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## N E W S L E T T E R

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# Free enterprise knows no boundaries – or does it?

Dear Ladies and Gentlemen,

It is a cornerstone of our market economy system that an entrepreneur is free to organise his business according to his ideas and to invest his capital in such a way that, from his point of view, it guarantees maximum return. However, it often happens that expenditures are not recognised as tax deductible, and there will be reclaims, liabilities, or – worst case scenario – criminal proceedings might be opened against the entrepreneur for emptying his business. This raises the question how far 'free enterprise' really goes and where it ends. Below we have compiled the most important financial considerations. We have worked on the basis of a stock company with a majority shareholder as managing director. These considerations can be applied, with small variations, to other legal forms and structures as well.

**What are the boundaries for free enterprise?**
In principle, entrepreneurial freedom ends at the point where others' justified claims on the company are put at risk. Both trade law and tax law state that commercial activity and all expenditures carried out by the company need to "commercially motivated", i. e. they need to be based on sound business thinking.

When dealing with independent third parties, a businessman enjoys considerable freedom as long as he remains within the law, and there is the assumption that all deals agreed are in line with the market and are commercially motivated. As the interests of the businessman and his company are in line it can be taken for granted that he will not act in favour of an outsider and thus damage his own company.

However, the situation is entirely different once a company is doing business with related persons, for example with the owner himself, his spouse, his children or other close relatives. Here, it may be said, lies a greater or lesser conflict of interest between the interests of the company, as represented by the entrepreneur, and his own personal interests, which are also very close to his heart. The situation becomes quite delicate when it comes to setting their own salaries, bonus payments, expense allowances, contracts with relatives either with or without actual functions in the company, but also by making "business transactions" that are not primarily benefiting the company, but its owner. Among these are the provision of sports cars, expensive holidays, and payments by the company to cover private costs of living. In this particular area free enterprise is clearly restricted to the "at arms' length" principle: As any deal agreed with close relatives is not automatically considered to be in line with the market, all those who could potentially be harmed need to be provided with evidence that all transactions have been made as if they had been done with an independent third party.

**Which stakeholder groups should be taken into account?**

There are three categories of stakeholder groups as potentially injured parties:

***a) Creditors of the company***

The term creditor has to be taken in a broad sense and includes all third parties that are in a contractual relationship with the company and are thus entitled to either payments or services by the company. To this group belong employees, suppliers, customers and business partners. As long as your company continues to exist and ideally is even making profits, it almost seems impossible for you, as entrepreneur, to cause injury to these stakeholder groups, as only claims against your company exist. However, the situation will change dramatically should your company go into bankruptcy. By definition, in this case, there are insufficient financial resources available to pay off all your creditors' demands. On top of that, you lose control over your own company, and the bankruptcy administrators take over. Their main aim is to keep damage to the creditors at an absolute minimum. In such a case, all your earnings as entrepreneur are routinely scrutinised and, should the prospects be promising, claims for repayment will then be made. Additionally there may be a criminal aspect: Instead of claiming financial compensation by means of civil action and having procedural costs covered by the bankruptcy assets, it is a lot more cost-effective to file criminal charges against the entrepreneur, for example, for qualified misappropriation. In this case the public prosecutor's office will execute preliminary proceedings at public expense, and any civil claims can be asserted rather cost-effectively during the criminal proceedings.

***b) Tax authorities***

As the amount of taxes due is based on the financial figures of a company, the treasury might miss out even if the company is successful. Not only is the levying of corporation tax affected, but also the entrepreneur's taxes as an individual, as all salaries and dividends – if applicable – have an effect on the amount of taxes due. The tax authorities have their own complex set of regulations at their disposal, which allows them to determine what has been commercially motivated and what can be considered "at arms' length." Given the public nature of tax debt, any tax adjustments are rather easy to assess, and claims relatively easy to collect.
Should the tax authorities conclude that you are pushing the boundaries of free enterprise, as long as all facts are at least clearly recognisable in the annual statement, in salary statements and in the tax return, there will be any adjustments of not commercially motivated expenditures, taxed hidden reserves and hidden distribution of profits. This will turn out to be a rather costly matter (very often next to tax on profits and private income tax, the withholding tax will be imposed and cannot be reclaimed anymore in these circumstances); however, there is almost no risk of criminal proceedings.

On the other hand, if the tax authorities cannot easily recognise the facts as such, because they are hidden somewhere in seemingly legitimate positions in the annual statement, criminal proceedings could be started. In contrast to an incorrectly completed tax return, the financial statement is considered a legal record, and a falsified financial statement can thus be regarded as falsification of documents and so meet the conditions to start proceedings for tax fraud.

Social insurances (in particular AHV) fall into this stakeholder group as well, as their required payments are also dependent on the company's figures. This area is covered by specific regulations that are in some aspects identical to tax regulations, and in others, differ from them. These must be adhered to as well.

### *c) Minority shareholders*
Minority shareholders have, pro-rata, the same shareholders' rights and claims on the company as the majority shareholder. However, very often they are not in a position to enforce their legal rights, as they can be outvoted by the majority shareholder at any time. Without special provisions, this is even possible for someone holding 49.9% of shares. Accordingly, minority shareholders are at risk of being outsmarted by the majority shareholder. Commercial law, however, has a number of protective clauses for minorities, though these are restricted to the information rights, the right to call a shareholder meeting, and an increased quorum for specifically far-reaching company decisions, without much influence on the actual balance of power.

As a consequence, during disputes one must always assume that a minority shareholder who sees himself out positioned by the majority shareholder will throw the whole gamut of civil and criminal law at the issue.

## How can these risks be controlled?
The best way to keep these risks under control is to avoid injuring those stakeholder groups mentioned above or, if possible, not to have a stakeholder group at all. Try to run your company as carefully as possible, be always aware of any risks and always ensure a sufficient capitalisation so you do not run the risk of going into bankruptcy – then you have nothing to fear from your creditors. Think carefully whether you want to accept minority shareholders and whether they can be trusted to cooperate with you, both in the long term and through bad patches. Of all the stakeholder groups mentioned above minority shareholders often represent the most unpredictable risk. Minority shareholders are no threat only if you own 100% of all shares. In no circumstances will you be able to avoid the tax authorities and all their regulations.

Even if the risks of claims made against you as an entrepreneur can never be fully be eliminated, they can be held under control by cautious management of your company, by clearly separating business and private life, and last but not least, by a modicum of modesty. The core element of your risk management should be a clear and comprehensive documentation of all transactions. Several tools are available for this:

### *a) Approved expenses regulations*
Tax authorities are a bit prickly particularly when it comes to expenses, as legitimate expenses are exempt from tax. The minimum even you as majority shareholder and managing director should do is to adhere to the expenses regulations in the instructions to the salary statement. Even better is an expense policy, approved by the tax authorities that delivers a clear guideline for you and your employees and guarantees everybody is treated the same. Stick to these expenses regulations, as the tax authorities will assume you adhere to it at all times.

***b) Tax rulings***
In cases of complex and possibly tricky situations, you always have the option to inform the tax authorities about them in advance and thus come to a binding tax arrangement. This way you create transparency and legal certainty. Tax rulings are a widely used instrument in case of restructuring or intragroup transfer pricing. Equally, deals of a private nature, for example tax arrangements regarding a sports car used for representative purposes, can be secured with a tax ruling. Once you have agreed to a tax ruling then adhere to it, as the tax authorities will be convinced you do so all the time.

***c) Voluntary compensation report***
Since the "Minder Initiative", companies listed on the stock market must present a compensation report at the annual general meeting. This is not mandatory for companies in private ownership, but recommended on a voluntary basis in cases where there are minor shareholders. If you regularly announce salaries and bonuses and the criteria by which they are set, you create transparency and effectively avoid arguments being started by minority shareholders claiming to have been kept in the dark, and thus deceived.

***d) Employment contracts and bonus payment agreements***
What for your employees is a sine qua non cannot be wrong for you as an entrepreneur. Bindingly settle your private relationship to your company in writing and adhere to it. Should you wish to alter anything in it, then put it down in writing as well and, for example, have this signed by your minor shareholders as well.

It may be absolutely legitimate to work for a minimum salary at a company that is fully owned by you, and then pay yourself a hefty bonus payment after a profitable year. However, this course of action could create problems in a company with minority shareholders. On paper the bonus payment very often looks completely out of line with the minimal fixed salary, and cries of rip-off, fat-cat payments and wilful enrichment may be forceful. In this case it would be adequate to set a fixed salary in advance and also a bonus payment agreement, both in line with the market, that can both be scrutinised objectively, with clear criteria, and ideally have both of these also signed by the minor shareholders.

***e) Job descriptions and timekeeping for relatives***
Per se, employment of your spouse or your children in your company is absolutely legitimate and can be beneficial for your company, as these are people that you really trust, or they – as your potential successors – might even have a very personal interest that your company is thriving. However, it is a must that you have written employment contracts in line with the market.

However, not only are pro forma employment contracts with family members receiving a salary without actually doing any work problematic, they are also illegal. To avoid any accusations in case of a dispute, there should be a job description for all working family members, containing clear details of their functions and all their duties and competencies within the company. On top of that they should be required, like any other regular employee, to keep written time reports. Some public prosecutors have even argued that employing your own wife is legitimate only if there are annual performance reviews including joint setting of targets, and these also need to be recorded in writing. From our point this requirement is not tenable, but employing your spouse should not differ very much from a regular employee.

**Conclusion**
To summarise, it has to be said that, when dealing with independent third parties, free enterprise knows almost no boundaries. However, free enterprise reaches its limits once there is a conflict of interest, be it in deals with yourself or with your relatives, or where a third party is injured by terms not in line with the market. Prudence, a sense of proportion, and transparency through clear documentation are requisite.

Kind regards

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