The Concept of Permanent Establishment In the Hungarian Corporate Income Tax Law With Particular Regard of the Real Estate Market [1]

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1.) Introduction. Historical Outline.

It is a great pleasure for me addressing the issue of the taxation of transnational Real Estate business involving Hungary.

It is worth mentioning that the scope of my speech, will be limited to the *tax issues* related to *immovable properties* business situated within Hungary. Hence, I will address both the activities aiming at creating *ex novo* Real Estate businesses and those aiming at gaining profits from Real Estates business already existing.

Although my contribution shall shed light on the "Hungarian" norms as for the Real Estate income taxation, I hold that, in order to draw a fair picture, the *scope* of the Hungarian Double Taxation Convention (hereinafter "DTCs") shall be considered, where needed.

Although it could appear far from the scope of this speech, I can not avoid in laying down some brief historical remarks as for the focal role Hungary played in the ambit of "international tax law" and, namely, in the ambit of the Double Taxation Conventions since the very beginning of this international practice (I refer, to the efforts on the issue of (international) "double taxation" stemming form the latest 1800s from some leading international organizations[3] and, namely, from the first strong inputs of the League of Nations).[4]

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[3] I refer to the working of the *Insitut de Droit International* which, since the "Cambridge" session (held in 1895), addressed the issue in hand. However, the role of this organization did not have a great influence on the development of the DTCs since its scope was not specifically income and capital international taxation. I also refer to the International Law Association workings (in the Portland and Maine conference of 1907 and in the London conference of 1908) whose scope, however, was not considered sufficient.
I stress, also, the important role of the International Chamber of Commerce, in this sector.

[4] The working of the League of Nations show a chronological convergence with the evolution of the DTCs within Europe as quoted above. In fact, in 1921, according with a recommendation of the Financial Committee (Résolution, proposées par la Commission des credits internationaux, n. 12 (cfr. *Conférence financière internationale de Bruxelees de 1920,* London, 1920) the League of Nation appointed the sc. "four economists" (namely, Professors Gijsbert Bruins from The Netherlands, Luigi Einaudi from Italy, Edwing Seligman from the USA and Sir. Josiah Stamp from the UK) in order to develop the criteria to be upheld in respect of the relevant problems of international tax law. The "four economists" delivered their work on the 3rd April 1923 (*Rapport sur la double imposition présenté au Comité financier par MM. Bruins, Einaudi, Seligman and Sir Josiah Stamp*, Genève, 1923).

As a matter of fact, at the beginning of last century the Austria-Hungary signed a number of treaties with German States[5] which can be considered the very *first* treaties with a wide scope in the ambit of taxes.[6]

In particular, the Austria-Hungary treaty signed with Prussia on the 21st of June 1899 is recognised as the *first* general international tax treaty.

The Hungarian sensitive approach for the issue of international taxation will lead Hungary and, in wider terms, the Center European States, to be at the heart of the creation of the first huge *corpus* of Double Taxation Conventions (shortly, "DTCs") after the First World War[7] until 1932 when the ambit of the DTCs expanded over the boarder of Europe.[8]

If one stands on the chronological evolution of the subject matter of International Tax Law stemming from the second half of the XIX century to the first half of the XX century, one can easy observe that the "main core" of the international tax law practice stands in the States of the centre of Europe.

In particular, analysing the historical elements quoted above, two factors have to be considered. Firstly, one has to highlight the focal importance of the first set of treaties of the second half of the XIX century which represent a fundamental input for the development of some key concepts of international tax law that subsequently were developed by the international organizations.[9] Secondly, the coexistence of the work of the international organizations and of the DTCs entered into by the States of the centre of Europe.

In the meanwhile, consistently with another resolution (see Résolution proposées par la Commission financière, n.13 (see, *Conférence économique internationale de Genes, Rapport de la Commission financière*, Genes, 1922) the Committee appointed another group of experts from some European countries (namely, Belgium, Czechoslovak, France, United Kingdom, Italy, The Netherlands and Switzerland. After the first report of 1925 the group was expanded in order to allow the participation of the representative of other States among which Poland and Germany) which delivered a first report on 1925 and, subsequently, other two reports in 1926 and 1927. These two reports, in one with the general report, was delivered to the Financial Committee on the 12th of April 1927.

The report of the League of Nations was delivered to some member and non-member States (namely, 27 States), among which Austria, Danzica, Romania and Hungary, on the 31st of October 1928 (See *Rapport présenté par la Réunion générale d'Experts gouvernamentaux en matière de double imposition et d'évasion fiscale* Geneve, 1928)

[5] Namely, the agreements with Prussia (1899), Liechtestein (1901), Saxon and Baviera (1903), Wurttemberg (1905), (none of which is still binding).

[6] These treaties (the latter one and the other signed until 1905) were complemented by the agreement entered into by Austria and Hungary, dated 1907 (which, in turn, was proceeded by other treaties entered into by the two States, namely, in 1868, 1869, 1871 and 1896)

[7] The DTCs entered into by Hungary in that historical phase were the ones with Czechoslovak and Germany, both entered into in 1923. Both the agreements were preceded by an agreement entered into by Germany and Poland. The latter one was a "provisory" one.

The one that likened Austria and Hungary, was signed in 1924. In the same year, other centre European States entered into other DTCs (see the Italy-Czechoslovak and Poland-Danzic DTCs).

In 1925 Hungary entered into another important agreement with Italy (I underline the importance of such an agreement, since, in the meanwhile, Italy signed a DTCs with Germany whose scope appear to be exactly the same of the Hungary-Italian one. ON this respect, for the sake of clarity, we have to quote also the DTC entered into on the 6th of April 1922 by Italy with the successors States of the Austria-Hungarian Empire – Austria, Jougoslave, Poland, Romania and Hungary – which, although being, by its very nature, a "multilateral treaty", was ratified only by Austria).

After three years, in 1928, Hungary entered into the DTCs with Jougoslave and Poland

[8] In the meanwhile Hungary signed other important agreements within Europe. Namely, consider the ones entered into by Hungary with Sweden and Romania

[9] I refer, namely, to the treaties entered into within 1899 and 1905 and to the key concepts of *"permanent establishment"* which finds its very origin inside these agreements.

As a matter of fact, one can observe that the reports of the experts of the League of Nations influenced[10] and, in turn, were influenced by the DTCs already entered into by the first half of the XX century.[11]

In the light of the scope of the present speech it is worth mentioning that the first tax treaties that were entered into in the last part of the XIX century contain the main core of the concept of the *"permanent establishment"*.[12]

2.) The Hungarian Corporate Income Tax. General Issues.

In order to fit the overall analysis into the hierarchical context it is related to, I start quoting Section 1, par 4 of the Act LXXXI of 1996 on Corporate Tax and Dividend Tax[13] (briefly, the "CTDT") which reads: *"Where an international agreement promulgated by an Act or Government Decree stipulates any derogation from this Act they shall override the provisions of this Act. ..."*[14].

Hence, as a preliminary issue, the trans-national concrete facts of the case shall be ruled according to DTCs where derogating from "internal" provision. More in particular, I stress the key importance of the relationship between the "permanent establishment" provisions contained into the Hungarian norms, on the one side, and the one laid down in the DTCs entered into by Hungary, on the other side,.

The Hungarian CTDT *subjective scope* is laid down in Sec. 2(1) which holds that all the entities listed in Subsections (2) to (4) shall be subject to corporate tax.

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[10] I refer to the focal importance of the Report of the "four economists" of 1923. In particular, the method for the avoidance of double taxation – allowing the taxation in the source State in some cases and in the residence States in other ones (the "fourth" method) was mainly followed in the DTCs entered into in the first part of the XX century (mostly in the period immediately preceding and following the First World War).

[11] This is the case of the report of the experts of 1925 which took into account the DTCs already signed in the first years of the XX century and the internal tax law. This is also the case of the project of bilateral convention n. I.*c* delivered in the 1927 report which recalls the DTCs entered into within the centre of Europe States.

[12] Namely, the specification of the concept of the *Stehendes Gewerbe* – already adopted in the Eastern part of Prussia – within the Prussia-Saxony tax treaty laid down a definition according to which a citizen of the other State may be taxed to the extent the enterprise used a *"business place"* (on this issue I refer to the in-depth analysis carried out by A.A. SKAAR, *Permanent Establishment – Erosion of a Tax Treaty Principle*, Deventer, 1991, pages 72 and 73).
The evolution of the concept through the judicial practice showed that the elements in order to create a *Stehendes Betrieb* (the concept, in German the *"Betriebsstätten"*, proper of commercial law, was subsequently upheld in the tax law field) were the existence of a physical location in the other State and the enterprise intention to go on performing the business activity in that State.
The gradual evolution of the concept led to the adoption of the concept within the Prussian code in 1891. The above mentioned Prussian concept constitute the grounding of the definition contained in Article 2(1) of the Austria-Hungary and Prussia DTC. In turn, the definition contained in the quoted DTC constituted the grounding for the subsequent agreements entered into by Austria-Hungary. At the end of the day, the Prussian concept, hence, shows a *"general definition"* of the basic rule of permanent establishment that influenced the most part of the DTCs signed by the States of the Centre of Europe (unlike the 1928 report).

[13] Promulgated, November, 15th, 1996.

[14] As amended by Sec. 170(2), q) of Act CIX of 2006 (in force as of January, the 1st, 2007. The Quoted Article provides, also, that "*... Derogation from this Act is also permitted if there is reciprocity, provided that this does not result in further tax liabilities on the part of the taxpayer when compared to those defined by the provisions of this Act ...*"

Non residents shall be deemed "subject to tax" to the extent their "place of management" is located in Hungary[15] or if they carry out business operations at their branches in Hungary[16]. In the latter case, non residents are addressed as *"non-resident entrepreneurs"*.[17].

Effective from 2005, non resident business without a branch within Hungary are no more considered "liable to" CTDT and, therefore, no *"Persons Subject to Corporate Tax"* (according to Sec. 2) as for the scope of Hungarian corporate income tax. In other words, in the absence of an *objective* presence in Hungary, no taxable income will arise in Hungary[18].

Non residents, therefore, will be taxable on income derived from "... *activities performed in* [the] *Hungarian branches ..."*.[19] This means that non-residents gain a "limited tax liability" (in contrast with the "unlimited tax liability" of resident taxpayers[20]) in relation to income produced in Hungary.

In this respect, it is worth observing that the wording of Section 3 CTDT seems rejecting the sc. "force of attraction" principle. In other words, to the extent income are *not* produced by way of a Hungarian permanent establishment, such an income will not be taxable in Hungary.

2.a) The P.E. Concept in the Hungarian Income Tax Law. The Basic Rule.

The CTDT provides for the important bipartition between the sc. "branch" (the *"fióktelep"*) and (what is referred to as) the "standard permanent establishment".[21]

The distinction stems from the issue of whether or not the non-resident enterprise does register a branch into the Register of Companies.

Namely, the CDTC provides for a substantial provision which is contained in Sec. "basic rule" of Sec. 3(2) according to which *"The tax liability of non-resident entrepreneurs shall apply to their income from entrepreneurial activities performed in their Hungarian branches"*.

Such a rule implies the existence of a "branch". Hence (in the absence of relevants DTCs) the interpretative approach, will be that of analysing whether or not there is

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[15] Sec. 2(3) CTDT introduced as of January the 1st 2006.

[16] Sec. 2(4) CTDT Introduced by Sec. 22 of Act LXI of 2006 (in force: as of January, the 1st 2007) and lastly amended by Sec. 401(1), Act CXXVI of 2007 (in force as January 2008). The Section addresses *"Foreign nationals and non-resident persons"*

[17] Formerly, CTDT addressed them as *"foreign organizations"*.

[18] On this issue, for a more in-depth analysis, see D. DEAK, *Tax Implication for the East EU Enlargement: The Case of Hungary*, in Diritto e Pratica Tributaria Internazionale, 2004, page 444.

[19] According to Sec. 3(2) ACT as amended Sec. 180(8), e), Act CXIX of 2005 (in force as of January, the 1st, 2006). This rule was established by Sec. 41 of Act XCI of 2003 (in force as of 2004)

[20] See Sec. 3(1) ACT.

[21] Distinction formerly analysed in K. KURUCZ-VARADI, K. TOTH, *Recent Changes in Corporate Taxation in Hungary*, Bulletin for International Fiscal Documentation, 5(2001), page 194.

"registered branch". This condition will be enough in order to hold the tax liability of the "non-resident" taxpayer.[22]

On the opposite, the scope of the Hungarian approach will be narrowed in cases falling under DTCs' provisions. In fact, the existence of a branch, as such, does not imply the existence of an *a priori* permanent establishment.[23]

As for the very "beginning" of the tax liability, Sec. 5(3) provides that the tax liability of a foreign entrepreneur *"... shall commence on the day his branch office is registered in the Register of Companies and terminate on the day the branch office is removed from the Register of Companies*."

However, in reading Sec. 5(3) CTDT a fundamental bipartition comes into consideration.

In fact, Section 5 takes into account, also, the case that the non-resident entrepreneur does *not* register a branch into the Register of Companies and reads: *"... If a foreign entrepreneur is engaged in business operations in Hungary through a business establishment that* has not [emphasis added] *been registered by the court of registry, his tax liability shall commence on the day on which the first legal statement that brings the place of business into existence is issued, and it shall terminate on the day on which the foreign entrepreneur is dissolved or the legal statement resulting in the dissolution of the business establishment is issued (even if the activities are continued in a branch office or in the form of a European public limited-liability company or a European cooperative society)."*

Hence, according to Hungarian corporate tax law, two forms of establishment have to be considered.

A *formal* one, which arises in the case of *registration* of a *branch* and a *non-formal* one, which arise in the case of *engagement* in *business operations* through a *business establishment*. The non-formal one, further, is defined by way of a "negative provision".[24]

It is quite evident that, unlike the "formal" presence of the (registered) branch, the *development of business operations* through a business establishment echoes the DTCs' concept of permanent establishment. More in detail, as a preliminary issue, one shall observe that the structure of the Hungarian definition follows the OECD structure as for the "basic rule", contained in Article 5(1) OECD Model, and as for the "positive list", contained in Article 5(2).

The Hungarian CTDT contains, also, a focal definition.

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[22] It is worth observing that, according to Act CXXXII of 1997 (the Act on Branches and Commercial Representation of Non-Resident Entities) branches are organizational unit of non-resident entities that gain an economic independence but have no separate legal personality.

[23] See OECD Model Commentary (1963) on Article 5(2), at par. 7. On the contrary, consider the Italian practice (namely, see OECD Model Commentary (1977), Observation on Article 5(2), in par. 43 and the relevant internal provision as for the definition of "permanent establishment" contained in the presidential decree 917 of 1986.

[24] In fact, Section 5 CTDT provides for a "basic rule" which refers to non-resident identified by way of a registered branch and, as a residual rule, it consider the case of non-residents "… *that* has not [emphasis added] *been registered by the court of registry"*.

In fact, as already said, Section 5(3) introduces the concept of *"business establishment"* as the "connection factor" which allows for the taxation of a non-resident entities in Hungary.

The latter concept recalls for the definition laid down in Sec. 4(33), a) CTDT which reads, a "*'place of business' means ... a permanent business establishment, equipment, and accessories that are used by the taxpayer in whole or in part for business activities irrespective of the legal title, whereby the term 'place of business' shall include, in particular, the place of management, representative offices established with a registered office in Hungary, offices, factories, plants, workshops, mines, crude oil or natural gas wells, and other facilities used to explore or exploit natural resources, ...".*[25]

One can observe that the OECD agreed concept which explains the concept of *"permanent establishment"* by way of the *"place of business"* one, is inverted, in fact, in the Hungarian CTDT, the *"place of business"* is defined as a *"permanent* business *establishment"*. The difference appear to be mostly a "semantic" one, since the *structure* of the "basic rule" is close to the OECD one.

In fact, in analysing it in the light of the *aim* of the "basic rule" in Article 5(1) – which is the adoption of a *test* in order to *qualify* the *objective presence* of the enterprise in the other country – we can hold that the "basic rule" contained in Sec. 4(33), a) CTDT lay down the essential *elements* which characterise the "permanent establishment test" contained in Article 5(1).

According to international practice (see OECD Model Commentary[26]), the basic definition of Article 5(1) contains three conditions. Namely, the permanent establishment concept implies (a) the existence of a "place of business"; (b) which must be "fixed" and (c) it must *serve* the business of the foreign enterprise[27].

Stemming from the analysis of the sc. *"objectivity of the P.E."* we consider that, the sc. *right to use* the place of business appear to be close to the OECD approach since Sec. 4(33), a) CTDT expressly holds that the *legal title* according to which the place of business is at the disposal of the enterprise is immaterial.[28]

Further, the internal rule is quite clear as for the sc. *"duration"* of the permanent establishment since the *first legal statement* of the non-resident creates the permanent establishment and, hence, the quality of *"taxable* (non-resident) *person"* as for the scope of the CTDT. The same holds true as for the termination of the permanent establishment, in fact, the permanent establishment ceases to exist when the *foreign entrepreneur* is dissolved.

[25] Section 4(33), a), CTDT as amended by Sec. 180(6), b), Act CXIX of 2005 (in force as of August, 18th 2006).
[26] OECD Model Commentary (2005) on Article 5(1), § 2.
[27] See the distinction adopted by A.A. SKAAR, *Permanent Establishment – Erosion of a Tax Treaty Principle*, Deventer, 1991, page 112, between *serving* the business activity and *being subject to* business activity.
[28] On the "right to use" test we observe that the basic rule contained in Sec. 4(33),) CTDT, by expressing that the *legal title* is immaterial, follows the rationale of paragraphs 4 and 4.1. of the OECD Model Commentary (2005) on Article 5(1).

At the end of the day, the provision is consistent with the rationale of the OECD Model Commentary[29] both as for the *commencing* and as for the *termination* of the permanent establishment.[30]

Another interesting issue to be addressed is that of the sc. *"functionality"* of the permanent establishment.

It is worth highlighting that the definition contained in Sec. 4(33), a) of the CTDT, someway differs from the one contained in the OECD Model. In fact, while the OECD Model refers to the *business of an enterprise* (carried out through the place of business), the Hungarian norm refers, generally, to *business activities* (used by the taxpayer "in whole or in part"). According to leading scholars the connexion with the normal exercise of the enterprise shall be analysed in the light of the business and the global objectives of the foreign enterprise.[31]

Secondly – and irrespective of the wording[32] – we consider that the sc. "positive list" has to be interpreted in the light of the international DTCs practice and, hence, be considered a *prima facie* permanent establishment list.

This conclusion appear to be coherent with the OECD approach which considers the cases contained in Article 5(2) DTC as "permanent establishment" to the extent *"... they meet the requirements of paragraph 1"*[33] and with the Hungarian (negative) stance on the issue in hand.[34]

2.b) The P.E. Concept in the Hungarian Income Tax Law. The Construction Clause.

The Hungarian CTDT pays particular attention to the issue of the sc. *construction clause* issue.

Section 4 of the CTDT – laying down the "definitions" – provides for a *corpus* of rules which fairly outlines the Hungarian approach in respect to "construction sites".

[29] See, OECD Model Commentary on Article 5(1), par. 11.

[30] As for the "termination", as a matter of fact, the *dissolution* of the foreign entrepreneur *erases* the logical-juridical foreword of the permanent establishment which is the *existence* of a (non-resident) enterprise.

[31] K. VOGEL, *On Double Taxation Conventions*, Deventer, 1990, page 207.

[32] The OECD Model (2005), Article 5(2) reads '*The term permanent establishment includes especially ...* while Sec. 4(33), b) CTDT reads *the term 'place of business' shall include, in particular* .... However, consider that the wording of the Hungarian provision recalls for the definition laid down in Article 5(2) OECD Model (1963) which reads *The term "permanent establishment" shall include especially ...* . and that the Commentary to the OECD Model of 1963 (on Article 5(2), at par. 7) expressed the view that such expression didn't create for an *a priori* permanent establishment. Therefore, we hold that such a conclusion can be transplanted into the interpretation of the Hungarian norm.

[33] Cfr. OECD Article 5(2), Model Commentary (2005), § 12.

[34] As a matter of fact, we shall observe that all the States which adopted a different perspective in respect of the official position of the OECD made relevant observations. This is the case of Italy (see § 43 Model Commentary (2005) in which Italy held that the cases listed in Article 5(2) have to be considered as *"a priori"* permanent establishments. Consistently, see the Italian definition of permanent establishment contained in the Presidential Decree n. 917 of 1986.

According to Sec. 4(33), b) *"... construction or assembly site (hereinafter jointly referred to as 'construction') site, including supervisory activities related thereto, if such construction continues for a total of at least three months (with or without interruption) with regard to individual construction sites irrespective of whether such activity is based on several independent contracts or whether it was commissioned by several parties; the construction project constituting one unit from an economic, business and geographical point of view shall be recognized as one construction site,..."*.

Roughly, one could say that the Hungarian norm shows many points of contact with the OECD approach and, consistently, with the relevant Hungarian DTCs.

However some differences have to be highlighted.

Firstly – unlike Article 5(3) OECD Model which applies to *"a building site or construction or installation project"* – the scope of the Hungarian rule is extended, also, to *"assembly sites"*.[35] The Hungarian provision is close to the UN Model provision which applies to assembly projects, however we share the view of leading scholars who hold that an assembly project will, in all cases, be considered a construction project and we consider that the same holds true for *assembly sites* which are*"... therefore also covered by the OECD model"*.[36]

To the same extent, the Hungarian rule follows the UN Model including in the construction clause the sc. *supervisory activities.*[37]

Such provision has the dramatic effect of *widening* the scope of the "internal" rule compared with the DTCs' one. This creates that, in the absence of a relevant DTC, the scope of the internal rule will be wider than the same case falling under DTCs' permanent establishment rules.

Secondly, I hold that, since the Hungarian CTDT "permanent establishment" rule is substantially patterned on the OECD Model one, some grounding observations could be shared between the two concepts (the "internal" and the "international" one).

As a matter of fact, the "construction clause" was firstly adopted in the *post*-First World War DTCs in order to lay down specific provision for regulating re-construction period. In fact, since Article 5(1), providing for the essential features of the permanent establishment implied the *permanence* of the fixed place of business, construction sites would have, naturally, fall outside the scope of the DTCs provisions.

The rationale of the relevant DTCs was followed, firstly, by the Society of Nations[38] and, secondly, by the OECD which included a specific provision in Article 5.[39]

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[35] More in detail, while Article 5(3) OECD Model provides that *"... a building site or construction or installation project"* is a permanent establishment if it fulfils certain conditions, Sec. 4(33), b) CTDT holds that the provision is limited to *"... construction or assembly sites ..."*

[36] Cfr. A.A. SKAAR, *Permanent Establishment – Erosion of a Tax Treaty Principle*, Deventer, 1991, page 353.

[37] Namely, UN Model (1980) Article 5(3)(a).

[38] We refer to the Mexico (1943) and London (1946) Models.

[39] See Article 5(2)(g) OECD Model (1963).

The provision, formerly included within the sc. "positive list" of Article 5(2), was, subsequently, shifted into a separate and specific clause: Article 5(3).[40]

The evolution of the concept in the international practice shows that in the specific case of construction sites, the criteria laid down in the basic rule of Article 5 OECD Model are derogated and substituted by a *"duration test"*.[41]

The same rationale is expressed, in my opinion, in the structure of Sec. 4(33) CTDT which adopts a *basic rule* unless a "construction sites" has to be analysed. In fact, according to international practice, the Hungarian approach was that of laying down a *general provision* (i.e. Sec. 4(33), a) and a, logical-chronologically subsequent, *derogation* (namely, Sec. 4(33) b).

As for the "duration" of the construction site, Sec. 4(33), b) CTDT fairly holds that *"such construction continues for a total of at least three months (with or without interruption)"*.

I highlight that the provision according to which the *construction permanent establishment* arises also in the cases of *interruptions* appear to be quite fair since it shares the OECD stance that *"... a site should not be regarded as ceasing to exist when working is temporarily abandoned ..."*[42]. However, I hold that the definition of the Hungarian construction clause someway could widen the scope of the provision in respect of the OECD Model's approach.

Further, in analysing Sec. 4(33), b) CTDT, it is worth observing that the Hungarian construction clause provision has a concrete *anti-abuse scope*.

In fact, the rule applies to "… individual [emphasis added] *construction sites irrespective of whether such activity is based on* several independent [emphasis added] *contracts or whether it was commissioned by several parties*…".

The Hungarian CTDT, in this way, uphold the OECD approach which holds that, since the *"duration" threshold*, could give rise to abuses, it is up to States to counteract such a phenomenon.[43] Hence, the Hungarian legislator provided for an anti-avoidance rule which effectively counteracts the *"sub-contracting" scheme* which splits the *overall* construction contract in *two or more contracts* (or, more in general, *phases*) in order to lower the duration of the *single* construction sites.

In the latter perspective, the provision that *"... the construction project constituting one unit from an economic, business and geographical point of view shall be recognized as one construction site"* creates for an *effective* anti-avoidance rule coherent with the DTCs provisions. In fact, the Model Commentary specify that the building contract which forms a *"... coherent whole both commercially and geographically"*.[44]

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[40] See Article 5(3) OECD Model (1977). The subsequent Models upheld such an approach.

[41] In international practice, we refer to K. VOGEL, *On Double Taxation Conventions*, London, 1997, page 307.

[42] See OECD Model Commentary (2005) on Article 5(3), at § 19.

[43] The OECD Model Commentary (2005) on Article 5(3), at par 18 observes that such abusive schemes could fall under the scope of national anti-avoidance rules and, however, could be effectively counteracted by way of specific provisions *"... in the framework of bilateral negotiations"*.

[44] Cfr. OECD Model Commentary (2005) on Article 5(3), par 18.

According to the above observations, I hold that the sc. *"commercial coherent test"* creates for a common grounding in applying the DTCs entered into by Hungary, on the one side, and the Hungarian "internal" rules, on the other side.

One specific issue dealt with in Sec. 4(33), b) CTDT, however, creates for a more in-depth analysis in respect of the "OECD Model patterned" DTCs. I refer to the *"single or several"* client test.

In international practice, the issue in hand is widely debated since some author hold that the a coherent whole (economically and geographically) implies the performance of the activity at the same place and for the same client.[45]

On the contrary, scholars held that, according to Article 1 of the Vienna Convention, such an interpretation would be inconsistent with the intention of the parties which adopted a quite unambiguous text which does *not* refers to the issue of the *"single client"*.[46]

Hungarian corporate tax law – and namely Sec. 4(33), b) CTDT – reads that a *"... construction or assembly site"* constitutes a permanent establishment *"... with regard to individual construction sites irrespective of whether ... it was commissioned by several parties"*.

The scope of the rule is quite fair and unambiguous and, evidently, widens the scope of the rule since the it is immaterial whether or not the single contract (or, in wider terms, the single "business") is related to only one or more clients. This approach, in my perspective, influences, also, the interpretation of the DTCs entered into by Hungary.

In analysing the issue of the "duration test", I observe that the internal rule provides for a quite *short* duration threshold: *three months*.

It implies that, in the absence of a relevant DTC, the construction clause will apply, also, in "short-duration" construction sites. This circumstance creates for a wide taxation power of Hungary for income derived through building and construction sites situated within Hungary.

However, such observation could lead to misleading conclusions as for the convenience of investing in Hungary, in fact if one examine the Hungarian DTC network such perspective is totally reversed.

On this issue we refer on what will be said *infra* paragraph 3.

The criteria as for the computation of the "duration period" is dealt with in Section 4 of CTDT.

As for the *starting* date, Sec. 4(16) CTDT holds that the "... *'construction commencement date' means the day of commencement of works indicated in the construction or installation journal, in respect of subcontractors, the starting date indicated in the construction or installation journal*".

[45] See the stance of K. VOGEL, *Doppelbesteurungsabkommen*, art. 5 ann. 79, 1990.
[46] A.A. SKAAR, *Permanent Establishment – Erosion of a Tax Treaty Principle*, Deventer, 1991, page 365.

One first observation is that the rule provides for different approaches depending upon the fact that the rule applies to contractors or sub-contractors.

As for *general contractors*, the rule is that the start of the duration test coincide with the "*day of commencement of works*" that creates for the same criterion in respect of DTCs patterned upon the OECD Model[47] (however, unlike the OECD Model Commentary, nothing is said in respect of *"preparatory works"*).

As for *sub-contractors*, instead, the starting date is related to a formal element: the *starting date indicated* in the *project*[48].

As for the termination date, Sec. 4(15) CTDT holds that the expression *"'construction completion date' means the day on which the occupancy permit or continuation permit becomes operative, in respect of subcontractors, the day when his activities are completed;"*. Also this provision appear to be close to the OECD practice, hence, in general terms, I hold that the DTCs scope does converge with the internal approach.

Other relevant issues are not dealt with specifically from the Hungarian system.

For instance, see the s.c. *geographical location* of the permanent establishment (however, it holds true that such issue give rise to different approaches in respect of construction sites other but immovable properties – which express, as a general rule, an autonomous "constructional entity").[49]

See, also, the issue of the existence of *offices or workshop within the construction sites*. In the absence of any contrary provision, it appears coherent applying the OECD approach which considers that *no* permanent establishment does exists in the case of offices and workshop amounting to a permanent establishment under Article 5(2) associated with the construction activity if the duration test is not fulfilled.[50]

Until now, we have dealt with the construction *activity*, although nothing has been said in respect of the *nature* of the constructions.

Consider the case that a non resident company starts the activity to build the enterprise's local offices in Hungary. Herein a question arises: does it amount to a construction permanent establishment?

The answer is not so easy.

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[47] See OECD Model Commentary (2005) on Article 5(3), par. 19 which reads *"A site exists from the date on which the contractor begins his work"*.

[48] It is worth mentioning that the Commentary provides for *ad hoc* rules as for sub-contractors. See OECD Model Commentary (2005) on Article 5(3), par. 19

[49] The quoted expression is adopted in A.A. SKAAR, *Permanent Establishment – Erosion of a Tax Treaty Principle*, Deventer, 1991, pages. 367, in respect of the "commercial coherence test". I refer, also, to the learned Author's perspective at page 373 and seq.

[50] Cfr. OECD Model Commentary (2005) on Article 5(3), par. 16.

One of the leading Authors which dealt with the topic of the permanent establishment observed that the answer could not be find within the Commentary or the tax-treaty theory.[51]

I completely share the Author's view that, at least, such an activity can be considered a "preparatory activity" in respect of a "basic" permanent establishment (i.e. under Article 5(1) DTC).[52]

This means that, in the case in which the *construction activity* is *not* the *core business* of the enterprise (and the relevant building is *not* built to be *used* as office), the activity will fall under the basic rule and, therefore, no "duration test" will apply.

This issue is strongly influenced by the perspective one adopts in respect of the nature of business profits within the DTCs patterned upon the OECD Model. On this issue, I refer to the last part of this contribution (see paragraph 5.).

The final issue to be highlighted in respect of the Hungarian approach as for the permanent establishment construction refers to a case which falls outside the scope of the construction clause itself.

Sec. 4(33), d) CTDT holds that *"… a foreign person shall be regarded as having a place of business in cases of the utilization of real estate or natural resources in return for consideration, the transfer, sale and contribution in kind of any rights in immovables or in natural resources (hereinafter referred to as 'utilization of real estate') in return for consideration,"*.

This provision is surely one of the most interesting one since relates the mere *utilization* of real estate in return for consideration with the existence of a "place of business"

The provision could appear quite ambiguous since the *utilization* of real estate should fall under the "basic rule" of Sec. 4(33), a) CTDT and, hence, should this be the case, the "place of business" should meet the requirements of the sc. "basic rule".

On the opposite Sec. 4(33), d) CTDT seems laying down an *a priori* permanent establishment. Should this be the case (i.e. should one infer that this provision falls outside the scope of the "basic rule"), it is evident that the relevant DTCs – applicable in concrete

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[51] Question and answer are container in A.A. SKAAR, *op. cit.*, pages 414 and 415.

[52] In this respect, we shall recall Sec. 4(12) CTDT which holds that *"'preparatory or auxiliary operations' means activities carried out exclusively for a foreign person that do not fall under the scope of activities of such foreign person as defined in its articles of association, yet it facilitates or provides preparations for the performance of the activities contained therein"*. The Hungarian rule expressly refers to the article of association of the foreign enterprise in order to distinguish between core business (which does not amount to a permanent establishment) and preparatory and auxiliary activities (which are not ex se permanent establishment).

On this standpoint, the Hungarian perspective is coherent with the international practice of the OECD Model.

The OECD Model Commentary recognizes that it *"… is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not."* Hence it holds that the decisive criterion refers to the core business.

The Model Commentary (2005), on Article (5) reads that *"The decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole […] In any case, a fixed place of business whose general purpose is one which is identical to the general purpose of the whole enterprise, does not exercise a preparatory or auxiliary activity."* However, according to the Commentary, the latter one is a "case-by-case" test.

facts of the case – would supersede the (Hungarian) national incompatible rule.

However, in any case, this does not prejudice the applicability of the rule in non-DTC cases.

3.) The Permanent Establishment in the Hungarian DTC Network. Basic Rule and Construction Clause.

The Hungarian DTC network provides for a permanent establishment definition patterned upon the OECD Model on's structure.

The definition provides, in a number of DTCs, for a "basic rule" which reads *"For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on."*.[53]

The Hungarian DTC network, however, provides for some specific provisions as for the "basic rule" contained n Article 5(1).

Namely, Hungary includes the "place of production" in the permanent establishment "basic rule" of Article 5(1) DTCs.

For instance, see Article 5(1) DTC Austria-Hungary of 1975 which reads *"For the purposes of this Convention, the term "permanent establishment" means a fixed place of business* or production [emphasis added] *in which the activities of the enterprise are wholly or partly carried on."*.[54] Accordingly, Article 1 of the Protocol annexed to the Albania-Hungary DTC provides for a specification of the "place of business" in fact it holds that *"... it is understood that the term "place of business" includes also a place of production."*.[55]

On this issue, it appears that the DTC provision is coherent with the internal definition contained in Sec. 4(33), a), CTDT.

One can, further, observe that the specific provision laid down in the quoted DTCs recalls for the rule in Sec. 4(9), d), CTDT, which deals with *investment projects for* production *purposes.*. Namely Sec. 4(9), d) CTDT reads *"'investment project for production purposes' means any new building or equipment purchased and put into operation by the taxpayer for producing industrial or agricultural products, whereby the operating cost represents a part of the direct cost of the product"*.

[53] The quoted provision is in Article 5(1) Albania-Hungary DTC. Consistently with this provision, see Article 5(1) Belarus-Hungary DTC; Article 5(1) France-Hungary DTC; Article 5(1) Brazil-Hungary DTC; Article 5(1) Bulgaria-Hungary DTC.

[54] Consistently, see Article 5(1) of the United Kingdom-Hungary and Norway-Hungary DTCs. See, also Article 5(1) Uruguay Hungary DTC which holds that *A place of business also means a place of production.*

[55] See, also, Protocol to the Greece-Hungary DTC and Par. 1 of the Protocols annexed to the DTCs entered into with Japan, Kuwait, Luxembourg, Indonesia, Malaysia, Spain, Switzerland, Turkey and Thailand and Par. 2 of the Protocol to the Malta-Hungary DTC which reads *"It is understood that the term "place of business" includes also a place of production"*. Consistently, see Par. III of the Netherlands-Hungary DTC.

The *production purpose* is defined such as the *producing of industrial or agricultural products*.

In this perspective the internal definition seems to be consistent with the definition contained in Article 5(1) of the Belgian Hungarian DTC.

Article 5(1) Belgium-Hungary DTC reads "*For the purposes of this Convention, the term "permanent establishment" means a fixed industrial or commercial establishment through which the business of an enterprise is wholly or partly carried on."* Although the Belgium-Hungary DTC refers to the *"industrial or commercial establishment"* (and, hence, could supposed to be close to the internal Hungarian rule), I take the view that the Belgium-Hungary DTC *narrows* the scope of the permanent establishment definition since it identifies it[56] with the *"industrial and commercial"* establishment, unlike other Hungarian DTCs.[57]

As for the relevant DTC above analysed, one has to consider that the relevant DTC (i.e. Belgium-Hungary) was patterned upon the 1963 OECD Model which adopted the following definition: *"... "enterprise of a Contracting State"* [is] *an enterprise carried on by a resident of a Contracting State"*. Consistently, and widening the scope of the provision, the 2005 OECD Model holds that, "*the term "enterprise" applies to the carrying on of any* [emphasis added] *business"*.

We take the view that, consistently with a static interpretation of the relevant DTC, the scope of the rule should be narrower and limited to industrial and commercial activities.

Further, as for the issue of the sc. *construction clause*, one can observe that there is a huge number of DTCs entered into by Hungary that follow the OECD Model. Within the number of those actually binding, the vast majority adopt a separate clause (hence, do not follow the 1963 version of the OECD Model).

Some DTCs hold particular features.

The Philippines-Hungary DTC provides for two different clause as for the *building site or construction project* on the one side and *assembly or installation project* on the other side. Both of them shall last no more than *six months*.

Some other DTCs show a convergence towards the "internal" Hungarian construction clause.

Consider Article 5(3)(a) of the China-Hungary DTC which holds that the term "permanent establishment" encompasses: *(a) a building site, a construction, assembly or installation project or* supervisory activities [emphasise added] *in connection therewith, but*

[56] I consider that the identification of the *"industrial or commercial establishment "* echoes the former Austria-Italian DTC of 1922 (signed – although not ratified –, also, by Hungary) in which the "industrial or commercial enterprise" criterion was firstly adopted. On this issue, see J. AVERY JONES et al, *"The Origins of Concepts and Expressions Used in the OECD Model and their Adoption by States*", Bulletin for International Fiscal Documentation, 6(2006)

[57] See, Article 5(1) Egypt-Hungary DTC, which holds that the permanent establishment definition includes "... among others [emphasis added] *commercial and industrial activities,"*. To the same extent, see Article 5(1) Finland-Hungary DTC which holds that a permanent establishment is a "*fixed place of business* or [emphasis added] *industrial activities"*.

only where such site, project or activities continue for a period of more than twelve months; ".

It is evident that the DTC definition is patterned upon the internal provision since also the *"supervisory activities"* in connection with the building site fall within the permanent establishment concept.[58]

Another important issue arising in connection with the sc. *construction clause* stems from par. 1 of the Protocol to the Cyprus-Hungary DTC which reads that *(1) Notwithstanding the provisions of paragraph 3 of Article 5 of the Convention, the competent authorities of the Contracting States may, by mutual agreement, decide in each case that a building site or construction or installation or assembly project shall not constitute a permanent establishment even when it lasts more than 12 months.* In such a case, by way of *mutual agreement* the presumption is no more *irrebuttable*. However, the mutual agreement procedure appear to be a not so easy way[59].

In some other cases the scope of the construction clause is widened including other activities. See Article 5(3) of the Greece-Hungary DTC which includes also *"... An installation or structure used for the exploration for natural resources constitutes a permanent establishment only if it lasts more than three months."*

As for the issue of timing, it is worth mentioning that the Hungarian DTC network is of great interest for foreign enterprises investing in Hungarian real estate.

In fact, the time threshold, in some cases, is up to 24 months.

This is the case of the DTCs entered into with Austria, Bosnia, Denmark, Italy, Spain, United Kingdom and U.S.A.

It is evident that such huge time limit implies that, in particular circumstances, the sc. Construction permanent establishment could not arise and, hence, Hungary could not tax income deriving from such activities.

If one consider that the DTC entered into with France provides for a "18 months" test and that the vast majority of the other DTCs provide for a "one year" limit, it is evident that the *"construction clause p.e."* can be considered a point of strength of the Hungarian DTC network.

Another issue of great relevance in respect of the construction and building sites is the *profit apportionment* between the non-resident head office and the Hungarian permanent establishment.

In this respect, some Hungarian DTCs provide for a specific rule.

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[58] Consider, also, Article 5(3) of the Croatia-Hungary DTC; Article 5(3)(a) Egypt-Hungary DTC; Article 5(3) India-Hungary DTC; Article 5(3)(a) Indonesia-Hungary DTC; Article 5(3) Israel-Hungary DTC; Article 5(3)(a) Kazakhstan-Hungary DTC; Article 5(3)(a) Kuwait-Hungary DTC; Article 5(2)(g) Malta-Hungary DTC; Article 5(3)(a) Romania-Hungary DTC; Article 5(3) Russia-Hungary DTC; Article 5(2)(i) Thailand-Hungary DTC; Article 5(3)Vietnam-Hungary DTC.

[59] Article 2 of the Protocol to the Finland-Hungarian DTC provides that the competent authorities agreement as for the "construction clause time limit" could not, however, exceed the duration of 24 months (in respect of the ordinary time threshold of 12 months). The latter approach is uphold in the Protocol to the Norway/Hungary DTC.

Namely, the Cyprus-Hungary DTC's Protocol holds that *"Concerning Article 7 where a building site, construction, installation or assembly project constitutes a permanent establishment, only those profits can be attributed to that permanent establishment which derive from the activity of the building site, construction, installation or assembly project …"*[60].

The apportionment criterion is therefore the *activity* of the permanent establishment. I take the stance that the rule in hand fits exactly to the International tax law practice and, hence, is not a derogation to generally agreed principles.

4.) The Taxation of Capital Gains from Immovable Property in the Hungarian DTC Network.

Finally, as for the fiscal issues related to the Real Estate market, I shall lay down some brief remarks as for the taxation of capital gains arising from immovable property.

Let us consider the "immovable property" Article contained in the Hungarian DTC network. Article 6(1) of the Germany-Hungary DTC holds that *"Income from immovable property may be taxed in the Contracting State in which such property is situated"*

The provision, which allocates the taxation rights on *income* from immovable property, uphold the sc. *situs principle*, according to which income from immovable property is taxed in the State in which the immovable property is situated.

The rationale underlying such provision is fairly expressed in paragraph 1 of the OECD Model Commentary (2005) on Article 6 which reads, "*Paragraph 1 gives the right to tax income from immovable property to the State of source, that is, the State in which the property producing such income is situated. This is due to the fact that there is always a very close economic connection between the source of this income and the State of source"*.

The actual version of the Model Commentary reproduces a sentence introduced for the very first time in the OECD Model Commentary of 1977 which replaced the 1963 version.

In this respect, the Model Commentary of 1963 said something different. It held that "*All Double Taxation Conventions in force give the right to tax income from immovable property to the State of source, that is, the State in which the property producing such income is situated. This uniform practice in the Conventions is due to the fact that there is always a very close economic connection between the source of the income and the State of source. The rule laid down in paragraph 1 of the Article is in conformity with this practice."*

[60] Accordingly, see the Protocol to the DTCs entered into by Hungary with Albania, Belgium, Bosnia, Brazil, Cyprus, Germany, Greece, India, Luxembourg, Spain, Switzerland.

Hence, it is clear that the OECD position was strongly influenced by the International practice. In this respect, I refer to the pre-eminent "four economists" report (of 1923) which held that agricultural products are normally, sold on the place where they are cultivated and the *rent of houses* is generally, *paid to* a *local* agent.[61]

In other words, the very strong economic connection on the issue of immovable property was expressed, on the one side, by the *physical presence* of the immovable property and, on the other side, (and where existent) by the *deemed activity* (generating the income) that, as a general rule, definitively had a strict *physical connection* with the immovable property.

In this respect it is fair that there is a dramatic difference between merely deriving a "passive" rent and managing immovable properties in order to gain a rent.

This distinction is useful in order to separate cases of "passive" holding of building from case of "active management" of real estates. In the first case, the very *source* of income is the immovable property, as such. In other words, immovable property is the asset which, without any activity, generates such income. In the later case, the "activity" is the essential element that creates the income (the immovable property being a mere *object* of such *activity*).

The matter is, to what extent the "rental activity" could be deemed amounting to a business activity.

I hold that such a perspective could have dramatic implications in the DTCs interpretations. In fact, in dealing with the taxation of income from immovable property within the context of DTCs patterned upon the OECD Model, one has to consider the important relationship between the sc. *"situs principle"* and the sc. *"permanent establishment principle"*.

I refer, namely, to the provision contained in Articles 6 and 7 of the OECD Model. In particular, the issue is whether or not it arises the "permanent establishment" issue in connection with immovable propriety and, even before, whether or not it is correct analysing the topic of permanent establishment on the issue in hand.

In the International practice, the issue arose different stances.

A German scholar held that, irrespective of its source, income from immovable property should be regarded, exclusively, as a type of income that is dealt with in Article 6 DTC.[62]

[61] On this issue, see J. F. AVERY JONES *et al, The Origins of Concepts and Expressions Used in the OECD Model and their Adoption by States*, Bulletin for International Fiscal Documentation, 6(2006), page 239.

[62] A. RUST, *Situs Principle v. Permanent Establishment Principle in International Tax Law*, Bulletin for International Fiscal Documentation, 1(2002), pages 15 et seq.

To the same token, other scholars held that the sc. *situs principle* takes the precedence over the *p.e.* principle. However, unlike the author below, they argued that "*Immovable property income is a distinct and separate category of income in relation to business profits; Art. 6 is a specific article, as the Commentary states, but only to the extent that the phrase* 'specific article' *is not meant to be a* lex specialis.".[63] Their stance is grounded upon the consideration that the relationship that liken Article 7(7) DTC with the 'other' specific Articles (namely, Articles 10, 11, 12) has not the same scope of the rule that liken the *business profit* Article (Art. 7) with the *immovable property* Article (Art. 6).

On the opposite, such position was criticised by learned Author, who held that the stance below *"... requires reading into Art. 7 a rule that excludes any income from immovable property that constitutes business profits under domestic law. There is nothing in the Commentary to indicate that such an interpretation is appropriate."*.[64] In the latter Author's perspective, the questionshould be *"... whether income earning activities involving immovable property constitute a business under domestic law and therefore a business for purposes the OECD Model"* .

However, I take the stance that another important issue to be considered is the *very nature* of the relevant *immovable* property which, in turn, implies the (empirical) analysis of the *role* of such immovable property in relation to the *business* established within the State of *situs*.

In other words, it is worth highlighting that immovable property could assume different *shapes* (*rectius*, different roles) in relation to the *core business* of the enterprise and, hence, be categorised in different ways by the relevant internal laws. [65]

In this respect, I refer to my previous stance on the issue of the rationale behind the *situs* principle: *"... the* situs *principle centres on the existence of a strong economic link that binds the immovable property — understood as the source of income, capital or capital gains — to the State in which it is situated. The economic link exists as long as the immovable property is considered to be the "source" of the income, but ceases to exist when the immovable property is no longer considered as such."*.[66]

The theoretical basis for such an approach was grounded upon a particular norm adopted by the OECD in 2003 and on the analysis of a specific DTC network, the Canadian one.

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[63] R.A. PAPOTTI, N. SACCARDO, *"Interaction of Articles 6, 7 and 21 of the 2000 OECD Model Convention"*, Bulletin for International Fiscal Documentation, 10(2002), page 520).

[64] B.J. ARNOLD, *At Sixes and Sevens: The Relationship between the Taxation of Business Profits and Income from Immovable Property under Tax Treaties*, Bulletin for International Fiscal Documentation, 1(2006), page 6, footnote 7.

[65] I stress that the Hungarian norm is quite fair in widening the permanent establishment criterion in cases of *"... utilization of real estate or natural resources in return for consideration, the transfer, sale and contribution in kind of any rights in immovable or in natural resources (hereinafter referred to as 'utilization of real estate') in return for consideration,"* (Sec. 4(33), d) CTDT on which see supra). Hence, the mere *utilization* of the immovable property amount to a permanent establishment. However, one could wonder whether this rule is coherent with the perspective upheld by learned author (Skaar) that such an asset should *serve* the business of an enterprise.

[66] See the contribution I am co-author, *"Article 13 (4) of the OECD Model Convention: CGT on Alienation of Shares in Immovable Property Companies: Part II"*, Tax Planning International Review, 5(2006), page 5.

Stemming from the analysis of the relevant DTC rule, Article 13(4) provides that capital gains from the alienation of shares or quotas of immovable property the property of which consist mainly of immovable property will be taxed according to the rule of Article 13(1) [which provides for the taxation in the State where such immovable property is situated], and not according with Article 13, last paragraph [which provides for the taxation *only* in the State of residence of the alienator].

The rule, namely, Article 13(4) of the OECD Model (2003), *"By providing that gains from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from immovable property situated in a Contracting State may be taxed in that State, […] provides that gains from the alienation of such shares and gains from the alienation of the underlying immovable property, which are covered by paragraph 1, are equally taxable in that State."*.[67]

If one consider the OECD Model (2003) and the relevant Commentary, no doubt arise in respect of the fact that *all* gains deriving from the alienation of *whatever kind* of immovable property should fall under the rule of Article 13(1) and, where existent and if applicable, under the rule of Article 13(4).

Hence, in any case (and without any derogation), the sc. *situs principle* would be uphold.

To this token, one shall observe that the extensive Hungarian DTCs practice show a close convergence with the OECD practice.

See Article 12(4) Philippines-Hungary: "*Gains from the alienation of shares of a company, the property of which consists principally of immovable property situated in a Contracting State, may be taxed in that State …"*

Although being signed in 1997, the DTC, consistently with the wording of the OECD Model of 2003, provides that the allocation rule which does apply in the case of income from immovable property applies, to the same extent, in the case of capital gains arising in respect of immovable properties.

The rules applies irrespective of the *kind* of immovable property or, in other words, irrespective of the *role* of such immovable property within the business of the enterprise.

The same holds true for the India-Hungary DTC whose Article 13(2) holds that "*Gains from the alienation of shares of the capital stock of a company the property of which consists directly or indirectly principally of immovable property situated in a Contracting State may be taxed in that State."* and for the Finland-Hungary DTC whose Article 13(2) reads *"Gains from the alienation of shares or other corporate rights referred to in paragraph 4 of Article 6 may be taxed in the Contracting State in which the immovable property owned by the company is situated."*. Accordingly, Article 13(4) China-Hungary DTC provides that "*Gains from the alienation of shares of the capital stock of a company the property of which consists directly or indirectly principally of immovable property situated in a Contracting State may be taxed in that Contracting State."*

[67] OECD Model Commentary 2003, on Article 13(4), at 28.3.

According to the OECD stance on the issue in hand, one could express that, as for the DTCs entered into with Finland, Philippines, China and India (without any derogation) any income and capital gains derived from immovable property within a business is taxed (*rectius* "may be taxed") in the State of *situs* (whatever is the immovable property)[68].

If this is the rule, one could ask whether there is a room for some derogations.

In this respect, it is useful analysing the Hungary-Canada DTC.

Article 13(4) reads *"Gains from the alienation of: (a) shares […] the value of which […] is derived principally from immovable property situated in that other State; […] may be taxed in that State"*

The rule, as such, is totally consistent with the rules of the DTCs above mentioned. In fact, it provides that gains from the alienation of *any* immovable property – whatever the *use* of it within the business of the foreign enterprise – may be taxed in the State where it is located.

However, Article 13(4) provides, also, for a definition of 'immovable property' for the specific scope of Article 13.[69]

In fact, it provides that "*For the purposes of this paragraph, the term "immovable property" includes the shares of a company referred to in sub-paragraph (a) […] but does not include any property, other than rental property, in which the business of the company, […] is carried on."*

In other words, the sc. *situs principle* will *not* apply to the extent that (a) the immovable property is not a sc. *'rental property'* and (b) the immovable property *serve* for the carriage out of the business activity.

In the latter perspective, and as opposed to the DTCs quoted above[70] the role of the immovable property within the business of the enterprise is supposed to be *not* immaterial.

More in particular, one could argue that the fact that the immovable property is the *mean* for exploiting the business activity (not the *objective*) and therefore does not arise, as such, *immovable property income* -as for the scope of the DTC- creates that, also income from the alienation of such goods *should* uphold the same principle.

The above conclusion appear to be consistent with the Canadian DTCs practice as for the immovable property companies income's allocating rules.

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[68] The same observations hold true for the DTCs entered into with Egypt whose Article 13(4) reads "*Gains from the alienation of shares of the capital stock of a company the property of which consists directly or indirectly principally of immovable property situated in a Contracting State may be taxed in that State"*

[69] We highlight that the structure of the DTCs patterned on the OECD Model provides for a *renvoi* clause contained in Article 6(2) which provides that "immovable property" shall be defined in accordance with the law of the Contracting State in which the property in question is situated. Article 13, in turn, referring to the immovable property as defined in Article 6(2) applies definitively to the same object.

[70] Namely, the DTCs entered into with Egypt, India, Finland and Philippines.

In searching for the rationale behind Article 13(4)e, it is important stressing that, by its very nature, Article 13(4) aims at serving an *anti-avoidance* purpose. The provision, curbing the interposition of "intermediate" chains between the ultimate holder of the immovable property and the immovable property, fulfils the objective of re-giving systematic to the DTC context. In fact, in the absence of this anti-avoidance rule, the scope of the DTC could be avoided creating schemes that reach favourable – but abusive – tax lowering (results which could be deemed "non-systematic").

This being the context, it is worth mentioning that the interpretation of paragraph 4 of Article 13 is strongly linked to that of par. 1 and – since it is a specification of par. 1 – par. 4 *has* to be considered in the interpretation of the (wider and, in principle, "avoidable") Article 13(1).

If one shares the above standpoint, the scope of the Hungarian Canadian DTC which, someway, appears differing from the other Hungarian DTCs, could lead to different results.

In fact, one could consider that, since Article 13(4) of the Canada-Hungary DTC aims at treating capital gains from the alienation of "immovable property companies" in the same way as "immovable properties", the immovable properties as defined in Article 13(4) have to be the *same* as those in par. 1 of the same Article.

As a natural corollary, the taxation of capital gains arising from the alienation of immovable properties *in which the business is carried on* [other than rental properties] would have to be governed by Article 13(6) which provides for the taxation *only* in the *residence State.*

Should this be the case, one could argue that, in some specific and residual cases, capital gains from the alienation of immovable property companies could fall under the rule of Article 13(6) Canada-Hungary and, hence, be taxed *only* in the "residence State".

However – leaving apart the theoretical observations laid down below – in the perspective of the foreign investors, I take the view that the above interpretation could be counteracted by the Hungarian Tax Authorities and, therefore, I hold that a Ministry's stance on the issue in hand could help in understanding the one true meaning of the quoted clause.

The Hungarian DTC network arises further issues in this respect.

The relevant Protocols to the DTCs entered into with Latvia and Lithuania provide that "*It is understood that all income and gains arising from the alienation of immovable property situated in a Contracting State may be taxed in that State in accordance with the provisions of Article 13 of this Convention.*" The wording of the provision refers to *"all* [emphasis added] *income and gains"* arising from the *alienation* of immovable property.

I take the view there could be the room for holding that the above provision (at least implicitly) recognises that there is a substantial difference among the various types of immovable properties and, as a dramatic consequence, there could be a different DTC approach in respect of income and gains arsing form (different) immovable properties.

To the same token, I stress that, unless the Hungarian Tax Authorities will share the above interpretation, foreign investors should carefully consider to uphold such an approach which could be considered, in effect, as an aggressive tax planning and, hence, be effectively counteracted by the Hungarian anti-abuse rules.