The Real Estate M&A and Private Equity Review

Third Edition

Editors
Adam Emmerich and Robin Panovka

The Law Reviews

THE REAL ESTATE M&A AND PRIVATE EQUITY REVIEW

THIRD EDITION

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This article was first published in September 2018
For further information please contact Nick.Barette@thelawreviews.co.uk

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Published in the United Kingdom
by Law Business Research Ltd, London
87 Lancaster Road, London, W11 1QQ, UK

www.TheLawReviews.co.uk

ISBN 978-1-98765-12-3

Printed in Great Britain by
Encompass Print Solutions, Derbyshire
Tel: 0844 2480 112

ACKNOWLEDGEMENTS

The publisher acknowledges and thanks the following law firms for their learned assistance throughout the preparation of this book:

AKALIN ATTORNEYS AT LAW

ALI BUDIARDJO, NUGROHO, REKSODIPUTRO

ARENDT & MEDERNACH

ARTHUR COX

ASHURST LLP

BINDER GRÖSSWANG RECHTSANWÄLTE GMBH

BIRD & BIRD (INTERNATIONAL) LLP

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WARDYŃSKI & PARTNERS

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LATVIA

Gints Vilgerts and Linda Berzina[1]

I OVERVIEW OF THE MARKET

The Latvian real estate market can be described as a traditional market with mostly standard transactions. The most common forms of real estate deals are as follows:

a purchase of assets or business of the target company, including purchases of separate real estate or in combination with other assets (e.g. office building with all lease agreements);

b purchase of shares in the target company which in turn owns the real estate (it is common to incorporate additional special purpose vehicles into the overall holding structure);

c mergers or demergers of companies; and

d acquisition of the real estate by using a contractual joint venture.

Purchase of assets (business) and purchase of shares are the most common methods of structuring real estate deals in Latvia that are also preferred by financing banks. However, most of the high-value real estate transactions are engineered as sale of shares plus creation of a buying entity (with or without an in-kind investment of the real estate into the share capital of the target company) owing to a high real estate transfer tax (2 per cent from the value of the deal). Owing to potential high tax consequences, tax planning is required part of any transaction.

In recent years, market activity has been stable, and no major changes have occurred. Investors from Scandinavia, the Baltic states and the United States are interested in investing in properties in the retail and office markets, and, thus, transactions in retail and office markets constitute most of the transactions in the market.

Although it is stipulated that direct Nordic and international investments are few[2] in Latvian market, over the past few years we have nonetheless seen globally recognised investors entering the market for the first time – Blackstone, Partners Group, Lone Star Funds, etc.

With respect to public real estate companies, real estate investment trusts (REIT) and real estate private equity (PE) firms – the Latvian real estate market deals with these entities from other jurisdictions when they acquire assets (business) or shares in target companies in Latvia. Usually, a local company is established for the management and development of the investment project in Latvia.

1 Gints Vilgerts is a partner and Linda Berzina is an associate at Vilgerts.

2 Colliers International, 'Real Estate Market Overview: Annual Review 2017' on Latvia (for 2016).

The industrial real estate market attracts mostly local and international companies in order to meet their business needs, and investments are made into real estate to improve their core operations. Real estate developers are active in the residential real estate market and a number of residential projects are under way. Apartments are sold mostly to residents and, in substantially smaller proportion, to non-residents.

Activity in the land market segment has been steady and recent transactions show positive trends in multi-apartment residential and mixed-use developments (e.g., Swedish retailer IKEA acquired land to build its store and plans to finalise the construction and open the store in autumn 2018).

II RECENT MARKET ACTIVITY

In Latvia there are no official specific market and transaction reports, and usually information is gathered and reported by key players in the real estate market such as Colliers International and Ober-Haus Real Estate Advisors.[3]

i 2015

According to Colliers International, 2015 was a record post-crisis year in terms of investment;[4] however, Ober Haus has more down-to-earth opinion, indicating that in 2015 the number of deals and their value were at the same level as in the previous year.[5] In any case, several transactions in 2015 are worth mentioning.

The top transactions in the retail market in 2015 were as follows:

a Blackstone Real Estate Partners IV, the largest real estate private equity firm in the world, acquired real estate portfolio in Latvia (shopping centres in Riga: Alfa, Mols and Dole) from Norwegian Obligo Investment Management AS; as part of the agreement Blackstone entered into agreements with 10 funds managed by Obligo to acquire portfolios in Norway, Sweden, Finland, Latvia and Germany in an all-cash deal;[6]

b Partners Group, the international private capital company, purchased a real estate investment portfolio in Poland and the Baltic states, including the Olimpia shopping centre, from BPT Optima (subsidiary of the Danish investment company). The value of the transaction amounted to €163 million; and

c Hili Properties, a commercial real estate company headquartered in Malta, acquired nine retail centres throughout Latvia by purchasing shares in several target companies.[7] The deal amounted to €22 million.

3 According to the most recent market reports of the key players in the region – Colliers International, Ober-Haus Real Estate Advisors, CBRE Group, ORDO Group etc. Available at www.liaa.gov.lv/en/business-latvia/real-estate-market-research (accessed on 19 July 2018).

4 Colliers International, Latvia Real Estate Market Overview, Annual Review, 2016.

5 Ober Haus Real Estate Market Report, Baltic States Capitals, 2017.

6 www.ellex.lv/en/news-events/290?fid=897#ellex-klavins-advised-blackstone-in-the-largest-property-deal of-the-nordic-region-since-2008_7482 (accessed on 19 July 2018).

7 www.sorainen.com/en/Deals/4537/hili-properties-acquires-shopping-malls-in-latvia (accessed on 26 June 2017).

The top transaction in the office market in 2015 was the acquisition by EfTEN Capital, an independent Baltic commercial real estate fund manager currently managing three funds, of the Duntes Biroji Biznesam real estate. EfTEN entered the market in 2013, when it acquired a property near Riga, where it was planned to build a local shopping centre.

ii 2016

The top transactions in the retail market in 2016 were as follows:[8]

a Lone Star Funds, a global private equity and real estate investment fund, acquired Riga Plaza shopping centre. The value of the transaction amounted to €93.4 million; and

b EfTEN, an independent Baltic commercial real estate fund manager currently managing three funds, acquired the Domina Shopping shopping centre. The acquisition value was €74.5 million. The transaction was partly financed by Nordea bank in the amount of €45 million.

The top transactions in the office market in 2016 were as follows:

a Baltic Horizon Fund, an Estonian regulated closed-end contractual investment fund, acquired the Upmalas Biroji building;[9]

b Laurus Fund, a joint venture of the clients of the Swiss investment company Partners Group and Northern Horizon Capital, acquired the Geneba portfolio consisting of 42 properties in Latvia, Lithuania and Estonia from Geneba Properties NV, a Dutch commercial real estate company. The most important properties in the sold portfolio were the SEB bank buildings in the Baltic states;[10]

c Pillar Investment acquired the headquarters of AirBaltic for €6.2 million; and

d a group of private investors acquired the SWH Biroju Centrs building.

iii 2017

2017 was an active year with interesting transactions to report in the retail and office market, such as:

a the construction works of new shopping centres have commenced with completion expected in 2018–2019 (e.g., the Akropole centre in Riga, with a construction budget of €100 million);

b expansion of the existing Alfa and Origo shopping centres;

c a subsidiary of a Latvian shipping company sold the Preses Nams real estate to PN Project SIA, which is managed by Lithuanian real estate and private equity company Lords LB Asset Management. The transaction value amounted to €16.8 million; and

d in the office market: Z-Towers, Place 11.

vi 2018

So far, the following transactions should be mentioned, including ongoing transactions mentioned in 2017:

8 www.db.lv/ipasums/nekustamais-ipasums/top-10-investiciju-darijumi-latvija-komercipasuma-2016-gada-458752 (accessed on 19 July 2018).

9 www.sorainen.com/en/Deals/5144/baltic-horizon-to-acquire-upmalas-biroji-office-building-in-riga (accessed on 19 July 2018).

10 https://www.cobalt.legal/en/news-cases/cobalt-advised-geneba-in-sale-of-baltic-real-estate-portfolio-to-laurus (accessed on 19 July 2018).

a East Capital Baltic Property Fund III acquired Galleria Riga shopping centre. The sellers of the center are Fritrade SE and Titan Invest A/S. East Capital Baltic Property Fund III is a real estate fund established by East Capital in August 2015. It invests in high-quality commercial properties with well-established tenants in attractive locations in Tallinn, Riga and Vilnius. The equity capital of the fund is €100 million and it is targeted to institutional investors; and

b East Capital Baltic Property Fund III acquired P5, a newly built A-Class logistics and industrial park in Riga, Latvia. The total transaction price for the property was publicly announced and amounted to €10.6 million.

III REAL ESTATE COMPANIES AND FIRMS

i Publicly traded REITs and REOCs – structure and role in the market

REITs and REOCs from other jurisdictions are active in the Latvian real estate market. The said entities acquire cash-generating investment projects in Latvia and then manage and develop the projects by establishing local companies (usually private limited liability companies).

One of the REITs active in the Baltic states market is Baltic Horizon, which is the first listed Baltic REIT investing in commercial properties, including in Latvia. Baltic Horizon, which acquired an office building in Riga in 2016 (see above), is managed by Northern Horizon Capital AS, a subsidiary of Northern Horizon group. Northern Horizon Capital AS is a licensed alternative investment fund manager and is supervised by the Estonian Financial Supervision Authority.[11]

ii Real estate PE firms – footprint and structure

There have been no major real estate PE companies established in Latvia, but real estate PE firms from other jurisdictions, mostly EU based, are present in the Latvian real estate market.

IV TRANSACTIONS

i Alternative investment funds

Real estate-related operations of investment funds are regulated by the provisions of the Law on Alternative Investment Funds and their Managers.[12] Real estate acquired by an investment fund must be registered under the name of the investment management company managing the fund. Assets of the fund may be invested in real estate located in Latvia, the EU, European Economic Area or Organisation for Economic Co-operation and Development Member States, or other countries, specified in the prospectus once the real estate has been valued and the valuation is approved by an independent expert panel appointed by the management company.[13]

11 www.baltichorizon.com/ (accessed on 26 June 2017).

12 In force, as of 7 August 2013 (as amended on 30 March 2017).

13 https://www.bank.lv/en/statistics/information-for-data-users/lists/investment-funds-of-the-republic-of-latvia (accessed on 28 June 2017).

ii General overview of legal framework

The Latvian legal system is based on the civil (continental) law system. The main source of real estate law and civil transactions in Latvia is the Civil Law of the Republic of Latvia.

The main laws to be considered when entering into agreements in Latvia are, *inter alia*, as follows:

a the Commercial Law,[14] governing all company matters, including special commercial transactions;
b the Competition Law,[15] which deals with merger control and all other aspects of competition law;
c the Group of Companies Law,[16] which deals with company groups, holdings and multi-layered company structures;
d the Financial Instruments Market Law,[17] if the companies' bonds or shares are publicly traded;
e the Law on Governance of Shares and Companies of Public Bodies,[18] dealing with, *inter alia*, sale of shares of public bodies;
f the Insurance and Reinsurance Law,[19] governing acquisitions of shares in insurance companies or their portfolio;
g the Credit Institutions Law,[20] governing transactions with the shares (or transfer of loan portfolios) in banks or similar financial entities; and
h the Insolvency Law,[21] which applies if a target company is insolvent and distressed assets are acquired.

iii Deal structures

As was already mentioned, purchases of assets (business) and purchases of shares are the most common methods of structuring real estate deals in Latvia, and those will be discussed in more detail in this subsection. Because of high real estate transfer tax (2 per cent of deal value), most high-value real estate transactions are engineered as sales of shares after in-kind investment of the real estate into the share capital of the target company.

Purchase of shares

When purchasing shares in a target company, the main steps are as follows.

a Outlining the terms of the deal – the standard practice in all major business transactions is to sign a letter of intent (LoI) between the potential seller and potential buyer. The LoI outlines the terms of a deal and serves as an 'agreement to agree' between the parties, including price calculation method, time frame, confidentiality, exclusivity clauses and other provisions. In some cases the LoI only serves as a summary of agreed

14 In force as of 1 January 2002 (as amended on 15 June 2017).
15 In force as of 1 January 2002 (as amended on 5 October 2017)
16 In force as of 27 April 2000 (as amended on 16 March 2006).
17 In force as of 1 January 2004 (as amended on 26 October 2017).
18 In force as of 1 January 2015 (as amended on 15 March 2018).
19 In force as of 21 July 2017 (as amended on 3 May 2018).
20 In force as of 24 October 1995 (as amended on 1 March 2018).
21 In force as of 1 November 2010 (as amended on 31 May 2018, in force as of 1 July 2018).

terms between the seller and the buyer. Therefore, the LoI can include provisions that are both binding and non-binding, although in a standard transaction the LoI is binding.

b Due diligence process (DD) – once the LoI, or at least a confidentiality agreement is signed, the DD process commences, including legal, financial, technical, tax and other due diligence checks. The aim of the DD is to identify any potential risks that are likely to have a negative effect on the asset (business) or share value, and that need to be addressed in the share purchase agreement (SPA). Risks identified during DD can result with price adjustments, increased guarantees or even be a deal breaker.

c Negotiating transaction documents – in parallel to the DD process, the parties start negotiating the terms of the SPA and other transaction documents (e.g., corporate documents, financing documents – refinancing, pledges, etc.). In our practice, the first draft of the SPA is provided by the buy side.

d Signing of the documents – when the parties have agreed on all terms and conditions of the SPA and other transaction documents, signing of those documents takes place. The transaction can be structured as a simultaneous signing and closing or as a deferred closing. Deferred closing is more common.

e Payment of the purchase price – the standard practice in major business transactions is to open an escrow account in a bank (based on an escrow account agreement between the seller, the buyer and the bank), where the buyer transfers the purchase price. The funds are released from the escrow account in one or several tranches upon completion of specific conditions prescribed in the SPA and the escrow account agreement (e.g., resignation of the existing management board of the target company, termination of the agreements, completion of the constructions works, etc.), and the financing documents (e.g., registration of commercial pledges on the shares and assets, mortgage on the real estate, subordination of payments, etc.).

f Closing the transaction – the time for closing the transaction is required for the seller and/ or the target company to obtain any consents required for change of control or merger clearances, as well as to provide other documents and perform other acts required for closing, so that the title to the shares and control of the target company can be transferred from the seller to the buyer on the closing date. These include, for example, change of the target company's management board to ensure transfer of control to the buyer on the closing date.

Depending on the complexity of the transaction and the business type of the target company (e.g., whether it is a regulated company), and whether the purchase of shares of the target company is considered a merger under Latvian Competition Law, the time required for closing the transaction can vary from a couple of weeks to several months after signing the SPA and other transaction documents.

g Registration with the Latvian Register of Enterprises – according to the Latvian Commercial Law, changes to the (1) articles of association, (2) the management board and supervisory board, (3) the legal address of the target company, and (4) notification of change of shareholders of the target company, and other changes are to be registered with or notified to the Register of Enterprises, or a combination of these. In particular, the buyer shall disclose the ultimate beneficial owners of the Latvian company in the public register.

h Post-closing issues – there may be ongoing ties between the parties. Initially, it is likely that the parties will cooperate in determining the purchase price adjustment to reflect the amount of working capital or other net assets of the acquired company or assets at closing. The purchase price can also be adjusted if the seller's representations and warranties turn out to be untrue.

Purchase of real estate (assets or business)

When purchasing a real estate, the main steps are as follows.

a Signing of the real estate purchase agreement – the first step is the signing of the real estate purchase agreement. If the real estate is complex, it is possible that the parties sign an LoI or confidentiality agreement and carry out a DD process for the real estate, and enter into a purchase agreement only afterwards, as in share transfer deals.

b Escrow account agreement – once the real estate purchase agreement is signed, the parties enter into an escrow account agreement with a bank, and the buyer transfers the purchase price or part of it to the escrow account. The funds remain in the escrow account until the parties have fulfilled all the conditions for the release of the funds, in one or several tranches.

c Fulfilment of conditions – conditions that must be fulfilled by the seller or the buyer depend on the specifics of the real estate, but usually the seller needs to obtain refusal to exercise the rights of first refusal from the municipality or a third party; the seller must terminate certain agreements, etc.

d Application to the Land Register – the parties sign an application to the Land Register for registration of the buyer's title to the real estate in front of a notary public. One of the parties, usually the buyer, covers the state and stamp duties.

e Filing with the Land Register – the signed documents are filed with the Land Register. Usually the agreement sets strict time limits for each of the actions to be taken by the respective party.

f Transfer of the purchase price – once the buyer is registered as the owner of the real estate, the bank transfers the purchase price or the remaining part of it to the seller's designated bank account. Mortgages and prohibition notes are registered or deleted depending on the transaction.

Please note that the above is only a general overview of standard and straightforward share purchase and real estate purchase deals.

Portfolio deals

Foreign investors enter into portfolio deals as they provide sufficient diversification and volume, a larger market share and reduce overall risk and relative costs.

iv Acquisition agreement terms

The main terms of a standard acquisition agreement are, *inter alia*, as follows.

Purchase price calculating methods

One of the main provisions of the agreement is the method of calculating the purchase price and adjusting it post-closing.

Transfer of title

The title to the shares transfers when the new shareholder is entered into the shareholders' register and the entry is signed by the relevant parties before a notary public or in the Register of Enterprises.

Conditions precedent

Conditions that must be fulfilled by the seller or the buyer depend on the specifics of the real estate or the target company.

Representations and warranties

These depend mainly on the DD findings reported to the buyer; there are standard representations and warranties (e.g., that the seller is the sole owner of the shares or real estate) and specific representations and warranties (e.g., with respect to patents, environmental issues and licences).

Governing law

In the case of private share and asset transactions, the parties may choose the governing law. However, some aspects of the transaction are always governed by Latvian law (especially in relation to registration of the shares or real estate transfer, as well as other mandatory requirements).

For instance, the Commercial Law prescribes the documentation necessary in the event of reorganisation (shareholders' decisions, reorganisation agreement, auditor's reports, etc.) and what procedures should be followed (always ensuring that the interests of the shareholders and creditors are duly considered). In the case of a public offer, the necessary documentation and information to be included is prescribed by the Financial Instruments Market Law.

It is acceptable for a transaction to be subject to non-Latvian law, but owing to its connection with Latvia it might also be necessary to execute local transfer documents.

Dispute settlement

Latvia employs a three-tier judicial system. Alternatively, legal disputes can be settled by arbitration. In accordance with provisions of the Civil Procedure Law, any kind of evidence, including oral, is admissible. No evidence has priority over other evidence, and the court is obliged to assess any evidence provided by the parties.

In certain cases, the court may rule on securing claims of a financial nature prior to or during the proceedings. The security may include, *inter alia*, an encumbrance endorsement or a pledge-rights endorsement on real estate.

v Hostile transactions

The laws of the Republic of Latvia do not make any distinction between friendly and hostile transactions and the same regulatory framework is applicable in both cases.

vi Financing considerations

There is no special regulation with respect to financing for transactions in the laws of the Republic of Latvia and the parties are free to reflect on the financing method in the transaction documents. However, the choice of the financing method is based on various interrelated aspects – tax considerations (e.g., transfer pricing issues in case of related party financing, etc.), especially considering the new tax regime in force as of 1 January 2018, requirements of the financing bank(s), etc.

Obtaining financing by the buyer may be set as a precondition of the transaction. The financial provider may require registration of a charge (called a 'commercial pledge') over the target shares or a mortgage over the real estate, which is usually required to be registered simultaneously with the registration of the share transfer or the real estate transfer. Typically, that requires the consent of the seller and its creditor, but in practice they are not supportive.

vii Tax considerations

Corporate income tax in real estate deals

Share transfers are generally corporate income tax neutral. However, asset deals (and sometimes also share transfers) could form the corporate income tax basis.

Non-resident companies are taxed on their Latvia-source income through permanent establishment at the standard corporate income tax rate. If no permanent establishment is created, non-residents may be taxed with 3.75 per cent withholding tax (WHT) for qualifying payments.

Acquisition of real estate

Non-residents are required to pay the standard rate that amounts to 3.75 per cent of the purchase price of the real estate, or the cadastral value of the property, or valuation for mortgage purposes, whichever is higher.

If a real estate is invested in the share capital of a company, state fee is 1 per cent of the investment value. If a company acquires the title to the real estate because of reorganisation, the company is exempt from paying the state fee.

Sale of real estate

Several taxes may apply and those are:

a Value added tax (VAT) – sale of a new building is subject to VAT of 21 per cent. A building is not considered new, if at least a year has passed since the respective building has been put into an operation and the building has been used. In addition, in Latvia alternative VAT treatment exists – the 'option to tax'.

b WHT – WHT rate of 3.75 per cent is applicable in case a Latvian resident company purchases real estate in Latvia or shares in a real estate company from a non-resident. Tax refund is possible.

c Personal income tax (PIT) – individuals, sellers of the shares may also be taxed at the rate of 20 per cent on capital gains.

d Transfer pricing (TP) rules are applicable if transactions (sale, loans) are between related parties. A transfer price must be at arm's length. That means it must match the market price that two independent entities would apply in a similar transaction under the same or similar (comparable) conditions. Failure to do so might lead not only to tax surcharge but also penalties.

Real estate tax

Real estate tax is payable for all land and buildings in Latvia, owned both by individuals and companies. The local authorities in Latvian regions and towns are free to set tax rates on real estate in their area from 0.2 per cent to 3 per cent of its cadastral value, otherwise tax rates are defined by state apply. A tax rate exceeding 1.5 per cent of cadastral value may be charged only if the real estate is improperly maintained.

Tax due diligence

It is always advisable to carry out tax due diligence of the target company prior to closing of the transaction. If the accounting of the target company has been inaccurate in any aspect, then the risk is high that the Latvian tax authority will spot these inaccuracies during its audit and will impose a substantial fine on the target company.

viii Cross-border complications and solutions

Cross-border transactions are usually structured as sales of shares. Cross-border mergers are also possible, in which case the regulation on cross-border mergers prescribed by the Commercial Law (implementing EU directives) should be observed. Establishment of a European Company (Societas Europaea) is regulated by EC Regulation No. 2157/2001 (which is implemented by the Law on European Companies).

V CORPORATE REAL ESTATE

The Latvian real estate market is at an early development stage with respect to REITs and REOCs, and therefore there are no major and noteworthy transactions to report.

VI OUTLOOK

In the coming years, it is planned to improve the investment environment and legal framework governing the real estate market in Latvia, to make the industry more competitive. Representatives of the industry have undertaken to double the amount of annual investment in real estate by 2020 to achieve at least €600 million per annum, as agreed by and between the Ministry of Economics, the Ministry of Environmental Protection and Regional Development and representatives of the industry in the signing of a memorandum of understanding on 7 June 2017.[22]

Furthermore, the National Alliance of Real Estate Developers has undertaken to facilitate this contemplated increase in the volume of investment by 2020. This is likely to attract Nordic and international investors.

22 http://nniaa.lv/lv/zinas/nekustamo-ipasumu-attistitaji-apnemas-nozare-piesaistit-ne-mazak-par-600-miljoniem-eiro-gada (accessed on 26 June 2017).

Appendix 1

ABOUT THE AUTHORS

GINTS VILGERTS

Vilgerts

The practice of Gints Vilgerts, LLM, is mostly focused on all aspects of M&A, corporate restructuring and real estate, and on complex commercial dispute cases.

In the course of practising in Latvia and abroad (Russia, Belarus, Lithuania and Estonia) for the past eight years, he has participated in more than 50 transactions of total deal size in excess of €2 billion, for clients from more than 10 jurisdictions. Gints Vilgerts has also been a guest lecturer at the Stockholm School of Economics in Riga, Riga Graduate School of Law and Riga Business School.

Gints Vilgerts is a *Chambers Europe* and *The Legal 500* recommended practitioner in Latvia in the areas of M&A, corporate, real estate, construction and finance law.

Chambers Europe 2014: 'He puts everything into a business perspective and has brilliant ideas for how to solve our problems. He comes up with amazing solutions.'

The Legal 500 (2012): 'Excellent negotiation skills'; 'Vilgerts has always been impressive, and his work remains equally so, chiefly due to the level of service and quality of output.

Gints is included in Best Lawyers for Latvia in 2016, in the following practice areas: banking and finance law, corporate and M&A law, litigation and real estate law.

LINDA BERZINA

Vilgerts

Linda Bērziņa, LLM has been practising law since 2008 and is part of corporate, M&A and real estate and construction teams at Vilgerts.

Linda has gained extensive experience advising clients on all aspects of corporate law, ranging from day-to-day corporate matters, also standard company formations, liquidations, reorganisations and share transfer deals to complex corporate law aspects.

Linda is constantly involved in M&A transactions representing both sell-side and buy-side in various business sectors. Linda supports the M&A team through all stages of the transaction.

In the real estate and construction fields Linda consults wide range of clients: local and foreign investors, real estate developers, constructors. Linda represents clients in property sale and purchase transactions (both single properties and property portfolios), development of legal documentation, also she consults clients in complex lease issues and agreements on construction rights.

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Law
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ISBN 978-1-98765-12-3