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Transformation of companies
Transformation of companies in Hungary involve a wide-ranging set of processes that require considerable care and expertise to plan and carry out.
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Dear Readers,

WTS Global is organizing a full day conference in cooperation with **International Tax Review** – the 2017 **Indirect Tax Forum**, which will be held on March 30 in Düsseldorf.

As the conference takes place the day before the United Kingdom is expected to trigger Article 50 of the Lisbon Treaty – formally starting its exit from the European Union – panellists will discuss the impact Brexit will have on customs and other indirect tax considerations.

I will be participating in the panel discussion on the application of the generalised reverse charge mechanism starting at 15:30.

Should you be interested in more about the speakers and the topics to be discussed, please **click here!**

We hope to see you there.

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Challenges during transformation of companies

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The Hungarian Civil Code (Act V of 2013) prescribes the main rules of transformation of companies, while the detailed regulation is prescribed by Act CLXXVI of 2013 on the Transformation, Merger and Division of Legal Entities (hereinafter referred to as: transformation of companies). Transformation of companies involve an extremely **complex and multi-faceted process**, giving rise to legal, tax law and accounting problems.

What can motivate owners to make such decisions?

Reasons for changing a company's form can relate to managing owner responsibilities, emphasising the significance of the firm by evolving into a company limited by shares, bringing in new shareholders, or due to solving situations of capital loss. Mergers can be triggered by wanting to exploit presumed or hoped-for synergies, acquiring greater market share, or even just reaching better economies of scale. Separations of companies are generally motivated by wanting to remove divisions with a view to subsequently selling them.

What types of transformations are there?

According to relevant laws, transformation of companies can occur in the following forms:

- With a **change of company form**, a decision is made on changing the type of company (part nership, limited liability, company limited by shares).
- The two main kinds of **mergers** are the takeover and forming a new company (consolidation).
  - With a **takeover** only the legal entity being absorbed is wound up.
  - Following a **consolidation** both participating companies cease to exist and a new legal entity is created.

- The two main kinds of **separation** are the spin-off and the division.
  - With a **spin-off**, the separating company becomes a new legal entity, while the company it separated from continues operating in the same form.
  - In the case of a **division**, the original legal entity is wound up and its assets are transferred to new legal entities.

Transformation plan most important document of transformation of companies

The most important document of transformation of companies is the **transformation plan**, which includes the **draft statements of assets and liabilities** and the **draft inventory of assets and liabilities** as well as the **merger agreement** and the **separation agreement**.

The owners determine the course of the transformation in the transformation plan. As part of the transformation plan, decisions are reached, among other things, on the transformation method, date, company form, the exiting and joining members, the method for settling up with those leaving, the senior executives of the new company, the capital structure of the new and the continuing companies, and the auditor of the business transformation.

The draft statement of assets and liabilities is designed to present how they wish to distribute the **assets and liabilities of the continuing company** after the transformation, while the draft inventory of assets and liabilities details the draft statement of assets and liabilities as a supporting document.

The **final statement of assets and liabilities** and the **final inventory of assets and liabilities** provide the opening balances for the accounting records at the companies as of when the transformation is registered.

The merger or separation agreements contain the detailed rules for the merger or the separation.

What is the general process for a transformation in Hungary?

Transformation of companies are triggered with one or two decisions by the owners. With the **first decision**, the owners decide based on the proposal of the management if they agree with the intention of the transformation and what the type of the transformation should be. In the **second decision** they resolve to carry out the transformation based on the audited and approved draft statement of assets and liabilities. If the audited and approved draft statement of assets and liabilities are available at the time of the first decision, the **two decisions can be combined**. The decision on the transformation of companies must thereafter be **published** twice in the Hungarian Official Gazette.

The Court of Registration makes its decision on the transformation among others based on the submitted plan and the draft statement of assets and liabilities. The companies have to prepare their final statement of assets and liabilities and final inventory of assets and liabilities as of the registration date, as the reporting date. It is possible to request that the **transformation be registered on a given date**, which is advisable because it is better to prepare an accounting closure as of the end of a month.

! A new feature in relation to the registration at the court is that the tax authority (NAV) has to notify the Court of Registration that there are **no pending tax authority procedures**.

The audit of the transformation must be conducted by an **independent auditor** of the **audit firm appointed** by the company.

What else should you look out for during a transformation?

Transformation of companies in Hungary require very **thorough planning**. There are many deadlines to meet during the transformation, the various options provided by tax law can impact on the tax payment obligations that arise during the transformation, while several reports have to be published and several tax returns filed.

In light of the above, the transformation of companies constitute a very complex process; planning and implementing them carefully requires proper preparation and experience in various fields as well as knowledge of legal regulations. It is worthwhile considering the help of experts for all this.

Special rules

Under a **preferential transformation**, the Act on Corporate and Dividend Tax as well as the Act on Duties provide tax allowances, but there are stricter measures too if the transformation is not based on real economic and commercial reasons.

! A new element is **cross-border transformation**, during which a company is merging into a foreign enterprise, thereby terminating its legal personality and economic activity in Hungary.

Cash benefit system – simple and great?

In the case of a cash benefit system, we should take note of the following:

- maximum **HUF 100,000** (EUR 320) **p.a.**
- monthly payments, or lump-sum payment?
- **may not substitute for salary!**
- **over HUF 100,000** (EUR 320) it qualifies as **salary**
- **tax burden of 34.22%**
- pay attention to documenting benefit

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One of the strangest elements of the tax amendment rules in 2017 in Hungary was undoubtedly the financial allowance given as part of the cash benefit system, which qualifies as a fringe benefit and as such is subject to favourable taxation.

Until 2017, the purpose and provision method of the individual fringe benefits were clear, but the cash benefit not exceeding HUF 100,000 (EUR 320) per year raises several issues. This summary is for those who have already boldly introduced the cash benefit, and also for those who are just considering it.

The fringe benefit system in tax laws

The fringe benefit system is not defined in any of the Hungarian tax laws. According to the brief and apt description of the Central Information Department at the NAV, a fringe benefit system is an optional **flexible benefit system** compiled by the employer **which can be given to employees over and above their salary**. The employer has to define the types of benefits it provides for its employees in its fringe benefit policy.

Why is the cash benefit system advantageous?

Section 71 of the Act on Personal Income Tax provides for fringe benefits. One common trait of the benefits is that they can be **granted under favourable tax rates**, and the tax is paid by the payer, in contrast to employment-related tax. The base of the tax payable by the payer is the given income x 1.18, which is then subject to 15 percent personal income tax. In addition to the tax, the payer also has a 14 percent health care contribution payment obligation on the tax base. All of this **results in a 34.22 percent tax liability**. In addition to the favourable taxation, it should not be ignored that the benefit results in no additional administration, apart from being aligned into the fringe benefit policy and defining the scope of beneficiaries (in the case of fringe benefits in 2016 for example, the provision of public transport passes or the back-to-school support clearly entailed more administration).

What should you look out for with the cash benefit system?

The annual allocation is HUF 100,000 (EUR 320) if the employment lasts for the whole year. If the employee is employed only for part of the year, then the HUF 100,000 (EUR 320) is paid in proportion to the number of days spent in the employment providing eligibility for the fringe benefits.

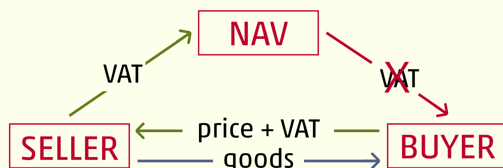
The employer can disburse the benefit either in one amount or in instalments, at its discretion. If the cash benefit exceeds the allocated amount, the excess portion becomes taxable based on the legal relationship between the parties, as income from employment, over and above the employment taxes and contributions. Consequently, an amount paid in one lump sum at the beginning of the year may result in additional administration if the employment of the employee is terminated during the year, and the portion exceeding the proportional amount has to be corrected and a self-revision is needed.

What kind of issues may arise?

During a potential tax authority inspection, can the Hungarian tax authority qualify the allowance under the cash benefit system as a hidden salary increase? Based on what factors will the tax authority inspect the fulfilment of the conditions of the cash benefit? Employers who gave a gross salary increase in 2017 for example, in addition to providing a cash benefit, will face a different risk level. There might be companies which previously had not used the fringe benefits system, but in 2017 would like to give the maximum cash benefit by rolling out a fringe benefit system, though not giving a gross salary increase at the start of the year. In their case, as the saying goes, it's a close-run thing. The risk of re-qualification as salary income is more likely if there is gross salary decrease for employees parallel to the introduction of the cash benefit system.

So when making the distinction from the salary, the taxpayer has to pay special attention to documenting the benefit. One of the basic principles of the Personal Income Tax Act is that no fringe benefit or other benefit can be given as consideration for an (independent or non-independent) activity. **When defining the tax liability of the benefit, the legal relationship between the parties and the circumstances of obtaining the income will always have to be taken into account.**

Reverse charge instead of normal VAT – another Hungarian case before the European Court of Justice



- The seller receives the price plus VAT from the buyer
- The seller transfers the VAT to NAV
- Since the VAT treatment is incorrect, the NAV does not refund the VAT to the buyer and levies 50% penalty
- The VAT remains in the state budget, VAT neutrality is violated

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An **issue affecting the NAV's** (Hungarian tax authority) **inspection and penalty practice** was brought to the European Court of Justice in the form of a request for a preliminary ruling. Member States normally use this opportunity if a question arises in respect of interpreting EU law. In this case, the issue is related to the provisions of the EU's VAT Directive, and the response will provide guidance for the application of reverse charge as per the Hungarian VAT Act as well.

So what is the issue?

The request for a preliminary ruling was submitted by the Kecskemét Public Administration and Labour Court. The defendant is the NAV Tax Directorate in Bács-Kiskun County, while the applicant is Tibor Farkas, who purchased a mobile hangar from an insolvent company in an auction. The applicant paid the purchase price along with the VAT charged on the transaction by the seller, and then deducted this VAT.

However, the Hungarian tax authority indicated that the **rules on reverse charge should have been applied for the transaction, so they challenged the deduction of the VAT.** The tax authority demanded payment of the VAT amount and **levied a penalty worth 50% of the VAT**.

This is not a one-off, isolated case; the NAV has previously qualified the deduction of VAT on invoices as unlawful where the invoices were incorrectly issued according to the rules of direct taxation instead of reverse charge rules.

The main question of the Hungarian court presiding in this instance was whether the tax authority's practice was EU-compatible when the tax authority declares that a purchaser is liable for a tax difference in a situation in which the seller issues an invoice in accordance with the ordinary tax system for a transaction to which the reverse charge procedure applies and declares and pays to the Treasury the tax relating to that invoice, and the purchaser deducts the VAT paid to the issuer of the invoice, even though purchaser may not exercise his right to deduct the VAT declared? The other question is related to the practice of levying fines, i.e. whether the 50% tax penalty is a proportionate sanction for selecting the incorrect taxation method when the Treasury did not lose any taxes and there is no evidence of abuse?

Where are we now?

As part of the procedure, the **Advocate General's opinion** was published not long ago, where the Advocate General investigates the case in detail and makes a proposal for the Court on interpreting the law. Based on the Advocate General's opinion, the NAV's procedure **is against EU law when it levies a penalty** even if there is no suspicion of tax fraud, while the NAV's procedure also **violates VAT neutrality**.

When forming its opinion, the Court largely relies on the Advocate General's opinion, a ruling contrary to this is very rare. In light of this, the Court is expected to form a similar opinion when making its decision.

So what happens now?

The question is how the NAV will proceed in the future if the European Court of Justice's legal interpretation for the Hungarian court is in favour of the applicant. Under the current legal environment, in cases like this the **most suitable procedure** would be if the NAV draws the affected parties' attention to their incorrect interpretation of the tax law regarding the reviewed transactions (reverse charge instead of normal taxation) and calls for the issuer of the invoice to correct it. After issuing the corrected invoice, the VAT balance would be restored and in this case neither the parties nor the budget would suffer any damage. Naturally, for this **the NAV cannot consider** the VAT originally deducted incorrectly **as an unlawful reclaim**.

Although this procedure would be desirable, it would not provide an appropriate solution in all cases. For example, it is difficult to remedy the VAT treatment of a transaction if the invoice issuer has ceased to exist in the meantime, or the purchaser can even incur financial losses if the seller is unable to repay the VAT after the invoice correction.

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