dividends paid. Thus, the withholding tax on dividends theoretically represents imposition of a second level of tax on corporate taxable income. Treaty reductions of this tax reflect the view that where the United States already imposes corporate-level tax on the earnings of a U.S. corporation, a 30-percent withholding rate may represent an excessive level of source-country taxation. Moreover, the reduced rate of tax often applied by treaty to dividends paid to direct investors reflects the view that the source-country tax on payments of profits to a substantial foreign corporate shareholder may properly be reduced further to avoid double corporate-level taxation and to facilitate international investment.

A REIT is a U.S. domestic corporation, trust, or association that is subject to the corporate income tax, but that receives a deduction for dividends paid to its shareholders if certain conditions are met. To qualify for the deduction for dividends paid, a REIT must distribute most of its income. As a result of the deduction for dividends paid, a REIT generally does not pay Federal income tax. Except for capital gain dividends, a distribution of REIT earnings is generally treated by the recipient as a dividend rather than as income of the same type as the underlying earnings.[20] Such distribution is subject to the U.S. 30-percent withholding tax when paid to foreign owners. However, the receipt of a distribution from a REIT is generally treated as a gain from the disposition of a U.S. real property interest that must be recognized by a nonresident alien individual or a foreign corporation to the extent that it is attributable to a sale or exchange of a U.S. real property interest by the REIT.[21]

REITs generally are organized to allow investment in primarily passive real estate investments. As such, income of a REIT often includes rentals from real estate holdings or interest from loans secured by real estate mortgages. Like dividends, U.S.-source rental income of foreign persons generally is subject to the 30-percent withholding tax (unless the recipient makes an election to have the rental income taxed in the United States on a net basis at the regular graduated rates). Unlike the withholding tax on dividends, however, the withholding tax on rental income generally is not reduced in U.S. income tax treaties. When rental income (or interest income) of a REIT is distributed to a foreign shareholder as a REIT dividend, it is treated as a dividend under U.S. internal law. U.S.-source interest income of foreign persons is not subject to U.S. withholding tax in certain circumstances. A REIT dividend does not, however, pass through to the REIT's shareholders the interest characterization of the REIT's underlying earnings.

U.S. internal law also generally treats a RIC as a corporation subject to corporate income tax, but that receives a deduction for dividends paid to its shareholders if certain conditions are met. The purpose of a RIC is to allow investors to hold diversified portfolios of securities. Dividends paid by a RIC generally are treated as dividends received by the payee, and the RIC generally pays no tax because it is permitted to deduct dividends paid to its shareholders in computing its taxable income. However, a RIC generally may pass through to its shareholders the character of its net long-term and, for taxable years beginning before January 1, 2008, net short-term capital gains by designating a dividend it pays as a long-term or short-term capital gain dividend, to the extent that the RIC has net capital gains. Nonresident aliens and foreign corporations generally are not subject to tax on capital gains. A distribution in a taxable year beginning before January 1, 2008 to a nonresident alien or foreign corporation made by a RIC that is (or, if certain exceptions were disregarded, would be) a U.S. real property holding corporation, however, is treated as gain recognized by that nonresident alien or foreign

[20] Because a REIT generally does not pay corporate-level tax, certain U.S. benefits of dividend treatment are not available. A U.S. corporate shareholder is not generally entitled to a dividends-received deduction for REIT dividends. REIT dividends generally are not qualified dividends eligible for the 15-percent rate available for individual shareholders.

[21] There is an exception for distributions to a shareholder that owns five percent or less of the REIT, if the REIT stock is regularly traded on an established securities market located in the United States. Sec. 897(h)(1). These distributions are treated as dividends under U.S. internal law.

corporation from the sale or exchange of a U.S. real property interest to the extent the gain is attributable to gain from sales or exchanges of U.S. real property interests.[22]

A RIC that earns interest income that would not be subject to U.S. tax if earned by a foreign person directly ("qualified interest income")[23] generally may designate a dividend it pays in a taxable year beginning before January 1, 2008 as derived from that interest income, to the extent of such income.[24] Nonresident aliens and foreign corporations are not subject to tax on such interest-related dividends. The aggregate amount that may be designated by a RIC as interest-related dividends generally is limited to the sum of qualified interest income less the amount of expenses of the RIC properly allocable to the interest income.

Hungary

Dividends paid by Hungarian resident companies to nonresident individuals are subject to a 16-percent withholding tax. In contrast, dividends paid to nonresident companies are generally not subject to withholding tax.

Proposed treaty limitations on internal law

In general

Under the proposed treaty, dividends paid by a company that is a resident of a treaty country to a resident of the other country may be taxed in that other country. The dividends also may be taxed by the country in which the dividend-paying company is resident (the source country), but the rate of tax is limited. Under the proposed treaty, source-country taxation of dividends generally is limited to 15 percent of the gross amount of the dividends paid to residents of the other treaty country. A lower rate of five percent applies if the beneficial owner of the dividends is a company that owns directly at least 10 percent of the voting stock of the dividend-paying company. According to the Technical Explanation, shares are considered to be voting shares if they provide the power to elect, appoint or replace any person vested with the powers ordinarily exercised by the board of directors of a U.S. corporation.

The term "beneficial owner" is not defined in the proposed treaty and therefore is defined under the internal law of the country imposing tax (i.e., the source country). The Technical Explanation states that the beneficial owner of a dividend for purposes of this article is the

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[22] The exception described in the immediately preceding footnote also applies for distributions by RICs.

[23] Qualified interest income of the RIC is equal to the sum of its U.S.-source income with respect to: (1) bank deposit interest; (2) short term original issue discount that is currently exempt from the gross-basis tax under section 871; (3) any interest (including amounts recognized as ordinary income in respect of original issue discount, market discount, or acquisition discount under the provisions of sections 1271-1288, and such other amounts as regulations may provide) on an obligation that is in registered form, unless it is earned on an obligation issued by a corporation or partnership in which the RIC is a 10-percent shareholder or is contingent interest not treated as portfolio interest under section 871(h)(4); and (4) any interest-related dividend from another RIC.

[24] Sec. 871(k)(1)(C).

person to which the dividend income is attributable for tax purposes under the laws of the source country.

According to the Technical Explanation, however, special rules apply to companies holding shares through fiscally transparent entities, such as partnerships. In such cases, the rules of paragraph 6 of Article 1 (General Scope) of the proposed treaty and paragraph 1 of the diplomatic notes apply to determine whether the dividends should be treated as derived by a resident of a treaty country. The laws of the residence country determine who derives the dividend, and the laws of the source country determine whether the person who derives the dividends is the beneficial owner of the dividends. The principles of paragraph 6 of Article 1 (General Scope) of the treaty also apply to determine whether other requirements have been satisfied, such as the ownership threshold that must be met to qualify for the 10-percent rate under this article.

The proposed treaty provides a zero rate of withholding tax for dividends received by a pension fund, provided that the dividends are not derived from the carrying on of a business, directly or indirectly, by the pension fund. For these purposes, the term pension fund is defined in subparagraph 1(k) of Article 3 (General Definitions).

Dividends paid by U.S. RICs and REITs

The proposed treaty generally denies the five-percent rate of withholding tax to dividends paid by U.S. RICs and REITs.

The 15-percent rate of withholding (or zero rate for dividends received by a pension fund) generally is allowed for dividends paid by a RIC. The 15-percent rate of withholding (or zero rate for dividends received by a pension fund) is allowed for dividends paid by a REIT, provided one of three additional conditions is met: (1) the beneficial owner of the dividend is an individual or pension fund holding an interest of not more than 10 percent in the REIT; (2) the dividend is paid with respect to a class of stock that is publicly traded, and the beneficial owner of the dividend is a person holding an interest of not more than five percent of any class of the REIT's stock; or (3) the beneficial owner of the dividend holds an interest in the REIT of not more than 10 percent, and the REIT is diversified (i.e., the value of no single interest in real property held by the REIT exceeds 10 percent of the gross value of the REIT's total interest in real property).

The proposed treaty also provides that the above rules apply to dividends paid by companies resident in Hungary that are similar to U.S. RICs and REITs. However, the Technical Explanation notes that no such entities existed under Hungary's domestic law at the time of signature of the proposed treaty.

Definitions and special rules and limitations

The proposed treaty generally defines dividends as income from shares or other corporate participation rights that are not treated as debt, as well as other amounts that are subject to the same tax treatment by the source country as income from shares (for example, constructive dividends). The Technical Explanation notes that the term is defined broadly and flexibly, and is intended to cover all arrangements that yield a return on an equity investment in a corporation as determined under the tax law of the source country.

The proposed treaty's reduced rates of tax on dividends do not apply if the dividend recipient carries on business through a permanent establishment in the source country and the holding in respect of which the dividends are paid is effectively connected with that permanent establishment. In this case, the dividends are taxed as business profits (Article 7).

The proposed treaty prevents each treaty country from imposing a tax on dividends paid by a resident of the other treaty country unless the dividends are paid to a resident of the first country or are attributable to a permanent establishment in that country. The proposed treaty also restricts the rights of a treaty country to impose corporate level taxes, other than a branch profits tax, on undistributed profits. The Technical Explanation notes that this does not restrict a treaty country's right to tax its resident shareholders on undistributed earnings of a corporation resident in the other country. Thus, the authority of the United States to impose taxes on subpart F income, earnings deemed invested in U.S. property, and income of a passive foreign investment company that is a qualified electing fund is not restricted under the proposed treaty.

The proposed treaty allows each treaty country to impose a branch profits tax on a company resident in the other country if the company has income attributable to a permanent establishment in that country, derives income from real property in that country that is taxed on a net basis under the treaty, or realizes gains taxable in that country under the treaty. In the case of the United States, the base of the tax is limited to the "dividend equivalent amount," consistent with the branch profits tax under U.S. internal law (section 884). In the case of Hungary, the base of the tax is limited to an amount that is analogous to the dividend equivalent amount. The rate of branch profits tax is limited to five percent.

Relation to other articles

The Technical Explanation notes that the saving clause of paragraph 4 of Article 1 of the proposed treaty (General Scope) permits the United States to tax dividends received by its residents and citizens, subject to the special foreign tax credit rules of paragraph 4 of Article 23 (Relief from Double Taxation), as if the proposed treaty had not come into effect.

The benefits of the dividends article are also subject to the provisions of Article 22 of the proposed treaty (Limitation on Benefits).

Article 11. Interest

Internal taxation rules

United States

Subject to several exceptions (such as those for portfolio interest, bank deposit interest, and short-term original issue discount), the United States imposes a 30-percent withholding tax on U.S.-source interest paid to foreign persons under the same rules that apply to dividends. U.S.-source interest, for purposes of the 30-percent tax, generally is interest on the debt obligations of a U.S. person, other than a U.S. person that satisfies specified foreign business requirements. Also subject to the 30-percent tax is interest paid by the U.S. trade or business of a foreign corporation. A foreign corporation is subject to a branch-level tax on certain “excess interest” of a U.S. trade or business of that corporation. Under this rule, an amount equal to the excess of the interest deduction allowed to the U.S. business over the interest paid by the business is treated as if paid by a U.S. corporation to a foreign parent and, therefore, is subject to the 30-percent withholding tax.

Portfolio interest generally is defined as any U.S.-source interest that is not effectively connected with the conduct of a trade or business if the interest (1) is paid on an obligation that satisfies certain registration requirements and (2) is not received by a 10-percent owner of the issuer of the obligation, taking into account shares owned by attribution. The portfolio interest exemption does not apply to certain contingent interest income.

If an investor holds an interest in a fixed pool of real estate mortgages that is a real estate mortgage interest conduit (“REMIC”), the REMIC generally is treated for U.S. tax purposes as a pass-through entity, and the investor is subject to U.S. tax on a portion of the REMIC’s income (generally, interest income). If the investor holds a so-called “residual interest” in the REMIC, the Code provides that a portion of the net income of the REMIC that is taxed in the hands of the investor – referred to as the investor’s “excess inclusion” – may not be offset by any net operating losses of the investor, must be treated as unrelated business income if the investor is an organization subject to the unrelated business income tax, and is not eligible for any reduction in the 30-percent rate of withholding tax (by treaty or otherwise) that would apply if the investor otherwise were eligible for such a rate reduction.

Hungary

Hungary generally does not impose tax (by withholding or otherwise) on Hungarian-source interest paid to nonresident individuals or foreign corporations.

Proposed treaty limitations on internal law

The proposed treaty provides that interest arising in one treaty country (the source country) and beneficially owned by a resident of the other treaty country generally is exempt from tax in the source country. This exemption from source-country tax is similar to the rule of the U.S. Model treaty.

The proposed treaty defines interest as income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor’s profits. In particular, interest includes income from government securities and from bonds or debentures, including premiums and prizes attaching to those securities, bonds, or debentures. The term “interest” also includes all other income that is treated as income from money lent under the tax law of the treaty country in which the income arises. Interest does not include income covered in Article 10 (Dividends). Penalty charges for late payment also are not treated as interest.

The exemption from source country taxation does not apply if the beneficial owner of the interest carries on business through a permanent establishment in the source country and the debt-claim in respect of which the interest is paid is effectively connected with that permanent establishment. In that circumstance, assuming the beneficial owner of the interest is a resident of one of the treaty countries, the interest is taxed as business profits (Article 7). According to the Technical Explanation, interest attributable to a permanent establishment but received after the permanent establishment is no longer in existence is taxable in the country in which the permanent establishment existed.

The proposed treaty addresses non-arm's-length interest charges between a payor and a beneficial owner that have a special relationship. Paragraph 5 of Article 11 provides that the article applies only to the amount of interest that would have been agreed in the absence of a special relationship. Any excess amount is taxable according to the laws of each treaty country, with due regard being given to other provisions of the proposed treaty. For example, excess interest paid to a parent corporation may be treated as a dividend under a country's internal laws and, accordingly, would be entitled to the benefits of Article 10 (Dividends). The Technical Explanation notes that the term "special relationship" is not defined in the proposed treaty and states that the United States considers the term to include the relationships described in Article 9 (Associated Enterprises). Those relationships, according to the Technical Explanation, involve control as defined under the transfer pricing rules of section 482.

The proposed treaty provides two anti-abuse exceptions to the general source-country exemption from tax on interest. The first exception relates to contingent interest payments. The rule for interest arising in Hungary is stated differently from the rule for interest arising in the United States, but in substance those rules are largely similar to one another. If interest arising in Hungary is determined with reference to (1) receipts, sales, income, profits, or other cash flow of the debtor or a related person, (2) any change in the value of any property of the debtor or a related person, or (3) any dividend, partnership distribution, or similar payment made by the debtor or a related person, the interest may be taxed in Hungary in accordance with its laws. If the beneficial owner is a resident of the United States, however, the interest may not be taxed at a rate exceeding 15 percent (that is, the rate prescribed in paragraph 2(b) of Article 10 (Dividends)).

The proposed treaty similarly permits the United States to tax interest arising in the United States that is contingent interest and therefore does not qualify as portfolio interest under U.S. law. As with contingent interest arising in Hungary and beneficially owned by a U.S. resident, however, the rate of U.S. tax on contingent interest arising in the United States and beneficially owned by a Hungarian resident may not exceed 15 percent.

The second anti-abuse exception provides that the exemption from source-country taxation does not apply to interest that is an excess inclusion with respect to a residual interest in a REMIC. That interest may be taxed by each treaty country in accordance with its domestic law. The Technical Explanation states that this exception is consistent with the policy of sections 860E(e) and 860G(b) that excess inclusions with respect to a REMIC should bear full U.S. tax in all cases.

The Technical Explanation notes that the benefits of Article 11, like benefits provided by other articles, are subject to the saving clause of paragraph 4 of Article 1 (General Scope) and are available only if a resident satisfies the limitation-on-benefits requirements of Article 22.

Article 12. Royalties

Internal taxation rules

United States

Under the same system that applies to dividends and interest, the United States imposes a 30-percent withholding tax on U.S.-source royalties paid to foreign persons. U.S.-source royalties include royalties for the use of or right to use intangible property in the United States.

Hungary

Hungarian-source royalties paid to nonresident companies and individuals are not generally subject to withholding tax.

Proposed treaty limitations on internal law

The proposed treaty provides that royalties arising in a treaty country (the source country) and beneficially owned by a resident of the other treaty country are generally exempt from tax in the source country.

The term "royalties" as used in this article means 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 cinematographic films), any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial, or scientific experience. The term royalties also includes gain from the alienation of any such property, to the extent the gain is contingent on the productivity, use, or disposition of the property. The Technical Explanation states that any gain from the alienation of royalty-producing property that is not contingent on the productivity, use, or disposition of the property is gain addressed in Article 13 (Capital Gains).

The term royalties does not expressly include consideration for the use of computer software. The Technical Explanation states that consideration received for the use, or the right to use, computer software is treated either as royalties or as business profits, depending on the facts and circumstances of the transaction giving rise to the payment. The primary factor in determining whether consideration is treated as royalties or as business profits is the nature of the rights transferred.

The exemption from source country tax does not apply if the beneficial owner of the royalties carries on a business through a permanent establishment in the source country, and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment. In that event, the royalties are taxed as business profits (Article 7). According to the Technical Explanation, royalties attributable to a permanent establishment but received after the permanent establishment is no longer in existence remain taxable under the provisions of Article 7 (Business Profits), and not under this article.

The proposed treaty addresses the issue of non-arm's-length royalties between related parties (or parties otherwise having a special relationship) by providing that this article applies only to the amount of arm's-length royalties. Any amount of royalties paid in excess of the arm's-length amount is taxable according to other provisions of the proposed treaty. For example, excess royalties paid by a subsidiary corporation to its parent corporation may be treated as a dividend under local law and, thus, entitled to the benefits of Article 10 (Dividends).

Article 13. Capital Gains

Internal taxation rules

United States

Generally, gain realized from the sale of a capital asset by a nonresident alien individual or a foreign corporation is not subject to U.S. tax unless the gain is effectively connected with the conduct of a U.S. trade or business or, in the case of a sale by a nonresident alien individual, that individual is physically present in the United States for at least 183 days in the taxable year. A nonresident alien individual or foreign corporation generally is subject to U.S. tax on gain from the sale of a U.S. real property interest as if the gain were effectively connected with a trade or business conducted in the United States. "U.S. real property interests" include interests in certain corporations if U.S. real property comprises at least 50 percent of the assets of the corporation.

Hungary

Under Hungarian tax rules for individuals, capital gains from the disposition of property are generally taxable at a flat 16-percent rate. A reduced rate of 10 percent applies to capital gains realized on the disposition of certain investments held for more than three years, while exemptions are provided for capital gains realized on the disposition of certain investments held for more than five years as well as real property the proceeds of which are used to purchase retirement property for the seller or his or her relatives. In the case of corporations, capital gains are generally included in income, but gains from the disposal of stock in certain subsidiaries in which the corporation has owned at least a 30-percent interest for one year are exempt. Capital losses may be deducted in the same manner as ordinary losses.

Proposed treaty limitations on internal law

The proposed treaty provides rules governing when a treaty country may tax gains from the alienation of property by a resident of the other treaty country. The rules generally are consistent with those included in the U.S. Model treaty.

Under the proposed treaty, gains derived by a resident of one treaty country that are attributable to the alienation of immovable property (real property) situated in the other country may be taxed in that other country. For the purposes of this article, immovable property (real property) situated in the other treaty country includes: (1) immovable property (real property) referred to in Article 6 (Income from Immovable Property (Real Property))—that is, an interest in the immovable property (real property) itself; and (2) in the case of the United States, a U.S. real property interest. Under U.S. internal law, a U.S. real property interest includes, among other property, shares in a U.S. corporation that owns sufficient U.S. real property interests to satisfy an asset-based test. The Technical Explanation clarifies that the taxation of distributions made by a REIT or by certain RICs is governed by this Article, rather than Article 10 (Dividends), when they are attributable to gains derived from the alienation of real property. In addition, gains derived by a resident of a treaty country from the alienation of shares or comparable interests that derive more than 50 percent of their value, directly or indirectly, from immovable property (real property) situated in Hungary may be taxed in Hungary.

The proposed treaty includes a standard provision (included in the OECD model) that permits a treaty country to tax gains from the alienation of movable property (that is, property other than immovable property (real property)) that forms a part of the business property of a permanent establishment that an enterprise of the other treaty country has in the first treaty country. This rule permits source-country taxation of gains from the alienation of the permanent establishment (alone or with the enterprise as a whole). According to the Technical Explanation, this taxation is permitted whether or not the permanent establishment exists at the time of alienation. Consequently, income that is attributable to a permanent establishment, but that is deferred and is received after the permanent establishment no longer exists, may nevertheless be taxed in the treaty country in which the permanent establishment was located. This rule is similar to a rule in U.S. internal law.

The Technical Explanation notes that a resident of Hungary that is a partner in a partnership doing business in the United States generally will have a permanent establishment in the United States as a result of the activities of the partnership that rise to the level of a permanent establishment. The Technical Explanation states that under the proposed treaty, the United States may tax the partner's distributive share of income realized by the partnership on the disposition of movable property forming part of the partnership's business property in the United States.

The proposed treaty provides that gains derived by an enterprise of one treaty country from the alienation of ships or aircraft operated or used in international traffic, or of personal property related to the operation of the ships or aircraft, are taxable only in that country. The Technical Explanation notes that this rule applies even if the gains are attributable to a permanent establishment maintained by the enterprise in the other treaty country. Similarly, gains derived by an enterprise of one treaty country from the alienation of containers (including trailers, barges, and related equipment for the transport of containers) that are used for transport of goods or merchandise, are taxable only in that country, unless the containers are used for transport solely between places within the other treaty country.

Gain from the alienation of any property other than the property described above is taxable under the proposed treaty only in the country in which the person alienating the property is a resident.

The proposed treaty includes a special rule that permits the imposition of certain expatriation taxes. This rule provides that if an individual, on ceasing to be a resident of one treaty country is treated as alienating any property for its fair market value and is taxed in that country, then the individual may make an election with respect to tax treatment in the other treaty country. Under the election, the individual is treated as having alienated and reacquired the property for an amount equal to its fair market value immediately before he ceased to be a resident of the first treaty county. The Technical Explanation provides that an individual must make the election consistently with respect to all properties treated as alienated, and states that an individual treated as alienating multiple properties under this special rule may make the election only if the deemed alienation of all such properties results in a net gain. The Technical Explanation elaborates that at the time the treaty was signed, certain types of property are excluded from the deemed disposition rules in the case of individuals who cease to be citizens or long-term residents of the United States: a deferred compensation item as defined under Code section 877A(d)(4), a specified tax deferred account as defined under Code section 877A(e)(2), and an interest in a nongrantor trust as defined under Code section 877A(f)(3).

The Technical Explanation states that the saving clause of paragraph 4 of Article 1 (General Scope) permits the United States to tax its citizens and residents as if the proposed treaty had not come into effect. In addition, the benefits of this Article 13 are available only to a treaty country resident that satisfies one of the conditions in Article 22 (Limitation on Benefits).

Article 14. Income from Employment

The proposed treaty provides that income from employment such as salaries, wages, and other similar remuneration derived by a resident of one treaty country generally may be taxed only by the country of residence. However, if the employment is exercised in the other treaty country (the source country), then that country may also tax the remuneration derived from the employment. However, the source country may not tax the remuneration if three conditions are met: (1) the individual is present in the source country for not more than 183 days in any 12-month period commencing or ending in the taxable year concerned; (2) the individual is paid by, or on behalf of, an employer who is not a resident of the source country; and (3) the remuneration is not borne by a permanent establishment of the employer in the source country (whether or not such expenses are actually deductible when determining the taxable income of the permanent establishment).

According to the Technical Explanation, this article applies to any form of compensation for employment, including payments in kind. Further, it applies without regard to the timing of the payment. Thus, a bonus paid to a resident of a treaty country with respect to services provided in the other treaty country would be subject to the terms of this article even if the bonus is paid in a subsequent year.

This article is subject to the provisions of the separate articles covering directors' fees (Article 15), pensions and income from social security (Article 17), government service (Article 18), students and trainees (Article 19), and professors and teachers (Article 20). Thus, even though a treaty country may have the right to tax income from employment under this article, the right may be preempted if the income is also described, for example, in Article 18 (Government Service).

The proposed treaty contains a special rule that permits income from employment derived by a resident of one treaty country for employment as a member of the regular complement (including the crew) of a ship or aircraft operated in international traffic by an enterprise of the other treaty country to be taxed only in the first treaty country. U.S. internal law does not impose tax on such income of a person who is neither a citizen nor a resident of the United States, even if the person is employed by a U.S. entity.

The Technical Explanation notes that Article 14 is subject to the saving clause of paragraph 4 of Article 1 (General Scope). Consequently, if a U.S. citizen who is a resident of Hungary performs services as an employee in the United States and meets the requirements for source country exemption, the United States may nevertheless tax the income earned from that employment (subject to the proposed treaty's foreign tax credit rules).

Article 15. Directors' Fees

Under the proposed treaty, directors' fees and other similar payments derived by a resident of one treaty country for services rendered in his or her capacity as a member of the board of directors of a company that is a resident of the other treaty country are taxable in that other treaty country. This rule is an exception to the more general rules of Articles 7 (Business Profits) and 14 (Income from Employment). Thus, as noted in the Technical Explanation, it is not relevant to establish whether the fee is attributable to a permanent establishment in a treaty country in determining whether a director's fee paid to a nonemployee director is subject to tax in the country of residence of the corporation.

Article 16. Entertainers and Sportsmen

The proposed treaty addresses the taxation in a treaty country of entertainers and sportsmen resident in the other treaty country from the performance of services as entertainers and sportsmen. The Technical Explanation states that the proposed treaty applies to the income both of an entertainer or sportsman who performs services on his own behalf and of an entertainer or sportsman who performs services on behalf of another person, either as an employee of that person, or pursuant to any other arrangement. The rules of this article take precedence, in some circumstances, over those of Articles 7 (Business Profits) and 14 (Income from Employment).

In general

Paragraph 1 describes the circumstances in which a treaty country may tax the performance income of an entertainer or sportsman who is a resident of the other treaty country. Under the paragraph, income derived by an individual resident of a treaty country from activities as an entertainer or sportsman exercised in the other treaty country may be taxed in that other country if the amount of the gross receipts derived by the performer exceeds $20,000 (or its equivalent in Hungarian forints) for the taxable year. The Technical Explanation states that the determination as to whether the $20,000 threshold has been exceeded is made separately with respect to each year of payment.

According to the Technical Explanation, the monetary threshold is intended to reach entertainers and athletes who are paid relatively large sums of money for short periods of service, and who would, therefore, normally be exempt from host-country tax under the standard personal services income rules.

Tax may be imposed under paragraph 1 even if the performer would have been exempt from tax under Article 7 or 14. On the other hand, if the performer would be exempt from host-country tax under Article 16, but would be taxable under either Article 7 or 14, tax may be imposed under either of those articles. For example, a performer who receives less than the

$20,000 threshold amount and therefore is not taxable under Article 16 nevertheless may be subject to tax in the host country under Article 7 or 14 if the tests for host-country taxability under the relevant article are met.

The Technical Explanation states that nothing in Article 16 precludes a treaty country from withholding tax from payments during the year and refunding the tax after the close of the year if the monetary threshold has not been met.

The Technical Explanation states that Article 16 applies to all income connected with a performance by the entertainer, such as appearance fees, award or prize money, and a share of the gate receipts. Income derived from a treaty country by a performer who is a resident of the other treaty country from other than actual performance, such as royalties from record sales and payments for product endorsements, is covered not by Article 16 but by other articles of the treaty, such as Article 12 (Royalties) or Article 7. The Technical Explanation states that in determining whether income falls under Article 16 or another article, the controlling factor is whether the income in question is predominantly attributable to the performance itself or to other activities or property rights.

According to the Technical Explanation, where an individual fulfills a dual role as performer and non-performer (such as a player-coach or an actor-director), but his role in one of the two capacities is negligible, the predominant character of the individual's activities should control the characterization of those activities. In other cases, there should be an apportionment between the performance-related compensation and other compensation.

Income accrues to another person

The Technical Explanation states that paragraph 2 of Article 16 is intended to address the potential for circumvention of the rule in paragraph 1 when a performer's income does not accrue directly to the performer himself, but to another person.

For example, the "employer" may be a company established and owned by the performer, which is merely acting as the nominal income recipient in respect of the remuneration for the performance (a "star company"). The performer may act as an "employee," receive a modest salary, and arrange to receive the remainder of the income from his performance from the company in another form or at a later time. In that case, absent the provisions of paragraph 2, the income arguably could escape host-country tax because the company earns business profits but has no permanent establishment in that country. The performer may largely or entirely escape host-country tax by receiving only a small salary, perhaps small enough to place him below the monetary threshold in paragraph 1.

Paragraph 2 seeks to prevent this result. Under paragraph 2, when the income accrues to a person other than the performer, the income may be taxed in the treaty country where the performer's services are exercised, without regard to the provisions of the proposed treaty concerning business profits (Article 7) or income from employment (Article 14), unless the contract pursuant to which the personal activities are preformed allows the person other than the performer to designate the individual who is to perform the personal activities.

According to the Technical Explanation, the premise of this rule is that, in a case in which a performer is using another person in an attempt to circumvent the provisions of paragraph 1, the recipient of the services of the performer would contract with a person other than that performer (i.e., a company employing the performer) only if the recipient of the services were certain that the performer himself would perform the services (that is, the contract mentioned the performer by name or description or else allowed the recipient of the services to designate who is to perform the services). If instead the person to whom the income accrues is allowed to designate the individual who is to perform the services, then it is likely that the person is a service company not formed to circumvent the provisions of paragraph 1.

Taxation under paragraph 2 is on the person providing the services of the performer. Paragraph 2 does not affect the rules of paragraph 1, which apply to the performer himself. According to the Technical Explanation, the income taxable by virtue of paragraph 2 is reduced to the extent of salary payments to the performer, which fall under paragraph 1.

Relationship to other articles

Article 16 is subject to the provisions of the saving clause of paragraph 4 of Article 1 (General Scope). Thus, if an entertainer or a sportsman who is resident in Hungary is a citizen of the United States, the United States may tax all of his income from performances in the United States without regard to the provisions of Article 16, subject to the foreign tax credit provisions of Article 23 (Relief from Double Taxation). In addition, the benefits of this article are subject to the provisions of Article 22 (Limitation on Benefits).

Article 17. Pensions and Income from Social Security

This article deals with the taxation of private pensions, social security benefits, annuities, and, to a limited extent, pension funds, as defined in Article 3(k). This article does not cover payments of government pensions covered under Article 18 (Government Service).

Pension distributions

Under the proposed treaty, pensions and other similar remuneration paid to a resident of a treaty country in consideration of past employment is taxable only in that country. The proposed treaty also precludes the individual's country of residence from taxing the portion of pension income arising in the other country to the extent such income would have been exempt if the beneficiary were a resident of the other country. These rules are the same as those in the U.S. Model treaty. The proposed treaty does not include, however, the provisions of the U.S. Model treaty that address cross-border contributions to pension funds.

According to the Technical Explanation, the term "pensions and other similar remuneration" includes both periodic and lump sum payments and is intended to encompass payments made by qualified private retirement plans. According to the Technical Explanation, in the United States, the plans encompassed by "pensions and other similar remuneration" include: (1) qualified plans under Code section 401(a); (2) individual retirement plans (including individual retirement plans that are part of a simplified employee pension plan that satisfies Code section 408(k), individual retirement accounts, and Code section 408(p) accounts); (3) Code section 403(a) qualified annuity plans; (4) and Code section 403(b) plans. Distributions from

Code section 457 plans may also meet this definition if they are not paid with respect to government services covered by Article 18 (Government Service). The Technical Explanation states that if the competent authorities agree, distributions from other plans that generally meet criteria similar to those applicable to the types of plans listed above may also qualify as pensions and other similar remuneration.

Pensions in respect of government services covered by Article 18 (Government Service) are not covered by the term "pensions and other similar remuneration." Such pensions are covered either by paragraph 2 of this article, if they are in the form of social security benefits, or by paragraph 2 of Article 18.

Timing of pension income and pension funds

The proposed treaty provides that neither country may tax a resident on pension income earned through a pension fund that is a resident of the other country until such income is distributed. When a resident receives a distribution from a pension fund, such distribution is subject to taxation in accordance with the provisions of this article (or, if relevant, Article 18 (Government Service)). For example, if a U.S. citizen contributes to a U.S. qualified plan while working in the United States and then establishes residence in Hungary, Hungary is prevented from taxing currently that fund's earnings and accretions with respect to that individual. For purposes of this provision, rollovers to another pension fund in the same country are not treated as distributions.

The term "pension fund" is defined in paragraph 1(k) of Article 3 (General Definitions) and means any person established in a treaty country that (1) is generally exempt from income taxation in that country, and (2) is operated principally to administer or provide pension or retirement benefits or to earn income for the benefit of one or more such arrangements.

Social security benefits

The proposed treaty, like the present treaty and the U.S. Model treaty, provides for exclusive source-country taxation of payments made under provisions of the social security or "similar legislation" of the United States or the mandatory pension scheme of Hungary. The Technical Explanation states that the term "similar legislation" is intended to refer to United States tier 1 Railroad Retirement benefits.

This provision is an exception to the saving clause of paragraph 4 of Article 1 (General Scope) by virtue of subparagraph 5(a) of Article 1. Thus, only Hungary, and not the United States, may tax Hungarian social security benefits paid to a U.S. citizen or resident. The provision under the proposed treaty applies to both private sector and government employees.

Annuities

The treatment of annuities is expressly addressed in the U.S. Model treaty, but not in the proposed treaty. Therefore, annuities are treated as other income that is subject to residence-country taxation under Article 21 (Other Income). In general, such residence-country taxation of annuities is similar to the treatment provided in the current treaty and the more explicit U.S. Model treaty.

Alimony and child support

Unlike the U.S. Model treaty, the proposed treaty does not expressly address the treatment of alimony and child support payments. Therefore, both are treated as other income that is subject to residence-country taxation under Article 21 (Other Income). In general, this treatment is the same as that provided in the current treaty. The U.S. Model treaty, however, provides a similar result for alimony, but exempts child support payments from tax in both treaty countries.

Saving clause

Paragraph 1(a) of this article is subject to the saving clause of paragraph 4 of Article 1 (General Scope). Thus, for example, a U.S. citizen who is a resident of Hungary and receives a pension or annuity payment from the United States may be subject to U.S. tax on the payment, notwithstanding the rules in that paragraph that gives the recipient's country of residence the exclusive taxing right. Paragraphs 1(b), 2, and 3 of this article are excepted from the saving clause by virtue of paragraph 5(a) of Article 1. Thus, the United States will not tax U.S. citizens and residents on the income described in those paragraphs even if such amounts otherwise would be subject to tax under U.S. law.

Article 18. Government Service

Article 18 (Government Service) is consistent with both the U.S. and OECD Model treaties. Under this article, salaries, wages and other remuneration (other than a pension) paid by a treaty country or a political subdivision or a local authority of that treaty country to an individual for services rendered to that treaty country or subdivision or local authority may be taxed only by that treaty country. The remuneration is exclusively taxable by the other treaty country if the services are rendered in that other country and the individual providing the services is a resident of that other country who is a national of that other country or who did not become a resident of that other country solely for the purpose of rendering the services.

Any pension or other similar remuneration paid by, or out of funds created by, a treaty country or a political subdivision or a local authority of that treaty country to an individual in respect of services rendered to that treaty country or subdivision or local authority, other than a social security payment made by the United States to a Hungarian resident or a payment by Hungary to a United States resident or citizen under Hungary's mandatory pension scheme, is taxable only in that treaty country. However, such a pension is taxable only in the other treaty country if the individual is both a resident and a national of the other country. The Technical Explanation states that pensions paid to retired civilian and military employees of the government of either treaty country are intended to be covered by this provision.

When benefits paid by a treaty country in respect of services rendered to that country (or political subdivision or local authority) are in the form of U.S. social security benefits or benefits under Hungary's mandatory pension scheme, those payments are covered by paragraph 2 of Article 17 (Pensions and Income from Social Security). As a general matter, the result is the same whether Article 17 or 18 applies, since both social security benefits and government pensions are taxable exclusively by the source country (that is, the paying country). The

Technical Explanation states that the result differs only when the payment is made to a person who is both a citizen and a resident of the other country who is not also a citizen of the source country. In this situation, social security benefits remain taxable at source while government pensions are taxable only in the residence country.

Remuneration or a pension paid for services performed in connection with a business carried on by a treaty country (or a political subdivision or a local authority of the treaty country), is subject to Articles 14 (Income from Employment), 15 (Directors' Fees), 16 (Entertainers and Sportsmen), and 17 (Pensions and Income from Social Security).

Under paragraph 5(b) of Article 1 (General Scope), the saving clause (paragraph 4 of Article 1) does not apply to the benefits conferred by one of the treaty countries under Article 18 if the recipient of the benefits is neither a citizen of that country nor a person who has been admitted for permanent residence (in the United States, a "green card" holder). As an example, the Technical Explanation states that a resident of the United States who, in the course of performing functions of a governmental nature, becomes a resident (but not a permanent resident) of Hungary is entitled to the benefits of Article 18. The Technical Explanation states that, similarly, an individual who receives a pension paid by the government of Hungary in respect of services rendered to the government of Hungary may be taxed on this pension only by Hungary unless the individual is a U.S. citizen or green card holder.

Article 19. Students and Trainees

The treatment provided to students and business trainees under the proposed treaty is similar to the provision in the U.S. Model treaty and the OECD Model treaty.

Under the proposed treaty, a student or business trainee who visits a treaty country ("host country") and who is, or was immediately prior to visiting the host country, a resident of the other treaty country is exempt from income tax in the host country on certain payments received if the primary purpose of the visit is education or training. The exempt payments are limited to those payments the individual may receive for his or her maintenance, education, or training as long as such payments are from sources outside the host country. In the case of business trainees, the exemption from income tax in the host country applies only for a period not exceeding one year from the time the visitor first arrives in the host country for the purpose of training. The Technical Explanation states that, if a business trainee remains in the host country for more than a year, he will not retroactively lose the treaty benefits for the first year.

The proposed treaty also provides students and business trainees with an exemption for income from personal services performed in the host country up to a total of $9,000 or its equivalent in Hungarian Forints annually. The competent authorities are required to adjust this amount every five years to take into account changes in the U.S. personal exemption and standard deduction.

A business trainee is an individual who is in the host country temporarily either (1) for the purpose of securing training required to qualify the individual to practice a profession or professional specialty or (2) as an employee of, or under contract with, a resident of the other treaty country for the primary purpose of acquiring technical, professional, or business experience from a person other than that resident.

The saving clause of paragraph 4 of Article 1 (General Scope) of the proposed treaty does not apply under this article in the case of an individual who is neither a citizen of the host country nor admitted to permanent residence in the host country (that is, in the United States, the individual does not acquire a green card). Such an individual is thus entitled to the exemptions under this article. The saving clause does apply, however, to citizens and permanent residents of the host country. As an example, the Technical Explanation refers to a person who is not a U.S. citizen, and who visits the United States as a student and remains long enough to become a resident under U.S. law, but does not become a permanent resident. This individual is eligible for the exemption under this article from U.S. tax on remittances from abroad that would otherwise constitute U.S. taxable income.

Article 20. Professors and Teachers

The treatment provided to professors and teachers under the proposed treaty is similar to the treatment provided under the present treaty, with certain modifications. Such a provision is not part of either the U.S. Model treaty or the OECD Model treaty.

Under the proposed treaty, a professor or teacher who visits a host treaty country for the sole purpose of teaching or carrying out advanced study (including research) at a university, college, or other establishment for higher education or other recognized research institute, and who, immediately before the visit was a resident of the other treaty country, is exempt from tax in the host treaty country on any remuneration received for such teaching or advanced study. Remuneration received for conducting research primarily for the private benefit of a specific person or persons, however, is not tax exempt. The exemption applies only for a period of two years starting from the date the professor or teacher visits the host treaty country. If the visit exceeds two years, the individual may be subject to tax in the host treaty country for the entire period of his or her visit.

Pursuant to paragraph 5(b) of Article 1 (General Scope), the saving clause of paragraph 4 of Article 1 does not apply to this article in cases in which an individual is neither a citizen nor a lawful permanent resident (for immigration law purposes) of the host treaty country. Thus, for example, Hungarian professors or teachers who may be considered U.S. residents for purposes of the proposed treaty, but who are not U.S. citizens or U.S. residents for immigration law purposes, are not subject to U.S. tax on remuneration that is within the scope of this article.

Article 21. Other Income

The proposed treaty includes a catch-all provision that assigns taxing jurisdiction over items of income beneficially owned by a resident of a treaty country and not addressed in the other articles of the proposed treaty. The general rule is that such items are taxable only in the country of residence of the person receiving the income. This right of taxation applies whether or not the residence country exercises its right to tax the income covered by the article. This rule is similar to the rules in the U.S. Model and OECD Model treaties.

An item of income is addressed in another article if it is the type of income described in the article and, in most cases, has its source in one of the treaty countries. For example, royalty income that is beneficially owned by a resident of a treaty county is addressed in Article 12 (Royalties) if the royalty income arises in the other treaty country, but not if the royalty income arises in a third country. However, profits derived in the conduct of a business are addressed in Article 7 (Business Profits) whether or not they have their source in one of the treaty countries.

According to the Technical Explanation, examples of types of items of income covered by this article include income from gambling, punitive (but not compensatory) damages, and covenants not to compete. This article also applies to income from a variety of financial transactions, when such income does not arise in the course of the conduct of a trade or business. For example, income from notional principal contracts and other derivatives are covered if derived by persons not engaged in the business of dealing in such instruments, unless such instruments were used to hedge risks arising in a trade or business. This article also applies to securities lending fees derived by an institutional investor and guarantee fees paid within an intercompany group, unless the guarantor is engaged in the business of providing such guarantees to unrelated parties.

Like the present treaty, but unlike the U.S. Model treaty, the proposed treaty does not specifically address annuities, alimony, or child support. Accordingly, such items are covered by this article. This article also applies to items of income that are not addressed in the other articles because of their source, character, or some other attribute. For example, Article 11 (Interest) addresses only the taxation of interest arising in one of the treaty countries. Therefore, interest arising in a third country that is not attributable to a permanent establishment is subject to this article.

Distributions from partnerships are not generally covered under this article because partnership distributions generally do not constitute income. Under the Code, partners include in income annually their distributive share of partnership income, and partnership distributions themselves generally do not give rise to income. A similar result is attained under U.S. law with respect to distributions from trusts. Trust income and distributions that, under the Code, have the character of the associated distributable net income (for example, interest or royalties) generally are covered by another article of the proposed treaty.

The general rule of residence taxation does not apply to income (other than income from immovable property (real property) as defined in paragraph 2 of Article 6) if the beneficial owner of the income is a resident of one country and carries on business in the other country through a permanent establishment situated therein, and the income is attributable to such permanent establishment. In such a case, the provisions of Article 7 (Business Profits) will apply.

This article is subject to the saving clause in paragraph 4 of Article 1 (General Scope). Accordingly, U.S. citizens who are residents of Hungary will continue to be taxable by the United States on income to which this article applies, including relevant third-country income.

Article 22. Limitation on Benefits

In general

The proposed treaty includes rules that are similar to the limitation-on-benefits provisions included in other recent U.S. income tax treaties and protocols. These rules are intended to prevent the indirect use of the proposed treaty by persons who are not entitled to its benefits by reason of residence in the United States or Hungary. The present treaty does not include a limitation-on-benefits provision.

The proposed treaty is intended to limit double taxation caused by the interaction of the tax systems of the United States and Hungary as they apply to residents of the two countries. At times, however, residents of third countries attempt to benefit from a treaty by engaging in treaty shopping. Treaty shopping by a third-country resident may involve organizing, in a treaty country, a corporation that is entitled to the benefits of the treaty. Alternatively, a third-country resident eligible for favorable treatment under the tax rules of its country of residency may attempt to reduce the income base of a treaty country resident by having that treaty country resident pay to it, directly or indirectly, interest, royalties, or other amounts that are deductible in the treaty country from which the payments are made. Limitation-on-benefits provisions are intended to deny treaty benefits in certain cases of treaty shopping or income stripping engaged in by third-country residents.

Generally, a resident of either treaty country is entitled to all the benefits accorded by the proposed treaty if the resident has any one of six listed attributes. The six attributes are that the resident is: (1) an individual; (2) one of the two treaty countries or a political subdivision or local authority of one of the two countries; (3) a company that satisfies a public company test or that is a subsidiary of a public company; (4) a pension fund that satisfies a beneficiaries test; (5) an organization that is established in its country of residence exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes, even if all or part of its income or gains are exempt from tax under the residence country's domestic law; or (6) an entity that satisfies an ownership test and a base erosion test. A resident that is none of these may be entitled to treaty benefits with respect to certain items of income under the derivative benefits test or the active business test.

Special rules apply to treaty country residents that function as headquarters companies for multinational corporate groups.

Special anti-abuse rules govern items of income derived from one of the treaty countries by an enterprise resident in the other treaty country in so-called "triangular cases." In addition, a special rule applies in certain cases in which a company that is resident in one treaty country, or a company that controls such a company directly or indirectly, has outstanding a class of shares entitling a shareholder to a disproportionate part of the company's income.

A person that does not satisfy any of the requirements described above may be entitled to the benefits of the treaty if the source country's competent authority so determines.

Six attributes for qualification for all treaty benefits

Individual

Under the proposed treaty, an individual resident of the United States or Hungary is entitled to all treaty benefits. If, however, such individual receives income as a nominee on behalf of a third-country resident, and thus is not the beneficial owner of the income, benefits may be denied.

Governments

The proposed treaty provides that the United States and Hungary, and any political subdivision or local authority of either country, are entitled to all treaty benefits.

Publicly traded companies and subsidiaries

A company that is a resident of the United States or Hungary is entitled to all treaty benefits if the principal class of its shares, and any disproportionate class of shares, is regularly traded on one or more recognized stock exchanges (the "regular trading test") and either (1) the company's principal class of shares is primarily traded on a recognized stock exchange in its country of residence (or in the case of a company resident in Hungary, on a recognized stock exchanged located within the European Union ("EU") or in any other European Free Trade Association ("EFTA") country or, in the case of a company resident in the United States, on a recognized stock exchange located in another country that is a party to the North American Free Trade Agreement ("NAFTA")) (the "primary trading test"), or (2) the company's primary place of management and control is in its country of residence (the "management and control test"). Certain key elements of the regular trading test, primary trading test, and management and control test are described below.

The term "principal class of shares" means the ordinary or common shares of a company representing the majority of the aggregate voting power and value of that company. If the company does not have a single class of ordinary or common shares representing the majority of the aggregate voting power and value, then the "principal class of shares" means that class or those classes of shares that in the aggregate represent a majority of the aggregate voting power and value of the company.

A company that is resident in one treaty country has a "disproportionate class of shares" if any outstanding class of shares is subject to terms or other arrangements that entitle a shareholder to a larger portion of the company's income, profit, or gain in the other treaty country than that to which the shareholder would be entitled in the absence of those terms or arrangements. For example, if a company resident in Hungary has outstanding a class of tracking stock that pays dividends based upon a formula that approximates the company's return on its assets employed in the United States, that class of stock shall be considered a disproportionate class of shares.

The term "regularly traded" is not defined in the proposed treaty and therefore has the meaning it has under the laws of the relevant treaty country, usually the source country. In the United States, the term has the same meaning as under Treas. Reg. section 1.884-5(d)(4)(i)(B).

Based on that provision, the Technical Explanation states that a class of shares is regularly traded if (1) trades in the class of shares are made in more than de minimis quantities on at least 60 days during the taxable year, and (2) the aggregate number of shares in the class traded during the year is at least 10 percent of the average number of shares outstanding during the year. The Technical Explanation notes that trading on one or more recognized stock exchanges may be aggregated for purposes of meeting the "regularly traded" requirement.

The term "recognized stock exchange" means the NASDAQ System owned by the National Association of Securities Dealers, Inc.; any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange under the U.S. Securities Exchange Act of 1934; the stock exchange of Budapest; the stock exchanges of Amsterdam, Brussels, Frankfurt, London, Paris, Vienna, Warsaw, and Zurich; and any other stock exchange agreed upon by the competent authorities of the treaty countries.

The term "primarily traded" is not defined in the proposed treaty and therefore has the meaning it has under the laws of the relevant treaty country, usually the source country. In the United States, the term has the same meaning as under Treas. Reg. section 1.884-5(d)(3). Based on that provision, the Technical Explanation states that stock of a corporation is primarily traded in the company's country of residence if the number of shares in the company's principal class of shares that are traded during the taxable year on all recognized stock exchanges in the treaty country of which the company is a resident exceeds the number of shares in the company's principal class of shares that are traded during that year on established securities markets in any other single foreign country.

A company the principal class of shares of which is regularly traded on a recognized stock exchange but which does not satisfy the primary trading test (that is, the requirement that a company's principal class of shares be primarily traded on a recognized stock exchange in the company's country of residence) may claim treaty benefits if it satisfies the management and control test — that is, if the company's primary place of management and control is in the treaty country of which it is a resident. A company's primary place of management and control is located in the treaty country in which the company is a resident only if the executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial, and operational policy decision making for the company (including direct and indirect subsidiaries) in that country than in the other treaty country or any third country, and if the staff that support the management in making those decisions are also based in that residence country.

The Technical Explanation notes that the management and control test should be distinguished from the "place of effective management" test used by many countries and in the OECD Model treaty to establish residence. The place of effective management test has been interpreted to mean the place where the board of directors meets. Under the proposed treaty, by contrast, the management and control test looks to where day-to-day responsibility for the management of the company (and its subsidiaries) is exercised.

A company that does not satisfy the regular trading test and either the primary trading test or the management and control test (because, for example, its shares are not publicly traded) may be entitled to treaty benefits if shares representing at least 50 percent of its aggregate voting power and value are owned, directly or indirectly, by five or fewer companies that satisfy the regular trading test and either the primary trading test or the management and control test, provided that, in the case of indirect ownership, each intermediate owner is a resident of the United States or Hungary. This rule allows certain subsidiaries of publicly traded companies to be eligible for all benefits under the proposed treaty.

Pension funds

A pension fund organized in one of the treaty countries is entitled to all the benefits of the proposed treaty if more than 50 percent of the organization's beneficiaries, members, or participants are individuals resident in either the United States or Hungary. According to the Technical Explanation, for purposes of this provision, the term "beneficiaries" refers to the persons receiving benefits from the organization.

Tax-exempt organizations

An organization established in its country of residence exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes is entitled to treaty benefits notwithstanding that all or part of its income or gains may be exempt from tax under the domestic law of that country. The Technical Explanation notes that a tax-exempt organization other than a pension fund qualifies for benefits without regard to the residence of its beneficiaries or members.

Ownership and base erosion tests

An entity that is a resident of one of the treaty countries is entitled to treaty benefits if it satisfies both an ownership test and a base erosion test.

An entity that is a resident of a treaty country satisfies the ownership test if on at least half the days of the taxable year at least 50 percent of each class of the entity's shares or other beneficial interests are owned, directly or indirectly, by residents of that treaty country who are entitled to treaty benefits under the limitation-on-benefits article as individuals, governments, parent companies that meet the public company test, pension funds, or tax-exempt organizations. In the case of indirect ownership, each intermediate owner must be a resident of the same treaty country as the entity seeking to satisfy the ownership test. Paragraph 6 of the diplomatic notes provides that, for purposes of meeting the 50-percent ownership requirement on at least half the days of the taxable year, there is no requirement that the days on which the test is satisfied must be consecutive.

The base erosion test is satisfied only if less than 50 percent of the person's gross income for the taxable year, as determined in that person's country of residence, is paid or accrued, directly or indirectly, in the form of payments deductible in the person's country of residence, to persons who are not residents of either treaty country entitled to treaty benefits under this article as individuals, governments, parent companies that meet the public company test, pension funds, or tax-exempt organizations. Arm's-length payments made in the ordinary course of business for services or tangible property, and certain payments in respect of financial obligations to a bank (including, in the case of Hungary, a credit institution) that is not related to the payor, do not count against the entity in determining whether the 50-percent threshold is reached.

The Technical Explanation states that trusts may be entitled to the benefits of this provision if they are treated as residents under Article 4 (Resident), and they otherwise satisfy the ownership and base erosion tests.

Active business test

Under the proposed treaty, a resident of one treaty country is entitled to treaty benefits with respect to an item of income derived from the other country if (1) the resident is engaged in the active conduct of a trade or business in its residence country, and (2) the income from the other country is derived in connection with or is incidental to that trade or business. The proposed treaty provides that the business of making or managing investments for the resident's own account does not constitute an active trade or business unless the business is insurance or securities activities carried on by an insurance company or registered securities dealer, or, in the case of a resident of the United States, are banking activities carried on by a bank, or in the case of a resident of Hungary, are regulated services carried on by a financial institution.

The term "trade or business" is not defined in the proposed treaty. According to the Technical Explanation, under paragraph 2 of Article 3 (General Definitions) of the proposed treaty, when determining whether a resident of Hungary is entitled to the benefits of the proposed treaty under the active business test with respect to an item of income derived from sources within the United States, the United States will ascribe to this term the meaning that it has under the laws of the United States. Accordingly, the Technical Explanation states, the U.S. competent authority will refer to the regulations issued under section 367(a) for the definition of the term "trade or business." In general, a trade or business will be considered to be a specific unified group of activities that constitute or could constitute an independent economic enterprise carried on for profit. Furthermore, a corporation generally will be considered to carry on a trade or business only if the officers and employees of the corporation conduct substantial managerial and operational activities.

The Technical Explanation elaborates on the requirement that an item of income from the source country be derived "in connection with" or be "incidental to" the resident's trade or business in its residence country. The Technical Explanation provides that an item of income is derived in connection with a trade or business if the income-producing activity in the source country is a line of business that "forms a part of" or is "complementary to" the trade or business conducted in the residence country by the income recipient.

According to the Technical Explanation, a business activity generally will be considered to form part of a business activity conducted in the source country if the two activities involve the design, manufacture, or sale of the same products or type of products, or the provision of similar services. The line of business in the country of residence may be upstream, downstream, or parallel to the activity conducted in the country of source. Thus, the line of business may provide inputs for a manufacturing process that occurs in the source country, may sell the output of that manufacturing process, or simply may sell the same sorts of products that are being sold by the trade or business carried on in the country of source.

The Technical Explanation states that for two activities to be considered to be "complementary," the activities need not relate to the same types of products or services but should be part of the same overall industry and should be related in the sense that the success or failure of one activity will tend to result in success or failure for the other. Where more than one trade or business is conducted in the country of source and only one of the trades or businesses forms a part of or is complementary to a trade or business conducted in the country of residence, it is necessary, according to the Technical Explanation, to identify the trade or business to which an item of income is attributable. Royalties generally are considered to be derived in connection with the trade or business to which the underlying intangible property is attributable. Dividends are deemed to be derived first from earnings and profits of the treaty-benefited trade or business and then from other earnings and profits. Interest income may be allocated under any reasonable method consistently applied. A method that conforms to U.S. principles for expense allocation will be considered a reasonable method.

The Technical Explanation further states that an item of income derived from the country of source is "incidental to" the trade or business carried on in the country of residence if production of the item facilitates the conduct of the trade or business in the country of residence. An example of incidental income is the temporary investment of working capital of a person in the country of residence in securities issued by persons in the country of source.

The proposed treaty provides that if a resident of a treaty country carries on a trade or business activity in the other country that gives rise to an item of income, or derives an item of income arising in the other treaty country from a related person, the active business test applies to the item of income only if the trade or business activity in the residence country is substantial in relation to the trade or business activity in the source country. The determination is made separately for each item of income derived from the source country.

The Technical Explanation explains that the substantiality requirement is intended to prevent a narrow case of treaty-shopping abuses in which a company attempts to qualify for benefits by engaging in de minimis connected business activities in the treaty country in which it is resident (that is, activities that have little economic cost or effect with respect to the company business as a whole). The determination of substantiality is made based upon all the facts and circumstances and takes into account the comparative sizes of the trades or businesses in each treaty country, the nature of the activities performed in each country, and the relative contributions made to that trade or business in each country.

The Technical Explanation further discusses that, in addition to the subjective rule, paragraph 10 of the diplomatic notes provides for a safe harbor under which the trade or business in the treaty country in which a company is resident will be deemed to be substantial relative to the trade or business in the other treaty country based on three ratios. Under the safe harbor, a trade or business will be deemed substantial if, for the preceding taxable year, or for the average of the three preceding taxable years, the asset value, the gross income, and the payroll expense that are related to the trade or business of the company in the treaty country of residence each equals at least 7.5 percent of the company's proportionate share of the asset value, gross income, and payroll expenses that generate the income in the other treaty country, and the average of the three ratios in each such year exceeds 10 percent. To the extent the company in the treaty country of residence owns less than 100 percent of an activity conducted in the other treaty country, only the company's proportionate interest in such activity shall be taken into account.

The proposed treaty provides that, in determining whether a person is engaged in the active conduct of a trade or business in a treaty country, activities conducted by persons "connected" to that first person are deemed to be conducted by that first person. A person is "connected" to another person if one possesses at least 50 percent of the beneficial interest in the other (or, in the case of a company, at least 50 percent of the aggregate voting power and at least 50 percent of the aggregate value of the shares in the company or of the beneficial equity interest in the company), or another person possesses that requisite interest in each of the two entities. A person is also considered to be connected to another if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same person or persons.

<u>Derivative benefits rule</u>

The proposed treaty includes derivative benefits rules that are generally intended to allow a treaty-country company treaty benefits for an item of income if the company's owners would have been entitled to the same benefits for the income had those owners derived the income directly. Under these derivative benefits rules, a treaty-country company is eligible for treaty benefits for an item of income only if the company satisfies both an ownership requirement and a base erosion requirement.

A company satisfies the ownership requirement if shares representing at least 95 percent of the company's aggregate voting power and value, and at least 50 percent of any of the company's disproportionate class of shares, are owned directly or indirectly by seven or fewer persons who are equivalent beneficiaries. The term "disproportionate class of shares" has the same definition as the definition previously described. In addition, paragraph 11 of the diplomatic notes` states that the competent authorities of both countries will ordinarily grant treaty benefits in cases in which a company claiming derivative benefits is owned directly by up to 10 individuals, to the extent such individuals are equivalent beneficiaries and the company satisfies the base erosion requirement as well as any other requirements for benefits under the Convention.

A company satisfies the base erosion requirement for an item of income only if, in the taxable year in which the income item arises, the amount of the deductible payments or accruals the company makes, directly or indirectly, to persons who are not equivalent beneficiaries is less than 50 percent of the company's gross income for the year, as determined in the company's country of residence. Deductible payments do not include arm's-length payments in the ordinary course of a business for services or tangible property. The Technical Explanation notes that the base erosion requirement under the derivative benefits rule is the same as the base erosion test described previously (that is, the test that is included in the rules for determining whether a treaty country resident has one of the six attributes for qualification for all treaty benefits), except that, for the derivative benefits rule, deductible payments made to equivalent beneficiaries, not just to residents of a treaty country entitled to treaty benefits, are excluded from the payments that count toward the 50-percent limitation.

An equivalent beneficiary must be a resident of an EU member country, an EFTA country, or a NAFTA party (together, "qualifying countries") and must satisfy either of two criteria described below.

The first criterion includes two requirements. First, the person must be entitled to all treaty benefits under a comprehensive income tax treaty between a qualifying country and the country from which the benefits of the U.S.-Hungary treaty are being claimed (an "applicable treaty"), and this entitlement to treaty benefits must result from satisfaction of limitation-on-benefits provisions analogous to the proposed treaty's rules, described above, for individuals, governments, publicly-traded companies, pension funds, and tax-exempt organizations. If the applicable treaty does not include a comprehensive limitation-on-benefits article, this first requirement is satisfied only if the person would meet the proposed treaty's requirements for entitlement to treaty benefits as an individual, a government, a publicly-traded company, a tax-exempt organization, or a pension fund. Second, for income from dividends, interest, or royalties, the person must be entitled under an applicable treaty to a rate of tax on that income that is at least as low as the rate applicable under the proposed treaty.

For dividend, interest, or royalty payments arising in Hungary and beneficially owned by a resident of the United States, the proposed treaty includes a special rule for determining whether a company that is a resident of an EU member country satisfies the tax rate test for purposes of determining whether the U.S. resident is entitled to treaty benefits for the payments. The special rule provides that the EU member country resident satisfies the tax rate test if a dividend, interest, or royalty payment arising in Hungary and paid directly to that EU member country resident would be exempt from withholding tax under an EU directive even though the income tax treaty between Hungary and that EU member country would permit imposition of a higher withholding tax rate on that payment than is permitted by the proposed treaty. The Technical Explanation states that this special rule takes into account that withholding taxes on many intercompany dividend, interest, and royalty payments are exempt within the EU under various EU directives. The special rule is necessary, according to the Technical Explanation, because many EU member countries have not renegotiated their tax treaties to reflect the EU directives' elimination of withholding tax.

Under the second criterion for determining whether a resident of a qualifying country is an equivalent beneficiary, the resident must be a U.S. or Hungarian resident that is entitled to treaty benefits under one of the rules described previously for individuals, governments, publicly traded companies, pension funds, and tax-exempt organizations. Under this rule, according to the Technical Explanation, a Hungarian individual is an equivalent beneficiary for an item of income received by another treaty country resident regardless of whether the individual would have been entitled to receive the same benefits if it had received the income directly. The Technical Explanation states that this criterion is included to clarify that ownership by certain residents of a treaty country does not disqualify a U.S. or Hungarian company from treaty benefits under the derivative benefits rules. If, for example, 90 percent of a Hungarian company is owned by five companies that are residents of EU member countries and that satisfy the first criterion described above, and 10 percent of the Hungarian company is owned by a U.S. or a Hungarian individual, the Hungarian company still can satisfy the requirements of the ownership test of the derivative benefits rules.

Rules for headquarters companies

Under the proposed treaty, a resident of the United States or Hungary is entitled to treaty benefits if that person functions as a headquarters company for a multinational corporate group described below. A person is considered a headquarters company for this purpose only if each of several criteria is satisfied.

Overall supervision and administration

To be considered a headquarters company, a person must provide a substantial portion of the overall supervision and administration of the multinational corporate group. This supervision and administration may include, but cannot be principally, group financing.

The Technical Explanation states that a person will be considered to engage in supervision and administration only if it engages in a number of the following activities: group financing (but, as mentioned above, not as its principal activity), pricing, marketing, internal auditing, internal communications, and management. In determining whether a substantial portion of the overall supervision and administration of the group is provided by the headquarters company, that company's headquarters-related activities must be substantial in relation to the same activities for the same group performed by other entities.

Active trade or business

Under the active trade or business requirement, the multinational corporate group must consist of companies that are resident in, and engaged in an active business in, at least five countries, and the business activities carried on in each of the five countries (or five groupings of countries) must generate at least 10 percent of the gross income of the group. The Technical Explanation states that this active trade or business rule is the first of several requirements intended to ensure that the relevant group is truly multinational. According to the Technical Explanation, so long as there are at least five individual countries or groupings that each satisfy the 10-percent requirement, the income from multiple countries may be aggregated into nonoverlapping groupings in determining whether the 10-percent gross income requirement is satisfied. If the gross income requirement is not satisfied for a taxable year, the taxpayer may satisfy the requirement by applying the 10-percent gross income test to the average of the gross incomes for the four years preceding the taxable year.

The Technical Explanation gives the following example of the operation of the active trade or business requirement. HHQ is a Hungarian resident that functions as a headquarters company for a group of companies resident in the United States, Canada, New Zealand, the United Kingdom, Malaysia, the Philippines, Singapore, and Indonesia. In 2008, the total gross income of the multinational corporate group is $137, of which $40 is generated in the United States, $25 in Canada, $10 in New Zealand, $30 in the United Kingdom, $10 in Malaysia, $7 in the Philippines, $10 in Singapore, and $5 in Indonesia. Ten percent of the group's gross income in 2008 is $13.70; only the United States, Canada, and the United Kingdom satisfy the 10-percent requirement by themselves. Together, the New Zealand and Malaysia members generate $20 of gross income, and the Philippines, Singapore, and Indonesia members together generate $22 of gross income. These two groupings therefore may be treated as the fourth and fifth members of the group (in addition to the United States, Canada, and the United Kingdom) under the active trade or business requirement, and the requirement is satisfied in 2008.

Single-country limitation

The business activities carried on in any one country other than the residence country of the headquarters company must generate less than 50 percent of the gross income of the group. If this less-than-50-percent requirement is not satisfied for a taxable year, it will be satisfied if the average for the four immediately preceding the tax years is less than 50 percent. The Technical Explanation provides an example of the application of this rule:

Example: HHQ is a corporation resident in Hungary. HHQ functions as a headquarters company for a group of companies. HHQ derives dividend income from a U.S. subsidiary in the 2008 taxable year. The countries of residence of the companies in the group, the sites of their activities, and the amounts of gross income attributable to the companies for the years 2008 through 2012 are set forth below:

Company	**Situs**	**2012**	**2011**	**2010**	**2009**	**2008**
United States	U.S.	$100	$100	$95	$90	$85
Mexico	U.S.	10	8	5	0	0
Canada	U.S.	20	18	16	15	12
United Kingdom	U.K.	30	32	30	28	27
New Zealand	N.Z.	35	42	38	36	35
Japan	Japan	35	32	30	30	28
Singapore	Singapore	30	25	24	22	20
TOTAL		$260	$257	$238	$221	$207

Because the U.S. situs companies' total gross income of $130 in 2012 is not less than 50 percent of the gross income of the group, the provision is not satisfied with respect to dividends derived in 2012. However, the U.S. situs companies' average gross income for the preceding four years may be used in lieu of the preceding year's average. The United States' average gross income for the years 2008 through 2011 is $111 ($444/4). The group's total average gross income for these years is $230.75 ($923/4). Because $111 represents 48.1 percent of the group's average gross income for the years 2008 through 2011, the United States satisfies the single-country limitation.

Other country gross income limitation

No more than 25 percent of gross income of a headquarters company that is a resident of one treaty country may be derived from the other treaty country. Thus, according to the Technical Explanation, if the headquarters company's gross income for the taxable year is $200, no more than $50 of gross income may be derived from the other treaty country. If this gross income requirement is not met for the taxable year, it may be satisfied based on the average percentage for the four preceding years.

Independent discretionary authority

The headquarters company must have and exercise independent discretionary authority to carry out the overall supervision and administration functions described above for the overall supervision and administration requirement. The Technical Explanation states that this determination is made separately for each function. Thus, if a headquarters company is nominally responsible for group financing, pricing, marketing, and internal auditing functions, and another entity is actually directing the headquarters company as to the group financing function, the headquarters company would not be deemed to have independent discretionary authority for group financing, but it may have such authority for the other functions.

Income taxation rules

The headquarters company must be subject to the generally applicable income taxation rules in its country of residence. The Technical Explanation states that this reference should be understood to mean that the company must be subject to the income taxation rules to which a company engaged in the active trade or business would be subject. Thus, if one of the countries has or introduces special taxation legislation that imposes a lower rate of income tax on headquarters companies than is imposed on companies engaged in the active conduct of a trade or business, or provides for an artificially low taxable base for headquarters companies, a headquarters company subject to these rules is not entitled to treaty benefits under the headquarters company rules.

In connection with or incidental to a trade or business

The income that a headquarters company resident in one treaty country derives in the other treaty country must be derived in connection with or be incidental to the active business activities described in the special active trade or business requirement under the headquarter company rules," above. For example, according to the Technical Explanation, if a Hungarian company that satisfied the other requirements of the headquarters company rules acted as a headquarters company for a group that included a U.S. company, and the group was engaged in the design and manufacture of computer software, but the U.S. company was also engaged in the design and manufacture of photocopying machines, the income that the Hungarian company derived from the United States would have to be derived in connection with or be incidental to the income generated by the computer business to be entitled to treaty benefits under the headquarters company rules. The Technical Explanation similarly states that interest income received from the U.S. company also would be entitled to treaty benefits as long as the interest was attributable to the computer business supervised by the headquarters company. Interest income derived from an unrelated party, however, normally would not satisfy the in-connection-with-or-incidental to requirement.

The triangular case

The proposed treaty provides a special anti-abuse rule that, according to the Technical Explanation, addresses a Hungarian resident's use of the following structure to earn interest income from the United States. The Hungarian resident (who is otherwise qualified for benefits under this article) organizes a permanent establishment in a third country that imposes a low rate of tax on the income of the permanent establishment. The Hungarian resident then lends funds into the United States through the permanent establishment. The permanent establishment is an integral part of the Hungarian resident. Consequently, the interest income that the permanent establishment earns on the loan is entitled to exemption from U.S. withholding tax under the treaty. Under the tax treaty between Hungary and the third country, Hungary does not tax the income earned by the permanent establishment. Alternatively, Hungary may choose to exempt the income of the permanent establishment from Hungarian income tax. Consequently, the income is not taxed in Hungary or the United States, and is only lightly taxed in the third country.

Under the proposed treaty, the United States may impose withholding tax on the interest payments if the combined tax actually paid on the income in Hungary and the third country is less than 60 percent of the general rate of company tax applicable in Hungary.

Although the example in the Technical Explanation involves interest income, the triangular provision applies to all types of income. Any dividends, interest, or royalties to which the provision applies may be subject to a maximum withholding tax rate of 15 percent. Any other income to which the provision applies is subject to tax under the domestic law of the source country, notwithstanding any other provision of the proposed treaty.

According to the Technical Explanation, the principles of the U.S. subpart F rules are employed to determine whether the profits of the permanent establishment are subject to an effective rate of tax that is above the specified threshold.

The triangular provision does not apply to royalties that are received as compensation for the use of, or the right to use, intangible property produced or developed by the permanent establishment itself. In the case of any other income, the triangular provision does not apply if that income is derived in connection with, or is incidental to, the active conduct of a trade or business carried on by the permanent establishment in the third country (other than the business of making, managing, or holding investments for the person's own account, unless the business is insurance or securities activities carried on by an insurance company or registered securities dealer, or, in the case of a resident of the United States, are banking activities carried on by a bank, or in the case of a resident of Hungary, are regulated services carried on by a financial institution.

The triangular provision applies reciprocally. However, the United States does not exempt the income of a third-country permanent establishment of a U.S. resident from U.S. tax, either by statute or by treaty.

Grant of treaty benefits by the competent authority

Under the proposed treaty, a resident of a treaty country that is not otherwise entitled to treaty benefits under this article may nonetheless be granted treaty benefits if the competent authority of the other treaty country determines that the establishment, acquisition, or maintenance of the resident and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the proposed treaty.

According to the Technical Explanation, the competent authority's discretion under this provision is broad. The competent authority, for example, may grant all treaty benefits, may grant benefits only with respect to a particular item of income, and may set time limits on the duration of any relief granted. The competent authority of the source country is required to consult with the competent authority of the residence country before denying treaty benefits under this provision.

Article 23. Relief from Double Taxation

Internal taxation rules

United States

The United States taxes the worldwide income of its citizens and residents. It attempts unilaterally to mitigate double taxation generally by allowing taxpayers to credit the foreign income taxes that they pay against U.S. tax imposed on their foreign-source income. An indirect or "deemed-paid" credit is also provided. Under this rule, a U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and that receives a dividend from the foreign corporation (or an inclusion of the foreign corporation's income) is deemed to have paid a portion of the foreign income taxes paid by the foreign corporation on its earnings. The taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid for the year the dividend is received.

A fundamental premise of the foreign tax credit is that it may not offset U.S. tax on U.S.-source income. Therefore, the foreign tax credit provisions limit the foreign taxes that a taxpayer may claim as credits for the year to the amount of the taxpayer's U.S. tax liability attributable to its foreign-source income. The limitation is computed separately for "passive category income" and other income to prevent the crediting of foreign taxes on certain high-taxed foreign-source income against the U.S. tax on certain types of traditionally low-taxed foreign-source income. Other limitations may apply in determining the amount of foreign taxes that may be credited against the U.S. tax liability of a U.S. taxpayer.

Hungary

In general, double taxation relief is provided in the form of a tax credit available for foreign taxes paid on foreign-source income. The tax credit is limited to 90 percent of the foreign taxes paid and may not exceed the Hungarian tax liability.

Proposed treaty

Overview

One of the principal purposes for entering into an income tax treaty is to limit double taxation of income earned by a resident of one of the countries that may be taxed by the other country. Unilateral efforts to limit double taxation are imperfect. Because of differences in rules as to when a person may be taxed on business income, a business may be taxed by two countries as if it were engaged in business in both countries. Also, a corporation or individual may be treated as a resident of more than one country and be taxed on a worldwide basis by both.

Part of the double tax problem is addressed in other articles of the proposed treaty that limit the right of a source country to tax income. This article provides further relief in circumstances in which both Hungary and the United States still tax the same item of income. This article is not subject to the saving clause; the country of citizenship or residence will waive its overriding taxing jurisdiction to the extent that this article applies.

Hungary tax relief for taxes paid to the United States

Specific rules are provided in paragraph 1 under which Hungary, in imposing tax on its residents, provides relief for U.S. taxes paid by those residents. Hungary is required to provide relief from double taxation under the proposed treaty through a mixture of allowing a foreign tax credit in certain circumstances and exempting income in other circumstances.

As a general rule, Hungary must exempt from tax income that a Hungarian resident derives that may be taxed by the United States under the proposed treaty. Hungary is, however, permitted to take into account the exempted income in calculating the amount of tax to be imposed on the remaining income of the Hungarian resident. According to the Technical Explanation, this rule provides "exemption with progression."

Hungary must provide a credit rather than an exemption in respect of limited classes of income. If a Hungarian resident derives dividend or interest income that the United States is permitted to tax under Article 10 or 11, Hungary must relieve double taxation by permitting the resident to deduct from its tax an amount equal to the tax paid to the United States. The deduction is not to exceed the amount of Hungarian tax attributable to the dividend or interest income.

Hungary is not required to grant an exemption from its tax for income that a Hungarian resident derives that is exempted from U.S. tax under the proposed treaty or is subject to a reduced rate of tax under paragraph 2 of Article 10 (Dividends) or paragraph 2 of Article 11 (Interest).

U.S. tax relief for taxes paid to Hungary

Paragraph 2 of Article 23 generally provides that the United States will allow a U.S. citizen or resident a foreign tax credit for the income taxes paid to Hungary, and will allow a U.S. corporation a deemed-paid credit when the U.S. corporation receives dividends from a Hungarian corporation in which the U.S. corporation owns 10 percent or more of the voting stock. The credit generally is to be computed in accordance with the provisions and subject to the limitations of U.S. law (as that law may be amended from time to time without changing the general principles of the proposed treaty provisions). This provision is similar to those found in the U.S. Model treaty and many U.S. tax treaties, and is consistent with U.S. law.

The proposed treaty provides that the taxes referred to in paragraphs 3(a) and 4 of Article 2 (Taxes Covered), which are Hungary's personal income tax and any identical or substantially similar tax imposed after the proposed treaty was signed, are considered income taxes for purposes of paragraph 2. The Technical Explanation states that this rule is based on the Treasury Department's review of Hungary's laws.

Paragraph 3 includes a resourcing rule that applies for purposes of paragraph 2. Under paragraph 3, an item of gross income (as determined under U.S. law) that is derived by a U.S. resident and that may be taxed by Hungary under the proposed treaty is deemed to be income from sources in Hungary for U.S. foreign tax credit purposes. The Technical Explanation states that this re-sourcing rule is intended to ensure that a U.S. resident can obtain an appropriate amount of U.S. foreign tax credit for taxes paid to Hungary when the proposed treaty assigns to

Hungary primary taxing jurisdiction over an item of gross income. As the Technical Explanation notes, the Code's foreign tax credit limitation generally applies separately to income re-sourced under treaties.

U.S. citizens who are resident in Hungary

Paragraph 4 provides special rules for the tax treatment of certain types of income derived by U.S. citizens who are residents of Hungary. U.S. citizens, regardless of residence, are subject to U.S. tax on their worldwide income. The U.S. tax on the income of a U.S. citizen who is a resident of Hungary may exceed the U.S. tax that may be imposed under the proposed treaty on the income if it were derived by a resident of Hungary who is not a U.S. citizen. The Technical Explanation states that the provisions of paragraph 4 ensure that Hungary does not bear the cost of U.S. taxation of its citizens who are residents of Hungary.

Subparagraph 4(a) provides a special credit rule for Hungary that limits the amount of credit Hungary must allow a resident of Hungary. The rule applies to items of income that would be either exempt from U.S. tax or subject to reduced rates of U.S. tax under the provisions of the proposed treaty if they had been received by a resident of Hungary who is not a U.S. citizen. The tax credit allowed by Hungary under paragraph 4 with respect to such items is limited to the U.S. tax that may be imposed under the proposed treaty, other than U.S. tax imposed solely by reason of the U.S. citizenship of the taxpayer under the provisions of the saving clause of paragraph 4 of Article 1 (General Scope).

For example, according to the Technical Explanation, if a U.S. citizen resident in Hungary receives portfolio dividends from sources within the United States, the foreign tax credit granted by Hungary would be limited to 15 percent of the dividend – the U.S. tax that may be imposed under subparagraph 2(b) of Article 10 (Dividends) – even if the shareholder is subject to U.S. net income tax because of his U.S. citizenship. With respect to royalty or interest income, Hungary would allow no foreign tax credit, because its residents are exempt from U.S. tax on interest income under the provisions of Articles 11 (Interest) and 12 (Royalties).

Subparagraph 4(b) eliminates the potential for double taxation that can arise because subparagraph 4(a) provides that Hungary need not provide full relief for the U.S. tax imposed on its citizens resident in Hungary. The subparagraph provides that the United States will credit the income tax paid or accrued to Hungary, after the application of subparagraph 4(a). It further provides that in allowing the credit of the taxes paid to Hungary, the United States will not reduce its tax below the amount that is creditable against Hungarian tax under subparagraph 4(a).

Since the income described in subparagraph 4(a) generally will be U.S. source income, special rules are required to re-source some of the income to Hungary in order for a taxpayer to be able to credit the tax paid to Hungary. This re-sourcing is provided for in subparagraph 4(c), which deems the items of income referred to in subparagraph 4(a) to be from foreign sources to the extent necessary to avoid double taxation under subparagraph 4(b).

The Technical Explanation includes two examples illustrating the application of paragraph 4 to a U.S. citizen resident in Hungary ("the U.S. citizen") that receives a $100 U.S.-source portfolio dividend. In both examples, the rate of withholding on a U.S.-source dividend is

15 percent and the U.S. income tax rate on U.S. citizens is 35 percent ("the U.S. citizenship tax"). In the first example, the Hungary tax rate that applies to the U.S. citizen that is resident in Hungary is 25 percent. In this example, Hungary allows the U.S. citizen to take a credit of $15 ($100 multiplied by 15 percent) against the Hungary resident tax of $25 under subparagraph 4(a). As a result, the net tax the U.S. citizen pays to Hungary post-credit is $10. In applying subparagraphs 4(b) and (c), the U.S. citizen first calculates the pre-credit citizenship tax of $35 ($100 multiplied by 35 percent). Since the tax the U.S. citizen owes to the U.S. government may not be less than the $15 of credit that the U.S. citizen takes against the Hungary income tax under subparagraph 4(b), the maximum U.S. citizenship tax eligible to be offset by a credit is $20 ($35 pre-credit citizenship tax less $15 of Hungary credit attributable to the dividend). As the $10 of net tax the U.S. citizen pays to Hungary is less than the $20 of U.S. citizenship tax that may be offset by a credit, the U.S. citizen may take a credit of $10 under subparagraph 4(b). Subparagraph 4(c) then applies to resource $28.57 ($10 divided by 35 percent) of the U.S.-source dividend as foreign-source income in the current year so that the U.S. citizen may take the credit under the U.S. foreign tax credit limitation.

In the second example, the Hungary tax rate that applies to the U.S. citizen that is resident in Hungary is 40 percent. In this example, Hungary allows the U.S. citizen to take a credit of $15 ($100 multiplied by 15 percent) against the Hungary resident tax of $40 under subparagraph 4(a). As a result, the net tax the U.S. citizen pays to Hungary post-credit will be $25. In applying subparagraphs 4(b) and (c), the U.S. citizen first calculates the pre-credit citizenship tax of $35 ($100 multiplied by 35 percent). Since the tax the U.S. citizen owes to the U.S. government may not be less than the $15 of credit that the U.S. citizen takes against the Hungary income tax under subparagraph 4(b), the maximum U.S. citizenship tax eligible to be offset by a credit is $20 ($35 pre-credit citizenship tax less $15 of Hungary credit attributable to the royalty). As the $25 of net tax the U.S. citizen pays to Hungary is greater than the $20 of U.S. citizenship tax that may be offset by a credit, the U.S. citizen may take a credit in the current year of $20 under subparagraph 4(b) with $5 of excess foreign tax credit available for carryover. Subparagraph 4(c) then applies to re-source $57.14 ($20 divided by 35 percent) of the U.S.-source dividend as foreign-source income in the current year so that the U.S. citizen may take the credit under the U.S. foreign tax credit limitation.

Relationship to other Articles

By virtue of subparagraph 5(a) of Article 1 (General Scope), this article is not subject to the saving clause of paragraph 4 of Article 1. Thus, the United States will allow a credit to its citizens and residents in accordance with this article, even if the credit were to provide a benefit not available under the Code (such as the re-sourcing provided by paragraph 3 and subparagraph 4(c)).

Article 24. Non-Discrimination

The proposed treaty includes a comprehensive nondiscrimination article. The article is substantially similar to the nondiscrimination article in the U.S. Model treaty and to provisions that have been included in other recent U.S. income tax treaties. The description below explains the scope and operation of the individual paragraphs and identifies instances in which the article varies from the U.S. Model treaty.

In general, neither treaty country is permitted to discriminate against persons from the other country. Not all instances of differential treatment are discriminatory. Rather, the Technical Explanation states that "only differences in tax treatment that materially disadvantage the foreign person relative to the domestic person are properly subject of the Article." According to the Technical Explanation, the underlying premise of the operative paragraphs is that if the differential treatment is directly related to tax-relevant differences, such treatment is not discriminatory within the meaning of the article, regardless of slight variations in the language used in the operative paragraphs. Examples of tax-relevant disparities in circumstances include the fact that one person is subject to worldwide taxation in a treaty country and another person is not, or the fact that an item of income may be taxed at a later date in one person's hands but not in another person's hands.

In paragraph 1, the proposed treaty provides that a national of one treaty country cannot be subject to taxation by the other treaty country if that taxation is "other or more burdensome than" that imposed on the treaty country's own comparably situated nationals in the same circumstances. In so providing, the language is consistent with the OECD Model treaty. In contrast, the language in the U.S. Model treaty omits reference to "other" taxation. Although the paragraph also departs from the U.S. Model treaty in that it does not include a statement to the effect that U.S. nationals subject to tax on a worldwide basis are not in the same circumstances as Hungarian nationals who are not U.S. residents, it achieves the same result by including a reference to taxation of worldwide income as a factor to be considered in determining whether circumstances are comparable.

Because this paragraph, unlike the succeeding paragraphs in this article, refers to nationals rather than residents, this paragraph may apply to a national without regard to the limitations of Article 22 (Limitation on Benefits). The term "national" includes both individuals and juridical entities, as defined in Article 3 (General Definitions). Thus, a citizen of one treaty country need not be a resident of either treaty country to claim the protection of this provision if circumstances are comparable. For example, a U.S. citizen who is resident in a third country is entitled to the same treatment in Hungary as a comparably situated Hungarian national.

Under paragraph 2 of the proposed treaty, neither treaty country may tax a permanent establishment of an enterprise of the other treaty country less favorably than it taxes income from similar activities carried on by its own enterprises. In this instance, the fact that the U.S. enterprise is subject to U.S. tax on its worldwide income does not provide a basis on which differential treatment of the Hungarian owned permanent establishment is permitted. However, the Technical Explanation notes that foreign ownership or control may justify differences in information reporting requirements, collection methods and related penalties.

As under both the U.S. and OECD Model treaties, paragraph 3 makes clear that a treaty country is not obligated to grant residents of the other treaty country any personal allowances, reliefs, or reductions for tax purposes on account of civil status or family responsibilities that it grants to its own residents.

Paragraph 4 is similar but not identical to that of the U.S. Model treaty, and generally prohibits discrimination in the treatment of amounts paid by an enterprise of one treaty country to a resident of the other treaty country, for purposes of computing its taxable profits, except to the extent that the anti-avoidance rules in other articles of the proposed treaty require otherwise. Those rules are prescribed in paragraph 1 of Article 9 (Associated Enterprises), paragraph 5 of Article 11 (Interest), or paragraph 4 of Article 12 (Royalties) and concern transactions between related persons. The Technical Explanation states that the exception relating to paragraph 5 of Article 11 (Interest) would include the denial or deferral of certain interest deductions under section 163(j) of the Code, thus allowing the United States to apply its earnings stripping rules. The language of the paragraph in the U.S. Model treaty refers to taxable profits and deductions of a resident rather than of an enterprise.

Debts of an enterprise of one treaty country to a resident of the other treaty country are also deductible for purposes of determining the taxable capital of the enterprise under the same conditions as if they had been owed to a resident of the first treaty country. Because the nondiscrimination provisions are not limited in application to those taxes identified in Article 2 (Taxes Covered), this provision is relevant to both treaty countries.

Paragraph 5 provides that the nondiscrimination rules also apply to enterprises of one treaty country that are owned in whole or in part by one or more residents of the other treaty country. An enterprise of one treaty country the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other treaty country may not be subjected in the first country to any taxation (or any connected requirement) that is more burdensome than the taxation (or connected requirements) that the first country imposes or may impose on other similar enterprises. As noted above, some differences in treatment may be justified on the basis of tax-relevant differences in circumstances between two enterprises. In this regard, the Technical Explanation provides examples of Code provisions that are understood by the two treaty countries not to violate the nondiscrimination provision of the proposed treaty, including the rules that tax U.S. corporations making certain distributions to foreign shareholders in what would otherwise be nonrecognition transactions, the rules that impose a withholding tax on non-U.S. partners of a partnership, the rules that prevent foreign persons from owning stock in subchapter S corporations, and the rules that prevent foreign corporations from joining in filing consolidated returns with domestic corporations.

The proposed treaty at paragraph 6 provides that nothing in this article may be construed as preventing either of the countries from imposing a branch profits tax as described in paragraph 8 of Article 10 (Dividends).

Paragraph 7 provides that the protection from discrimination applies to taxes of every kind and description imposed by either treaty country, or any political subdivision or local authority of that treaty country, whether or not within the definition of taxes covered in Article 2 (Taxes Covered). According to the Technical Explanation, however, customs duties are not regarded as taxes for purposes of this article.

Under paragraph 5(a) of Article 1 (General Scope), the saving clause in Article 1 is expressly inapplicable to this article. Thus, a U.S. citizen who is a resident of Hungary may claim benefits in the United States under Article 23 (Relief from Double Taxation).

Article 25. Mutual Agreement Procedure

The mutual agreement provision permits taxpayers to bring to the attention of the competent authorities problems that may arise under the proposed treaty and authorizes the competent authorities of the treaty countries to cooperate to resolve disputes, clarify issues, and address cases of double taxation not provided for in the proposed treaty. The saving clause of the proposed treaty does not apply to the mutual agreement procedure. Consequently, the United States may apply rules and definitions agreed to by the competent authorities under the mutual agreement procedure to a U.S. citizen or resident even if those rules and definitions differ from comparable provisions of the Code.

Under this article, a person who considers that the actions of one or both of the treaty countries cause that person to be subject to tax in a manner not in accordance with the provisions of the proposed treaty may, irrespective of internal law remedies, present a case to the competent authority of the treaty country of which the person is a resident, or if the case comes under paragraph 1 of Article 24 (Non-Discrimination), to the treaty country of which the person is a national.

The Technical Explanation notes that typical cases brought under the mutual agreement procedure will involve economic double taxation arising from transfer pricing adjustments but that other types of cases also may be brought. The Technical Explanation gives as an example a taxpayer who has received income that the source country has determined is deferred compensation and therefore is taxable in that country but which the taxpayer believes is a pension taxable only in the taxpayer's country of residence. The Technical Explanation notes that it is not necessary for a taxpayer to exhaust the remedies under the laws of the relevant treaty country before presenting a case to the competent authorities, nor does the fact that the statute of limitations may have passed for seeking a refund preclude bringing a case to the competent authority. Unlike the OECD Model treaty, no time limit is provided within which a case must be brought.

The proposed treaty provides that if an objection presented to a competent authority appears to be justified and that competent authority is not itself able to arrive at a satisfactory solution, that competent authority must endeavor to resolve the case by mutual agreement with the competent authority of the other treaty country, with a view to the avoidance of taxation that is not in accordance with the proposed treaty. The proposed treaty provides that any agreement reached will be implemented notwithstanding any time limits or other procedural limitations in the domestic law of either treaty country (for example, a country's applicable statute of limitations), provided that the competent authority of the other treaty country has received notice from the resident treaty country competent authority that such case exists within six years from the end of the taxable year to which the case relates. The Technical Explanation notes that if a taxpayer has entered into a closing agreement with the United States before bringing a case to the competent authorities, the U.S. competent authority will do nothing other than endeavor to obtain a correlative adjustment from Hungary. Procedural limitations can be overridden, according to the Technical Explanation, only for the purpose of making refunds and not to impose additional tax.

The competent authorities of the treaty countries are to endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the proposed treaty. The Technical Explanation notes that the competent authorities may, for example, agree to the same allocation of income, deductions, credits, or allowances between an enterprise in one treaty country and its permanent establishment in the other treaty country, or between related persons. These allocations are to be made in accordance with the arm's-length principle underlying Article 7 (Business Profits) and Article 9 (Associated Enterprises) of the proposed treaty. Agreements reached may also include agreement on a methodology for determining an appropriate transfer price, on an acceptable range of results under that methodology, or on a common treatment of a taxpayer's cost sharing arrangement. The Technical Explanation further notes that the competent authorities may agree to settle conflicts regarding the characterization of particular items of income, the characterization of persons, the application of source rules with respect to particular items of income, the meaning of a term, or the timing of an item of income. They may also agree as to advance pricing arrangements and as to the application of the provisions of each treaty country's domestic law regarding penalties, fines, and interest in a manner consistent with the purposes of the proposed treaty. The Technical Explanation clarifies that these examples are not exhaustive, and the competent authorities may reach agreement on other issues if necessary to avoid double taxation.

The proposed treaty provides that the competent authorities may consult together for the elimination of double taxation in cases not provided for in the proposed treaty and may agree to increases in any specific dollar amounts referred to in the treaty to reflect economic or monetary developments.

The proposed treaty authorizes the competent authorities to communicate with each other directly for purposes of reaching an agreement in the sense of this article. The Technical Explanation states that this provision makes clear that the competent authorities may communicate without going through diplomatic channels.

The Technical Explanation states that even after the proposed treaty has been terminated, a taxpayer may bring to the competent authorities a case involving a year for which the proposed treaty was in force.

The Technical Explanation addresses cases involving the taxing jurisdictions of more than two countries. The example given involves a parent corporation resident in country A that engages in transactions with its subsidiaries in countries B and C. The Technical Explanation notes that if there is a complete network of treaties among the three countries, the competent authorities of those countries should be able to agree on a three-sided solution to a problem.

A person may seek relief under the mutual agreement procedure even if the person is not generally entitled to benefits under the limitation on benefits rules of the proposed treaty.

Article 26. Exchange of Information and Administrative Assistance

The proposed treaty provides rules governing exchange of information and administrative assistance that are substantially similar to those in the U.S. Model treaty. The description below explains the scope and operation of the individual paragraphs and identifies instances in which the article varies from the U.S. Model treaty.

The United States and Hungary agree to exchange such information as is relevant in carrying out the provisions of the proposed treaty or in carrying out the provisions of the domestic laws of the two treaty countries concerning all taxes of any kind imposed by a treaty country. The use of the word "relevant" indicates the breadth of the scope of the exchanges, in establishing the standard for determining whether or not information may be exchanged under the proposed treaty. It conforms to the standard used in Code section 7602, which is the principal source of authority for U.S. information gathering and examination of records. Under section 7602, the IRS may request to examine any books, records or other material that "may be relevant," as confirmed by the U.S. Supreme Court in a line of cases beginning with *United States v. Powell.*[25]

In the United States, the administrative authority of the IRS to obtain information by service of an administrative summons extends to the territories and possessions under Code section 7651 in the same manner as if the possession or territory were a state. Thus, even though paragraph 1(h) of Article 3 (General Definitions) of the proposed treaty provides a definition of "United States" that limits its meaning to its geographic sense for most purposes under the proposed treaty and specifically carves out its possessions and territories, information in the U.S. possessions or territories is subject to exchange of information pursuant to a proper request under the proposed treaty.

Information may be exchanged to enable each treaty country to administer its own domestic law, to the extent that taxation under that law is not contrary to the proposed treaty. According to the Technical Explanation, the competent authority of one treaty country may request information about a transaction from the competent authority of the other treaty country even if the transaction to which the information relates is a purely domestic transaction in the requested country and information exchange about the transaction would not be undertaken to carry out the proposed treaty. As an example, the Technical Explanation states (referencing the OECD Model treaty) that if a U.S. company and a Hungarian company transact with one another through a company resident in a third country that has no treaty with the United States or Hungary, the U.S. and Hungarian competent authorities may, to enforce their internal rules, exchange information about prices their respective resident companies paid in their transactions with the third-country company.

The proposed treaty provides that exchange of information may include information relating to the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the proposed treaty. Consequently, the competent authorities may exchange information about collection cases, cases under civil examination or criminal investigation, and cases being prosecuted.

Exchange of information is not restricted by paragraph 1 of Article 1 (Personal Scope) or Article 2 (Taxes Covered). Accordingly, information about persons who are residents of neither

[25] 379 U.S. 48 (1964).

Hungary nor the United States may be requested and provided under this article. For example, if a third-country resident has a Hungarian bank account and the IRS believes that funds in the account should have been, but have not been, reported, the U.S. competent authority may request information from Hungary about the bank account. Similarly, the competent authorities may exchange information relating to a broader category of taxes beyond those otherwise covered by the proposed treaty, including, for example, U.S. estate and gift taxes, U.S. excise taxes, and Hungarian value added taxes.

Any information exchanged under the proposed treaty is to be treated as secret in the same manner as information obtained under the domestic laws of the treaty country receiving the information. The exchanged information may be disclosed only to persons or authorities (including courts, administrative bodies, and legislative bodies) involved in the administration, enforcement or oversight of the tax laws. Such functions include assessment, collection, civil and criminal prosecution, and the determination of appeals in relation to the taxes to which the proposed treaty applies. The authority to disclose information to persons involved in oversight of taxes includes authority to disclose to persons or authorities such as the tax-writing committees of the U.S. Congress and the Government Accountability Office. Such persons or authorities receiving the information may use the information only in the performance of their role in overseeing the administration of U.S. tax laws. Finally, exchanged information may be disclosed in public court proceedings or in judicial decisions.

If information is requested by a treaty country in accordance with this article, the proposed treaty provides that the requested treaty country must obtain the information in the same manner and to the same extent as if the tax of the requesting treaty country were the tax of the requested treaty country and were being imposed by that treaty country, notwithstanding that the requested treaty country may not need the information at that time for purposes of administering its own tax rules. According to the Technical Explanation, this rule clarifies that the limitations on information exchange described below do not prevent a treaty country from requesting information from a bank or a fiduciary that the treaty country does not need for its own tax purposes.

A treaty country is not required to carry out administrative measures at variance with the laws and administrative practice of either treaty country, to supply information that is not obtainable under the laws or in the normal administrative practice of either treaty country, or to supply information that would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy. The Technical Explanation notes, however, that if a treaty country is asked to provide information, it should provide the information even if its own statute of limitations period has expired for the issue to which the information relates. According to the Technical Explanation, the statute of limitations of the treaty country making the request should govern. The Technical Explanation also states that even if the limitations on information exchange mean that a treaty country is not obligated to supply information in response to a request from the other treaty country, the requested country may choose to supply the information if doing so does not violate its internal law.

The proposed treaty includes a paragraph which limits the ability of either country to refuse to provide the information requested based on the lack of need for such information in a domestic tax investigation, or the expiration of the limitations period in the requested treaty country. If the information is of relevance to the requester, the limitations described immediately above will not support a refusal to exchange the information.

The proposed treaty limits the ability of either country to posit that domestic secrecy laws preclude response to a request for information. The proposed treaty explicitly limits the scope of the general principle described above that the treaty is not intended to require any actions by a treaty country at variance with its domestic law, by providing that a treaty country cannot refuse to respond to a request for information based on the fact that the information is in the possession of financial institutions, nominees, or persons acting in an agency or fiduciary capacity. With regard to persons acting in an agency or fiduciary capacity, the scope of any override of domestic law is not explained in the Technical Explanation. Thus, a competent authority receiving a request for information from a financial institution may not decline the request based on an argument that domestic bank secrecy or similar rules override the proposed treaty obligations and preclude honoring the request.

The proposed treaty also provides that the competent authorities may not refuse to exchange information because it relates to information concerning ownership interests in a "person." The Technical Explanation states that this requirement will have the effect of requiring disclosure of the beneficial owner of bearer shares. However, because the language in the proposed treaty refers to "interests in a person," but not to interests in "instruments," it may not be sufficiently broad to require such exchanges with respect to bearer bonds.

The proposed treaty makes it possible for a treaty country to request that responsive information be provided in an authenticated form that will facilitate use of that information in the administrative or judicial proceedings in the requesting treaty country. Upon specific request by the competent authority of a treaty country, the other treaty country competent authority must provide information in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writings), to the same extent such depositions and documents can be obtained under the laws and administrative practices of the requested treaty country with respect to its own taxes.

Unlike the U.S. Model treaty, the exchange of information provision in the proposed treaty is not applicable to information with respect to years prior to the entry into force of the proposed treaty. For such years, the present treaty remains in effect.

Article 27. Members of Diplomatic Missions and Consular Posts

The proposed treaty contains the rule (also found in the U.S. Model treaty, the present treaty, and other U.S. tax treaties) that its provisions do not affect the fiscal privileges of members of diplomatic missions or consular posts under the general rules of international law or under the provisions of special agreements. Accordingly, the proposed treaty will not preempt the exemption from tax that a host country may grant to the salary of diplomatic officials of the other country. The saving clause is not taken into account in the application of this article to host country residents (i.e., persons who are resident for purposes of the proposed treaty) who are neither citizens nor lawful permanent residents (i.e., permanently resident for immigration law purposes) of the host country. Thus, for example, Hungarian diplomats who are considered residents of the United States for purposes of the proposed treaty (but not for purposes of U.S. immigration law) are not made subject to U.S. tax by the proposed treaty.

Article 28. Entry into Force

The proposed treaty provides that the treaty is subject to ratification in accordance with the applicable procedures of each treaty country, and instruments of ratification shall be exchanged. The proposed treaty will enter into force on the date of the exchange of instruments of ratification.

With respect to withholding taxes (principally dividends, interest, and royalties), the proposed treaty has effect for amounts paid or credited on or after the first day of the second month following the date on which the proposed treaty enters into force. The Technical Explanation provides an example, in which, as a result of the instruments of ratification being exchanged on April 25 of a given year, the treaty rate of withholding under paragraph 2 of Article 10 (Dividends) is applicable to dividends paid after June 1 of that year.

For other taxes, the proposed treaty has effect for taxes with respect to tax periods beginning on or after the first day of January next following the date on which the proposed treaty enters into force.

The proposed treaty provides that the present treaty generally ceases to have effect with respect to any tax as of the date the proposed treaty takes effect. The proposed treaty includes an election for taxpayers to temporarily continue to claim benefits under the present treaty with respect to a period after the proposed treaty takes effect if they would have been entitled to greater benefits under the present treaty. However, the election is applicable with respect to such taxpayer's taxes only until December 31, 2010, and thus was of potential significance only if the proposed treaty had been ratified prior to that date. The Technical Explanation notes that the taxpayer cannot apply certain provisions of the present treaty and, at the same time, apply other provisions of the proposed treaty. The taxpayer must choose one treaty or the other in its entirety.

An individual who is entitled to the benefits of Article 17 (Teachers) or Article 18 (Students and Trainees) of the present treaty at the time the proposed treaty enters into force will continue to be entitled to the benefits available under the present treaty as if that treaty were still in force. The benefits under the present treaty are available until such individual would cease to be entitled to such benefits if the present treaty remained in force.

Article 29. Termination

This article provides that the proposed treaty is to remain in effect indefinitely, unless terminated by one of the treaty countries. The treaty may be terminated at any time provided that six months prior notice of termination has been given through the appropriate diplomatic channels.

If notice of termination is given, the provisions of the treaty with respect to withholding at source will cease to have effect on January 1 of the next calendar year. Similarly, for other taxes, the treaty will cease to have effect for taxes chargeable with respect to the tax periods commencing on or after January 1 of the next calendar year. For example, if notice of termination is given on May 1, 2015, then provisions of the treaty with respect to withholding at source will cease to have effect on January 1, 2016. For calendar year companies, the treaty will cease to have effect for taxes chargeable to the tax period commencing January 1, 2016. However, for a company with a November 30 fiscal year end, the treaty will cease to have effect for taxes chargeable to the tax period commencing December 1, 2016.

VI. ISSUES

A. Treaty Shopping

In general

The proposed treaty, like nearly all U.S. income tax treaties, generally limits treaty benefits for treaty country residents so that only those residents with a sufficient nexus to a treaty country will receive treaty benefits. Although the proposed treaty generally is intended to benefit residents of Hungary and the United States only, residents of third countries sometimes attempt to use a treaty to obtain treaty benefits. This practice is known as treaty shopping. Investors from countries that do not have tax treaties with the United States, or from countries that have not agreed in their tax treaties with the United States to limit source-country taxation to the same extent that it is limited in another treaty may, for example, attempt to reduce the tax on interest on a loan to a U.S. person by lending money to the U.S. person indirectly through a country whose treaty with the United States provides a lower rate of withholding tax on interest. The third-country investor may attempt to accomplish this result by establishing in that treaty country a subsidiary, trust, or other entity that then makes the loan to the U.S. person and claims the treaty reduction for the interest it receives – a reduction in withholding tax that would not have been possible had the investor made the loan directly from his or her country of residence.

The present treaty between the United States and Hungary is one of only seven U.S. income tax treaties that do not include any limitation-on-benefits rules. Two of those seven treaties, including the treaties with Hungary and Poland, include provisions providing for complete exemption from withholding on interest payments from one treaty country to the other treaty country. Consequently, those two treaties may present attractive opportunities for treaty shopping. For example, a November 2007 report prepared by the Treasury Department at the request of the U.S. Congress suggests that the income tax treaty with Hungary has increasingly been used for treaty-shopping purposes as the United States adopted modern limitation-on-benefits provisions in its other treaties. In 2004, U.S. corporations that were at least 25-percent foreign owned made $1.2 billion in interest payments to related parties in Hungary, the seventh largest amount of interest paid to related parties in any single country.[26] With its inclusion of modern limitation-on-benefits rules, the proposed treaty represents a significant opportunity to mitigate treaty shopping. Nevertheless, the Committee may wish to inquire of the Treasury Department as to its plans to address the remaining U.S. income tax treaties that do not include limitation-on-benefits provisions.

Although the limitation on benefits rules in the proposed treaty are similar to the rules in other recent and proposed U.S. income tax treaties and protocols and in the U.S. Model treaty, they are not identical, and the Committee may wish to inquire about certain differences. In

[26] Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (Nov. 28, 2007). The report states that, as of 2004, it does not appear that the U.S.-Poland income tax treaty has been extensively exploited by third-country residents. Although the report also focused on Iceland to the same extent as Hungary, a 2007 Income Tax Convention with Iceland that includes a modern limitation-on-benefits provision has since taken effect.

particular, the Committee may wish to examine the rules for publicly-traded companies, derivative benefits, and certain triangular arrangements. The Committee also may wish to ask the Treasury Department about the special limitation-on-benefits rules applicable to headquarters companies.

Publicly traded companies

A company that is a resident of a treaty country is eligible for all the benefits of the proposed treaty if it satisfies a regular trading test and either a management and control test or a primary trading test. A company satisfies the regular trading test if its principal class of shares (and any disproportionate class of shares) is regularly traded on one or more recognized stock exchanges. Under the management and control test, the company's primary place of management and control must be in the treaty country of which the company is a resident. The primary trading test requires that a company's principal class of shares be primarily traded on a recognized stock exchange located in the treaty country of which the company is a resident or, in the case of a Hungarian company, on a recognized stock exchange in another EU or EFTA country, or in the case of a U.S. company, in another NAFTA country. A recognized stock exchange specifically includes, in addition to the U.S. and Budapest exchanges, stock exchanges of Amsterdam, Brussels, Frankfurt, London, Paris, Vienna, and Warsaw, as well as any other stock exchange agreed upon by the competent authorities of the treaty countries.

The Committee may wish to inquire about the primary trading test in the proposed treaty which is similar to the primary trading test in other recently enacted treaties but different from the test in the U.S. Model treaty. Under the U.S. Model treaty, the required trading must occur on a stock exchange in the treaty country of which the relevant company is a resident; trading on a stock exchange in another country may not be used to satisfy the test. A possible rationale for the U.S. Model treaty's narrower primary trading test is that a publicly-traded company should be eligible for treaty benefits only if it has a nexus with its country of residence. This same rationale may be the reason for the management and control test, found in both the proposed treaty and U.S. Model treaty, that may be satisfied in lieu of the primary trading test. A company that is a resident of the United States or Hungary may not have this nexus if it satisfies the proposed treaty's primary trading test because of trading on an exchange in a third country. Accordingly, the Committee may wish to ask the Treasury Department about the circumstances that justify allowing trading on third country exchanges to be used to satisfy the primary trading test. In particular, the Committee might ask when it is more appropriate to consider trading in the economic areas of the treaty countries (for example, NAFTA, EU, and EFTA countries) than to consider only trading in the treaty countries of which companies are resident. The Committee also may wish to inquire whether trends toward greater or lesser integration in Europe might affect Treasury Department considerations when negotiating about primary trading rules.

Although the proposed treaty's primary trading test is similar to the tests in the recent protocols with France and New Zealand, the stock exchanges specifically included in the definition of "recognized stock exchange" (under both the regular trading test and the primary trading test) differ among the Belgian treaty, the Swedish protocol and the proposed treaty. The Committee may wish to inquire about the criteria the Treasury Department considers when negotiating over the definition of a recognized stock exchange.

Derivative benefits

Like other recent treaties, the proposed treaty includes derivative benefits rules that are generally intended to allow a treaty country company to receive treaty benefits for an item of income if the company's owners (referred to in the proposed treaty as equivalent beneficiaries) reside in a country that is in the same trading bloc as the treaty country and would have been entitled to the same benefits for the income had those owners derived the income directly.

The derivative benefits rules may grant treaty benefits to a treaty country resident company in circumstances in which the company would not qualify for treaty benefits under any of the other limitation-on-benefits provisions. The U.S. Model treaty does not include derivative benefits rules. The Committee may wish to inquire about the circumstances that justify inclusion of these rules in new treaties notwithstanding their absence from the U.S. Model treaty.

Triangular arrangements

The proposed treaty includes special anti-abuse rules intended to deny treaty benefits in certain circumstances in which a Hungarian resident company earns U.S.-source income attributable to a third-country permanent establishment and is subject to little or no tax in the third jurisdiction and Hungary. Similar anti-abuse rules are included in other recent treaties and protocols. The U.S. Model treaty, however, does not include rules addressing triangular arrangements. The Committee may wish to ask the Treasury Department about the circumstances that justify inclusion of the anti-abuse rules notwithstanding their absence from the U.S. Model treaty. In particular, the Committee may wish to inquire whether the Treasury Department will insist on inclusion of anti-abuse rules whenever a treaty partner's internal tax rules provide an exemption for the income of a third-country permanent establishment of a treaty partner resident.

Headquarters companies

The proposed treaty includes special rules intended to allow treaty country benefits for a resident of a treaty country that functions as a headquarters company and that satisfies certain requirements intended to ensure that the headquarters company performs substantial supervisory and administrative functions for a group of companies: (1) that the group of companies is genuinely multinational; (2) that the headquarters company is subject to the same income tax rules in its country of residence as would apply to a company engaged in the active conduct of a trade or business in that country; and (3) that the headquarters company has independent authority in carrying out its supervisory and administrative functions. U.S. income tax treaties in force with Austria, Australia, Belgium, the Netherlands, and Switzerland include similar rules for headquarters companies. The U.S. Model treaty, however, does not include headquarters company rules.

The Committee may wish to ask the Treasury Department about the policies that justify deviating from the U.S. Model treaty and including rules in a treaty that grant headquarters companies treaty benefits when those headquarters companies would not be eligible for treaty benefits under any other limitation-on-benefits provision.

B. Exchange of Information and Administrative Assistance

Background

Tax treaties establish the scope of information that can be exchanged between treaty parties. Exchange of information provisions first appeared in the late 1930s,[27] and are now included in all double tax conventions to which the United States is a party. A broad international consensus has coalesced around the issue of bank transparency for tax purposes and strengthened in recent years, in part due to events involving UBS AG, the global financial crisis, and the general increase in globalization. In the proposed treaty, Article 26 (Exchange of Information and Administrative Assistance) closely tracks the language of the exchange of information provisions in the U.S. Model treaty in most respects. The proposed treaty facilitates the exchange of information, and tends to limit the circumstances in which the treaty countries can refuse to provide requested information. In particular, the proposed treaty permits the competent authorities to exchange such information as is relevant to the assessment, collection and enforcement of the domestic laws of the two countries, rather than limiting the information to that which is necessary. This conforms to the standard of section 7602 of the Code. The proposed treaty also requires that the other treaty country use its domestic powers to obtain the requested information in the same manner and to the same extent as if the tax of the requesting treaty country were the tax of the other treaty country and were being imposed by that treaty country, whether or not the treaty country receiving the request needs the information currently. Further, the proposed treaty provides that a treaty country may not refuse to provide requested information on the basis of domestic bank secrecy laws.

The proposed treaty, in paragraph 3 of Article 25 (Mutual Agreement Procedure), permits the competent authorities to resolve doubts of interpretation or application of the convention. Although not specified, such areas for consultation and agreement may include methods for ensuring adequate reciprocity and establishing timetables and minimum thresholds of tax in controversy to warrant use of this procedure.

Hungarian law relevant to exchange of information

Since the prior treaty between the United States and Hungary was signed in 1979, Hungary has acceded to membership in the EU. As a member of the EU, Hungary has implemented the various directives assuring mutual administrative assistance and compliance with international transparency norms, such as the Third EU Money Laundering Directive and the EU Savings Directive. It has successfully participated with other EU members in 20 "multilateral controls," a procedure under which two or more members conduct examinations of tax issues of the same or related taxable persons and share information.[28]

Hungary is a party to numerous agreements that include exchange of information provisions in compliance with the OECD standards and is fully committed to the transparency

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[27] Article XV of the U.S.-Sweden Double Tax Convention, signed on March 23, 1939.

[28] Forum on Tax Administration, OECD, "Joint Audit Report," (Istanbul, September 2010), p. 44.

standards of the OECD.[29] According to the OECD, there are no restrictions under the domestic laws of Hungary to limit access by Hungarian tax authorities to bank information for the purpose of exchanging such information. The tax authorities are also provided adequate information gathering and enforcement powers to compel production of the information responsive to a request for exchange, and need not establish the existence of a domestic interest in the requested information. However, if the information sought is of a type that the custodian of the information was not required to maintain, there may be limited ability to require production of such information.[30]

The Committee may wish to inquire specifically about any U.S. experience with requests for exchange of information under the present treaty. The information exchange program between the United States and Hungary has not been the subject of public commentary, whether negative or positive. Confirmation that there are no perceived deficiencies in its operation and that there is favorable experience to date may be advisable.

Effectiveness of the U.S. Model treaty Article 26

In addition to the above issues, which are specific to the agreement between the United States and Hungary, there are several questions about the effectiveness and scope of provisions that conform to the U.S. Model treaty. Since the proposed treaty was signed, there has been extensive bilateral and multilateral cooperation in addressing issues of cross-border tax compliance and financial regulatory reform. A broad international consensus has coalesced around the issue of bank transparency for tax purposes and strengthened in the past year. Greater attention to all means of restoring integrity and stability to financial institutions has led to greater efforts to reconcile the conflicts between jurisdictions, particularly between jurisdictions with strict bank secrecy and those seeking information to enforce their own tax laws.[31] As a result, the Committee may wish to inquire as to whether the U.S. Model treaty published in 2006 remains the appropriate standard by which to measure an effective exchange of information program.

The U.S. Model treaty conforms with the norms for transparency and effective exchange of information articulated by the OECD, which are in turn the standards by which the OECD determines whether a country is committed to transparency. Those standards require the

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[29] Information in this paragraph is based on the country summary assessment of Hungary's progress in implementing transparency standards, published as part of the annual report by the Global Forum on Transparency and Exchange of Information for Tax Purposes of the OECD. OECD, *Tax Cooperation: Towards a Level Playing Field, 2010 Assessment by the Global Forum on Taxation,* September 2010, p. 71.

[30] According to the OECD, the information is subject to information gathering measures "[o]nly if the tax authority investigates the taxpayer defined in a request for exchange of information and the control procedure is expanded to other taxpayers in contractual relationship with him." See, note at Table C.1, in OECD, *Tax Cooperation: Towards a Level Playing Field, 2010 Assessment by the Global Forum on Taxation,* September 2010.

[31] See, Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal; Part Three: Provisions Related to the Taxation of Cross-Border Income and Investment* (JCS-4-09), September 2009. Section VI of that pamphlet provides an overview of the international efforts to address these issues.

existence of mechanisms for exchange of information upon request; the availability of exchange of information for purposes of both criminal and civil tax matters; absence of restrictions of information exchange caused by application of the dual criminality principle[32] or a domestic tax interest requirement; respect for safeguards and limitations; strict confidentiality rules for information exchanged; and availability of reliable information (in particular bank, ownership, identity, and accounting information) and powers to obtain and provide such information in response to a specific request.[33]

1. Methods of exchange of information

The OECD standards do not require exchange other than upon specific requests for information, although the language permits the treaty countries to agree to provide for other exchange mechanisms. The OECD, in its commentary to the exchange of information provisions in the OECD Model treaty, specifies that the treaty "allows" the competent authorities to exchange information in any of three ways that treaty countries have traditionally operated[34] – routine, spontaneous,[35] or specific exchanges.[36] With regard to the latter type of exchange, the Committee may wish to inquire as to the extent to which a request that a treaty country provide information in response to a John Doe summons[37] is a specific request within the meaning of the

[32] The principle of dual criminality derives from the law regarding extradition and grounds for refusal to grant a request. Extradition is generally permitted only if the crime for which a person is to be extradited is treated as a similarly serious offense in the state in which the fugitive has sought refuge. *Restatement (Third) of the Foreign Relations Law of the United States*, sec. 476 (1987). The principle is relevant to a request for exchange of tax information only if the treaty in question limits the scope of its permitted exchanges to criminal tax matters.

[33] OECD, *Tax Cooperation: Towards a Level Playing Field, 2008 Assessment by the Global Forum on Taxation*, p. 8.

[34] OECD, Commentary on the Model Treaty Article 26, par. 9.

[35] A "spontaneous exchange of information" occurs when one treaty country who is in possession of an item of information that it determines may interest the other treaty country for purposes of its tax administration spontaneously transmits the information to its treaty country through their respective competent authorities.

[36] A "specific exchange" is a formal request by one contracting state for information that is relevant to an ongoing investigation of a particular tax matter. These cases are generally taxpayer specific. Those familiar with the case prepare a request that explains the background of the tax case and the need for the information and submit it to the Competent Authority in their country. If he determines that it is an appropriate use of the treaty authority, he forwards it to his counterpart.

[37] When the existence of a possibly noncompliant taxpayer is known but not his identity, as in the case of holders of offshore bank accounts or investors in particular abusive transactions, the IRS is able to issue a summons to learn the identity of the taxpayer, but must first meet greater statutory requirements, to guard against fishing expeditions. Prior to issuance of the summons intended to learn the identity of unnamed "John Does," the United States must seek judicial review in an *ex parte* proceeding. In its application and supporting documents,[37] the United States must establish that the information sought pertains to an ascertainable group of persons, that there is a reasonable basis to believe that taxes have been avoided, and that the information is not otherwise available.

article, and whether protracted litigation similar to that which occurred in the UBS litigation[38] can be avoided or shortened.

The Committee may wish to explore issues related to "routine exchange of information." In this type of exchange, also referred to as "automatic exchange of information," the treaty countries identify categories of information that are consistently relevant to the tax administration of the receiving treaty country and agree to share such information on an ongoing basis, without the need for a specific request. Information that is automatically shared under this authority may include information that is not taxpayer-specific, such as news about changes in domestic tax legislation, or it may comprise voluminous taxpayer filings, such as magnetic disks containing the information from IRS Form 1042-S, relating to U.S.-source fixed or determinable income paid to persons claiming to be residents of the treaty country receiving the forms. The type of information, when it will be provided, and how frequently it will be provided are determined by the respective Competent Authorities after consultation. Once an agreement is reached, the information is automatically provided.

The Committee may wish to inquire about the existence of any practical impediments to effective automatic exchange of information under the proposed treaty and what steps are needed to remove the impediments. In the past, there have been concerns that information received pursuant to automatic exchanges under bilateral and multilateral agreements was not in a usable form. Examples of practical hurdles that reportedly limited the value of information exchanged were the lack of timeliness of its production, lack of conformity in reporting periods, the need to translate the language of the documents and the currencies, and its voluminous nature.[39] To the extent that useful information can be gathered through exchange of information, the United States may be able to reduce its reliance upon self-reporting, that is, information provided by the taxpayer and, therefore, only available with respect to those in compliance with the tax laws.

Practical challenges with automatic exchanges are not exclusive to the United States. The OECD has developed standards for the electronic format of such exchanges, to enhance their utility to tax administration.[40] Despite these efforts to standardize the information exchanged and improve its usefulness, there remain numerous shortcomings, both practical and legal, in the routine exchange of information. Chief among them is the lack of taxpayer identification numbers ("TINs") in the information provided under the exchange, despite the recommendation of the OECD that member states provide such information.[41] Ideally, the information received

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[38] See, *United States v. UBS AG*, Civil No. 09-20423 (S.D. Fla.), enforcing a "John Doe summons" which requested the identities of U.S. persons believed to have accounts at UBS in Switzerland. On August 19, 2009, the United States and UBS announced an agreement (approved by the Swiss Parliament on June 17, 2010) under which UBS provided the requested information.

[39] Letter from Commissioner, IRS, to Chairman, Senate Committee on Finance (June 12, 2006), 2006 *Tax Notes Today* 115-17.

[40] *See*, OECD, Committee on Fiscal Affairs, *Manual on the Implementation of Exchange of Information Provisions for Tax Purposes*, Module 3 (January 23, 2006) ("OECD Exchange Manual").

[41] OECD Exchange Manual refers to a recommendation dating to 1997, "Recommendation on the use of Tax Identification Numbers in an International Context" C(97)29/FINAL (1997).

by the IRS should either include a TIN or be subject to a process referred to as "TIN perfection" to enable the IRS to correlate account data in the information received with a valid TIN in its taxpayer databases, although such an undertaking may be time-consuming and costly. Working Party 10 in the OECD continues work to standardize information production. As part of that effort, it recently surveyed countries about their experience, impediments to greater use of automatic exchanges and preferences for improving such exchanges. The Committee may wish to inquire how the United States responded to the OECD inquiries, and the priority it places on such improvements. In particular, an understanding of how and to what extent the IRS is able to use any information currently provided would help to evaluate the exchange of information programs.

The Committee may also wish to inquire about recently proposed regulations that expand information reporting by U.S. financial institutions on interest paid to nonresident aliens. Such reporting is not currently required, except with respect to payments to residents of Canada.[42] The recently proposed regulations would expand such reporting to include payments to any nonresident alien. In support of the proposed regulations, the preamble states "requiring routine reporting to the IRS of all U.S. bank deposit interest paid to any nonresidential alien individual will further strengthen the United States exchange of information program consistent with adequate provisions for reciprocity, usability and confidentiality in respect of this information."[43] The Committee may wish to explore the usability of the information exchanged with Canada under present regulations, its relationship to the exchange of information program with Canada, the extent to which expanded regulations would strengthen exchange of information under the pending protocol, as well as any additional attendant burdens that may arise as a result of these regulations.[44]

2. U.S. reciprocity in providing information

The United States has come under increasing pressure to eliminate policies that provide foreign persons with the ability to shelter income. The criticism has focused on disparities between the U.S. standards and foreign standards governing "know-your-customer" rules for financial institutions and the maintenance of information on beneficial ownership. With respect to the latter, U.S. norms have been criticized in recent years.[45] The Committee may wish to

[42] Treas. Reg. sec. 1.6049-4(b)(5).

[43] Prop. Treas. Reg. sec. 1.6049-4, 76 Fed. Reg. 1105 (January 7, 2011).

[44] The IRS and Treasury Department have requested written and electronic comments on the proposed regulations. A public hearing at which oral comments were presented was held on May 18, 2011.

[45] Financial Action Task Force, IMF, *Summary of the Third Mutual Evaluation Report on Anti-Money Laundering and Combating the Financing of Terrorism United States of America,* pp. 10-11 (June 23, 2006); Government Accountability Office, *Company Formations: Minimal Ownership Information Is Collected and Available,* a report to the Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, U.S. Senate GAO-06-376 (April 2006); Government Accountability Office, *Suspicious Banking Activities: Possible Money Laundering by US Corporations Formed for Russian Entities,* GAO-01-120 (October 31, 2006).

explore the extent to which either the existing U.S. know-your-customer rules or the corporate formation and ownership standards prevent the United States from providing information about beneficial ownership on a reciprocal basis with its treaty countries. The Committee may also consider whether there are steps to take that would help refute the perception that the United States permits states to operate as tax havens and that would help the United States better respond to information requests from treaty countries who suspect that their own citizens and residents may be engaging in illegal activities through U.S. corporations and limited liability companies.[46]

3. Override of domestic law privileges or confidentiality

The scope and operation of the provision that overrides potential arguments based on bank secrecy law of the requested treaty country presents questions about its possible impact on other privileges. Under the proposed article as well as both the OECD Model and U.S. Model treaties, a treaty country is generally not obligated to take any action at variance with its domestic law, including disclosure of professional or trade secrets. That principle is limited by a special rule, which provides that a treaty country may not decline to provide information on the ground that the information is held by a financial institution, nominee, or person acting in an agency or intermediary capacity. The Technical Explanations to the proposed treaty and to the U.S. Model treaty state that this rule overrides claims of bank secrecy, but do not address its potential intersection with the law of professional privileges. In contrast, the OECD explains the general principle and provides as an example of information that a requested treaty country could decline to obtain any information that would violate safeguards against self-incrimination.[47] The OECD further explains the abrogation of the general principle and clarifies that the provision may limit the use of certain claims of professional privilege, but only to the extent that the domestic law in question was so broad as to base its protection solely on the status of the person holding the information.[48] Under the OECD approach, a treaty country may refuse to supply information held by a bank, financial institution, agent, fiduciary or nominee as long as the ground for refusal is not the mere fact of the custodian's status as a bank, financial institution, agent, fiduciary or nominee. The OECD provides an example of a legal representative acting for a client in an agency capacity. To the extent that confidential communications between the legal representative and his client are protected under local law, the general rule against requiring a treaty country to violate its own law continues to apply and the treaty country may decline the request to exchange information.

At least one recently concluded treaty, the Income Tax Treaty between the United States and Finland,[49] departs from the U.S. Model treaty and expressly provides that the override of

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[46] E.g., the "Incorporation Transparency and Law Enforcement Assistance Act," S. 569, 111th Congress (2009), would require States to obtain and periodically update beneficial ownership information from persons who seek to form a corporation or limited liability company.

[47] OECD, "Commentary to the OECD Model Treaty Article 26," par. 15.2.

[48] OECD, "Commentary to the OECD Model Treaty Article 26," pars. 19.12, 19.14.

[49] Senate Treaty Doc. 109-18.

domestic law is not intended to include the ability to obtain information that would reveal confidential communications between a client and an attorney, in cases in which the client seeks legal advice. The Committee may wish to inquire as to the intended scope of the provision of the proposed treaty and of the U.S. Model treaty, and the extent to which the provision may override any privilege or confidentiality law that may be available under a treaty country's domestic law, and the circumstances in which this provision is likely to be involved. The Committee may wish to specifically inquire about its effect on the attorney-client privilege in the United States.