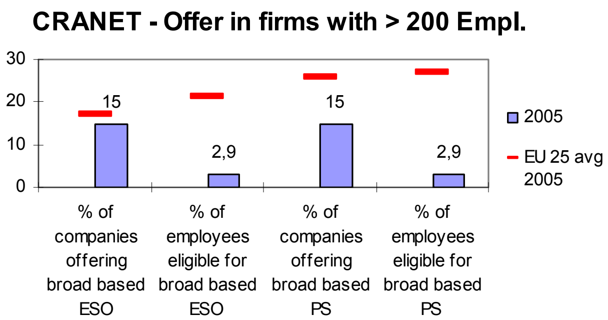
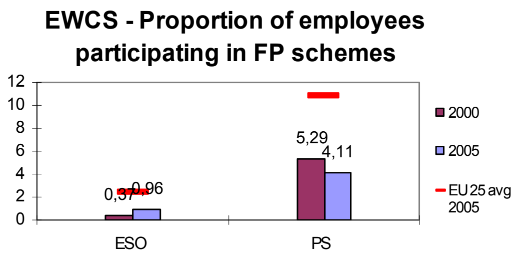
XII. Hungary

Employee ownership has been the main form of financial participation in Hungary. It has been variously structured to include employee acquisition of state assets on preferential terms during the first wave of privatisation, employee share ownership as a part of external privatisation, long-term incentive plans, and stock options. In the first stages of privatisation, the most prevalent form of employee ownership was the Hungarian Employee Share Ownership Programme, modelled on the US ESOP. Although briefly popular as a quick expedient for getting assets into the hands of company employees, now that privatisation is over, the number of ESOP companies is on the decline. Except for the Approved Employee Securities Benefit Programme, introduced by tax laws in 2003, the other PEPPER schemes, including profit-sharing, are found only to a limited extent. Having little support in official economic policy, they are not formally registered or reported. As for profit-sharing, according to Hewitt Associates[120], eight out of ten Hungarian enterprises utilise short-term incentives that go beyond the simple sales premium. Of these, 20 per cent use profit-sharing; most (67 per cent) base profit shares on the employee's status in the hierarchy, but many (23 per cent) set other criteria as well. According to the survey, however, only 10 per cent of employees entitled to a profit share actually receive one.





1. General Attitude

Trade unions at the national level actively promoted employee ownership in various forms. Local trade unions, however, often took a surprisingly passive stand, declaring their interest in employee buyouts but taking no role in organising the procedure. Other local trade unions actively lobbied for preferential shares and also ESOP buyouts. In addition to influencing privatisation decisions, unions usually had at least one of their leaders

120 The incentive systems of 50 companies were surveyed in 2003, the majority of which were large ones in terms of sales and number of employees.

as a member of the organising committee and the ESOP trust. Employees and their trade union representatives regarded the ESOP and other buyout schemes as tools for preserving jobs. Since the end of privatisation in 1998, lobbyists have fought, so far with little success, to gain political support and financial incentives for extending the use of ESOPs beyond the privatisation process, and to make use of this technique in cases of liquidation. Another important effort of lobbyists was to amend ESOP and tax laws to protect existing ESOPs from an unfavourable economic environment. To summarise, Hungary has no focused policy on employee ownership. Although political parties on both left and right declare their commitment in the past as well as most recently, the principle has yet to be translated into economic policy.

2. Legal and Fiscal Framework

The legal framework of employee financial participation includes both profit-sharing and employee share ownership. However, no specific legal or tax incentives for profit-sharing are granted either to employer or employee. Company law explicitly regulates employee shares, including stock options. Recently an Approved Employee Securities Benefit Programme with specific incentives has been introduced.

a) Share Ownership

Employee privatisation on preferential terms (1991, 1995, 2007) – The privatisation law of 1991 contained various preferential privatisation techniques. In 1995 a new Law on Privatisation, still in force, reduced some allowances for employees, but offered at the same time new forms and techniques, that is, privatisation on deferred terms, employee privatisation on preferential terms, *'Egzisztencia'* credit, and ESOPs.[121] In 2007 the Law on Privatisation was superseded by the Law on State Property[122] which, however, preserved the described incentive system. Privatisation offers three financial techniques for acquiring employee ownership on preferential terms: (1) price reduction, (2) purchase by instalment, and (3) purchase on credit. Thus a discount of up to 150 per cent of the annual minimum salary is possible. However, the nominal value of shares thus acquired may not exceed 15 per cent of the company's registered capital nor the discount granted exceed 50 per cent of the purchase price. In the event of paying the discounted price in installments, except if sold within the framework of an ESOP (see below), a down payment of fifteen per cent is required in cash, upon which payment of the remainder may be deferred for a period of up to three years at the prevailing interest rate charged on public debts. Further, Hungarian citizens may take up to 50 per cent of the property that they wish to acquire, up to a

121 Law XXXIX of 1995 on the Realisation of Entrepreneurial Property in State Ownership; Governmental Decree No. 28 of 1991 on 'Egzisztencia' Credit and Deferred Payments Benefits (see below).

122 Law CVI of 2007 on State Property in force since 1 January 2008.

maximum of HUF 50 million, as an *'Egisztencia' credit*, regardless of the number of buyers.[123]

Employee stock ownership programme (1992, 2003, 2007) – In Hungary the US ESOP system strongly influenced the law regulating the establishment and functioning of ESOPs.[124] Basically, the Hungarian ESOP followed the American 'trust' model. However, there is a major difference between the two systems: while the Hungarian ESOP is a privatisation vehicle with the organisation ceasing to exist as soon as all the securities are paid for and their ownership transferred to the employees, the US ESOP continues to administer the securities of employees.[125] The Hungarian ESOP is an independent legal entity; so-called 'privatisation' and 'non-privatisation' ESOPs exist. In the case of the former, the ESOP buys the property of the State Property Agency or of municipalities; there are incentives attached to this form. In the latter case, shares or business shares not at the disposal of the State Property Agency are sold, for example, already existing securities or securities issued in connection with capital increase. The only difference between the two forms is that there are no specific incentives encouraging companies or employees to establish non-privatisation ESOPs. If the employees decide that the ESOP should remain in place, regulations for the period after repayment (for example, rules for marketing shares) must be developed.[126] The ESOP is fully liable for its obligations. Members of the ESOP are not liable for its debts except for the securities already allocated to them. Until the shares are transferred to the plan participants the ESOP owns the shares. As for the exercise of property rights, participants have voting rights in proportion to their registered shares, but only up to a maximum of 5 per cent of the property acquired by the ESOP.

Tax exemptions for *'privatisation' ESOPs* allow the company to offer tax allowances for property sold to the ESOP as prescribed by the Corporate Tax Law. Accordingly, the company may deduct up to 20 per cent of the amount paid to the ESOP from its tax base. ESOPs were not subject to corporate profit tax until 31 December 1996. However, after that date, the income of ESOP falls under the rules of the Law on Corporate Tax and Dividend Tax, and, accordingly, 16 per cent tax is paid on their taxable income.[127] According to Personal Income Tax Law, securities transferred from the company to employees

123 Section 58 (3) of Law XXXIX of 1995 on Realisation of Entrepreneurial Property in State Ownership. This rule applies to ESOP credits as well.

124 Regulated by Law XLIV of 1992 on Employee Share Ownership Programme, which entered into force on 14 July 1992, amended with Law CXIX of 2003 and Articles 38-42 of Law CVI of 2007 on State Property.

125 Another difference between the American and Hungarian regulation was that under the 1992 ESOP Law there were no 'fairness' rules (this led to disproportionately large manager ownership); however, this was changed with the 2003 Amendments.

126 In absence of such legal regulations, the majority of ESOP organisations ceased to exist after the loans were repaid. Moreover, the established forms of operating the asset (for example setting up a limited company) involve considerable costs. See Boda et al. (2006).

127 Two special rules apply in calculating the ESOP tax base: (1) the tax base should be reduced by the amounts paid by private persons as their own contribution to the ESOP and by the amounts of subsidy paid by other private or legal persons or by the employer company (under general rules these amounts would have been considered income); (2) at the same time, the tax base must be increased by the acquisition value of the shares given to the ESOP participants (under general rules this amount would be accounted among expenditures, thus reducing the profit.

are tax free since they are not considered income; however, when the employee sells these shares, the proceeds are taxed at the capital gain rate of 20 per cent.[128]

Private Companies (1988) – Employees' shares, first introduced by the Law on Business Associations of 1988, still exist under the current law. They are registered shares and can be issued free of charge or at a reduced price in accordance with the provisions of the Articles of Association of the joint-stock company, for example, in the context of a Long-Term Incentive Plan or a broad-based Stock Option Plan. Employees' shares may be issued in conjunction with a simultaneous share capital increase of the joint-stock company, up to a maximum of 15 per cent of the increased share capital. A joint-stock company may pass a resolution entitling employee held shares to dividends from after-tax profits to be distributed amongst shareholders prior to the shares belonging to other categories or classes of shares, but following shares granting preferred dividends. In the event the employee dies or terminates his or her employment, except in the case of retirement, his or her heir or the employer has the right to transfer the employee's shares to other company employees within six months.[129] The employer company can distribute them free or at a discounted price, making this form of financial participation very attractive to employees. However, this form of share acquisition enjoys no tax incentives. Since 1 January 2003, income received in the form of securities is no longer regarded as an allowance in kind.[130] Thus, in the case of employees' shares, the difference between the purchase price and the sale price is subject to personal income tax.

Approved Employee Securities Benefit Programme (2003) – At the beginning of 2003, new legislation[131] came into effect allowing companies to set up state-recognised, tax-qualified stock plans. The organiser of an Employee Securities Benefit Programme has to submit an application for its recognition to the Ministry of Finance which informs the relevant tax authorities of its decision. To be approved, the programme must comply with certain proscribed conditions, for example, only securities issued by the applicant company or by its majority shareholder may be offered in the programme; statutory threshold levels of at least 10 per cent employee participation and a management share of less than 25 per cent representing less than 50 per cent of total share value. At the time of sale, the employee is taxed on the spread between exercise price and sale price. This capital gain is

128 See Section 18 (4) of Law XLIV of 1992 on Employee Share Ownership Programme and Section 66 of Law CXVII of 1995 on Personal Income Tax; Securities acquired from already taxed personal income of the participant of the programme are not taxable.

129 If this deadline expires without success, at the first shareholders' meeting thereafter the company shall withdraw the employees' shares in question with a corresponding reduction in its share capital, or shall decide to sell such shares after transforming them into ordinary, preference or interest-bearing shares.

130 The applicable rules of taxation are determined by the legal relationship between the private person and the provider. In the case of securities provided by employer to employee, such income is considered as income from employment, and the pertinent tax rules have to be applied. See Informant of the Tax and Financial Control Administration (APEH) on the Rules on Securities Allowance in Force from 1 January 2003. Source: Hungarian CD Jogtar (28 February 2005).

131 Law CXVII of 1995 on Personal Income Tax; Decree of the Ministry of Finance No. 5 of 2003 on the Procedure of Registration of Approved Employee Securities Benefit Programme, and on the Rate of Administration Service Fee for the Initiation of the Procedure.

taxed at 20 per cent, separately from other income.[132] Companies have no withholding or reporting obligations in connection with employee stock option or purchase plans. The first HUF 500,000 of the shares that have met vesting requirements are not taxable at exercise or vesting. Any shares deemed non-qualified are taxed as normal employment income (progressive scale from 18 to 38 per cent). Vested shares must be held in a security account overseen by a trustee during an obligatory three year vesting period which ends on 31 December of the second year after the securities have been acquired. At the end of the vesting period, employee shareholders enjoy the same rights as any other shareholder of the same class. The most recent amendment of the Law on Personal Income Tax (Act LXI of 2006) stipulates that gains of all share purchases and similar transactions should be added up in the given tax year and that in calculating the tax base, instead of the nominal value at the time of allocating the share option, the actual value at the time of purchase is the relevant number, not the nominal value at the time of allocation. At the same time, according to the interpretation of the officers at the Ministry of Finance, the amendment abolished the blocking period.

b) Profit-Sharing

Except for section 5 of the Labour Code, stating that an employer may grant any benefit to its employees if it is provided in a non-discriminatory manner, no regulations exist. There are neither tax allowances nor other incentives for profit-sharing; any kind of benefit paid to employees falls under the Personal Income Tax Law and there is no allowance for employers.

c) Participation in Decision-Making

Employee representatives make up one third of the supervisory board in companies with more than 200 employees. In companies with more than 200 employees having a two-tier board system (both a supervisory and a management board), the works council has the right to nominate one third of the members of the supervisory board. In companies with a single-tier board system (only a board of directors), employee participation at the board level must be regulated by an agreement between the works council and the company. This is a new development (prior to the 2006 legislation only two-tier board structures were possible), and it represents a potential weakening of employee representation at the board level, since there are no minimum requirements. Furthermore, Article 42 of the Law on State Property requires, that prior to adopting a decision concerning the sale of an enterprise under majority state ownership, the employees' representatives must be informed about any possible opportunities regarding the acquisition of ownership by the employees. Workplace representation in Hungary is provided by both local trade unions and (since 1992) elected works councils, with the balance between the two varying over time. After legal amendments initiated by the socialist government elected in 2002, only the union has the right to negotiate collective agreements.

[132] While personal income tax is payable because the shares are regarded as earned income, no social security contribution must be paid (earlier share benefits were regarded as in-kind benefits, belonging to the highest income tax bracket (44 per cent), and the social security contribution was also payable).