

Funding demand side. Obstacles and prerequisites

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Capital funding in Lithuania:

an investors' paradise

OR

obstacle course?



Forms of funding

/ **Choice of company in demand of funds**

- Equity
- Mezzanine (junior, convertible loan)
- Bank (secured, senior) loan

/ **Often one company combines all 3**

Equity supply terms

/ **Fair dealing**

- Transparency and control
- Arms' length shareholders dealing with company
- Non-compete / non-solicitation with company

/ **Governance**

- Majority and minority representation
- Minority veto on major decisions
- Agreed voting on listed items

/ **Financing**

- Anti-dilution vs obligation to fund
- Dividends only after servicing all debt and company investment needs

/ **Exit**

- Initial lock-in
- Joint exit in foreseen future (drag along, tag along, joint sale)
- Right of first refusal

No security for shareholder loans

Rule

...when borrowing from its shareholders, the company may not pledge its assets to the shareholders...

Obstacle?

- / Ensure balance between the shareholders and other creditors of the company?
- / Restricted right for non-controlling shareholders vs full ban?
- / Capital maintenance rules as alternative

Capped interest rate for shareholder loans

Rule

...when company borrows from a shareholder, the interest may not be higher than the average interest rate offered by commercial banks...

Obstacle

- / Better treat interest as constructive dividend?
- / Mezzanine (junior, unsecured) financing always more expensive than loan financing
- / Taxation rule different: arm's length (not commercial bank) interest as an allowable deduction from company's profit up to thin capitalization ratio of 4:1

Financial assistance restricted

Rule:

... a company may not directly or indirectly advance funds, give loans or offer security for the discharge of obligations to third parties if such actions are aimed at enabling other persons to acquire shares in the company...

Obstacle

/ Rule circumvented in practice

- By merger of debtor SPV into the target and refinancing of bridge loan (tested in court)
- By dividend or other forms of distribution



Case: acquisition of UAB Bitė Lietuva:

- / The bidding company was merged with target company. The loan, granted for the purpose of acquiring UAB Bitė Lietuva, was pushed down onto the balance sheet of the target company

Then

- / Taxable profit of UAB Bitė Lietuva was reduced by accumulated interest as allowed deductions

However

- / The State Tax Inspection: “*such reorganization (merger of the companies) was not economically beneficial to the target, so deductions are not allowed*”; deductions are allowed only if such merger gives economic benefit to the target

- / Scheme seen as financial assistance matter only for tax purposes (still being tested in courts)

Classes of shares – no flexibility

Class of Shares

- / Lithuanian Company Law allows **ordinary shares** that carry a voting rights and **preference shares** (up to 1/3 of all capital) a with a right to cumulative dividend and with or without voting right.
- / BUT, the laws does not provide classification of shares with differentiated voting rights.

Obstacles

- / Dividend of preference shares is set as % of their nominal value (not flexible)
- / Different class of shares would help to attract new financial investors with customary protections while allowing founders to retain more voting power and operational control
 - In private companies this is usually solved with shareholders agreements
 - In listed companies this is not possible (in whole EU, not only Lithuania)

Holding structures – Lithuania vs Latvia

TAX	LITHUANIA	LATVIA
Corporate income tax (CIT) rate	Standard 15% For qualified SMEs 5%	15%
Dividends received from a SubCo	Tax exempt, if SubCo is not established in a statutorily designated low tax zone and: (1) SubCo is established in EEE and its profit is subject to CIT or (2) HoldCo owns >10% of SubCo for >12 months.	Tax exempt, if SubCo is not established in a statutorily designated low tax zone.
Taxation of capital gains from the sale of shares in SubCo	Tax exempt, provided: (1) SubCo in EEE or a country with a Double Tax Treaty and (2) SubCo is subject to CIT and (3) HoldCo holds >25% of SubCo for >2 years (in reorganization >3 years). In case HoldCo later distributes profit earned from the non-taxable income to a natural person (LT resident), the distribution will be taxed double with 15% CIT and 15% withholding tax. <i>E.g. in listed holding company capital gains paid to natural persons taxed, to legal persons - not taxed</i>	Tax exempt, if SubCo is not established in a statutorily designated low tax zone. In case HoldCo later distributes profit earned from the non-taxable income to a natural person (LV resident), the distribution will be taxed only once with 10% withholding tax.

Partnerships – prerequisites

Partnership (*lt. Ūkinė bendrija*) offers possibilities to:

- structure the capital;
- implement capital returns;
- flexible business management.

/ Law on Partnerships allows to follow good global practice – to incorporate mutual funds on the basis of Limited Liability partnership legal entity form.

Obstacles

- / The partnership in Lithuania is a taxation subject which is not tax transparent as in some other countries.
- / Under new Law on Partnerships not only general but also limited partners will have to be disclosed in the Register of Legal Entities, which makes them less attractive for purely financial investors that are limited partners.

Funds - prerequisites

Collective Investment Undertakings

- / For professional and non-professional investors;
- / Flexible management and investing
 - Lack of experience in regulation and supervision; EU best practices not always followed (e.g. diversification requirements during exit period)
- / Management activity of mutual funds is a subject to VAT exemption (exempt activities);
- / Funds are tax transparent (with some exceptions)

However

- / Activity of Collective Investment Undertakings is subject to licensing, which makes it slower and less flexible
- / There are certain drawbacks in tax regime
 - / E.g. contribution of shares into a fund by natural person are taxed as sale vs contribution to the holding company