# TREASURY DEPARTMENT TECHNICAL EXPLANATION OF THE CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE HUNGARIAN PEOPLE'S REPUBLIC FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME

GENERAL EFFECTIVE DATE UNDER ARTICLE 25: 1 JANUARY 1980

This treaty was negotiated on the basis of the U.S. Model Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital published on May 18, 1976. A revised version of that Model was published on May 1977. In nearly all respects the two versions are substantially the same. The May 1977 version reflects the revised Model Double Taxation Convention on Income and Capital published by the Organization for Economic Cooperation and Development (OECD) in January 1977 which modified the 1963 OECD Model. Many of those revisions were available at the time this treaty was negotiated and were also taken into account.

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## ARTICLE 1
## Personal Scope

This Article identifies the persons who come within the scope of the Convention (hereinafter referred to as "the treaty").

Paragraph 1 is taken directly from the U.S. Model Income Tax Convention (hereafter "the U.S. Model") of May 1977, but with the wording revised so that the general rule is stated first and the exception follows. The general rule is that the treaty applies to residents of one or both of the Contracting States. The term "resident" is defined in Article 4 (Fiscal Domicile). The exception is that in certain cases the treaty may also apply to residents of third countries because of their relationship to a resident of a Contracting State. For example under paragraph 5 of Article 9 (Dividends) the treaty refers to dividends derived by residents of third countries, and Article 23 (Exchange of Information) may apply to residents of third countries.

Paragraph 2 contains the traditional "saving clause" under which each Contracting State reserves the right to tax its residents, as determined under Article 4 (Fiscal Domicile), and its citizens as if the treaty had not come into effect. In the case of the United States the "saving clause" applies to former citizens as well as to current citizens. This is standard U.S. treaty policy (see Revenue Ruling 79-152). A former U.S. citizen whose loss of citizenship had as one of its principal purposes the avoidance of income tax will continue to be subject to U.S. income tax, in accordance with the provisions of section 877 of the Internal Revenue Code, for a period of ten years following the loss of citizenship. The substance of this paragraph is the same as that of paragraph 2 of Article 1 of the U.S. Model of May 1977. The saving clause is drafted reciprocally because in certain cases the Hungarian People's Republic also taxes on the basis of citizenship. The Hungarian income tax on intellectual activities applies at graduated rates of 6 to 60 percent on royalties derived by Hungarian citizens wherever resident. However, since the reference to former citizens has no effect under the laws of the Hungarian People's Republic, that clause was simplified by making the reference applicable only to former citizens of the United States.

Paragraph 3 sets forth certain exceptions to the application of the saving clause where other provisions of the treaty reflect overriding policies. For example, the saving clause does not affect the benefits provided under paragraph 2 of Article 15 (Pensions). Social security benefits and other public pensions paid by the Hungarian People's Republic are taxable only by the Hungarian People's Republic even though the recipient may be a resident or citizen of the United States, and conversely. Similarly, the benefits provided under Article 20 (Relief from Double Taxation), Article 21 (Non-Discrimination), and Article 22 (Mutual Agreement Procedure) are available to residents and citizens of the Contracting States notwithstanding the saving clause.

In some other cases the saving clause overrides benefits conferred by the treaty to citizens or persons having immigrant status in a Contracting State, but does not override those benefits as applied to residents who are not citizens and do not have immigrant status in that State. This second category of exceptions to the saving clause refers to the benefits conferred by a Contracting State under Article 16 (Government Service), Article 17 (Teachers), Article 18 (Students and Trainees), and Article 24 (Effect of Convention on Diplomatic and Consular Officials, Domestic Laws and Other Treaties).

This paragraph follows closely paragraph 3 of Article 1 of the U.S. Model of May 1977. It differs only in omitting a cross reference to child support payments under subparagraph (a) and in adding a cross reference to teachers under subparagraph (b). The U.S. Model of May 1977 contains a specific rule on child support payments not found in this treaty, and does not include an article on teachers such as the one found in this treaty.

## ARTICLE 2
## Taxes Covered

Paragraph 1 states the general rule that the treaty applies to income taxes imposed on behalf of a Contracting State. Except for Articles 21 (Non-Discrimination) and 23 (Exchange of Information), the Convention does not apply to taxes on capital, and it applies to income taxes imposed only at the national level. Capital taxes were omitted because, since the United States does not have such taxes at the national level there is no double taxation, including them would be nonreciprocal and there is no U.S. tax against which to credit Hungarian taxes on capital. Moreover, the Hungarian taxes on capital are not major taxes; they apply primarily to housing, vacant land and farm property. The Hungarian People's Republic does not now have any local income taxes. Only the national government imposes income taxes, although the revenue from some of those taxes is turned over to the county governments.

Paragraph 2 designates the existing taxes to which the Convention shall apply. In the case of the United States these are the Federal income taxes imposed by the Internal Revenue Code, the excise tax on insurance premiums paid to foreign insurers (Code section 4371) and the excise tax with respect to private foundations (Code section 4940). The accumulated earnings tax (Code 531) and the personal holding company tax (Code section 541) are not covered by the treaty. These provisions, which are found in subparagraph (a), are identical to paragraph 2(a) of the U.S. Model of May 1977.

In the case of the Hungarian People's Republic, there are eight existing income taxes covered by the treaty: the general income tax, the income tax on intellectual activities, the profit tax, the profit tax on economic associations with foreign participation, the enterprises' special tax, the levy on dividends and profit distributions of commercial companies, the profit tax on state- owned enterprises, and the contribution to communal development to the extent that it is imposed in respect of income taxes covered by the treaty. The contribution to communal development is imposed as a surtax to the general income tax and the income tax on intellectual activities. It was agreed that it will be covered by the treaty to the extent that it is imposed on those or any other income tax covered by the treaty, but not if it should be imposed as a surtax to a tax not so covered. Under paragraph 1 of Article 20 (Relief from Double Taxation), the United States agrees that the Hungarian taxes enumerated in paragraphs 2(b) and 3 of this Article are income taxes for purposes of the U.S. foreign tax credit.

Paragraph 3 provides that the treaty shall also apply to subsequently imposed taxes which are substantially similar to the existing taxes covered by the treaty. The competent authorities agree to notify each other of changes in their respective tax laws and any official published material relating to the application of the treaty. This provision is identical to paragraph 3 of the U.S. Model of May 1977.

Paragraph 4 provides that for some purposes the treaty also applies to taxes other than national income taxes. For the purposes of Article 21 (Non-Discrimination), the treaty applies to taxes of all kinds imposed at all levels of government. For the purposes of Article 23 (Exchange of Information), the treaty applies to taxes of every kind imposed at the national level. These provisions also correspond to those found in the U.S. Model of May 1977.

## ARTICLE 3
## General Definitions

Paragraph 1 defines the principal terms used throughout the treaty. Unless the context otherwise requires, the terms defined in this paragraph have a uniform meaning throughout the treaty. It should be noted that a number of important terms are defined in other Articles. For example the terms “resident” and "permanent establishment" are defined in Articles 4 (Fiscal Domicile) and 5 (Permanent Establishment), respectively, and the terms "dividends" and "interest" are defined in Articles 9 (Dividends) and 10 (Interest).

Paragraph 1 follows paragraph 1 of the U.S. Model of May 1977 in defining the terms "person", "company", "enterprise of a Contracting State", "international traffic", "competent authority", and the term "United States". The definition of the United States includes the continental shelf of the United States in accordance with section 638 of the Internal Revenue Code and the regulations thereunder. The term "Hungarian People's Republic" is defined to include the territory of the Hungarian People's Republic. Hungary does not have a territorial sea or continental shelf.

The only departure in this paragraph from the U.S. Model of May 1977 is the definition of the term “nationals,” which is relevant for purposes of Article 21 (Non-Discrimination). In this treaty “national” is defined to mean an individual citizen of a Contracting State and any legal person, partnership, and association deriving its status as such from the law in force in a Contracting State. The definition of "national" as an individual citizen is found in the U.S. Model in Article 24 (Non-Discrimination), paragraph 2. The additional definition of legal persons, partnerships and associations as nationals of a Contracting State is taken from the OECD Model Draft Income Tax Convention of January, 1977, where it appears in Article 24 (Non-Discrimination).

Paragraph 2 is from the U.S. Model of May 1977. It provides that terms not defined in the treaty shall have the meaning which they have under the laws of the Contracting State relating to the taxes to which the treaty applies, unless the context of the treaty requires otherwise and unless the competent authorities agree on an acceptable definition under the terms of Article 22 (Mutual Agreement Procedure).

ARTICLE 4
Fiscal Domicile

This Article sets forth rules for determining the residence of individuals, corporations, and other persons for purposes of the treaty. A definition of residence is important because, except as otherwise provided in the treaty, only a resident may claim the benefits of the treaty.

Paragraphs 1 through 5 of this Article correspond to paragraphs 1 through 5 of Article 4 (Resident) of the U.S. Model of May 1977. Paragraph 6 of the U.S. Model does not appear because it is relevant only with respect to countries which impose tax on a remittance basis, and that is not the case in the Hungarian People's Republic.

Paragraph 1 lists a number of criteria which may be used under the laws of a Contracting State to determine residence, such as domicile, residence, citizenship, place of management, or place of incorporation. Thus, a U.S. citizen living in a third country is a resident of the United States under this treaty. A person liable to tax in a Contracting State only on income from sources in that State is not considered to be a resident of that State for purposes of the treaty. For example, a diplomat of the Hungarian People's Republic or of a third country stationed in the United States is not a resident of the United States for purposes of the treaty.

When applied with respect to income derived by a partnership, estate, or trust, the term "resident" applies only to the extent that the income derived by such partnership, estate, or trust is subject to tax as the income of a resident of a Contracting State either in its hands or in the hands of the partners or beneficiaries. For example, if a Hungarian partnership which is comprised of one partner resident in Hungary and another partner resident in a third country derives dividends from the United States, the limitation of U.S. tax under the provisions of Article 9 (Dividends) of this treaty apply only to the portion of the dividend attributable to the partner who is a resident of Hungary.

Paragraph 2 provides a series of tie-breakers for assigning a single residency to a person who under paragraph 1 would be a resident of both countries. The first test is where the individual has a permanent home. If this test is inconclusive because the individual has a permanent home in both countries or in neither of them, the second test is where his center of vital interests is located, in other words, where his personal and economic relations are closer. If this test does not provide a satisfactory answer, the third criterion is where the individual has an habitual abode; and if he has an habitual abode in both countries or in neither of them, he is deemed to be a resident of the State of which he is a national. Should the individual be a national of both countries or of neither of them, then it is left to the competent authorities of the Contracting States to settle the question by mutual agreement.

Paragraph 3 provides that a company, which under paragraph 1 is a resident of both Contracting States, shall be considered a resident only of the Contracting State under the laws of which it is created or organized, whether at the national level or under the laws of a political subdivision. Thus, a corporation incorporated under the laws of a state of the United States is a resident only of the United States for purposes of the treaty.

Paragraph 4 provides that if a person other than an individual or a company is a dual resident of the Contracting States, the competent authorities shall attempt to agree on a single residence in one of the Contracting States for such person.

Paragraph 5 provides that an individual national of one of the Contracting States shall also be considered to be a resident of that State if that individual is employed by that Contracting State or an instrumentality thereof and is engaged in the performance of governmental functions for the employing State and remains subject to income tax by the employing State as if he continued to be a resident thereof. This provision also applies to the spouse and minor children residing with such an employee if they are also subject to income tax by the sending state. This paragraph is not found in the OECD Model. It is provided in the U.S. Model of May 1977. Under its terms, a U.S. diplomat or other employee of the United States government performing governmental functions for the United States outside of the United States is considered to be a resident of the United States for purposes of this treaty and therefore entitled to the benefits provided in the treaty for residents of the United States, such as the reduced rate of Hungarian withholding tax with respect to dividends and the exemption from Hungarian tax of interest and royalties paid to residents of the United States. And conversely, a Hungarian diplomat stationed in the United States is a resident of the People's Republic of Hungary for purposes of the treaty.

## ARTICLE 5
## Permanent Establishment

This Article defines the term "permanent establishment," which is relevant to the taxation of business profits under Article 7 (Business Profits). With only a few minor exceptions, this Article is the same as Article 5 (Permanent Establishment) of the U.S. Model of May 1977.

In paragraph 1 the term "or production" was inserted after the phrase "fixed place of business" at the request of the Hungarian delegation, because in the Hungarian language "business" does not encompass all trade or business activities but has a more limited meaning. For the same reason, it was also decided to change the reference "through which the business of an enterprise is wholly or partly carried on" to "through which the activities of an enterprise are wholly or partly carried on. The term "fixed place of business" appears also in subparagraphs (d), (e) and (f) of paragraph 4 and in paragraph 5. However, it was not necessary to insert the term "or production" in those paragraphs because they do not pertain to production activities.

The term "place of management" was inserted in paragraph 2 at the request of the Hungarian delegation to provide greater uniformity with the OECD model. The U.S. Model of May 1977 excludes this term because it lacks clarity and in any event a place of management would normally require an office, which is specifically listed.

Paragraph 3 is the same as in the U.S. Model of May 1977. It provides that a building site or construction or installation project or an installation or drilling rig or ship used for the exploration or development of natural resources constitutes a permanent establishment only if it lasts more than 24 months. In such a case, it constitutes a permanent establishment from the first day.

Paragraph 4 lists a number of exceptions to the general rule that a fixed place of business or production through which the activities of an enterprise are carried on constitutes a "permanent establishment." Paragraph 4 is the same as paragraph 4 of Article 5 of the U.S. Model of May 1977. It is also the same as the comparable paragraph in the 1977 OECD Model, with the exception that subparagraph (f) of this treaty provides that the maintenance of a fixed place of business solely for any combination of the activities mentioned in subparagraphs (a) through (e) does not constitute a permanent establishment, whereas under subparagraph (f) of the OECD Model (paragraph 4 of Article 5) there is an additional condition that the overall activity of the fixed place of business resulting from this combination must be of a preparatory or auxiliary character for the enterprise.

Paragraphs 5 and 6 refer to the use of agents. Under paragraph 5 a dependent agent acting on behalf of an enterprise who habitually exercises an authority to conclude contracts in the name of the enterprise is deemed to constitute a permanent establishment of that enterprise except to the extent that his activities are limited to those mentioned in paragraph 4, which would not constitute a permanent establishment when carried on at a fixed place of business. Paragraph 6 provides that merely because an enterprise of one Contracting State makes use in the other Contracting State of a broker or other agent of independent status acting in the ordinary course of business, it will not therefore be considered to have a permanent establishment in that other State.

Paragraph 7 states that the fact that a corporation which is a resident of one Contracting State is either the subsidiary or the parent of a corporation which is a resident of the other Contracting State is not in itself relevant in determining whether the corporation has a permanent establishment in the other Contracting State. What is relevant is whether the subsidiary or parent corporation carries on an activity which, within the provisions of the Article, would constitute a permanent establishment of the other company. The same rules apply to two or more subsidiaries of the same company.

## ARTICLE 6
## Income from Immovable Property
## (Real Property)

This Article provides that income from real property, including income from agriculture and forestry, may be taxed by the Contracting State where the property is situated. This rule does not confer an exclusive right of taxation to the State where the property is situated, but simply confirms that the situs State has the primary right to tax such income regardless of whether the income is derived through a permanent establishment in that State. This Article is identical to paragraphs 1 through 4 of Article 6 of the U.S. Model of May 1977.

Paragraph 5 of the U.S. model providing for a binding election to be taxed on a net basis was deleted as unnecessary; such an election is available under U.S. law, and the Hungarian People's Republic taxes income from real property on a net basis in any event.

This Article, except for the addition of the parenthetical reference to real property, is identical to Article 6 of the OECD Model of January 1977.

## ARTICLE 7
## Business Profits

This Article provides rules for the taxation by a Contracting State of income from business activity carried on in that State by a resident of the other State.

Paragraph 1 provides that business profits of an enterprise of one Contracting State shall be taxable only in that State except to the extent that such profits are attributable to a permanent establishment through which the enterprise carries on business activities in the other Contracting State. This rule is also found in the U.S. Model of May 1977 and the OECD Model of January 1977.

Paragraphs 2 and 3 are also taken from the U.S. Model of May 1977. Paragraph 2 provides that the profits to be attributed to a permanent establishment are those which it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions. Paragraph 3 provides that there shall be allowed as deductions those expenses incurred for the purposes of the permanent establishment, whether incurred in the State where the permanent establishment is located or elsewhere. The deductible expenses include a reasonable allocation of administrative expenses, research and development expenses, interest, and other expenses incurred for the purposes of the enterprise as a whole or the part thereof which includes the permanent establishment.

Paragraph 4(a) is the same as paragraph 4 of Article 7 of the U.S. Model of May 1977. It provides that the mere purchase by a permanent establishment of goods or merchandise for the enterprise shall not result in profiles being attributed to the permanent establishment. Paragraph 4(b) adds that the mere delivery to the permanent establishment of goods or merchandise for its use shall not give rise to the attribution of profit to the permanent establishment. Paragraph 4(b) was added at the request of the Hungarian delegation because they have had difficulty with other countries assessing profits to a permanent establishment in such cases.

Paragraph 5 provides that where business profits include items of income dealt with separately in other Articles of the treaty, then the provisions of those separate articles override the provisions of this Article. Thus, for example, the taxation of income of shipping and aircraft companies dealt with in Article 8 (Shipping and Air Transport) is governed by that Article and not by this Article. Similarly the taxation of dividends, interest, and royalties is controlled by Articles 9 (Dividends), 10 (Interest), and 11 (Royalties); however, the terms of those articles provide that where dividends, interest, or royalties derived by a resident of a Contracting State are effectively connected with a permanent establishment or fixed base of that resident in the other Contracting State, then the provisions of this Article or of Article 13 (Independent Personal Services) shall apply.

This Article does not include two paragraphs which appear in Article 7 of the U.S. Model of May 1977. One such paragraph (paragraph 5) of the U.S. Model provides that the method for determining the profits attributable to a permanent establishment shall be used each year unless there is good and sufficient reason to change. This provision was inserted in the U.S. Model only for uniformity with the OECD Model; its deletion is not of any consequence. The second such deletion is paragraph 7 of Article 7 of the U.S. Model which provides a definition of "business profits". The primary purpose of that definition is to state that film rentals and rentals of tangible personal property are business profits, and therefore subject to the provisions of Article 7, with the result that such income derived by a resident of one Contracting State may not be taxed by the other Contracting State except to the extent attributable to a permanent establishment in the latter State. The Hungarian delegation objected to defining such rentals as business profits. However, they were willing to provide for exemption at source on royalties and on income not expressly mentioned when not attributable to a permanent establishment in Hungary. Consequently, it was agreed to delete the definition of business profits and to deal with film rentals under Article 11 (Royalties) and rentals of tangible personal property under Article 19 (All Other Income).

## ARTICLE 8
## Shipping and Air Transport

Paragraph 1 provides that profits of an enterprise of one of the Contracting States from operating ships or aircraft in international traffic shall be taxable only in that Contracting State.

Paragraphs 2 and 3 clarify what income is to be considered profits from the operation of ships or aircraft. Paragraph 2 states that profits from the rental on a full or bareboat basis of ships or aircraft operated in international traffic are covered by the exemption at source provided in paragraph 1 if such rental profits are incidental to operating profits. The lessee need not be a resident of a Contracting State. Paragraph 3 states that profits from the use, maintenance, or rental of containers and related equipment for the transport of goods or merchandise in international traffic are also covered by the exemption at source provided in paragraph 1.

Paragraphs 1 through 3 of this Article are taken directly from the U.S. model income tax convention of May 1976. In the U.S. model of May 1977, the exemption of rental income was broadened to include the rental on a full or bareboat basis of ships or aircraft if such rental profits are incidental to the operating profits or if the lessee operates the ships or aircraft in international traffic, in which case it is not necessary that such profits be incidental to operating profits to qualify for the exemption. That revision had not been made at the time that this treaty was being negotiated.

Paragraph 4 was inserted at the request of the Hungarian delegation to make certain that the income derived from the ticket sales of offices in the United States of Malev Airlines would not be subject to United States tax, although attributable to a permanent establishment in the

United States, and conversely for ticket sales of U.S. airlines and shipping companies in Hungary. It is taken from the income tax treaty between Hungary and Austria.

## ARTICLE 9
## Dividends

Article 9 in the U.S. Model deals with associated enterprises. In this treaty, that topic is dealt with in an exchange of notes accompanying the treaty. Consequently, beginning with Article 9 the numbering of this treaty is not consistent with that of the U.S. Model.

This Article limits the rate of tax which may be imposed by either Contracting State on dividends paid by a company which is a resident of that State to a shareholder resident in the other Contracting State.

Such dividends may be taxed in the State of residence of the recipient. They may also be taxed in the State of which the company paying the dividends is a resident, but at rates which shall not exceed 5 percent of the gross amount of the dividends when the beneficial owner is a company resident in the other Contracting State and owns, directly or indirectly, at least 10 percent of the voting stock of the company paying the dividends, and 15 percent of the gross amount of the dividends in all other cases. These rules are also found in Article 10 of the U.S. Model of May 1977.

The Hungarian People's Republic imposes under its levy on dividends and profit distributions (paragraph 2(b)(vi) of Article 2 (Taxes Covered)) a "remittance" tax on dividends paid by a Hungarian joint venture. The tax is imposed on the distributing entity at a statutory rate of 20 percent. Technically, the definition of dividends does not cover the Hungarian "remittance" tax because it is imposed on the distribution rather than on the receipt of dividends. However, Hungary agrees that under this paragraph the rate of remittance tax will be reduced to 5 percent or 15 percent on distributions to U.S. residents.

Paragraph 3 defines "dividends" as income from shares or other rights participating in profits, but not debt-claims, and income from other corporate rights taxed in the same way as income from shares under the tax law of the State of which the company making the distribution is a resident. This definition is also found in the U.S. Model of May 1977.

Paragraph 4 provides that where the shares or holding in respect of which the dividends are paid is effectively connected with a permanent establishment or fixed base of the recipient in the country of which the company paying the dividends is a resident, then the dividends are taxable in accordance with the provisions of Article 7 (Business Profits) or Article 13 (Independent Personal Services), rather than under the other provisions of this Article.

Paragraph 5 provides that, in general, a Contracting State may not impose tax on dividends paid by a company which is a resident of the other Contracting State as a general rule, but that there are three exceptions to this rule:

(1) where the dividends are paid to a resident of the first-mentioned State,

(2) where the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or fixed base in the first State, or

(3) where the dividends are paid out of profits attributable to a permanent establishment in the first State of the company paying the dividends, provided that at least 50 percent of that company's gross income from all sources was attributable to a permanent establishment of the company in that first State.

Where only the third of these three conditions applies, the rate of tax which may be imposed on such dividends is subject to the limitations provided in paragraph 2 of this Article when the dividends are paid to a resident of the other Contracting State.

For example, if a corporation created under the laws of the Hungarian People's Republic and doing business in the United States pays dividends, those dividends could be taxed by the United States if paid to a resident of the United States. They could also be taxed by the United States if the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or a fixed base in the United States. And, finally, they could be taxed by the United States if the dividends are paid out of profits attributable to a permanent establishment of the Hungarian corporation in the United States, but only if at least 50 percent of the company's gross income from all sources was attributable to a permanent establishment in the United States. The final case preserves the United States tax on dividends paid by a foreign corporation which are considered to be of U.S. source under section 861(a)(2)(B) of the Internal Revenue Code. If paid to residents of the Hungarian People's Republic, such dividends would be subject to U.S. tax at the reduced rates provided in paragraph 2.

The Hungarian People's Republic does not have a comparable source rule to that of section 861(a)(2)(B) of the U.S. Internal Revenue Code. To make it clear that Hungary will not impose its remittance tax twice, once on the remittance by a joint venture to a U.S. partner under paragraph 2, and again under paragraph 5(c) on the dividend paid by the U.S. partner to its U.S. parent, a statement was included in the exchange of notes that Hungary will not impose its remittance tax under paragraph 5(c).

## ARTICLE 10
## Interest

This Article deals with the taxation by one Contracting State of interest derived by a resident of the other Contracting State.

Paragraph 1 provides the rule found in the U.S. Model of May 1977 that interest shall be exempt from tax at source and taxable only in the state of residence. However, the wording of the U.S. Model which refers to interest "derived and beneficially owned" by a resident of a Contracting State was changed at the request of the Hungarian delegation to the language of the OECD Model (Article 11, paragraph 1) which refers to interest "arising in a Contracting State and paid to a resident of the other Contracting State."

Paragraph 2 contains the definition of interest found in the U.S. Model of May 1976. It differs from the U.S. Model of May 1977 and from the OECD Model only by not specifically excluding penalty charges for late payment from the definition of interest. This is not a difference of substance.

Paragraph 3 provides that where the debt-claim in respect of which the interest is paid is effectively connected with a permanent establishment or fixed base which the recipient of the interest maintains in the other Contracting State, then the interest is taxable in accordance with the provisions of Article 7 (Business Profits) or Article 13 (Independent Personal Services) rather than under this Article.

The exchange of notes includes a provision with respect to interest not at arm's length paid between related persons.

## ARTICLE 11
## Royalties

Paragraph 1 contains the rule found in the U.S. model of May 1977 (Article 12) which gives the exclusive right of taxation of royalties to the state of residence of the recipient. However, the wording was revised to conform to the language of the 1963 OECD Model (Article 12), which parallels the language of the 1977 OECD Model with respect to interest (Article 11), to read "Royalties arising in a Contracting State and paid to a resident of the other Contracting State shall be taxable only in that other State."

Paragraph 2 contains a definition of royalties, taken from the U.S. model of 1977 (Article 12, paragraph 2) but including rather than excluding cinematographic films or films or tapes used for broadcasting. The last sentence of the definition of royalties found in the U.S. Model, relating to gains derived from the alienation of property which are contingent upon the productivity, use or disposition of such rights or property was deleted, at the request of the Hungarian delegation.

Paragraph 3 provides that where the right or property in respect of which the royalties are paid is effectively connected with a permanent establishment or fixed base maintained by the recipient of the royalties in the other Contracting State, then the royalties shall be taxed in accordance with the provisions of Article 7 (Business Profits) of Article 13 (Independent Personal Services) rather than in accordance with the provisions of this Article.

Paragraph 4 of the U.S. model of May 1977 dealing with royalties paid at other than arm’s length between related persons was deleted because the Article on associated enterprises was deleted. The substance of this paragraph is found in the exchange of notes accompanying the treaty.

## ARTICLE 12
## Capital Gains

This Article contains the same provisions as found in the U.S. Model of May 1977

(Article 13) with the exception that the reference to gains from the disposition of rights or property contingent on the productivity, use or disposition of the property as described in Article 12 (Royalties) was deleted to correspond to the deletion of that sentence from Article 12.

Paragraph 1 provides that gains from the alienation of immovable property are taxable in the state where the property is situated.

Paragraph 2 provides that a Contracting State may tax gains from the alienation of movable property which is part of the property of a permanent establishment or fixed base in that State of a resident of the other Contracting State. However, gains derived by an enterprise of one Contracting State from the alienation of ships, aircraft, or containers which it operates in international traffic are taxable only in the state of residence of that enterprise. This latter provision relating to ships, aircraft and containers is also found in the U.S. Model but in a separate paragraph (paragraph 3 of Article 13).

Paragraphs 1 and 2 do not confer an exclusive right to tax. Such gains may also be taxed by the State of residence, subject to the provisions of Article 20 (Relief from Double Taxation). Paragraph 3 provides that gains from the alienation of any property other than property identified in paragraphs 1 and 2 are taxable only in the State of which the recipient is a resident.

## ARTICLE 13
## Independent Personal Services

The treaty provides separate articles dealing with the taxation of income from independent and dependent personal services. Independent personal services are services performed by an individual for his own account where he receives the income and bears the losses arising from such services. Income from services in which capital is a material income-producing factor, however, will generally be governed by the provisions of Article 7 (Business Profits). Generally, services rendered as a director of a corporation, or by physicians, lawyers, engineers, architects, dentists, artistes, athletes, and accountants who perform personal services as sole proprietors or partners are independent personal services, whereas services performed as an employee or as an officer of a corporation constitute dependent personal services.

This Article is the same as Article 14 of the U.S. Model of May 1977, with the addition of paragraph 2 which illustrates the kinds of services covered by this Article. Paragraph 2 is based on paragraph 2 of Article 14 of the OECD Model, but the term used in that model, "professional services" has been changed to "personal services," and artistes and athletes have been added to the list of examples because in this treaty, unlike in the OECD model, they are treated under the general rules for independent or dependent personal services rather than in a special article.

The rule provided in this Article is that income derived by an individual who is a resident of a Contracting State from the performance of personal services in an independent capacity shall generally be taxable only in that State. However, such income may also be taxed in the other Contracting State if such services are performed in that other State and either

(a) the individual is present in that other state for more than 183 days in the taxable year, or

(b) the income is attributable to a fixed base in that other state which the individual has regularly available there for the purpose of performing his activities.

## ARTICLE 14
## Dependent Personal Services

This Article is the same as Article 15 of the U.S. Model of May 1977. It provides that, subject to the provisions relating to pensions (Article 15) and income for government services (Article 16), remuneration derived by a resident of a Contracting State in respect of an employment may be taxed by that other State only to the extent that the remuneration is for employment exercised in that other State. Even in that event, the remuneration is taxable only in the recipient's state of residence if the recipient is present in the other state for not more than 183 days in the taxable year, is paid by or on behalf of an employer who is not a resident of the other State, and the remuneration is not borne by a permanent establishment or fixed base of the employer in the other State.

Paragraph 3 provides a special rule for crew members of ships or aircraft operated in international traffic. Remuneration for such services is taxable only in the Contracting State of which the enterprise operating the ship or aircraft is a resident.

## ARTICLE 15
## Pensions

This Article corresponds to paragraph 1 of Article 18 of the U.S. model of May 1977. It provides that, subject to the provisions of paragraph 2 of Article 16 (Government Services), pensions and similar remuneration beneficially derived by a resident of one Contracting State in consideration of past employment are taxable only in the state of residence of the recipient, but that social security payments and other public pensions paid by one of the Contracting States to a resident of the other state or to a United States citizen are taxable only in the paying state. The first paragraph deals with pensions in consideration of private employment. The second paragraph deals with retirement benefits which are not related to prior employment, such as social security payments and U.S. railroad retirement benefits. Pensions in consideration of government employment are covered under Article 16 (Government Services).

The U.S. Model (Article 18) provides additional paragraphs 2, 3 and 4 which deal respectively with annuities, alimony, and child support payments. Those paragraphs were deleted in this treaty. Annuities, alimony, and child support payments therefore come under Article 19 (All Other Income).

## ARTICLE 16
## Government Service

With one exception this Article is the same as Article 19 of the U.S. Model of May 1977.

Paragraph 1 provides as a general rule that remuneration other than pensions paid by a Contracting State or a political subdivision or local authority thereof to any individual for services rendered shall be taxable only in that State. It also provides an exception, however. The exception is that such remuneration shall be taxable only in the other Contracting State if the services are rendered in that other State and the individual is a resident of that other State and either is also a national of that State or did not become a resident of that State solely for the purpose of performing the services (for example, if the individual was a local resident when hired by the first State). This rule and the exception to it are also found in the OECD Model of January 1977.

The U.S. Model also includes a special provision for the spouse of dependent children of an individual employed by one of the Contracting States and sent to perform governmental services in the other Contracting State and who is not a national of that other Contracting State. In such a case under the U.S. Model, if the spouse or a dependent child of such an individual were to also become employed by the first Contracting State after having become resident in the other Contracting State that spouse or child would also be exempt from tax by that other Contracting State on the remuneration for those services. The purpose of this special rule is to cover the case where the wife or child of a U.S. embassy employee in Budapest, for example, also becomes employed by the U.S. Embassy in Budapest after having established residence there. However, this relatively modest purpose is not immediately clear from the complicated language inserted in at the end of paragraph 1 in the U.S. Model. Moreover, it is unnecessary in this case because under paragraph 5 of Article 4 (Fiscal Domicile) such an individual would be considered a resident of the United States (the country of nationality) for all purposes of the treaty. Consequently, that additional language was deleted.

Paragraphs 2 and 3 of Article 16 are the same as paragraphs 2 and 3 of the U.S. Model of May 1977. Paragraph 2 provides that a pension paid by a Contracting State or a political subdivision or a local authority thereof to any individual as consideration for services rendered to that State or subdivision or local authority is taxable only in that State unless the recipient is both a national and a resident of the other State, in which case such income is taxable only in the other Contracting State. Paragraph 3 provides that the provisions of this Article apply only to remuneration and pensions in respect of governmental services. Remuneration and pensions in respect of services performed in connection with a business carried on by a Contracting State or a political subdivision or local authority thereof are taxable under the provisions of Articles 13 (Independent Personal Services), 14 (Dependent Personal Services), and 15 (Pensions), as the case may be.

## ARTICLE 17
## Teachers

At the request of the Hungarian delegation, this Article was inserted. It is the same as Article 17 of the income tax treaty between the United States and Poland.

The Article provides that when a resident of one of the Contracting States goes to the other Contracting State for a period not expected to exceed two years for the purpose of teaching or engaging in research or both at a university or other recognized educational institution in that other State, at the invitation of that other State or of a recognized educational institution in that State, the income for personal services of teaching or research at that educational institution shall be exempt from tax by the host State for a period not exceeding two years from the date of arrival in that State. This exemption does not apply to income from research carried on primarily for private benefit. If the two-year period is exceeded, the exemption is not lost retroactively; it will still apply to the first two years. However, to qualify for the exemption, the individual must have gone to the other Contracting State for a period which was not expected to exceed the two years.

## ARTICLE 18
## Students and Trainees

This Article is substantially the same as Article 20 in the U.S. Model of May 1977. It provides that a resident of one of the Contracting States who goes to the other Contracting State for the purpose of full-time education or training shall be exempt from tax in that other Contracting State on payments made to him from sources outside that State for the purpose of his maintenance, education, or training. It further provides that such a student or trainee may elect to be treated for tax purposes as a resident of the State which he is visiting for the purposes of education or training. Under this rule, a Hungarian student or trainee in the United States may elect to be taxed on his world-wide income in the United States and to claim the same deductions and personal exemptions which are available to U.S. residents. Such an election would benefit a student or trainee with limited income, especially if he is supporting dependents, since a nonresident alien is only allowed one personal exemption and may not use the zero bracket amount. The election would presumably not be made by a student or trainee with a large amount of foreign source income. Once the election is made, it may not be revoked during the time when this Article is applicable, except with the consent of the competent authority of the host State.

## ARTICLE 19
## All Other Income

This Article conforms to paragraph 1 of Article 21 of the U.S. Model of May 1977. It provides that any income of a resident of a Contracting State which is not covered by other articles of this treaty shall be taxable only in the residence State.

The items of income covered by this Article include annuities, alimony, child support payments, and rentals of tangible personal property.

The U.S. Model of May 1977, like the OECD Model of January 1977, contains a second paragraph, which excepts from the rule of paragraph 1 income derived by a resident of a Contracting State which is effectively connected with a permanent establishment or fixed base of that resident in the other Contracting State; in such cases, the income is covered instead under the provisions of the articles dealing with business profits or independent personal services. The Hungarians agreed with this rule, but felt that it was self-evident and therefore did not wish to include specific language in this Article which they would have to explain to their tax authorities and taxpayers. It was agreed that the substance of this rule would be put instead in the exchange of notes.

## ARTICLE 20
## Relief from Double Taxation

Paragraph 1 of this Article is taken from the U.S. Model of May 1977. It provides that the United States shall give a foreign tax credit for income taxes paid to the Hungarian People's Republic, subject to the limitations provided in U.S. law. The taxes referred to in paragraphs 2(b) and 3 of Article 2 (Taxes Covered) are considered income taxes for purposes of the credit. The treaty guarantee of a foreign tax credit is independent of the statutory grant of a credit under the Internal Revenue Code, but the amount of the credit to be allowed is determined in accordance with the limitations provided in the Internal Revenue Code. The Article provides a credit both for taxes imposed on the recipient and an indirect credit for taxes paid with respect to the profits of a corporation of the Hungarian People's Republic out of which dividends are paid to a United States corporation owning at least 10 percent of the voting stock of the Hungarian corporation paying the dividends

Paragraph 2 provides that the Hungarian People's Republic shall, with the exception of dividends from United States corporations, exempt from tax United States source income derived by residents of the Hungarian People's Republic. In the case where a resident of the Hungarian People's Republic is a United States citizen, the exemption applies to all income derived from sources within the United States in the case of other residents of the Hungarian People's Republic, the exemption applies to income which may be taxed by the United States in accordance with the provisions of this treaty other than the "saving" clause of paragraph 2 of Article 1 (Personal Scope). In the case of dividends which may be taxed in the United States in accordance with the provisions of paragraph 2 of Article 9 (Dividends), the Hungarian People's Republic will allow a foreign tax credit for the amount of tax imposed by the United States, up to the Hungarian tax attributable to such dividends. This credit is available with respect to the United States withholding tax; Hungary was not prepared to extend the credit to also cover the underlying corporate tax on the profits out of which dividends are paid in the case of dividends from a United States subsidiary to a Hungarian parent corporation. As a practical matter, cases of Hungarian corporations deriving dividends from U.S. subsidiaries are uncommon. In the absence of a treaty, the Hungarian People's Republic taxes the worldwide income of residents and provides no statutory relief from double taxation.

The Hungarian People's Republic may take into account exempt income in determining the amount of tax on the taxable portion of income derived by residents of the Hungarian People's Republic. This method of avoiding double taxation, often referred to as "exemption with progression," is provided for in the OECD Model of January 1977 and is commonly used by countries which choose the exemption method of avoiding double taxation.

ARTICLE 21
Non-Discrimination

The provisions of this Article are substantially the same as those of paragraph 1 and paragraphs 3 through 6 of Article 24 of the U.S. Model of May 1977. Paragraph 2 of Article 24 of the U.S. Model contains a definition of the term "nationals" which in this treaty appears in Article 3 (General Definitions) and is broadened to include legal persons.

Paragraph 1 provides that nationals, including legal persons as well as individuals, shall not be treated less favorably with respect to taxation and connected requirements by the other Contracting State than are nationals of that other Contracting State in the same circumstances. Nationals who are subject to tax on their worldwide income by a Contracting State are not in the same circumstances as nationals not taxed on their worldwide income by their State of nationality. Thus, United States citizens who are not residents of the United States are not in the same circumstances with respect to United States taxation as nationals of the Hungarian People's Republic are not citizens of the United States, and therefore, the United States taxation of nationals of the Hungarian People's Republic as nonresident aliens may differ from the United States taxation of United States citizens resident in the Hungarian People's Republic without violating this provision.

Paragraph 2 provides that a Contracting State may not impose more burdensome taxes on a permanent establishment of an enterprise of the other State than it imposes on its own enterprises carrying on the same activities.

Paragraph 3 prohibits discrimination in the matter of deduction. Interest, royalties, and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State must be deductible for determining taxable profits under the same conditions as if they had been paid to a resident of the first-mentioned State. The U.S. Model contains language explaining that the term "other disbursements" includes a reasonable allocation of executive and general administrative expenses, research and development expenses, and other expenses incurred for the benefit of a group of related enterprises. That sentence was deleted from this treaty as excessively detailed and not necessary. The paragraph also provides that debts incurred by an enterprise of a Contracting State to a resident of the other Contracting State shall be deductible in determining taxable capital under the same conditions as if the debts had been contracted to a resident of the first-mentioned State.

Paragraph 4 requires that a Contracting State not impose more burdensome taxation on a subsidiary corporation owned by residents of the other Contracting State than it imposes on similar corporations which are locally owned.

Paragraph 5 repeats the statement of paragraph 4 of Article 2 (Taxes Covered) that this Article applies to taxes of every kind and description imposed by all levels of government.

ARTICLE 22

Mutual Agreement Procedure

This Article is substantially the same as Article 25 of the U.S. Model of May 1977. It does not include the illustrative material in paragraph 3 of that Article which gives examples of the types of matters the competent authorities may agree to, such as a common attribution or allocation of income, deductions or credits. That elaboration, which is not found in the OECD Model, was deleted at the request of the Hungarian delegation to preserve greater uniformity with the OECD Model and because it was considered to be self-evident. Its deletion does not narrow the scope of the Article.

Paragraph 1 provides that a taxpayer who considers that the actions of one or both of the Contracting States result in taxation not in accordance with the treaty, may present his case to the competent authority of the State of which he is a resident or national.

Paragraph 2 provides that the competent authority, if it considers the objection to be justified, and if it is not able to arrive at a solution itself, shall endeavor to resolve the case by mutual agreement with the competent authority of the other Contracting State. Any agreement reached shall be implemented without regard to any statutory time limits of the Contracting States. Thus, for example, if it is agreed that tax liability should be adjusted downward, a refund of the excess tax paid will be made even though the ordinary statute of limitations may have expired.

Paragraph 3 provides that the competent authorities shall endeavor by mutual agreement to resolve any difficulties or doubts which may arise in the interpretation of application of the treaty. They may also consult together to eliminate double taxation in cases not foreseen in the treaty. This language is identical to that of paragraph 3 of the OECD Model of January 1977. The same language is also found in paragraph 3 of the U.S. Model of May 1977, but as indicated above that paragraph also includes additional language giving examples of questions which might be resolved through the mutual agreement procedure.

Paragraphs 4 and 5 provide that the competent authorities may communicate with each other directly for the purpose of reaching agreements in accordance with this Article and that they may prescribe regulations to carry out the purposes of the treaty. Both paragraphs are identical to paragraphs 4 and 5 of the U.S. Model of May 1977.

ARTICLE 23

Exchange of Information

The three paragraphs of this Article are identical to paragraphs 1 through 3 of Article 26 of the U.S. Model of May 1976. Except for minor language changes, these paragraphs are the same as paragraphs 1 through 3 of Article 26 of the U.S. Model of May 1977. Paragraphs 4 and 5 of the U.S. Model (both the 1976 and 1977 versions) deal with assistance in collection where treaty benefits accrue to persons not covered by the treaty. Undertaking such a collection obligation is a departure from Hungarian practice, and they preferred to deal with this issue in the exchange of notes rather than in the Article itself.

Paragraph 1 provides that the competent authorities shall exchange such information as is necessary for carrying out the provisions of the treaty or of their domestic laws concerning taxes covered by the treaty. It also provides assurances that information so exchanged will be protected in the same manner as information obtained under domestic laws with respect to secrecy and disclosure.

Paragraph 2 explains that the obligation undertaken in paragraph 1 to exchange information does not require a Contracting State to carry out measures contrary to the laws and administrative practice of either State or to supply information not obtainable under its laws or in the normal course of its administration, or to supply information which would disclose trade secrets or other information the disclosure of which is contrary to public policy.

Paragraph 3 states that when information is requested by a Contracting State in accordance with this Article, the other State shall obtain the information as if the tax in question were a tax of that other State, whether or not the case involves a tax liability in that other State. Further, the paragraph specifies that the State to which a request has been made shall provide information in forms usable in the judicial practice of the requesting State, such as depositions of witnesses and copies of unedited original documents, to the extent that such forms of information can be obtained under the laws and practices of the State to which the request is made when enforcing its own taxes.

In accordance with paragraph 4 of Article 2 (Taxes Covered) this Article applies to all taxes at the national level.

## ARTICLE 24
## Effect of Convention on Diplomatic and Consular Official, Domestic Laws and Other Treaties

This Article corresponds to Article 27 of the U.S. Model of May 1977. Paragraph 1 provides that this treaty shall not affect taxation privileges of diplomatic or consular officials under other special agreements or under international law.

Paragraph 2 provides that the treaty shall not restrict any benefit provided by the laws of either Contracting State or by any other agreement between the Contracting States. Thus, for example, a Contracting State may not impose a tax by virtue of a provision of this treaty which allows it to tax if such a tax is not provided for under its internal law.

## ARTICLE 25
## Entry into Force

In the Hungarian People's Republic an international agreement concluded by the Government does not require ratification. Therefore, the usual wording of this Article was changed to refer to ratification "or approval" and to specify that the treaty enters into force when the parties have notified one another that their respective constitutional requirements have been met. On the United States side, this requires approval by the Senate, in which case an instrument of ratification will be signed and provided to the Hungarian People's Republic. In exchange, the Hungarian People's Republic will provide us with a notice of approval of the treaty by their Government.

Once the treaty enters into force it will have effect with respect to withholding taxes on income paid or credited on or after the first day of the second month following the entry into force of the treaty, and with respect to other taxes on income of taxable periods beginning on or after January 1 of the year following the entry into force. Thus, for example, if the treaty were to enter into force on December 1, 1979, the reduction or elimination of withholding at source on dividends, interest, and royalties would apply with respect to such income paid or credited beginning on February 1, 1980, and the provisions concerning taxes not withheld at the source would apply as of January 1, 1980. These timing provisions are taken from Article 28 of the U.S. Model of May 1977.

## ARTICLE 26
## Termination

The treaty shall remain in force indefinitely unless terminated by the Government of one of the Contracting States. The Government of either Contracting State may terminate the treaty after five years from the date on which it enters into force by giving at least six months' prior notice through diplomatic channels. In that event, the treaty will cease to have effect with respect to taxes withheld at the source for income paid or credited beginning on January 1 of the following year, provided that the six months' period of notice has expired by that time (i.e., if notice is given by June 30 of one year, the termination will be effective on January 1 of the following year). With respect to other taxes, the termination would be effective with respect to taxable periods beginning on or after January 1 of the following year, again providing that the six months' period has expired by that time.

## EXCHANGE OF NOTES

As indicated in the respective Articles, it was agreed that a number of points would be covered in an exchange of notes to accompany the treaty rather than in the body of the treaty Articles themselves. The primary reason for moving these points to an exchange of notes was to simplify the text of the treaty by removing from it a number of points which were considered elaborations of points already made or implicit in the articles. In one case with reference to assistance in collection, the provision was moved to the exchange of notes because it is regarded by Hungary as an exception to its ordinary treaty policy; no similar provision is included in the OECD Model and the issue had not previously been encountered by the Hungarian People's Republic. The exchange of notes constitutes a part of the treaty and is legally binding on the parties.

Paragraph 1 simply states that the Hungarian People's Republic will not impose a tax on dividends paid by a U.S. corporation out of profits of a joint venture in Hungary. The remittance tax provided under Hungarian law will be imposed, at the reduced rates provided in paragraph 2 of Article 9 (Dividends), on distributions to U.S. partners in joint ventures; no second tax will be imposed on such distributions.

Paragraph 2 provides the same rule with respect to the income covered under Article 19 (All Other Income) that is provided separately in Articles 9 (Dividends), 10 (Interest), and 11 (Royalties), to the effect that when such income is effectively connected with a permanent establishment or fixed base of the recipient of the income in the other Contracting State, it will be taxed in accordance with the provisions of Article 7 (Business Profits) or Article 13 (Independent Personal Services).

Paragraph 3 states that each Contracting State may apportion or allocate income, deductions, credits, and allowances between related enterprises of the two Contracting States in accordance with its internal law. The United States will apply its rules and procedures under section 482 of the Internal Revenue Code. The wording of this provision, which refers to "enterprises" and "dealings" and considers only related enterprises of the two Contracting States is not intended to limit the scope of application of section 482. It was agreed that both Contracting States would deal with non-arm’s length transactions in accordance with the provisions of its internal law. However, the Hungarian delegation objected to spelling out the scope of such laws in the treaty, finding the language of both the U.S. Model and the OECD Model on this point excessively complex. It was therefore decided to simply refer to internal law in the exchange of notes and allow each State to apply its law as it would do in the absence of a treaty. Similarly, the treatment of excessive interest or royalties paid between related persons will be resolved in accordance with internal law.

Paragraph 4 contains the rules usually found in paragraphs 4 and 5 of the Article on exchange of information and administrative assistance (Article 26 in the U.S. Model of May 1977). The Hungarian People's Republic agrees to attempt to collect on behalf of the United States the additional tax due to the United States when a resident of a third country receives dividends, interest, or royalties in Hungary from which U.S. tax has been withheld at the reduced treaty rate or waived under the treaty when the recipient, not being a resident of Hungary, is not entitled to the benefits of the treaty. The provision is worded reciprocally, but is probably less relevant for Hungary which imposes its dividend tax on the distributing entity and does not withhold tax on interest paid abroad, so that the only relevant case would be with respect to the Hungarian tax on royalty payments. It is agreed that neither Contracting State in fulfilling this commitment is required to carry out administrative measures different from those used to collect its own taxes or contrary to its sovereignty, security or public policy.