

## Baltic Newsletter

Legal, tax and the economy – news from Estonia, Latvia and Lithuania

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### Dear reader:

The Baltic States no longer bring up the rear in overcoming the economic crisis. Media coverage on Estonia, Latvia and Lithuania has taken on a decidedly more positive slant lately, and while Estonia had shown remarkable prudence during the crisis, it may well be the surprisingly clear outcome of the recent Latvian elections that have helped most to create new confidence in the region. The introduction of the Euro in Estonia this coming January may well come to be the appropriate symbol of an incipient Baltic renaissance.

We can see it in our daily work: Investor interest in Estonia, Latvia and Lithuania is on the rise. It is not just EU-funded public infrastructure contracts that draw foreign companies back to the shores of the Baltic Sea; rather, investors discover the significant opportunities in the field of renewable energies, while logistics, manufacturing and the agricultural markets are regaining their traditional appeal.

The time, indeed, is right: Compared to five or six years ago, there now exist a large number of essentially robust companies that are well established in the market but very receptive to foreign money; wages are low and the tax and legal environment remains favorable. So there is reason for optimism, and word seems to be out.

Rödl & Partner will keep you posted – among other channels by way of this newsletter, the first issue of which you are reading right now.



Very truly yours,  
Jens Pastille  
Managing Partner Baltic States

## The Baltics after the crisis – A recovering economy opens opportunities for investments

“We know that you can turn an aquarium into fish soup, but how do you turn fish soup into an aquarium?” goes a Russian joke about the economies of the ex-Soviet states in the 1990’s. Only a short time later, the newly re-born national economies of Estonia, Latvia and Lithuania seemed to have mastered just this feat: Faster than anyone else in Central and Eastern Europe they exchanged their hardly competitive heavy industry for a flexible and innovative service economy, and adapted their legal and tax systems to the requirements of international investors. The three small countries were rewarded not only with EU membership, but also with rapid growth rates that resembled those of the Far Eastern “tiger states”. From 2005 to 2007, the Latvian gross domestic product grew by double figures each year, and Estonia and Lithuania were never far behind.

Most observers for the Baltic States predicted the “hard landing”, which indeed occurred. However, that the foreseeable end of the Baltic boom would coincide with a financial and economic crisis of global proportions was barely suspected by any of the players until the fall of 2008. Extremely cheap money provided by mostly Scandinavian banks had force-fuelled public and private spending in the heated years before, and when the same banks suddenly slammed the brakes on at the end of 2008, the result was a meltdown of private and public solvency. The currencies of the three countries, pegged to the Euro via the European Exchange Rate Mechanism II, became hopelessly overvalued, and talk of national bankruptcy was making the rounds. Literally overnight, politics and society as a whole found themselves confronted with mass unemployment and a collapse of spending power, with all the obvious social and budgetary consequences to boot.

Only two years later, the picture has changed completely. The crisis did consume the increase in wealth from the boom years, with the Baltic national economies now reaching about the level of 2005. And yet, the governments in Tallinn, Riga and Vilnius did not only make significant headway toward balanced budgets through fiscal discipline, but also managed to retain the external value of their currencies and the peg to the Euro. Unlike Latvia, Estonia and Lithuania were even able to forego assistance from the IMF and the European Union. And while Riga

did call an emergency loan of 7.5 billion Euros, the surprisingly stable and recently re-elected government can permit itself a tentative sigh of relief following two years of strict and enormously painful budgetary discipline that has won respect all across the European Union.

Driven by destabilisation fears and the looming danger of private debts mostly denoted in foreign currency, the Baltic States chose not to resort to devaluation in order to save whatever could be saved of their international competitiveness. Instead, a tough strategy of “internal devaluation” was applied, radical cuts in public spending decreased costs on all levels, while rising unemployment rates and dropping inflation aided the effort. Today, compared to before the crisis, all three countries have regained a satisfactory level of competitiveness in terms of wages, services, construction cost and real estate.

The numbers allow for cautious optimism, as, according to the forecasts of the EU commission, all three countries will in 2011 show a healthy growth of three to four per cent in their gross domestic products (GDP). Estonia, which will be entering the Euro zone come January, has already been able to record a moderate growth this year. But the fevered rush of the boom years has given way to a newly found sense of sobriety, and the Baltic renaissance does not come without challenge: High unemployment rates of more than 15 per cent will continue to be a structural problem. The crisis in Western Europe has for the moment slowed the exodus of well-educated and multilingual professionals to Scandinavia, Great Britain and Ireland, opening excellent recruitment perspectives for domestic and foreign investors. The very same effect, however, could rapidly become the greatest stumbling block on the path to full recovery. Without a sustainable turnaround on the employment market a new wave of emigration could drain the Baltics of skilled labor and once more let salaries rise to uncompetitive levels.

Positive figures and news are again arriving from the condemned financial sector. The Swedish market leaders in the Baltic States, Swedbank and SEB, have increased their results four-fold in the second quarter of 2010 year-on-year, not least due to their slowly recovering Baltic business. Good news also from the always suggestive M&A markets: The sale of companies and large assets in the three countries is no longer marked by rescue transactions; strategic acquisition and resale considerations have started to again inform the decisions of sellers and buyers. The pricing structure, however, now differs greatly from

the numbers called as recently as 2008: According to the latest study by the Latvian financial consultant Prudentia SIA, the average price for a Latvian company worked its way from eleven to 16 EBITDA down to a corridor of four to six EBITDA – good news indeed for foreign direct investment.

So now, is the crisis over in the Baltic States? We dare

to answer with a pronounced “yes”. However, economically complex times lie on the road ahead – they come not without risk, but also carry unique opportunities for the prudent, long-term oriented investor.

Jens Pastille, Attorney-at-law, Riga  
Nils Mroczkowski, Attorney-at-law, Riga

## Country News

### Estonia

#### Economy

##### Introduction of the Euro on 1 January 2011

On 1 January 2011, Estonia is introducing the Euro to replace the national currency the Estonian Kroon. Conversion shall take place at a rate of 1 EUR = 15.6466 Kroons. Bank balances will be converted with an exactness of 1 Euro cent with a rounding of the third decimal place. From the moment of the introduction of the Euro, all bank transactions and payments will be made exclusively in Euros. Accounts are to show the closing balance in Kroons, the exchange rate and the opening balance in Euros. There is no transfer period for deposit money, conversion shall be immediate. Prepayments and standing orders will be converted by the merchant banks. Contract provisions shall not be affected by the currency conversion; all contractual obligations shall continue to remain valid. No party has the right to demand an amendment or supplement to existing contracts on the grounds of the introduction of the Euro, as payment obligations in Kroons will by operation of law automatically convert to a corresponding obligation in Euros. From the date of the introduction of the Euro, Kroons and Euros will circulate as parallel means of payment for a period of 14 days. Following this period, coins and notes in Kroons will lose their validity. Special regulations apply to stamps and other documents that verify an executed prepayment: three months prior to the introduction of the Euro, all authorities are obliged to meet transfer phase regulations

for the validity of documents issued by the authorities. Value indicia (postage stamps etc.) will remain valid for at least three years. Tickets for public transport shall remain valid for at least three months. Other certificates verifying an executed prepayment will retain their validity until the date provided on the certificate. The retail industry has been under obligation to price their goods in Kroons and Euros since 1 July 2010. This obligation shall continue until 31 July 2011.

#### Tax

##### Social tax

Amendments to the law on social tax were implemented on 1 July 2010. These amendments are intended to promote new jobs for the unemployed and increase part time employment by decreasing social tax and making the calculation more transparent and fair: So far employers were obliged to base the social tax payable by an employee on the national minimum wage for a full time position, even if the employee was only employed part time. Now the social tax may be calculated based on the actual salary. If a worker is employed by several employers, a summary calculation of the social tax payable can be performed from two or more employment relationships.

##### Capital gains tax

On 1 January 2011 a law on tax exemptions for private investment will come into force. Until now the tax advantages of corporations and other legal entities did not extend to natural persons. In Estonia, retained profits of a company are not subject to taxation, which first occurs when dividends are paid to the owners of a company. In

order to create the possibility of tax-free reinvestment for natural persons, the Estonian parliament (Riikogu) passed the new law on 3 June. The law permits the opening of a specially designated investment account, through which gains can be accumulated for tax-free reinvestment.

## Law

### Energy law

The Estonian parliament (Riikogu) passed amendments to the Electricity Market Law on 28 February. Through this a partial deregulation of the electricity market took effect on 1 April 2010, launching a gradual process toward full liberalisation by 2013. This first step effects the establishment of an electricity exchange, where providers and industrial purchasers whose annual consumption is above two GWh can freely trade electricity. For lower consumption grades and private consumers free choice of the provider will become possible from 2013. The law further defines the scope of state aid for co-generation plants using biomass from forestry and agricultural industry.

### Residency law

From 1 October amendments to the Aliens Law have been implemented. With these amendments the requirements for the residency of foreigners for educational purposes in the Republic of Estonia have been stipulated more precisely. Applications for the granting of a short term residence permit can now be submitted by all foreigners, who have legally entered Estonia, legally reside there and require the residence permit for educational purposes. At the same time, the law reacts to the increasing influx of travellers across the open borders: Those operating commercial cross-border passenger transports to Estonia are now responsible for checking on a traveller's immigration status already at the point of origin.

## Lithuania

## Tax

### Ordinances and notifications from the fiscal authorities

By issuing a new ordinance the Ministry of Finance decreased the default interest on tax arrears to 0.03% per day of arrears, from the previous 0.04% in the fourth quarter 2010.

On 17 September 2010 the revenue authority supplemented the Directive to Art. 7 of the Property Tax Act in notice no. (18.40-31-1)-R-888. The Property Tax Act is not applicable to property owned by corporate entities when:

- This is a charity and the use is solely for charitable purposes
- If the corporate entity generates more than 50% of its income through agricultural activities within the tax period concerned.

By way of an Administrative Directive the highest tax inspectorate officially certified the application of the VIES (VAT information exchange system) and the EMCS (Excise Movement and Control System), effective 12 August 2010. The former system enables the cross-border transmission to data of VAT payers registered in member states as well as individual cross-border transactions, while the latter permits for the movement of goods subject to excise duty within the EU under a preliminary deferral of the obligation to pay tax.

## Law

### Commercial law

From 1 March 2010, amendments affecting the shareholders of closed corporations became effective. These concern numerous companies and require activity on the part of the company – altogether a less than investor-friendly increase in bureaucratic hassle and likely unsuccessful step to force more transparency in ownership.

Closed stock corporations, (UAB, the Lithuanian equivalent of a limited liability company) established prior to 01 March 2010 must now submit a list of shareholders to the Commercial Registry of the Republic of Lithuania (VĮ Registrų centras) by 1 October 2010. Until now, the obligation to register shareholders only applied in the event

that all shares were held by one person (sole shareholder). Information to be included ranges from data on the company and its shareholders to details on the time of acquisition of respective shares.

The list of shareholders is to be signed by the general manager of the company. Upon each amendment of the details stipulated above, a new list must be compiled and submitted to the commercial registry within five days. The company's General Manager is responsible for the compilation of the list of shareholders and for its submission to the commercial registry.

### **Law on Securities**

On 29 July 2010, the Lithuanian securities commission passed Directive no. 1K-5 (published in Valstybės Žinios, 2010, no. 92-4896), which supplements the provisions on the preparation and acceptance of mandatory offers with effect as of 4 August 2010. At the same time the provisions for the content and type of securities prospectuses were amended. Standards for the basic prospectus and the content of the addenda to the prospectus are provided in detail.

### **Criminal Law**

On 2 October 2010, amendments to the Criminal and Offences Law (Art. 1731) from 21 September 2010 (no. XI-1016) took effect. Hereinunder, offences with regard to financial accounting are pursued. A new fining framework was stipulated including for the following offences:

- Infringement of the duty to record business transactions – LTL 100 – 200 fine;
- Infringement of the duty to record cash and tangible assets – LTL 200 – 500 fine;
- In repeated cases of the above offences – LTL 500 – 2 000 fine.

## **Latvia**

### **Tax**

On 9 June 2010 amendments to the Income Tax Law (Par iedzīvotāju ienākuma nodokli) were implemented together with the Minister Cabinet's Directive No. 899 on the application of the Income Tax Law. In the following, we summarize the most important changes:

#### **Gifts, education costs and health**

The value of a gift received by a natural person is fully taxable if the gift applies to cover costs incurred through the participation in an educational programme at a Latvian or European Union accredited institution. However, expenses for education and medical care of family members are not deductible in the annual income tax return.

#### **Royalties and income from property**

Several popular tax loop holes have been closed: Not only author's fees but also royalties as well as income from property ownership, e.g. cellar, garage or storage space which do not constitute living space are now subject to the income tax.

#### **Business trips**

Expenses that a non-resident recovers from his Latvian employer for business trips to Latvia are not subject to income tax.

#### **Taxation of small companies**

On 1 January 2010 the law on the taxation of micro-companies (Mikrouzņēmumu nodokļa likums) took effect, in which the procedure for the collection of taxes from corporations (as well as sole traders and personal companies) whose turnover is no more than LVL 70,000 and who do not employ more than 5 employees is regulated. Tax benefits apply for these companies.

### **Law**

#### **Commercial Law**

On 1 May 2010 amendments to the Commercial Law (Komerclikums) came into force, creating limited liability companies (LLC) with low share capital, the so-called Micro-SIA. For such entity the share capital can be as low as LVL 1. However, the law requires that no more than

five shareholders are natural persons, all members of the board are also shareholders and none of the shareholders are shareholders of other Micro-SIAs. The Micro-SIA is further obliged to build a mandatory reserve of at least 25 % of the company's profit until LVL 2000 is reached (corresponding to the minimum capital of regular LLCs). In addition the shareholders are personally liable for the difference between the registered capital and LVL 2000.

### **Employment law**

Effective 25 March 2010, amendments to the Employment Law (Darba likums) broadened the rights of employers to terminate employment contracts. With the newly worded Art. 101 of the Employment Law, employers may now lay off employees who have been unable to work for more than six consecutive months or a total of 12 months within a period of three years as a result of illness. Excluded are pregnancy, maternity leave, proven employment related illness or incapacity as a result of an industrial accident.

### **Procurement and concessions**

On 7 September 2010 amendments to the law on public-private partnerships came into force, aiming to make the process of public tenders more transparent. The amendments affect a range of procedural issues, from the publishing of results in concession tenders to the conclusion of concession agreements, all the way over to the procedures and deadlines for challenging a concession award.

### **Immigration law**

On 1 July 2010 amendments to the immigration law (Imigrācijas likums) created additional possibilities for non-EU citizens to obtain a residency permit in Latvia. Under the new provisions, a limited residence permit for five years can be issued to a citizen of a third country, provided that person

- invests LVL 25000 in the share capital of a Latvian corporation and can prove a certain tax base in Latvia; or
- purchases real estate for at least LVL 100.000 in the Riga metropolitan area or another city, or LVL 50,000 in another location in Latvia; or
- makes a fixed deposit of LVL 200,000 for at least 5 years in a bank account located in Latvia.

The changes aim to attract investors, not least due to the Schengen privileges enjoyed automatically by any Latvian resident: Since 21 December 2007, a Latvian residency permit entitles to visa-free entry to the Schengen Zone for residency purposes for up to 3 months within a 6 month period.

## Internal

### **Ģirts Osis joins Rödl & Partner**

Our Latvian office welcomes a new member of our law firm: Ģirts Osis, former Senior Counsel with SEB (then Unibanka) and most recently member of the board at Danske Bank Latvia, joined our Riga office this summer to become Senior Counsel and head of the M&A team. With Mr. Osis Rödl & Partner gains one of the leading Latvian experts in transactions and financing.



### **Mart Nõmper heads Estonian branch**

A change of leadership took place in our Estonian branch in summer. The branch is now headed by Mart Nõmper, former head of the audit service line.



### **Strengthening of the audit service line in Latvia**

Through the appointment of Kaspars Rutkis, previously Big Four and most recently CFO with a large car importing company, as new head of audit, our Riga office can further strengthen its profile: Kaspars Rutkis is not only an experienced auditor but also a distinguished expert in transactions. He is supported by his new audit manager Sintija Kaņepe, who also sports a Big Four résumé.

### **New attorney in Tallinn**

Well prepared for the resurging M&A market is also Alvin, Rödl & Partner in Tallinn: The Estonian law firm of Rödl & Partner welcomes Ms. Kairi Kurisoo, a renowned M&A specialist, and so reinforces its strong position in the transactions business.

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