



Embassy of the United States of America

Budapest

February 4, 2010

His Excellency
Dr. Péter Oszkó
Minister of Finance
Republic of Hungary

Excellency,

I have the honor to refer to the Convention signed today 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 (the “Convention”) and to confirm on behalf of the Government of the United States the following understandings reached between our two Governments:

1. With reference to paragraph 6 of Article 1 (General Scope) of the Convention, it is understood that income from sources within one of the Contracting States received by an entity that is organized in either of the Contracting States and that is treated as fiscally transparent under the laws of either Contracting State shall be treated as income derived by a resident of the other Contracting State to the extent that such income is subject to tax as the income of a resident of the other Contracting State. It is further understood that this paragraph shall not apply with respect to income received by an entity that is organized in a third state.
2. With reference to paragraph 2 of Article 2 (Taxes Covered) of the Convention, it is understood that the term “movable property” means all property other than immovable property (real property) as defined in Article 6 (Income from Immovable Property (Real Property)) of the Convention.
3. With reference to paragraph 1) b) of Article 3 (General Definitions) of the Convention, it is understood that partnerships (betéti társaság, közkereseti társaság) established in Hungary are taxed by Hungary as corporations, and therefore fall within the definition of “company”.
4. With reference to paragraph 1) j) i) of Article 3 (General Definitions) of the Convention, it is understood that in the case of the United States, the term “nationality” includes citizenship.
5. With reference to paragraph 2 of Article 7 (Business Profits) of the Convention, it is understood that the principles of the OECD Transfer Pricing Guidelines shall apply, by analogy, for the purposes of determining the profits attributable to a permanent establishment. Accordingly, any of the methods described therein, including profits methods, may be used to determine the income of a permanent establishment so long as those methods are applied in accordance with the Guidelines.

6. With reference to paragraph 2) e) i) of Article 22 (Limitation on Benefits), it is understood that the conditions of paragraph 2) e) i) shall be met if the ownership test is satisfied on at least half the days of the taxable year, without regard to whether the days on which the test is satisfied are consecutive.

7. With reference to paragraph 2) e) ii) and 4) b) of Article 22 (Limitation on Benefits) of the Convention, it is understood that the term “accrued” shall have the meaning given to it under the domestic law, including the accounting principles applicable for tax purposes, of the State of residence of the person seeking the benefits of the Convention.

8. With reference to paragraph 3) a) and 6) b) of Article 22 (Limitation on Benefits) of the Convention, it is understood that the term “regulated financial services” means the services listed in paragraph (1) of Section 3 of Hungarian Act CXII of 1996 on Credit Institutions and Financial Enterprises, or any subsequently enacted similar legislation agreed to by the competent authorities.

9. With reference to paragraph 3) a) of Article 22 (Limitation on Benefits), it is understood that a resident of a Contracting State engaged in the active conduct of a trade or business in that State may obtain the benefits of the Convention with respect to an item of income derived in the other Contracting State under this paragraph if that item of income is derived in connection with or is incidental to that trade or business. The following example illustrates this result:

HUCo is a company resident in Hungary. HUCo’s main function is the development of new drugs, and in carrying out this business HUCo operates a large research and development facility in Hungary. Once HUCo’s staff completes its research and the drugs are approved for sale, HUCo licenses the new drugs it develops to other members of its multinational group, including USCo, a company resident in the United States. USCo manufactures HUCo’s products in the United States, and pays royalties to HUCo with respect to the license agreements for the drugs that HUCo develops. HUCo is engaged in the active conduct of a trade or business in Hungary. The royalties paid by USCo are derived in connection with HUCo’s research and development activity. Therefore, assuming HUCo’s activities are substantial in relationship to the activities of USCo, as discussed in paragraph 10 below, HUCo is entitled to treaty benefits with respect to its U.S.-source royalty income.

10. With reference to paragraph 3) b) of Article 22 (Limitation on Benefits) of the Convention, it is understood that the substantiality requirement of paragraph 3) b) is intended to prevent a narrow case of treaty-shopping abuses in which a company attempts to qualify for treaty benefits by engaging in de minimis connected business activities that have little economic cost or effect with respect to the company’s business as a whole.

Whether a trade or business is substantial for purposes of this paragraph shall be determined based on all the facts and circumstances. Such determination shall take into account the comparative sizes of the trades or businesses in each Contracting State (measured by reference to asset values, income and payroll expenses), the nature of the activities performed in each Contracting State, and, in cases where a trade or business is conducted in both Contracting States, the relative contributions made to that trade or business in each Contracting State. In

making each determination or comparison, due regard shall be given to the relative sizes of the U.S. and Hungarian economies.

In any case, however, a trade or business shall 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 in the first-mentioned State equal at least 7.5 percent of the resident's (and any related parties') proportionate share of the asset value, gross income and payroll expense, respectively, that generated the income in the other State, and the average of the three ratios exceeds 10 percent. If the resident owns, directly or indirectly, less than 100 percent of an activity conducted in either State, only the resident's proportionate interest in such activity shall be taken into account for purposes of the test described in this paragraph.

The following examples demonstrate the application of the substantiality requirement.

Example 1

(i) V, a resident of a country that does not have a tax treaty with the United States, wants to acquire a U.S. financial institution. However, since its country of residence does not have a tax treaty with the United States, any dividends generated by the investment would be subject to withholding under U.S. domestic law. V establishes a Hungarian corporation with one office in a small town to provide investment advice to local residents. That Hungarian corporation acquires the U.S. financial institution with capital provided by V.

(ii) The U.S. source income is generated from business activities in the United States that are related to the investment advisory business conducted by the Hungarian parent. However, the substantiality test would not be met in this example, so the dividends would remain subject to withholding under the domestic law of the United States rather than the rate provided in Article 10 (Dividends).

Example 2

(i) S is a banking organization that is organized and managed and controlled in Hungary. S has a large number of local branches and customers in Hungary and sufficient employees to provide banking services to those customers. However, because the banking market in Hungary is crowded with competitors, S determined that it needed to establish branches outside Hungary in order to expand its business. In accordance with that plan, S established branches in several major cities in the United States to engage in the same type of banking business as in Hungary. Over time, the U.S. branches have grown significantly, and now are equal in size to the entire Hungarian business of S.

(ii) The business activities of the U.S. branches of S are related to the business conducted by S in Hungary. Because S has a large number of local branches and employees in Hungary, the activities of S in Hungary are substantial for purposes of subparagraph 3) b) of Article 22.

Example 3

HUCo, a Hungarian corporation, owns 100 percent of the stock of USCo, a U.S. corporation, and 50 percent of the stock of HUSub, a Hungarian corporation. HUCo does not directly conduct an active trade or business. USCo and HUSub are actively engaged in the music business. USCo has a number of employees who are responsible for discovering new recording artists. USCo also produces recordings and is responsible for production and distribution within the United States. Employees of HUSub are responsible for promoting the recordings in Hungary and developing a distribution strategy for the rest of Europe. European sales of U.S. recording artists contribute substantially to the profitability of USCo.

HUCo receives payments of interest and dividends from USCo. In order for these payments to be entitled to treaty benefits under paragraph 3 of Article 22, HUCo must be considered to be engaged in the active conduct of a trade or business in Hungary. Under subparagraph 3) b), because HUCo and USCo are related persons, the activities conducted in Hungary and attributed to HUCo must be substantial in relation to the activities conducted by USCo. HUCo will be deemed to satisfy this requirement if the ratio of the assets, income and payroll attributable to HUCo to the assets, income and payroll attributable to USCo are at least 10 percent and each ratio is at least 7.5 percent.

For each of the four most recently concluded taxable years, the asset values, gross income and payroll expenses of these corporations that are attributable to the trade or business were as follows:

	USCo	HUSub
Assets.....	\$300	\$50
Income.....	50	10
Payroll.....	60	10

HUCo has no assets, income or payroll that are attributable to the trade or business. The assets, income and payroll of HUSub that are related to the trade or business may be attributed to HUCo, however, under subparagraph c), since HUCo is connected to HUSub by reason of its 50% beneficial ownership in HUSub. Accordingly, 50 percent of HUSub's assets, income and payroll are attributed to HUCo. The amounts attributed to HUCo and the percentage of USCo's corresponding amounts are as follows:

	HUCo	HUCo as a Percentage of USCo
Assets.....	\$25	8.3
Income.....	5	10.0
Payroll.....	5	8.3

Since none of these percentages is greater than 10 percent, HUCo does not meet the requirements for the safe harbor described above. Moreover, application of the three-year average rule does not change the result, since the relevant amounts for the three preceding years (and the resulting ratios) are equal to those for the first preceding taxable year.

Nevertheless, HUCo will still qualify for benefits with respect to dividends received from USCo. The activities performed by HUSub are substantial in relation to those of USCo, taking into account the contributions of each company to the overall business of the group.

11. With reference to paragraph 4) a) of Article 22 (Limitation on Benefits) of the Convention, it is understood that the competent authorities of both countries shall ordinarily grant treaty benefits under paragraph 7 of Article 22 in cases where a company claiming benefits under paragraph 4 is owned directly by up to 10 individuals, provided that such individuals are equivalent beneficiaries (as defined in paragraph 8) e)) and the requirements of paragraph 4) b) and any additional requirements for benefits prescribed by the Convention are satisfied.

12. The Government of the Republic of Hungary has informed the Government of the United States of America that it understands that the obligations of the Republic of Hungary under this Convention are consistent with its obligations as a member of the European Union. Should the Republic of Hungary at some point in the future find that its obligations under this Convention are inconsistent with the requirements that apply to Hungary as a member of the European Union, either Contracting State may seek consultations regarding the possible negotiation of amendments to the Convention.

I have the further honor to propose to you, on behalf of the Government of the United States of America, that the present note and Your Excellency's affirmative reply thereto confirming that your Government shares these understandings shall constitute an agreement between our two Governments on these points which shall enter into force on the same date as the Convention.

Accept, Excellency, the assurances of my highest consideration.

Sincerely yours,