

**Arkadij Vocish, Olga Lukashina**

Baltic International Academy

## **INVESTMENT AND INCENTIVE POSSIBILITIES OF HOLDING COMPANIES IN LATVIA**

Latvian entrepreneurs are still very reluctant to utilise the form of a holding company in organisation of their business undertakings. They prefer to incorporate companies as limited liability companies (Ltd) instead. The situation as it is on November 5, 2007 shows that out of 55.3 thousand of registered businesses in Latvia only 202 (0.36%) operate as holding companies. There are more than 46 thousand (83.17%) limited liability companies<sup>1</sup>.

The above condition certifies that Latvian entrepreneurs do not realise the great investment, incentive and tax advantages provided for in the legislation of Latvia exclusively for holding companies. Therefore there is a clear need to promote the training and explanatory activities of the relevant direction.

Business in Latvia badly needs investments, in particular, taking into account the harsh competition among the EU countries it has to face. This need can be satisfied in two ways. First – attraction of investments for the equity investments (emission of shares of stock – ordinary shares, preferred shares, personnel shares). Another option is attraction of credit resources. The first of the above means improves financial stability indices of a firm, and the second one causes contrary consequences.

The special investment possibilities of holding companies are related to, first of all, the entitlement to emit shares, and second, to the exclusive (in comparison to other businesses) entitlement to issue convertible bonds. Let's look at these two possibilities of holding companies.

**Shares.** On the first glance, any closed commercial company seems not be deprived of the entitlement to increase its stock capital by means of attraction relatively free resources of new members. However, any such investor, who invests its financial resources or property (or even by means of capitalization of a company's liabilities towards it) in the stock capital of, for example, a limited liability company, is entitled to account for two new perspectives open to it. First of all, it is related to

---

<sup>1</sup> Distribution of businesses based upon the form of business organisation. Data from Lursoft data base – [www.lursoft.lv/ur\\_stat\\_19](http://www.lursoft.lv/ur_stat_19).

gaining more votes at the General Meeting, and consequently increased control over the company. It is based upon the stipulation of the Commercial Law of the Republic of Latvia that the voting rights of members of a limited liability company are distributed based upon the principle “one share equals one vote”. Secondly, the above investor of a limited liability company has its claims for a certain share of the company profit, which is distributed by the mechanism of dividend payments, and for an equal share of a liquidation quota.

A holding company, although its operation is essentially based upon the principle of proportional distribution of votes, dividends, liquidation quota and a share in the capital, still can quite freely escape the implementation of the above principle by means of emitting preferred shares and offering them to investors. First, such shares do not entitle their holders to have voting rights, and second, they restrict their entitlement to dividends payments and liquidation quota to a certain threshold established in the emission regulations of such shares. In such a way an emission of preferred shares and corresponding investments in the stock capital of a holding company do not result in increased control over a company by such shareholders.

The lack of control over a company by holders of preferred shares is valid until the moment while the company guarantees the payment of promised dividends to them. If such a payment is not made, these shareholders obtain voting rights, at the same time maintaining their preferred entitlement to receive dividends and the liquidation quota. It means that the emission of preferred shares serves as an incentive for other shareholders (having voting rights) to adopt resolutions on at least partial allocation of the profit of a holding company for dividends payment and not its complete direction towards the reserve or stock capital at the General Meeting.

Besides the above, a risk that investors – holders of preferred stock may obtain voting rights at the General Meeting, and consequently control over the company, encourages members of the executive and supervisory institution of a holding company (Management Board and Supervisory Board) to ensure a profitable operation of a company and not to permit the appearance of losses. A reason for that is an increased risk of presenting claims against them on reimbursement and a risk of changing members of Management Board and Supervisory Board.

Thus, when a holding company utilises its entitlement to emit preferred shares, on the one hand, it increases possibilities of receiving investments in equity capital of a holding company without investors obtaining control over the company, and on the other hand, it strengthens the system of incentives, forcing members of Management Board and Supervisory Board to manage the company focusing to the generation of profit and encouraging the voting members to adopt resolutions on at least a particular distribution of generated profit as dividends.

In relation to the above it is worth stating that amendments to the Commercial Law of the Republic of Latvia, valid as from May 21, 2004 even strengthen the above described investment and incentive possibilities of a holding company. Prior to the amendments the share of preferred stock in the equity capital of a holding com-

pany was restricted to 25% during first two years of operation and to one half of the equity capital later on. Now these restrictions have been deleted. Consequently, the share of preferred stock may be of any volume; however, it cannot amount to 100% of the equity capital because in such a case none of shareholders would have voting rights.

Investment and incentive possibilities related to emission of preferred shares are strengthened by another condition: according to the Law the existing shareholders, including holders of previously emitted preferred shares and personnel shares, are given priority rights in purchasing such shares.

Attraction of personal savings of employees of a holding company to investments in the equity capital serves as another incentive. First, it creates an interest of employees of a company in its efficient (profitable) operation. Besides, this type of incentive is even stronger than distribution of personnel shares free of charge, because such shares do not entitle them to voting rights even when the General Meeting of voting shareholders adopts a resolution on profit distribution. Second, the offer to employees of a company to subscribe for the preferred shares is advantageous to a holding company itself. This advantage is related to the possibility of at least a partial compensation for low wages subject to two types of taxes by means of payment of dividends no subject to any tax.

Another investment possibility of a holding company is based on the entitlement to emit shares into public (stock-exchange and out of stock-exchange) circulation. In this way a company has an option to attract resources of broad groups of population and other (business) subjects, including the ones, who do not wish to make their names public. However, it should be noted that quite a small part of potential issuers use this investment chance in Latvia.

As it was stated above, personnel shares do not present an investment importance for a holding company, first of all, because they are distributed to employees and management members free of charge, on the account of net profit of a company. Still, their role as an incentive causes a certain interest in them. The legal norm on the possibility of emission of such shares stipulated that a company (now it is only a holding company, and earlier also a joint stock company was included) presents shares to its employees for the purpose of increasing their being interested in the results of their work. Dividends on this type of shares are paid according to the same procedure as dividends on ordinary voting shares. Besides, these shares are also exempt from taxation, which should make the payment of dividends instead of high wages to employees, members of Management Board and Supervisory Board more profitable.

The above legal norm is not implemented because of several reasons. First, quite many holding companies (like any other companies) operate with quite a low profit or even losses instead of profit. It is quite often that profits are just not disclosed attempting to evade taxes. In the result, there is nothing to pay dividends from. Second, even holding companies operating with profit do not dare to distribute at least

a portion of such a profit as dividends. Most often voting shareholders decide to direct profit to the reserve fund or to leave it undistributed at the General Meeting. In such cases there is no purpose in obtaining personnel shares, because holders of these shares are not entitled to receive a liquidation quota, which presents the only chance to receive a part of the profit gained by the employer at some time. Third, without voting rights holders of such shares lose a chance to exercise any impact upon the shareholders' resolution on the destiny of the earned profit. It means that, on the one hand, the legal norms of Latvia as if create a tool of providing an additional tax-free incentive to employees; on the other side they create obstacles in the way to include these incentives to the actual mechanism of incentives in a company.

Thus, the wide "assortment" of shares allows a holding company to utilise exclusive possibilities of gaining additional investments in the equity (which means own) capital. Such investment strengthen the financial independence of a holding company, reduces the risk of insolvency of such a limited liability company and creates additional incentive for efficient (profitable) work (not available in a limited liability company).

However, investment possibilities of holding companies are not restricted to the above described ones. Besides the exclusive chance to attract resources into the equity capital, this type of a business form provides extensive possibilities for the attraction of loan capital. All the other businesses have to face a choice – either to look for additional resources from co-owners of a company (then it is possible to receive them in the form of a loan without the mandatory security), from their friends and relatives, or to approach external investors. In this case it will be necessary to provide a security or a guarantee. It is not always possible to provide such.

According to the currently valid and earlier legislation holding companies are permitted to issue bonds – special debt obligations equal to either registered or bearer securities based upon their legal status.

**Bonds** as debt obligations present investments in the loan capital of a company. Their issue allows to carry out an extensive advertisement campaign with the purpose to attract resources of both shareholders and company employees, as well as relatively free resources of external investors – natural, legal and other entities. The only possible incentive for purchasing bonds – securities of a private company – may be a higher interest rate than that offered by credit institutions for deposits. The profitable operation of a holding company serves as a guarantee of payment of promised interest on bonds. It can be inspected by investors based upon the data available in public reports of a holding company, or by means of participating in General Meetings (without gaining voting rights) or by means of implementing their rights "to familiarise with documents of a company to the extent defined by the General Meeting".

Legislation of Latvia does not restrict the amount of interest (profit) on investments in the form of bonds. Therefore theoretically this profit can be quite high and attractive for investors. No other form of business organisation presents a possibility

for such a broad attraction of investments of natural or legal entities with public announcement of such an attraction of borrowed resources based upon the promised (however, not guaranteed) interest income. This is an exclusive right of a holding company.

Legislation of Latvia provides for a certain legal protection of holders of bonds. It is stipulated that such securities of a holding company shall be convertible into shares. The term for such a conversion is stated in the regulations of issue of bonds.

The status of a holder of bonds and its rights externally are similar to the status and rights of a holder of preferred shares – both of them are investors of a holding company, they both can participate in General Meetings of the company without voting rights, they both are entitled to receive a defined interest income on their investments, they both gain voting rights in certain cases (when an issue involving an investor's interests is resolved). A holder of a convertible bond is as if a potential shareholder of a company. And still the rights of holders of such securities characterise one of the above as a co-owner of a company and the other as a creditor. It can be seen, first, in the fact that a holding company may leave a portion of its profit undistributed or to direct it to the reserve or equity capital. In this way the equity capital of the company grows or is accumulated. A holder of bonds, who has not converted its debt obligations into shares (prior to the capitalisation of debts), does not have any chances to receive its share of this accumulated equity capital. A holder of preferred shares, in its turn, has such a chance – however, only in the case, when its priorities are related not only to the special entitlement to dividends, but also special entitlement to the liquidation quota. If holder of preferred shares does not have the latter entitlement, their legal status within a company is actually very close to that of holders of bonds. The only difference is that in case of liquidation of a holding company or its bankruptcy holders of debt obligations will be accounted for as creditors and have higher chances to return their investment in the holding company than shareholders.

Possibilities of a holding company to issue bonds look quite attractive in legislation of Latvia. Still, this form of attraction of unsecured debt obligations has not become widely popular. Main reasons for it should be searched for in the tax legislation of Latvia containing huge restrictions, detaining conditions for attractions of large amounts of non-bank loans and credits.

Thus, the Law of the Republic of Latvia “On Personal Income Tax” imposes a tax of 25% upon interest payments to natural entities – residents and non-residents of Latvia. According to this norm, for example, the promised 8% annual interest on bonds turns into 6% after the application of tax. At the situation when bank deposits carry 5% annual interest and taking into account the increased risk of investment in private business the attractiveness of bonds is clearly reduced.

On the other side, the Law “On Corporate Income Tax” is also in force and it penalises a company issuing bonds. The Law stipulates that a company borrowing

funds shall clearly distribute its debt interest obligations into two groups for the purpose of assessment of the tax as follows:

- 1) payments to residents of Latvia,
- 2) payments to non-residents of Latvia.

The interest payments to the first of the above groups of creditors increase expenses of a company reduce its profit and taxable income – it means they are excluded from the amount subject to income tax.

The interest payments to the second of the above groups also are included in the borrower's expenses, first, and also reduce the profit. However, later this amount (full or partial) shall be included in the profit subject to income tax – it shall be reversed for the purpose of taxation.

The issue of how big portion of interest payments should be reversed for the purpose of taxation is solved individually by each borrowing company. Based upon the factors stipulated in the legislation, a company annually calculates the so called amount of permitted interest payments on credits and loans taken not from credit institutions of Latvia. One of such factors is the average short-term borrowing interest approved in the Republic of Latvia and published by the Central Statistics Board of Latvia. Without facing a risk of a tax payment a borrower can agree to pay the same interest rate increased by 20%. If an interest, which is double of the bank rate, is paid to holders of bonds – non-residents, the whole amount of the “difference” of paid interest is included in the profit subject to corporate income tax.

In this way the tax legislation of Latvia provides for the payment of taxes on bond interest. Such a taxation of an the same interest payments of both holders of bonds (creditor, investor) and a holding company – issuer of bonds (borrower) considerably reduces the potential possibilities of a holding company to issue bonds.

In the summary of the review of investment and incentive possibilities available to a holding company, the following can be concluded: despite the existing restrictions and obstacles in the legislation of Latvia, a holding company as a legal structure of business still has more opportunities compared to the other types of businesses.

## Literature

- Kommercheskij zakon (s izmeneniāmi na 1.01.2008), Seriā „Zakonodatel'stvo Latvijas Respubliki”, VIV, Rīga 2008.
- Nalogi. Sbornik aktualizirovannyh zakonov Latvii, Seriā „Zakonodatel'stvo Latvijas Respubliki”, VIV, Rīga 2008.
- Aigars Strupišese. Komerclikuma komentāri. III sējums. B daļa. Kapitālsabiedrības. Rīga, A. Strupiša birojs 2003.
- Netners K., Nodokļu plānošana, RTU, Rīga 2007.
- Lukashina O., Rekomendāciji po izucheniu nalogovogo zakonodatel'stva Latvii, VIV, Rīga 2008.

---

## **INWESTYCJE I ZACHĘTY INWESTYCYJNE DLA SPÓŁEK HOLDINGOWYCH NA ŁOTWIE**

### **Streszczenie**

Artykuł jest przeglądem zachęt inwestycyjnych dla spółek holdingowych na Łotwie. Jego konkluzja jest następująca: mimo istniejących ograniczeń i przeszkód w ustawodawstwie tego kraju spółka holdingowa ma większe możliwości inwestycji niż inne formy prawne biznesu.