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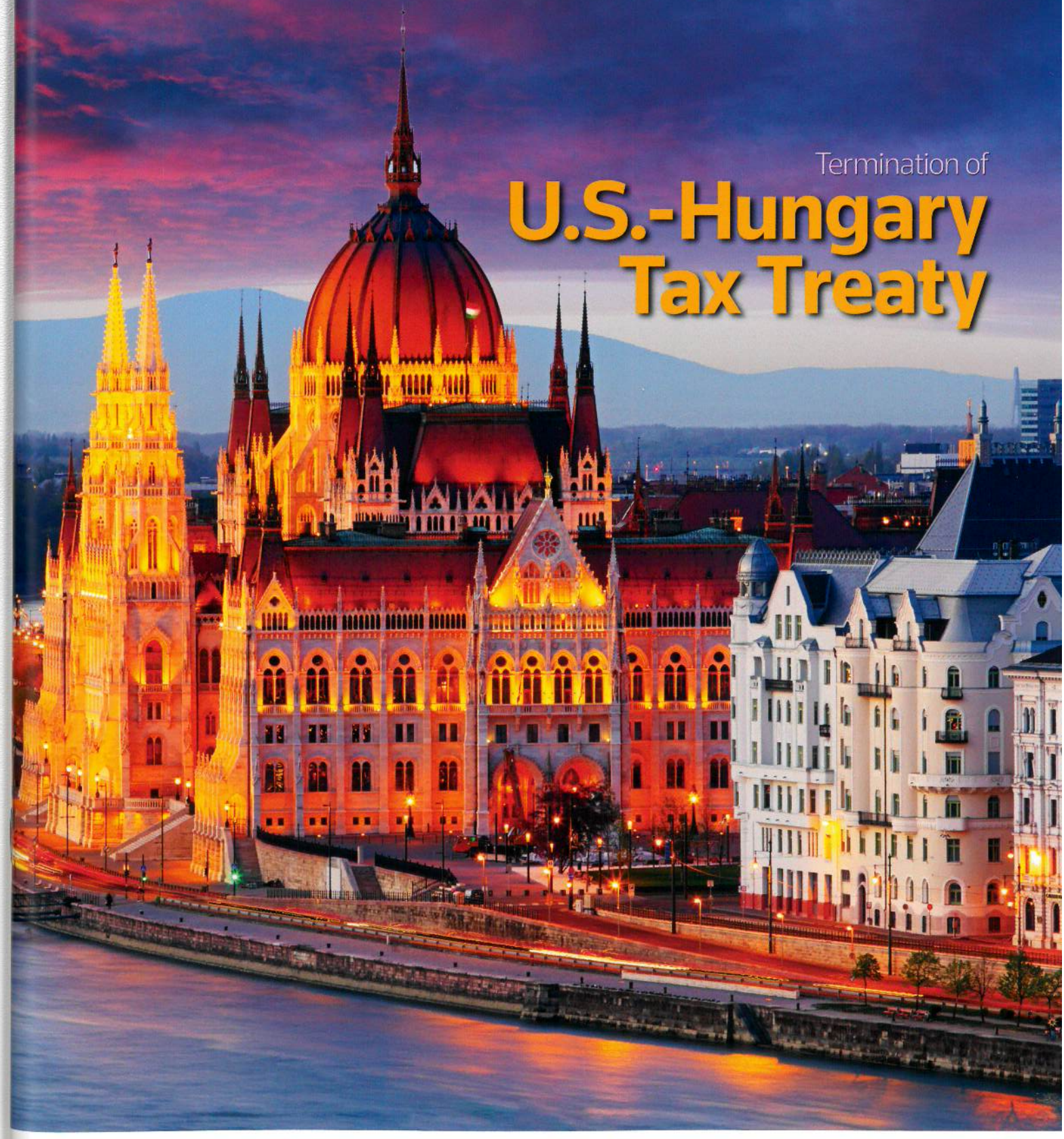

Termination of U.S.-Hungary Tax Treaty

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U.S.-HUNGARY TAX TREATY TERMINATION

What Hungarian High Tech Companies Need to Know

A significant number of Hungarian tech companies that receive U.S.-source income (in the form of licensing income or royalties) have likely utilized the U.S.-Hungary income tax treaty to avoid U.S. withholding tax or U.S. income tax on this income.

ANTHONY DIOSDI AND ISTVÁN CSŐVÁRI

On July 8, 2022, the Biden administration announced that it will terminate the United States-Hungary Income Tax Treaty that was enacted in 1979. The provisions of the tax treaty will no longer apply beginning on January 1, 2024. According to a July 8, 2022, article in the *Wall Street Journal* entitled "U.S. Moves to End Tax Treaty With Hungary", the U.S. Department of the Treasury (the "Treasury") explained that its action was based on long-standing concerns with Hungary's tax system and the treaty itself, and a lack of satisfactory action by Hungary to remedy these concerns in coordination with other EU member countries that are seeking to implement the OECD Pillar Two global minimum tax proposal. The treaty's termination will apply to U.S.-source dividends, interest, and royalties for payments made on or after January 1, 2024. A new U.S. income tax treaty with Hungary was agreed to in 2010 (to replace the 1979 tax treaty), primarily to add a Limitation on Benefits ("LOB") provision. However, the 2010 tax treaty has not been ratified due to objections of Senator Rand Paul. In addition, according to the same July 8, 2022 article in the *Wall Street Journal*, the Biden administration does not support the 2010 treaty because Hungary recently reduced its corporate tax rate.

A significant number of Hungarian tech companies that receive U.S.-source income (in the form of licensing income or royalties) have likely utilized the U.S.-Hungary income tax treaty to avoid U.S. withholding tax or U.S. income tax on this income. With the termination of the U.S.-Hungary income tax treaty, Hungarian tech companies with U.S.-source income will need to consider tax planning options to reduce their exposure to U.S. taxes. This article discusses some of the U.S. tax considerations for foreign investors such as Hungarian tech companies investing in the U.S. or receiving income from the U.S.

Taxation of Foreign Corporations by the United States; Effectively Connected and Non-Effectively Connected Income

With the imminent termination of the U.S.-Hungary tax treaty, some Hungarian tech companies have considered establishing a U.S. branch or U.S. entity. For U.S. tax purposes, a Hungarian tech company will typically be considered a foreign corporation. The U.S. taxes foreign corporations on the net amount of income effectively connected with the conduct of a trade or business within the U.S. [1] Therefore, under the U.S. Internal Revenue Code, the existence of a U.S. trade or business is the touchstone of U.S. taxation of a foreign corporation's profits. Despite its importance, there is no comprehensive definition of the term "trade or business" in the Internal Revenue Code or its regulations. The relevant case law suggests that a U.S. trade or business exists only if the activities within the U.S. are considerable, continuous, and regular and are engaged in for profit.

A foreign corporation engaged in a U.S. trade or business is subject to U.S. taxation on the income effectively connected with the conduct of that U.S. trade or business. [2] Effectively connected income includes the following three categories of income:

1. Certain types of U.S.-source income; [3]
2. Certain types of foreign-source income attributable to a U.S. office; [4] and
3. Certain types of deferred income that is recognized in a year that the foreign person is not engaged in a U.S. trade or business, but which would have been effectively connected income if the recognition of the income had not been deferred; [5]

A foreign corporation engaged in the conduct of a U.S. trade or business can take deductions against its effectively connected gross income. These deductions include those for expenses, losses, and other deductions that are directly related to the effectively connected gross income (e.g., cost of goods sold), as well as a ratable portion of any deductions that are definitely related to any specific item of gross income.

In addition to the regular U.S. corporate income tax, foreign corporations engaged in a U.S.- trade or business may become subject to the branch profits tax. The branch profits tax equals 30 percent of a foreign corporation's dividend equivalent amount. This tax attempts to mirror the 30 percent withholding tax imposed on U.S. subsidiary corporations that repatriate earnings to their foreign owners. The dividend equivalent amount of a foreign corporation is reduced by annual increases in such corporation's net equity, and is increased by annual reductions in its net equity. As a result

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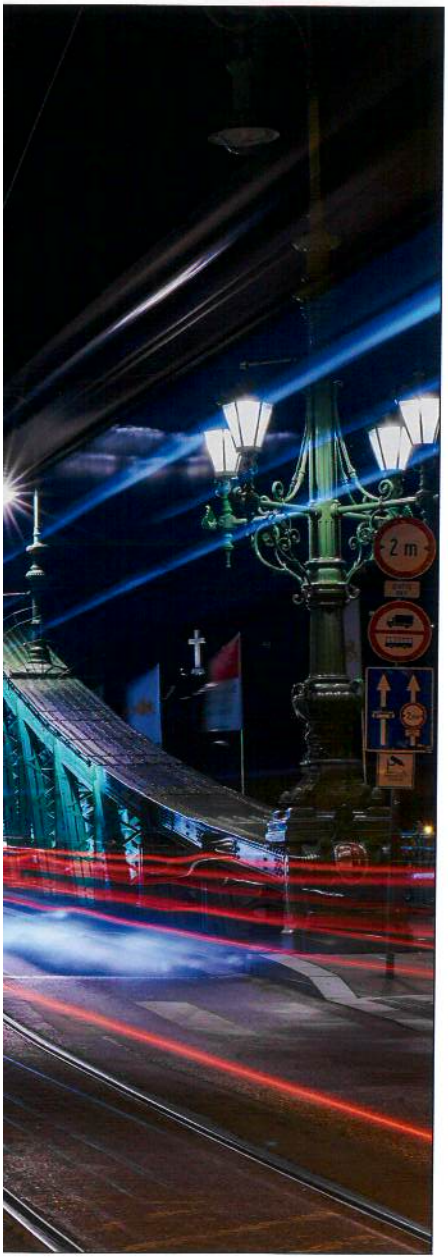


of the branch profits tax, the direct ownership of U.S. businesses by foreign corporations is generally not advisable. Nevertheless, the branch profits tax may be reduced or eliminated if the foreign investor is resident of a country with which the U.S. has a favorable treaty. [6] The existence or absence of such a treaty may make a critical difference in U.S. tax planning.

Since the U.S.-Hungary income tax treaty will be terminated on January 1, 2024, any Hungarian tech companies considering investing in the U.S. through a U.S. corporation or branch must closely examine the risk of becoming subject to the U.S. branch profits tax before moving forward with such an investment.

Income Not Effectively Connected with a U.S. Trade or Business

Foreign corporations not engaged in a trade or business in the U.S. are subject to a flat 30 percent withholding tax (without deduction or credit) on its U.S.-source income that is not effectively connected income. Internal Revenue Code Section 881(a)(1) describes this category of U.S.-source income, which is generally passive in nature, as "fixed or determinable annual or periodic gains, profits, and income" ("FDAP income"). A foreign corporation's U.S.-source FDAP income is taxed on a gross basis without offsetting deductions. This is in contrast with the tax on income effectively connected with a U.S. trade or business, which is assessed on a net basis. In any event, the flat 30 percent withholding tax may be reduced or eliminated by applicable tax treaties.

The passive income categories subject to the flat 30 percent withholding tax include:

1. FDAP income such as interest, dividends, rents, salaries, wages, premiums, annuities, compensation, and other remunerations; and
2. Variable or contingent gains from the sale or exchange of intangible property such as patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other "like" property.

Royalties and Licenses

Many Hungarian tech companies receive royalty income from U.S. clients. U.S.-source royalty income may be classified as FDAP income subject to the 30 percent withholding tax. The rules governing U.S. taxation of royalty income are complicated. Rents and royalties are U.S.-source if the property is located or used in the U.S., and are foreign source if the property is located or used abroad. [7] All other factors, such as where the property was produced or the place of contract, are ignored. The dividing line between the licensing of intangible property and the outright sale of intangible property is not always clear. Generally, a sale results if all substantial rights of ownership are transferred. However, even if all or substantially all ownership rights are transferred, the gains from such transfer will still be treated as FDAP income and taxed at the gross 30 percent rate so long as such gains are "contingent on the productivity, use or disposition of the property".

Source of Income from Leases, Licenses, and Services Distinguished

The sourcing rules under Internal Revenue Code Sections 861 and 862 instruct whether income from payments of a particular transaction will be treated as U.S.-source or foreign-source income or partly both based on an allocation provision. Personal services are sourced under the "place of performance" standard. In comparison, rental income of tangible property is sourced based on where the property is located. Royalty and licensing income associated with intangible personal property is sourced according to where the intangible property is used, which is where the legal protection sought by the licensee is sought. For example, in 2024 a licensee remits fees to the manufacturer of copyrighted software for use in the United States. The manufacturer or developer of the software is a foreign corporation based in Hungary, which no longer has a tax treaty with the United States. The fees paid by the licensee are U.S.-source FDAP income and will be subject to the 30 percent withholding tax.

1 See IRC Section 871(b) and IRC Section 882(a). For this purpose, the U.S. includes the 50 states and the District of Columbia, but not U.S. possessions. See IRC Section 7701(a)(9).

2 See IRC Section 871(b) and Section 882(a).

3 See IRC Section 864(c)(2) and (3).

4 See IRC Section 864(c)(4).

5 See IRC Section 864(c)(6) and (7).

6 See IRC Section 884(e)(2)(B); Treas. Reg. Section 1.884-5T. See IRS Notice 87-56, note 83, infra, regarding the favorable U.S. treaty jurisdiction.

7 See IRC Section 861(a)(4) and IRC Section 862(a)(4).

Income from Computer Programs and Cloud Transactions

As mentioned above, income from copyrights, patents, or similar intangibles may be treated as "royalties" and therefore FDAP income under a "license" arrangement, or gain from the sale of the intangible property if substantially all rights of ownership are transferred, or as services income if the income is principally derived in the form of compensation for services performed with respect to the property. Where a Hungarian tech company receives payments but does not have ownership in the intangible property, the payments are usually treated as compensation for services. Where the Hungarian tech company owns the property but transfers less than substantially all of its ownership rights, the transaction is generally characterized as the grant of a license.

Treasury Regulation Section 1.861-18 provides rules for classifying income from the transfer of computer programs as well as income from the provision of services or know-how with respect to computer programs. Under these rules, transactions involving computer programs are categorized as one of the following four transaction types:

1. A transfer of a "copyright right" in the program, which is treated as a sale if "all substantial rights" in the copyright as to a particular country are transferred and, if less than all substantial rights are transferred, a license generating royalty income;
2. A transfer of a copy of the program, which is treated as a sale of the copy if "the benefits and burdens" of ownership in the copy are transferred and, if not, a lease generating rental income;
3. The provision of services with respect to the development or modification of the program; or
4. The provision of "know-how" relating to computer programming techniques where such know-how consists of information subject to trade secret protection and is furnished under conditions preventing unauthorized disclosure.

These rules, which were issued in 1998, did not directly address "cloud computing" transactions, which are a more recent phenomenon. Cloud computing permits consumers to access and use, via the internet, software programs stored on a provider's servers. The cloud computing customer typically does not acquire a copy of the program or any copyright rights in the program. The customer also typically does not receive any development services or programming know-how from the cloud computing provider. Cloud computing transactions generally follow three models: 1) software as a service ("SaaS"); 2) platform as a service ("PaaS"); and 3) infrastructure as a service ("IaaS"). SaaS allows customers to access applications on a provider's cloud infrastructure through an interface such as a web browser. PaaS allows customers to deploy applications created by the customer onto a provider's cloud infrastructure using programming languages, libraries, services, and tools supported by the provider. IaaS allows customers to access processing, storage, networks, and other infrastructure resources on a provider's cloud infrastructure.

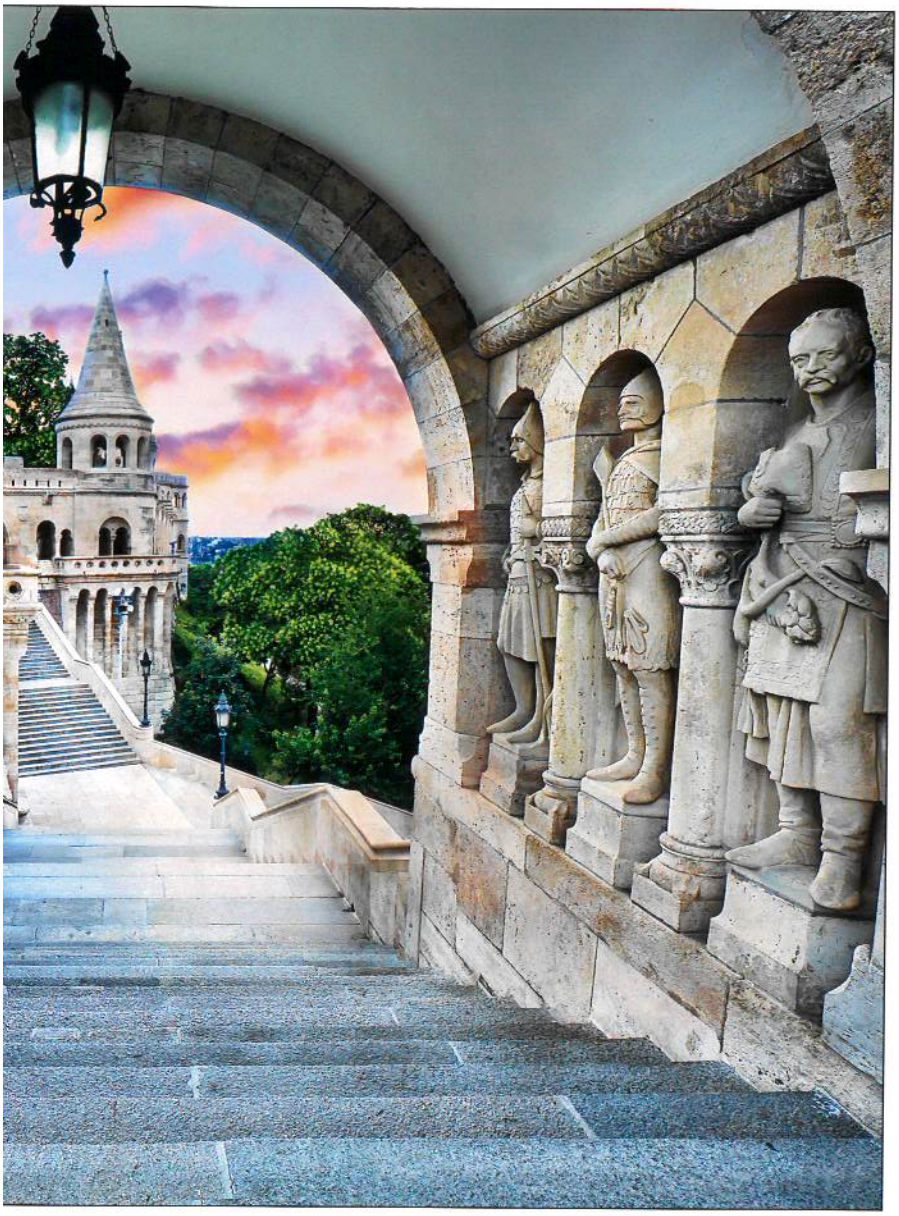
In 2019, the Treasury and the IRS issued proposed regulations that sought to categorize cloud computing transactions as either a lease of property or the provision of services. These regulations, however, have yet to be finalized and adopted. Until then, Internal Revenue Code Section 7701(e)(1) and applicable case law are the relevant sources of guidance on how to categorize cloud computing transactions.

Section 7701(e)(1) identifies six factors, each of which, if true, would weigh in favor of characterizing a transaction as a lease instead of a provision of services. These six factors are: 1) the customer is in physical possession of the property; 2) the customer controls the property; 3) the customer has a significant economic or possessory interest in the property; 4) the provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract; 5) the provider does not use the property concurrently to provide significant services to entities unrelated to the customer, and 6) the total contract price does not substantially exceed the rental value of the property for the contract period. These six factors are neither weighted nor all-inclusive. Any Hungarian tech company whose business involves cloud computing

or similar transactions will need to take these factors into account in order to determine the U.S. characterization of its income.

Effect of Treaties on U.S. Withholding Taxes

The income tax treaties that the U.S. has entered into generally reduce or eliminate withholding taxes on specified items of U.S.-source income that is not attributable to a permanent establishment in the United States. In order to qualify for the benefits under these treaties, a foreign individual or entity must not only be a resident of one of the countries party to the treaty, but also



satisfy additional restrictions set forth in the treaties' LOB provisions, which have arisen to curtail the practice of "treaty shopping." In the corporate context, most treaties deem a corporation that is organized under the laws of a country as a resident of that country. Historically, being a resident of a contracting state was all that was needed for a corporation to claim treaty benefits. This single requirement, together with the relative ease with which corporations could be formed and operated under the laws of many jurisdictions, led companies to form corporate entities in a third country specifically chosen to take advantage of that country's favorable tax treaty. For this reason, LOB provisions require a corporation who is a resident of a contracting state to also satisfy one of several tests before such a corporation can claim benefits under the treaty. Among these tests are the "publicly traded company test," the "ownership-base erosion test," the "active trade or business test," and the "derivative benefits test." A corporate resident needs to meet only one of these tests. The tests are generally designed to ensure that there is sufficient nexus between the corporation and its country.

[8] See Rev. Proc. 2023-7, section 3.01(4). Notwithstanding this policy, the IRS is not prevented from providing guidance on the legal interpretation of a particular LOB provision in a specified treaty.

LOB Corporate Tests under the Treaties

Upon termination of the U.S.-Hungary tax treaty on January 1, 2024, some Hungarian tech companies with U.S.-source royalty income will become subject to a 30 percent withholding tax. In some cases, a Hungarian tech company may be able to utilize a tax treaty entered into between the U.S. and a third country to reduce or eliminate U.S. withholding tax on royalty income. It bears emphasizing, however, that no two treaties are identical. Each treaty is separately negotiated by the U.S and the other country. As a consequence, the LOB provision in one treaty may differ subtly or even quite significantly from the LOB provision in another treaty. Often tailored to account for each country's particular tax situation at the time, every LOB provision requires careful analysis, a task made all the more difficult given the paucity of case law and the IRS's prevailing policy of not issuing guidance on whether a party would be entitled to the benefits of a specified treaty. [8]

The following is a summary of the four corporate tests as they exist in the most recent U.S. Model Income Tax Treaty published in 2016 (the "2016 Model Treaty"). This summary is intended only to provide a brief overview of each test's requirements in the 2016 Model Treaty and should not be construed to be an exact reproduction of the requirements in any other treaty.

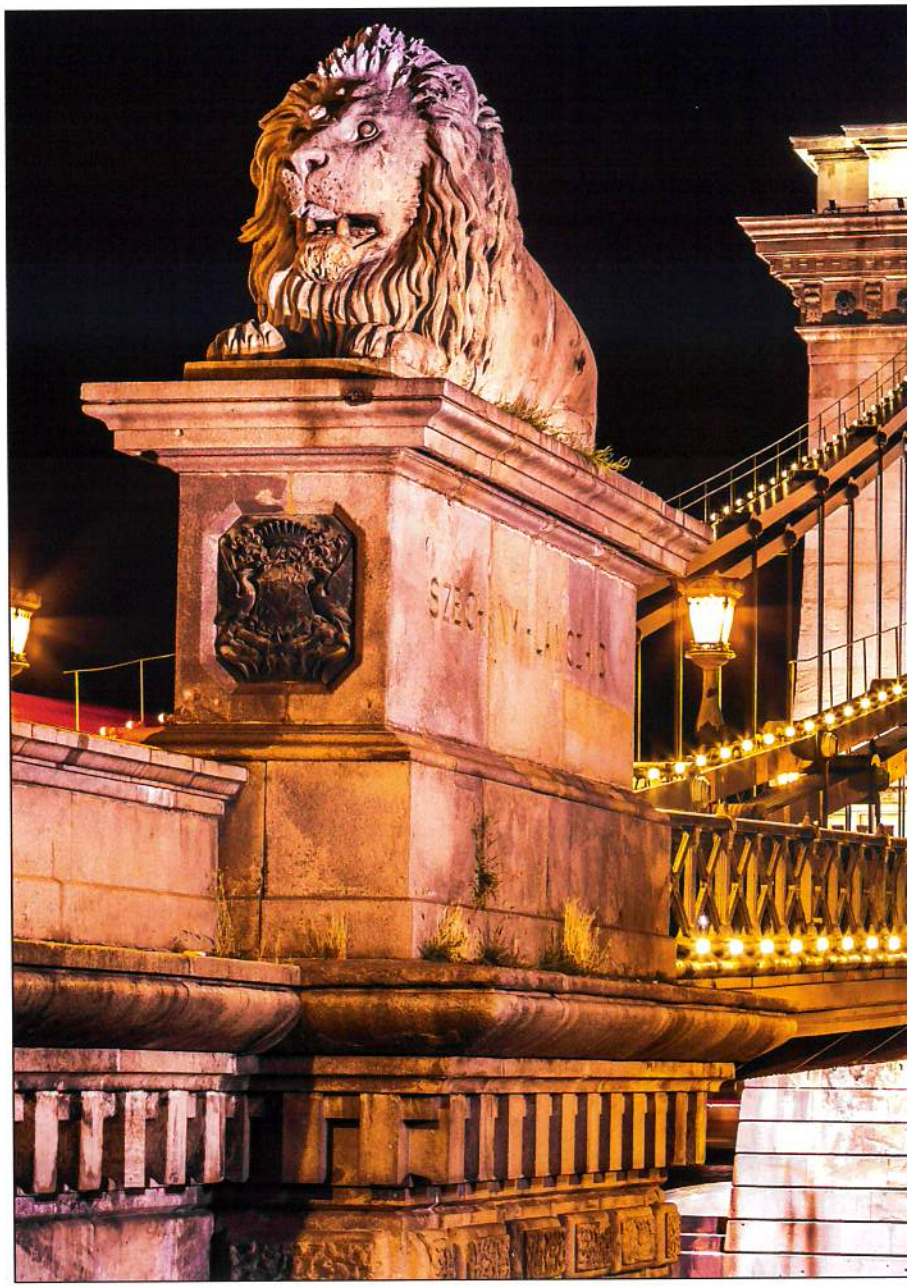
Publicly Traded Company Test

Under the publicly traded company test in the 2016 Model Treaty, a corporation must be a "publicly traded company" which is defined as a corporation whose principal class of shares is regularly traded on one or more recognized stock exchanges and either 1) such shares are also primarily traded on one or more recognized stock exchanges located in the contracting state where the corporation is a resident or 2) the corporation's primary place of management and control is in the contracting state where the corporation is a resident.

Ownership-Base Erosion Test

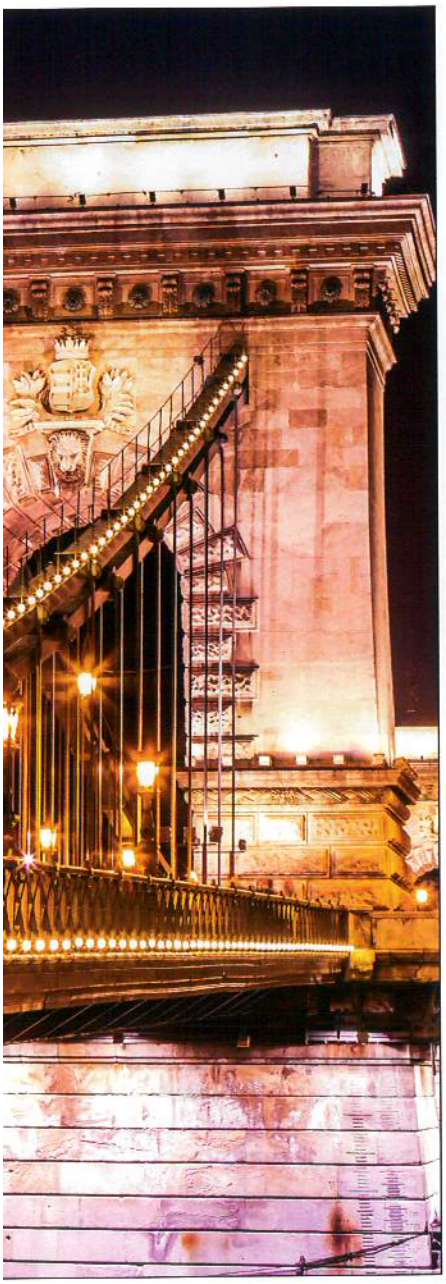
The ownership-base erosion test in the 2016 Model Treaty consists of two parts, both of which must be satisfied. The first part addresses the composition of the corporation's owners and requires that at least 50 percent of the aggregate voting power and value of the corporation's shares be owned, directly or indirectly, by owners who are residents of the same contracting state where the corporation is a resident. These owners must own their shares in the corporation for a period of time equal to at least one-half of the corporation's taxable year, and each such owner must be either an individual, a contracting state (or subdivision), a publicly traded company, or a qualified pension fund or tax-exempt organization.

The second part of the ownership-base erosion test addresses erosion of the corporation's tax base. Specifically, this second part provides that certain payments made by the corporation in the taxable year must not total 50 percent or more of its gross income for such year. A payment is subject to this 50 percent limitation if it is deductible for tax purposes in the contracting state where the corporation is a resident and if such payment is made by the corporation to a restricted recipient. Restricted recipients include 1) recipients who are not residents of either contracting state and are not entitled to the benefits of the treaty as an individual, a contracting state (or subdivision), a publicly traded company, or a qualified pension fund or tax-exempt organization and 2) recipients who are connected to the corporation (by at least a 50 percent ownership interest) and benefit from a special tax regime with respect to the deductible payment. The payments limited by this second part of the test do not include arm's-length payments made in the ordinary course of business for services or tangible property.



Active Trade or Business Test

Under the active trade or business test in the 2016 Model Treaty, a corporate resident that is engaged in the active conduct of a trade or business in its country of residence is entitled to treaty benefits on income derived from the source country to the extent that such income emanates from, or is incidental to, that trade or business. Moreover, if the income is derived from any trade or business activity conducted by the corporation in the source country, then the corporation's trade or business activity in its residence country must be substantial in relation to the same or complementary trade or business activity carried on in the source country. Whether a trade or business activity is substantial for these purposes is determined based on all the facts and circumstances. Under this test, active trade or business generally involves a specific unified group of activities that constitute (or could constitute) an independent economic enterprise carried on for profit. In this regard, the corporation's officers and employees (excluding, for this purpose, any independent contractor) must carry out substantial managerial and operational activities of the trade or business. Active trade or business does not include holding companies, group financing, group supervision and administration, or the mak-



ing or management of investments. Activities conducted by persons connected to a corporation can be attributed to the corporation.

Derivative Benefits Test

The purpose of the derivative benefits test is actually to expand treaty benefits to a corporate resident in either contracting state with respect to an item of income. This test applies to closely held corporations that cannot otherwise qualify for treaty benefits to obtain treaty relief. Similar to the ownership-base erosion test, the derivative benefits test in the 2016 Model Treaty also consists of two parts, both of which must be satisfied. The first part requires at least 95 percent of the aggregate voting power and value of the corporation be owned, directly or indirectly, by seven or fewer shareholders who are equivalent beneficiaries. An "equivalent beneficiary" is a person who is the resident of another country that has entered into its own bilateral income tax treaty with the U.S. and who is entitled to the benefits of that other treaty as either an individual, a contracting state (or subdivision), a publicly traded company, or a qualified pension fund or tax-exempt organization within the meaning of the other treaty. However, the benefits afforded to the person by the other treaty (or by any domestic law or other international agreement) must be at least as favorable as the ones afforded by the current treaty under which the person is an equivalent beneficiary. For example, if the other treaty subjects the person to a rate of tax on dividends, interest, or royalties that is higher than the rate applicable under the current treaty, then the person would be disqualified from being an equivalent beneficiary under the current treaty.

The second part of the derivative benefits test mirrors that of the ownership-base erosion test in that it too limits the corporation's payments that are deductible for tax purposes in the contracting state where the corporation is a resident to be less than 50 percent of its gross income for the taxable year. However, the second parts of both tests differ in who they define to be a restricted recipient of the deductible payment. In the case of the derivative benefits test, restricted recipients include 1) recipients who are not equivalent beneficiaries, 2) recipients who are equivalent beneficiaries only because they function as a headquarters company for a multinational corporate group consisting of the corporation and its subsidiaries, and 3) recipients who are equivalent beneficiaries that are connected to the corporation (by at least a 50 percent ownership interest) and benefit from a special tax regime with respect to the deductible payment.

"Equivalent Beneficiaries" under the Derivative Benefits Test of Various Treaties

The following U.S. income tax treaties contain a derivative benefits provision in their LOB articles: Belgium, Canada, Denmark, Finland, France, Germany, Iceland, Ireland, Jamaica, Luxembourg, Malta, Mexico, the Netherlands, Sweden, Switzerland, and the United Kingdom.

Each of these treaties has a specific "equivalent beneficiary" definition. For example, the U.S. treaties with Canada and Jamaica, like the 2016 U.S. Model Income Tax Treaty, broadly allow residents of any jurisdiction that has an income tax treaty with the U.S. to be treated as equivalent beneficiaries. In contrast, the U.S. treaties with Belgium, Sweden, and Finland limit equivalent beneficiaries to residents of a country in the EU or EEA, residents of a NAFTA country, and residents of Switzerland. The U.S. treaty with Mexico is even narrower, limiting equivalent beneficiaries to residents of a NAFTA country.

In addition to these country residency requirements, each treaty has other requirements that the equivalent beneficiary must satisfy in order to meet the derivative benefits test. For example, the derivative benefits tests in most treaties are similar to the one in the 2016 U.S. Model Income Tax Treaty in that they require the equivalent beneficiary to be entitled to the benefits under the other bilateral income tax treaty as an individual, a qualified contracting state (or subdivision), a publicly traded company, or a pension fund or tax-exempt entity within the meaning of that other treaty. As a consequence, a person who is an equivalent beneficiary under such a derivative benefits test in one treaty cannot be counted as a qualifying owner under the ownership-base erosion test in the same treaty (and also cannot meet the active trade or business test, in any, in such treaty). Treaties that contain this requirement include the U.S. treaties with Belgium, Denmark, France, Germany, Iceland, Malta, Mexico, the Netherlands, Sweden, and Switzerland.

Like the 2016 Model Treaty, these treaties provide that, if another country's

tax treaty with the United States lacks a LOB provision, then a person who is a resident in that other country can still be an equivalent beneficiary under the current tax treaty if such person would otherwise qualify as an individual, a contracting state (or subdivision), a publicly traded company, or a qualified pension fund or tax-exempt entity within the meaning of the current tax treaty.

The income tax treaty with Luxembourg allows an equivalent beneficiary to satisfy the derivative benefits test by qualifying under the active trade or business test (as well as qualifying as one of the four types of persons described above). Since Hungary is a member of the EU, a Hungarian tech company may be treated as an equivalent beneficiary under another tax treaty entered into with another EU country. For example, assume residents of Hungary establish a U.K. company that has an active trade or business in the U.K. Also assume that the U.K. company establishes a subsidiary in Luxembourg that owns intellectual property that is licensed to the U.S. The combined rate of withholding on royalties under both the U.S.-Luxembourg and U.S.-U.K. income tax treaties are zero. Luxembourg has a favorable regime for the taxation of intellectual property resulting in an effective corporate income tax rate of approximately five percent. The royalties paid from the U.S. to Luxembourg would qualify for the zero percent withholding rate under the U.S.- Luxembourg income tax treaty because the U.K. company would be an equivalent beneficiary, despite the fact that it is owned by nonresidents of the U.K., is not publicly traded in the U.K., is not a subdivision of the U.K. government, and is not a U.K. pension fund or tax-exempt organization.

The termination of the U.S.-Hungary treaty might be a problem for the Luxembourg-United Kingdom- Hungary hypothetical. This is because the first part of the Derivative Benefits Test in the 1986 Luxembourg treaty reads:

> "4. Except as provided in subparagraph (c), a company that is a resident of a Contracting State shall be entitled to all the benefits of this Convention if: (a) 95 percent of the company's [i.e., Luxembourg Subsidiary's] shares is ultimately owned by seven or fewer residents of a state that is a party to NAFTA or that is a member State of the European Union and with which the other State has a comprehensive income tax convention;... (d)(i) The Term 'resident of a member State of the European Union' means a person that would be entitled to the benefits of a comprehensive income tax convention in force between any member State of the European Union and the Contracting State [i.e., the U.S.] from which the benefits of this Convention are claimed.."

The term "ultimately" probably means that there must be a U.S.- Hungary Treaty in effect- i.e., there is a look-through such that the Hungarian shareholders are the "ultimate" owners of the whole corporate structure, and the U.S. is the Contracting State from which the benefits of the U.S.-Luxembourg Convention are claimed. Thus, it does not appear that a treaty between Hungary and the U.K. - or a treaty between Hungary and Luxembourg - is enough.

Further, even if the analysis does end at the U.K. Intermediary (and doesn't look through it to the shareholders of the Hungarian Parent), there could be some uncertainty whether the U.K. Intermediary can still be an "equivalent beneficiary" under the U.S.- Luxembourg treaty after Brexit. While the U.S. and the U.K. have entered into a "Competent Authority Arrangement" between them agreeing that the U.K. is grandfathered under the U.S.-U.K. treaty, this arrangement by itself does not legally apply to the U.S.-Luxembourg

9 Treas. Reg. Section 1.881-3(a)(2)(ii)(A).

10 *Id.*

treaty or any of the other bilateral treaties that the U.S. has with other countries.

Thus, Hungarian residents may potentially establish corporations in certain countries such as the United Kingdom, Ireland, Austria, and Spain to reduce U.S. withholding tax under an "equivalent beneficiary" theory. However, any planning involving the tax treaties with any third countries under an "equivalent beneficiary" to reduce or eliminate a U.S. withholding tax should be carefully scrutinized.

Provisions that May Deny Treaty Benefits

The conduit financing regulations enacted in Internal Revenue Code Section 7701(l) prevent claiming treaty benefits with respect to royalty payments. The Treasury was authorized under Internal Revenue Code Section 7701(l) to issue regulations that would allow multi-party financing arrangements to be reclassified as transactions directly between any two or more parties involved. In accordance with Section 7701(l), the Treasury introduced regulations in 1995 to clarify when the IRS can recharacterize multi-party financing transactions for U.S. withholding tax purposes.

Under these regulations, the IRS can ignore the involvement of an intermediate entity in a multi-party financial arrangement for withholding tax purposes if the intermediate entity is deemed to be a conduit entity. A conduit entity is an entity whose participation in the financing arrangement is designed to minimize U.S. withholding tax liability and is part of a tax avoidance plan, and is one that is either related to the financing/financed entity or entered into the transaction as a result of the financing entity. The regulations define a financing arrangement as a series of financing transactions by which one person (the financing entity) advances money or other property, or grants rights to use property, and another person (the financed entity) receives money or other property, or rights to use property, if the advance and receipt are effected through one or more other persons (intermediate entities). [9] A financing transaction includes a debt, lease, or license. [10]

Prior to the enactment of the 2017 Tax Cuts and Jobs Act, with certain exceptions, under the conduit regulations, an instrument that was classified as equity for U.S. tax purposes did not constitute a financing transaction. Thus, it was common for non-U.S. persons and non-U.S. entities to utilize hybrid instruments (an instrument treated as debt for foreign tax purposes but equity for U.S. purposes) to capitalize an intellectual property holding company that would hold intellectual property. The intellectual property company would then license the intellectual property to a U.S. person in exchange for a royalty payment. The payment of the royalties to the foreign holding company was classified as interest for foreign income tax purposes and a dividend for U.S. income tax purposes. These structures were not subject to the conduit financing rules because the subsequent payment by the intellectual holding company was treated as a dividend.

Recently, the IRS and Treasury issued final and proposed anti-conduit regulations. These regulations will cause the conduit financing regulations to expand the types of equity interests that are treated as financing transactions. The regulations will include a financing transaction of so-called hybrid instruments.

Conclusion

This article is intended to acquaint Hungarian tech companies with some of the principal tax planning issues associated with U.S. taxation of intellectual property. This area is relatively complex and is constantly evolving with Congress entertaining new tax laws, the IRS issuing new regulations and interpretations, and courts rendering new rulings in this area. As a result, it is crucial that Hungarian tech companies consult with a qualified international tax attorney both in the U.S. and in Hungary. ●