Hungary, Farewell

by H. David Rosenbloom

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In this article, Rosenbloom explains the need to protect the integrity of international tax treaties, focusing on the limitation on benefits clause and its absence in the 1979 treaty with Hungary.

One law that is never repealed is the law of unintended consequences. The text of the law is short, but clear: There are always unintended consequences.

Welcome, Comrade

In late fall 1978 I found myself on a flight from Frankfurt to Budapest. I was the international tax counsel at the U.S. Treasury Department. My mission was to negotiate the finishing touches on a convention for the avoidance of double taxation between the United States and Hungary — a tax treaty. I was traveling alone. The other member of the U.S. team working on this treaty, the estimable Marcia Field (who died in October 2023), remained in Washington.

The days were short, the skies leaden, and the air cold as we departed Frankfurt. Upon landing in the dark at the airport in Budapest, our plane, full of passengers, taxied on the tarmac and came to a stop well short of the gate. A door opened, a stairway of some sort was raised or lowered, and there came into the cabin a young man in a heavy military uniform, wearing a fur hat with a large red star in the center and bearing an impressive Kalashnikov rifle. My name was called. I rose and was escorted out of the plane, down the stairway, and to a waiting vehicle. Arrival formalities were nonexistent, or at least I was unaware of them. We proceeded to a comfortable hotel, the Hilton, that had been constructed only a year or two earlier on the hilly Buda side of the city, with a view toward the flat expanse of Pest.

So began the final negotiations for a U.S. tax treaty with a Soviet client nation. My military escort remained at my side, or at any rate nearby, for the duration of the negotiations, always bearing a firearm, always silent. (Not that I would have understood a word he said — Magyar, the Hungarian language, lies well beyond my capabilities.) I met with László Akar, general director for international monetary affairs at the Hungarian Ministry of Finance, and his team — László Mohai, counselor to the Ministry, Csaba Mohi, and Pal Sowlt.

I had joined the Treasury in the summer of 1977, and by this time I had some experience with treaty negotiations: Jamaica, Canada, France, the United Kingdom. I knew, more or less, what to expect. I had discussed treaty issues with foreign negotiators far more experienced than I, including Pierre Kerlan from France, Al Short from Canada, Canute Miller from Jamaica, and Ann Smallwood and Freddie Dalton from the United Kingdom. My only surprise with respect to the Hungarian negotiating team was that it was so well-versed in the work of the OECD.

I was later to notice the OECD model convention on the desks of Russian negotiators when, in 1979, I went to Moscow to negotiate a protocol to the treaty with the Soviet Union. That, too, surprised me.

Here was the odd thing about the negotiations in Budapest: The United States had almost no economic presence or interest in Hungary, and there was certainly no need for a treaty to deal with Hungarian investment in the United States. The agreement was intended on both sides not as a means of mitigating international double taxation, but rather as a political document. Hungary wished to demonstrate to the world that it could act on its own, independent of its Soviet overlords, and the United States was willing to meet the Hungarians on those terms. When completed, the treaty would be signed by Michael Blumenthal, secretary of the U.S. Treasury, and Lajos Faluvégi, Hungarian minister of finance, on February 12, 1979. Tax treaties rarely attract such high-level attention. This one did, and it entered into force the following September.

As I write these words in the early days of January 2024, that treaty has come to an end. The United States terminated it by giving notice in the form prescribed by the treaty itself. A replacement treaty, on which I provided counsel to the Hungarian side, was negotiated in the late 2000s and signed in February 2010, but has been blocked from going into effect through the efforts of Sen. Rand Paul, R-Ky., whose objections to the treaty are obscure, at least to me.

Limitation on Benefits

Over the 44-year life of the 1979 treaty it became a notable source of problems for the United States. Freed from the Soviet yoke in the late 1980s, Hungary refashioned itself as a conduit jurisdiction, what some would consider a tax haven, and set out to attract investors from other countries to make U.S. investments through Hungarian entities. The treaty lacked a limitation on benefits provision, a measure designed to impede treaty shopping. LOB provisions had come into existence with the 1975 U.S. treaty with the United Kingdom, and the specific terms of the LOB article mutated over the years, growing in length and sophistication.

The process reached a major inflection point with the 1989 treaty with Germany, when the United States had to decide whether the LOB concept should be short, simple, and flexible, with much discretion lodged with tax authorities; or whether it should be detailed, highly articulated, and supposedly more "certain" in its application. Treasury chose the latter approach and the path from that point on was toward ever-increasing length and detail. In the 1970s, however, the LOB concept was in a primitive phase, and not endorsed by the OECD. It would have been difficult to envision that any such provision should be inserted in a treaty with a Soviet satellite.

One would have had to be extraordinarily prescient to be concerned about tax treaty abuse or treaty shopping with respect to Hungary in the late 1970s. The revenue consequences of the treaty were stated by Treasury to be negligible "for the foreseeable future." Considered by the Senate together with five other tax treaties, including the controversial third protocol to the 1975 treaty with the United Kingdom, the treaty with Hungary attracted almost no attention as it moved through the advice and consent process. Statements about the treaty by International Tax Counsel to the Joint Committee on Taxation David H. Brockway and Assistant Secretary of the Treasury for Tax Policy Donald C. Lubick were brief and bland. Neither statement took note of the fact that the investment or holding companies article that had appeared in the U.S. model income tax convention of May 1977 was missing in the agreement with Hungary. That article read in its entirety as:

> If 25 percent or more of the capital of a company which is a resident of a Contracting State is owned directly or indirectly by individuals who are not residents of that State, and if by reason of special measures the tax imposed by that State on that company with respect to dividends, interest or royalties arising in the other Contracting State is substantially less than the tax generally imposed by the first-mentioned State on corporate business profits, then, notwithstanding the provisions of Articles 10 (Dividends), 11 (Interest), or 12 (Royalties), that other State may tax such dividends, interest or royalties. For the purposes of this Article, the source of dividends, interest or royalties shall be determined in

accordance with paragraph 3 (a), (b), or (c) of Article 23 (Relief from Double Taxation).

A detailed comparison between the OECD model convention (also of 1977) and the Treasury's model did not mention the absence of the investment or holding companies provision from the OECD model. An attached memorandum noted only that:

> the U.S. Model contains a separate article designed to limit the opportunity for third country residents to take advantage of the treaty benefits by organizing a holding or investment company in one of the contracting states.

It is observed in the memorandum that the commentary to the OECD model suggests it may be appropriate to provide for special treatment of investment or holding companies in bilateral treaties. A detailed explanation of the Hungary treaty submitted by the joint committee makes no mention of the absence of any such provision.

The Senate Foreign Relations Committee reported the Hungary treaty out of committee on June 15, 1979, with little substantive comment. The treaty received Senate advice and consent on July 9, 1979, by a vote of 98 to 0, with two members absent. It entered into force on September 18, 1979, and first had effect, in accordance with the treaty's terms, on November 1, 1979.

I do not consider myself remiss in failing to foresee the substantial deleterious effects that flowed from the lack of an LOB provision in this treaty. No one saw them. On the other hand, the tolerance of a large and growing problem by U.S. tax authorities over many subsequent years may not be so easily excused.

Protecting Treaty Integrity

For many reasons, which I have discussed both in the classroom and in writing, I believe that if the United States is to have a sound tax treaty program, and if it persists in pursuing a tax treaty policy of a predominantly capital-exporting country (a policy I consider highly questionable), it must be serious about protecting the integrity of each bilateral treaty that it negotiates. I am therefore — and was in the 1970s —in favor of the LOB concept, though my inclination was (and remains) to keep the provision general and flexible along the lines of the LOB article in the treaty with Cyprus and not, as the United States decided for the 1989 treaty with Germany, specific, detailed, and complex. I strenuously opposed the Germany solution, to no avail (I had long since departed Treasury). At the time of the negotiations with Hungary, the most that might have been considered was the skeletal investment or holding company provision, which would have been inadequate in any event. I have no recollection of any discussion of that provision with the Hungarians. As I have noted, no such provision appeared in the OECD model convention, and the Hungarian delegation generally balked at anything not found in the OECD.

Over the years I have seen my fair share of abusive planning involving Hungary and the 1979 treaty. I have witnessed Brazilian entities that relied heavily on the treaty in channeling U.S. investments because Brazil has refused to enter into good-faith treaty negotiations with the United States. Income from direct U.S. investments by Brazilians is therefore subject to U.S. tax at statutory rates. I have seen drilling rigs in the Gulf of Mexico chartered from Hungarian post office box "companies" sharing space in Budapest apartment buildings with spas and retail stores. I know of Hungarian entities with Swiss branches claiming benefits under the 1979 treaty and reducing any conceivable Hungarian tax. In short, I have seen a good sample of Hungarian situations dependent, crucially, on the lack of an LOB article in the 1979 treaty.

Now that treaty is gone. It had become a valuable asset of the Hungarian government and the Hungarian tax and financial communities. Some might say it was high time for the United States to give notice of revocation.

Yet, given my personal involvement with this treaty, I find myself contemplating the arc of its existence, starting with that young soldier with the red star on his fur hat. I ask myself what might be learned here. These are the lessons I draw from this 44-years-in-the-making episode:

1. There is no existing mechanism, in Treasury, the IRS, Congress, or elsewhere, for reviewing the operation in practice of tax treaties once they are negotiated and

enter into force. Even when problems with a given treaty emerge, it is painful and difficult for the United States to revoke a treaty relationship.

2. At their best, tax treaties are a useful tool of tax policy. Employed rationally, they supplement and modify statutory rules, to the benefit of both taxpayers and the fisc. But the benefits of tax treaties can be questioned, and the absence of a mechanism for ongoing review certainly contributes to suspicion of these agreements.
3. If a tax treaty can be abused, it will be abused. There is a great deal of sophistication in the tax world, not limited to the United States. Gaps, lacunae, and unfortunate word choices can and probably will come back to haunt the negotiators.
4. The case for tax treaties would evaporate if there were an adjudicative body before which international tax disputes could be brought for resolution. The mutual agreement procedure in the typical tax treaty is the only dispute resolution game in town and surely the most compelling argument for having treaties. Most other functions of a modern tax treaty can be pursued through statutes, regulations, and international agreements falling short of a treaty.
5. Negotiators obviously try their best to achieve results that will stand the test of time. But the task is impossible. No matter how perfect the negotiated product, the law of unintended consequences will have its way.

These lessons are universal. None of them is limited to the U.S.-Hungary experience. ■