Business Advice Series Part Two: Ten typical mistakes investors make in Hungary

Setting the house on a good foundation

Many decisive aspects of a company's future are determined during the time in which it is being set up. Any mistakes made in this phase, especially mistakes related to taxation, will become painfully evident as time goes on. Amending elements of the company can be very expensive, and often meets the resistance of other stakeholders. In the life of a company, its founding is already the first critical situation.

Although many investors opt to buy stakes in already existing companies, a business venture in Hungary often begins with the founding of a new company "of one's own," frequently in the form of a Kft (limited liability company). Next to choosing the form of company to establish, the most important act is composing shareholders' or partnership agreement of the company, that is, its charter.
Sole-owner companies do not have problems in this respect: the business owner writes his own charter and then during the further administration of the business he only has to be mindful of keeping to the formalities of that charter.

Many around the table
It is a different story when founding a company with several stakeholders. All essential decisions on the structure of the company are set in stone for years. Even after that, any amendment of the company's charter requires a unanimous vote. In addition, after years of productive collaboration, the owners often neglect to update the charter. This can add serious complications to the situation if the stakeholders later come into conflict. Although the most recent amendment of to the Corporate Entities Act makes it possible to bring suit to expel a stakeholder from a company, the procedure can be very drawn out, and the outcome is not predictable. In short: everything the investor neglects to do right in the beginning will come back to haunt him.
As I already mentioned in the previous article in this series: when setting up a multi-owner company, if you are not in a position to choose the chief executive of the company yourself, you should acquire at least 75% of the shares plus one vote. If the CEO were going to be someone from your own company, then it would be wise to have a stake of 50% plus one vote, in order to have control of the company.
Among the most important provisions in the company's charter are: those delineating the power and authority of the CEO, as well as of the power and authority of the companies that have the right of approval at the shareholders' meetings (the authority of the CEO to deal with third parties cannot be restricted, at any rate); provisions on the various types of requisite majority needed to approve given corporate actions; and stipulations governing company valuations conducted if stakeholders divest or if the company is dissolved.
When it comes to the question of voting strength, one must bear in mind that the other stakeholder should not be in a position to make decisions concerning important corporate actions - such as issuing new shares - by himself. It is, by the way, always easier to raise capital through capital injections rather than doing a formal capital increase, since this saves you the cost of the registration fees at the company court.
As regards the CEO: it should not be your goal to restrict the daily dealings of your company's top manager through a veritable straightjacket of a charter. At the same

time, there are certain internal actions that he should not be permitted to take without the approval of the stakeholders.
A CEO can be appointed for a maximum of five years. His contract is still valid if he is discharged from his appointment before his appointment expires, and he is no longer employed as the CEO but as "plant manager." This arrangement can end up being pretty pricey. You should link the responsibilities for running the company and the duration of the CEO appointment contract.

Taxing forms

The choice of company form is, in and of itself, the deciding factor that determines the company's tax obligations. Despite the fact that the EU Parent-Subsidiary Directive has introduced some simplifications - dividends paid to companies with major stakes in one another are no longer taxable - the form of the company, and to a certain extent the composition of its charter, sets the way investors' returns are taxed. Depending on which double-taxation treaty applies, dividend payments are subject to as little as five percent tax or as much as 15%. Moreover, it also makes a big difference whether the recipient of the dividend (either an individual or a company) is only deducting the withholding tax due in Hungary, or is getting a complete exemption from further taxation in his home country. This is something that should be co-ordinated between all of the Hungarian and foreign tax advisors involved.
The payout of a branch to its parent company abroad, for instance, is exempt from dividend tax in some double-taxation treaties, and can even end up being tax-free in the destination country. And, as before, interest payments from abroad (to private individuals), as well as royalties from abroad are still tax free in Hungary, a fact that should be considered at the time the company is being set up.
The relationship between the design of the charter and the level of taxes the company pays is a key consideration when it comes to real estate trading companies. The acquisition of property is subject to a ten percent property-transfer tax (though in Hungary it is called rather stamp duty). A company that lists the trading of real estate in its charter as its main activity can opt for a two percent tax, on the supposition that the property will be disposed of within two years, but this language must already be in the charter registered with the company court before the company buys the real estate.

The ‘Advice to foreign investors’ series points out recurrent pitfalls of doing business in Hungary, and gives helpful advice for running a successful business in Hungary.