We make sense.

A FAVOURABLE TIGHTENING OF THE RULES? THE RULES ON THIN CAPITALISATION ARE CHANGING

Due to an EU directive adopted last year, certain rules on corporate tax are changing with effect from 2019 – including the provisions on interest deduction due to "thin capitalisation." Although the purpose of the directive was to defeat tax avoidance and tighten up the tax regulations, the new rules on interest deduction are actually becoming more of a blessing than a curse for businesses in Hungary.

Thin capitalisation as we've known it so far

The thin capitalisation rules, which are in place throughout the world, aim to prevent international corporate groups from eliminating the profits of their subsidiaries or other member companies though excessive loan financing. If a parent company or other company group member finances further companies in the same group mostly or exclusively with loans, then the interest paid on the loan could serve as a means of soaking up the group member's entire profit and thus its corporate tax base.

As a response to this, most countries, including Hungary, cap the amount of interest payable on loans provided by other corporate group members, or the extent to which it can be offset against the corporate tax base. Under the Hungarian rules effective until 2018, if the loan received from group members exceeded three times the equity, then the corporate tax base had to be increased by an extent proportionate to the amount by which the loans exceeded this limit. The past regulation granted several exemptions from the obligation to increase the tax base. For example, the rule did not apply to back-to-back financing or to the deduction of interest on loans received from financial institutions.

What's changing from 2019?

The provisions in effect from 2019 completely rewrite the old set of rules on thin capitalisation. From this year, the pre-tax profit is to be increased by that part of the interest paid by the business which exceeds both EUR 3 million and 30% of the company's EBITDA. In contrast to the previous rules, however, from this year the interest on loans from financial institutions also needs to be taken into account when calculating thin capitalisation.

The exemption for back-to-back structures remained. An additional allowance is that taxable entities are now able to carry their non-deductible interest expenses forward for 5 years, similarly to deferred losses, and it is possible to offset them in an extent of up to 50% of pre-tax profit.

This means that if, for this year, the total extent of interest paid by a company does not exceed EUR 3 million, then it does not have to worry about the rules on thin capitalisation at all. And there are unlikely to be many businesses in Hungary that exceed this limit. And even if the interest expenses of a Hungarian business do exceed the threshold in a given situation, it may still be possible to deduct all the interest by remaining within the 30% of EBITDA limit. Further, if the business still exceeds the limit, the excess interest amount can be carried forward to the following years. So from now on – except in the case of artificial structures – the thin capitalisation rules will be effectively redundant in Hungary.

Who benefits from this?

The EU is obviously shifting the battle against thin capitalisation to the level of large corporations. This makes the new regulations clearly favourable for small and medium-sized enterprises, who no longer have to engage in all sorts of number crunching to work out the average daily amount of their equity and borrowings in any given tax year.

The rule is also favourable for groups of companies that until now – principally for valid legal and technical reasons – financed their Hungarian undertakings exclusively or primarily with loan rather than with capital.

And last but not least, the new calculation method will have a positive impact on all of the many businesses that have minimal equity (or even negative equity): from now on these companies will not automatically fall into the thin capitalisation trap.