Article

Tax benefits of the asset management foundation and trust in Hungary

Ákos Menyhei*

Abstract

The tax treatment of the trust, the private foundation and the AMF is based on tax neutrality in Hungary, providing at least an equal and not burdensome treatment of these vehicles compared to any other alternative legal solutions. This treatment includes that the trustee and the foundation are treated as intermediaries from a tax and stamp duty perspective, with the outcome that the acquisition of the ownership of the transferred assets by the trustee or foundation does not trigger taxation. Moreover, asset owners are encouraged to use these vehicles as significant tax benefits that are provided in connection with the asset transfer, management and distribution.

The two most important wealth and estate planning vehicles in Hungary are the trust and the asset management foundation (AMF). Both were designed to provide long-term solutions for families and private individuals to protect their assets against the risks of the quickly changing legal and economic environment. Many European countries with Roman law-based continental legal systems accepted that the trust or trust like fiduciary solutions may provide an additional vehicle for wealth preservation and have thus implemented the trust in their legal systems. There are two ways of implementing the fiduciary relationship into a Roman law-based legal system:

1. By joining the Hague Convention on trusts[1], or
2. By changing the legal environment to accommodate the trust in the legal system.

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Hungary chose the second way and elaborated a very sophisticated legal environment to implement the trust concept into its legal system. Parallel to the implementation of the trust, the rules of private foundation were relaxed, propelling the creative legal thinking to a new zenith with the implementation of the asset management foundation (AMF) and the hybrid trust.[2] The result of the recent legislative actions is that the most important asset and privacy protection vehicles are available in Hungary, and high net wealth families may choose the best option according to their needs. As both the trust and the AMF were implemented with legislative actions, the accounting, their administration, and tax treatment, as well as other important rules on

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1. Convention of 1 July 1985 on the Law Applicable to Trusts and on their Recognition.
2. Á Menyhei and J Zsoldos, "Privacy protection in Hungary", 26(6) Trusts & Trustees (2020) 542–549; A Menyhei, "The new Hungarian asset management foundation", 25(6) Trusts & Trustees (2020) 599–610.

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how to set up these vehicles, to register their ownership to the assets, to prepare the books, do the administration and report the income are precisely regulated. The detailed regulations provide certainty for both the service providers and the clients. Wealth worth billions of EURO has moved to these new instruments over the last seven years. The success can partially be explained by the detailed rules and the resulting legal certainty. Moreover, the fight against the so-called financial centers may have propelled the quick switch, but this cannot be the sole reason. The tax benefits of the trust and the private foundations I believe have accelerated the decision making of the asset owners to change their structures rapidly to the new trust and private AMF structures. This article provides a comprehensive summary of the tax benefits available for trusts and AMFs in Hungary.

Tax benefits of a transfer of assets to a trust of AMF

trusts situated and AMFs registered in Hungary enjoy tax neutral treatment.

First things first—trusts situated and AMFs registered in Hungary enjoy tax neutral treatment. This means that the tax treatment of these vehicles is never more burdensome than that of any other alternative legal solution. Moreover, the asset transfer from the settlor/founder to the trustee or AMF is free of any charges in Hungary, there is no hidden taxation or similar type of financial burden[3]. Even the VAT rules are tax neutral. The trustee or AMF may take over the previous VAT position of the settlor/founder. Thus, the VAT treatment is not a decisive element of the decision-making.[4]

In many countries, settlors/founders of trusts and foundations confront the dilemma that the transfer of assets into a trust/AMF creates deemed income for them. This is quite the opposite in Hungary as the Personal Income Tax Act[5] (PIT Act) provides a definite exemption. For the purpose of determining the day when a private individual earns the income, the conclusion of a fiduciary asset management contract (trust) or the creation of a foundation (or joining a foundation as a co-founder at a later stage) shall not be considered as exercising the right of disposition by the private individual, acting as settlor, or founder (co-founder) of a foundation.[6]

The result of this exemption is that the transfer of assets into a trust/AMF does not create any income;

The result of this exemption is that the transfer of assets into a trust/AMF does not create any income; therefore, there is no tax obligation for the private individual acting as settlor/founder; even if the current market price is higher than the original acquisition price of the transferred assets.

Moreover, the Accounting Act[7] requires the settlor/founder and the trustee to determine the value of the transferred assets according to the market price paid between independent parties. The transferred assets will therefore be accounted for as principal (capital) of the trust or AMF at the current market price. This triggers an additional tax benefit aside from the lack of any deemed income treatment of the transferred assets. Annex 1 of the PIT Act lists the Tax-Exempt Revenues. Among others it provides [Article 7.26] that asset distributions made by the fiduciary to the private individual beneficiary

3. Act XCIII of 1990 on Duties, Section 17/D (1) The financial gains acquired by a person or organization notified to the state tax authority as a fiduciary (hereinafter referred to as "fiduciary manager"), and by a trust (hereinafter referred to collectively as "fiduciary") under a fiduciary asset management contract provided for in the Civil Code (for the purposes of this Subtitle hereinafter referred to as "contract"), furthermore, within the framework of the allocation of funds by the founder in accordance with the Act on Asset Management Foundations (hereinafter referred to as "founder's allocation of funds") shall not be subject to gift duty, including if acquired by way of succession by the fiduciary, but excluding if the fiduciary manager is named as beneficiary.

4. Act CXXVII of 2007 on Value Added Tax, Section 17 (5).

5. Act CXVII of 1995 on Personal Income Tax (PIT Act).

6. PIT Act Section 9 Paragraph (3).

7. Act C of 2000 on Accounting.

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from trust assets and the assets of private foundations shall be tax-exempt.

asset distributions made by the fiduciary to the private individual beneficiary from trust assets and the assets of private foundations shall be tax-exempt.

This tax exemption opens the opportunity to further tax planning as this is more than a tax deferral (like the lack of deemed income in relation to the transferred assets). This is a very rare real tax exemption at the level of a private individual. Let us assume the following facts: Mr Smith, a Hungarian tax resident individual, acquired a 10% company participation for EUR 1000 in 1997. Mr Smith is planning to retire and wishes to sell his company participation in the next five years. The current market value of the asset is EUR 1 million. If he sells the asset as a private individual, the difference between the current selling price and the recognized expenses (including the acquisition price of the asset) will be his taxable income and it will be subject to 15% personal income tax (PIT). However, if Mr Smith considers other factors in connection with his retirement plan, and sets up a trust in Hungary to which he transfers the company participation, it does not create any current tax obligation for him. Moreover, when the right time comes and the trustee sells the assets, only the capital gains of the trust (the difference between the market price at the time of the transfer of assets to the trust and the current selling price of the assets) will be subject to 15% PIT and only at the time of distribution. Mr Smith thus gains a tax deferral as well as tax exemption at the same time. The capital gain made by his trust is subject to PIT only at the time of the distribution (tax deferral) and the principal value of the company participation is tax exempt upon distribution. These rules however are applicable only if the intent of the settlor is aimed at creating a true and valid trust relationship. The tax exemption shall not apply if the private individual has acquired the beneficiary status in compensation for, or in connection with, some activity, transfer of asset, or a service [Annex 1 of the PIT Act, Article 7.26].

In summary, the transfer of assets by a Hungarian tax resident individual to a trust situated, and an AMF registered, in Hungary is completely tax and duty free in Hungary.

In summary, the transfer of assets by a Hungarian tax resident individual to a trust situated, and an AMF registered, in Hungary is completely tax and duty free in Hungary. The transfer of assets does not create deemed income for the Hungarian tax resident individual. Moreover, the transfer of assets to a trust or AMF eliminates the tax consequences for the capital gain which would derive from the difference of a low acquisition and higher selling price.

The tax benefits of operating trusts and AMFs

The AMF and the trust are subject to Corporate Income Tax[8] as both may have an economic purpose and are allowed to perform business activity. Although it is justified to treat the trust and AMF as a corporation from a taxation perspective, there are other aspects to be considered. Trusts and family foundations are typically set up by individuals for the benefit of individuals. It follows that, from a tax point of view, the AMF and the trust would suffer a disadvantage compared to the asset management carried out by a private individual, due to the fact that normally the income from assets managed by the trustee or AMF is subject to two levels of corporate and personal income taxation. Although the Hungarian corporate tax system in general contains certain advantages, such as inbound dividends not being subject to tax, and the participation exemption regime based on which the capital gain deriving from a disposition of a company participation held for more than a year is tax exempt, the economic double taxation of the private savings would discourage potential settlors or founders to use the trust

8. Act LXXXI of 1996 on Corporate Tax and Dividend Tax Section 2 (2) (g) and (l).

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and AMF for generational asset transfers. The disadvantage of the economic double taxation would be that, from the individual founder's taxation point of view, the transfer of assets would be treated as if he had placed the assets in a company. The income from the assets would be subject to 9% corporate income tax (CIT) at the trust's and the AMF's level and the distribution of assets would be subject to an additional 15% PIT on dividends, instead of just the 15% PIT when a private individual makes income gains from its own asset management. Therefore, if the taxation of the trust and AMF were to remain so, its tax treatment would not be neutral, which would greatly influence the decision-making of the founders.

The legislator recognized the importance of the tax neutral treatment of the trust and AMF and thus introduced special provisions in the PIT Act and the Corporate Income Tax Act (CIT Act) to solve the problem outlined above. Accordingly, a trust, a foundation and an AMF set up exclusively by a private individual and solely for the benefit of a private individual beneficiary may enjoy the tax benefits which are granted to private individual taxpayers in the PIT Act.

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The PIT Act contains the definition of a private foundation. It provides that a private foundation shall mean a foundation created according to the provisions of the Civil Code for the benefit of its founder and co-founders, or their relatives, as beneficiaries, or a non-public purpose AMF, provided that it is funded exclusively by a private individual founder, co-founder, and its funds consist solely of the donation (and its yields) made by a private individual.[9]

The importance of such a classification is that the PIT and the CIT Acts provide special tax treatment for private foundations and trusts set up solely by private individuals for the benefit of private individuals. Based on this special treatment, the tax benefits of the long-term investment contract are available for private foundations and trusts. Additionally, the CIT Act provides additional tax benefits as the financial type of income of the private foundation and trust is tax exempt if there is no other type of taxable income in the private foundation or trust in the given tax year.

According to the PIT Act, 'income from long-term investment' shall mean the profit the private individual has realized through placing cash assets under a long-term investment contract concluded with an investment service provider or a credit institution. This profit comprises the part of the amount that is in excess of the cash assets tied up according to the provisions, to which the private individual is entitled upon the maturity or interruption of the time deposit, but does not include the part treated as capital gains. In particular, income from "long-term investment" also includes the fair market value of the invested financial instruments, foreign currencies prevailing at maturity or the interruption of the time deposit, and the interest on deposit due at the time the contract is terminated or suspended.[10]

The working mechanism of the long-term investment contract is very simple. The private individual taxpayer opens a special segregated long-term investment account with a bank or investment service provider and transfers cash assets to the account. The client may invest the assets in different types of regulated investments, including state and corporate bonds, shares and indexes. The yield of the investments is tax exempt after a five-year term deposit and subject to only 10% PIT after a three-year term deposit.

The recent modification[11] of the PIT Act made the tax benefit of the long-term investment contract also available to trusts and AMFs as, according to the

9. PIT Act Section 3, paragraph 62.
10. PIT Act Section 67/B, paragraph 1.

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regulation, the long-term investment contract may be concluded by:

a. a private foundation for providing financial benefits to a private individual indicated as beneficiary,
b. a trustee for the performance of a trust relationship created with a private individual, as settlor, for the benefit of the private individual indicated as beneficiary,

with the proviso that these provisions shall apply to the tax liability on the return earned under the contract.[12]

The CIT Act completes the rules described above with an additional tax exemption. A trust managed under a trust relationship created by a private individual as settlor, solely for the benefit of a private individual as beneficiary and an AMF set up by a private individual as founder exclusively for the distribution of assets to a private individual as beneficiary, shall be exempt from tax liability, if all income earned in the tax year originates from the receipt or holdings of financial investments, receivables, securities or funds, the collection of proceeds thereof or from exercising the right of disposition over such assets.[13]

A trust managed under a trust relationship created by a private individual as settlor, solely for the benefit of a private individual as beneficiary and an AMF set up by a private individual as founder exclusively for the distribution of assets to a private individual as beneficiary, shall be exempt from tax liability, if all income earned in the tax year originates from the receipt or holdings of financial investments, receivables, securities or funds, the collection of proceeds thereof or from exercising the right of disposition over such assets.

This is more than a simple tax neutral treatment, this is a real tax exemption as it provides a tax exemption at the level of the trust or the AMF. This rule provides that the financial type of income is not subject to the normal 9% CIT at the trust or AMF level. The trust or AMF may accumulate the tax free income which will be subject to tax upon distribution only when the private individual beneficiary receives the assets.

In the case of the above two tax benefits being combined, it provides the opportunity for taxpayers to eliminate the income taxes (both the PIT and CIT) completely and to fully enjoy tax exempt income, if the following conditions are met:

- the trust or AMF must be created by a private individual or private individuals only,
- the beneficiaries of the trust or AMF must be a private individual or private individuals only,
- all income earned in the tax year must originate from the receipt or holdings of financial investments, receivables, securities or funds, the collection of proceeds thereof or from exercising the right of disposition over such assets,
- the income earned from the above including the original capital must be deposited in the form of money into a long-term investment account provided by a chartered investment service provider or financial institution,
- the assets must be kept in the long term investment account for a five-year term.

Tax benefits of the asset distribution from a trust or AMF

As the trust and AMF are treated as corporate taxpayers, the general rules of distribution are connected to this classification. Basically, the asset distribution is divided into two parts: distribution of the trust's and AMF's yield (income) and principal (capital). As it was explained earlier, the distribution of principal is not

11. It came into effect on 24 August 2019.
12. PIT Act Section 67/B paragraph 14.
13. CIT Act Section 20 paragraph 1.

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subject to tax in Hungary if the recipient is a private individual. Limiting the misuse of the tax exemption on the distribution of principal, the CIT provides that the trustee and the AMF are obliged to distribute the yield of the managed assets first, and after the distribution of the entire yield they may start with the distribution of the principal. The reasoning behind this distribution order is that the distribution of yield to private individuals is subject to 15% PIT or maximum 15% withholding tax. Therefore, the distribution order prevents the taxpayers to create a frozen cash value structure, when the taxable yield is subject to distribution very late, or is never distributed, and the trustee distributes principal only.

The distribution of yield from a trust or AMF is treated as a dividend distribution and is subject to 15% PIT, except if the beneficiary acquired its beneficiary status in compensation for, or in connection with, some activity, transfer of an asset or a service. In these cases, the distribution must be treated according to its real economic content and is subject to 15% PIT and additional uncapped 17.5% social contribution charges. The tax classification of asset distributions as dividends is beneficial for private individual beneficiaries as the social contribution charge on dividend distributions is capped, whilst the social contribution charge on other income is uncapped.

There is another consideration regarding the distribution of assets. As it was mentioned, the distribution of principal to private individuals is tax exempt. However, theoretically, a stamp duty payment obligation may arise, as the beneficiary receives the distribution as a gratuitous asset transfer. Under the Act on Duties, certain gratuitous asset transfers are subject to stamp duty if the transaction falls into the territorial and objective scopes of the Act. Nevertheless, the asset transfer is treated as tax neutral from this perspective too, as the distribution of the principal must be treated as a direct distribution from the settlor or founder to the beneficiary of the trust or AMF, disregarding the intermediate trustee and AMF. There is no stamp duty payment obligation among relatives in direct line, spouses and siblings if they receive gratuitous asset transfers from each other. Therefore, the distribution of principal from trusts or AMFs is stamp duty free if the settlor or founder and the beneficiaries fall into the exemption category.

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Summary

The tax treatment of the trust, private foundation and AMF is based on tax neutrality, providing at least an equal and not burdensome treatment of these vehicles compared to any other alternative legal solutions. This approach includes that the role of the trustee and foundation is treated as an intermediary one from a tax and stamp duty perspective, with the result that the acquisition of ownership of the transferred assets by the trustee or foundation does not trigger taxation. Moreover, the asset owners are encouraged to use these vehicles as significant tax benefits are provided in connection with the asset transfer, management and distribution.

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