

TAX NEWS

BULGARIA

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TAX NEWS

Just before the year-end all the Bulgarian tax laws are refreshed to get in line with the newly tailored budget for 2006. The purpose of this newsletter is to start shedding light on the more important amendments by reference as a beginning only to three of the revised tax laws. Although their review, as given below, did not establish any significant steps forward or tax cuts, but rather changes aiming at overcoming existing controversies and imperfections, the brief outline of the news could be of interest to persons with operations in Bulgaria.

CHANGES IN CORPORATE TAXATION

The amendments to the *Law on Corporate Income Taxation* ("LCIT"), promulgated in State Gazette, issue #102 of 20 December 2005, will take effect as of 1 January 2006. The changes basically refer to lowering and diversifying taxation of certain expenses, and some other more or less significant improvements.

• *Lower Taxation of Expenses*

Alternative corporate taxes on (i) out-of-pocket expenses (for representative purposes and entertainment, gifts not bearing obligor's trade name or trade mark), expenses for donations and sponsorship and (ii) expenses for maintenance, repairs and operation of vehicles (the term is broadened to include not only automobiles) will be cut down as of beginning of 2006 from 17% to 10%. Expenses for maintenance, repairs and operation of vehicles related to administrative activities shall be excluded from taxation leaving taxable only those related to management activities.

Social expenses will be subject to taxation at the lowered from 17% down to 15% rate. However, social expenses, rendered in kind in the form of organized food supply and recreation, as well as expenses for voluntary social security, health security, unemployment and Life insurance shall be taxed at the lower rate of 12% (instead of 17%).

Additionally, transport expenses for personnel or management staff for going to and back from work, upon use of public transport only, will be exempt from final tax as a social expense, as well as from any other regulation for profit tax purpose and will be a fully deductible expense. The definition of social expenses rendered in kind has been also revised to carve out any form of reimbursement for incurred expenses.

The purpose of such amendments is stated to be encouragement of tax obligors to incur such expenses and thus achieve their social purposes.

• *Tax Treatment of Collective Investment Schemes*

Full exemption from profit taxation has been introduced in respect of collective investment schemes admitted for public offering in Bulgaria and licensed closed investment companies under the *Law on Public Offering of Securities*, although dividends distributed by such persons will remain subject to

taxation under the general rules. In result, treatment of these two forms of collective investment schemes, i.e. contractual funds and closed investment companies has been equalized.

Further, capital gains of foreign beneficiaries from sale of shares in collective investment schemes, if concluded on the regulated securities market, will be exempt from withholding taxation.

● *Carry-forward of Losses*

A new exception has been introduced in respect of losses with a foreign source realized by a Bulgarian company in excess of its Bulgarian-sourced profit. It allows such losses to be carried forward and deducted in the following 5 years not only from profits abroad but also from profits from operations in Bulgaria, but only on condition that a EU country is involved as the source of the losses. Furthermore, losses deriving after 1 January 2001 from a EU (as of 31 December 2005) country that could be carried forward but have not been deducted until 31 December 2005 are allowed for deduction under general rules.

● *Transfer Pricing Rules for Loans*

The transfer pricing regulations in the LCIT have been amended in their part concerning borrowing and granting of loans at an interest rate deviating from the arm's length

principle. From beginning of 2006 the arm's length criterion will be no longer 25% of the statutory interest (which in some cases exceeds market levels), but shall be the market interest, defined as the interest determined between unrelated parties, at market conditions, by taking into account all specific terms of the transaction impacting the interest rate. The same market interest criterion will apply in respect to withholding taxation of interest payments made under financial leasing transactions, whenever the interest included has not been specified explicitly.

● *Miscellaneous*

The definition of fees for technical services, which are subject to withholding tax, has been supplemented with the exception for booked expenses for training and professional qualification within the meaning of the labor legislation.

Changes have been adopted regarding the last tax period of companies in liquidation.

Deferral of 60% of due profit tax granted as a form of tax incentive to cooperations participating in national cooperative unions has been extended from 2005 to 2010.

By virtue of the amended LCIT the definition of small and medium-sized enterprises in the *Law on Accountancy* has been also amended.

CHANGES IN VALUE ADDED TAXATION

The *Law on Value Added Tax* ("LVAT") has been amended as per State Gazette issue #100 of 13 December 2005, in effect as of 1 January 2006, save for some specific provisions. In general, adopted changes are directed towards harmonization with the *acquis* and resolving problematic cases occurring in the existing practice on implementation of the law.

• *VAT Registration and Deregistration Thresholds*

As of 1 April 2006 tax obligors will have the option to register for VAT purposes on the basis of reached lower taxable turnover of BGN 25,000 (from taxable transactions, including export, for a period of 12 consecutive months), i.e. half of the currently required turnover of BGN 50,000. Absent any changes as regards voluntary deregistration, tax obligors will be entitled to deregister if failing to keep taxable turnover of BGN 50,000 for a period of 18 consecutive months.

While the threshold for obligatory VAT registration remains at BGN 50,000 (accumulated for a period of 12 consecutive months from supplies, taxable at the rate of 20%), obligatory VAT deregistration threshold has been cut in half to BGN 25,000 for a period of 18 consecutive months.

Thus, the law makes a step towards broadening the scope of VAT registered persons by mitigating both registration and deregistration requirements.

• *VAT re Repairs and Improvement of Used Assets*

The new amendments to the LVAT also attempt to overcome a long-standing unreasonable practice

imposing to lessees undertaking for their own account the repair or renovation of leased assets, the obligation to charge VAT on the thus "gratuitous supply" to lessor resulting in repair or improvement service for the leased asset. Effective as of 1 January 2006 such repairs/ improvements, but only for assets used for a minimum of three years in sequence, will not constitute a supply. Similarly, improvements made by concessionaires to assets used under concession agreements shall not be considered supplies for VAT purposes if required under the concession agreement. Otherwise repairs and improvements not meeting the above said restrictive qualifications are categorized as supply of service. Thus, where the 3-year rule has not been met, the VAT charge obligation in respect of such service supply has been deferred to the date of termination of the agreement or discontinuation of use of the asset, when the repaired/ renovated asset is actually delivered back into the possession of its owner. Such changes are also supported by explicit definitions of repairs and improvements. The amended LVAT also expressly introduces a VAT refund right of the lessee/ concessionaire for the goods and services used for the purpose of making the repairs and improvements when the latter are

not regarded as supplies for VAT purposes.

• *Tax Base of Supplies with Real Estates*

In order to eliminate the practice of VAT evasion in cases of transfer of real estates, other than land, the amended LVAT provides that as of 1 January 2006 the VAT taxable base of transfers of real estates shall be the higher of (i) the tax evaluation of the real estate determined pursuant to the *Law on Local Taxes and Fees* and (ii) the tax base determined pursuant to the general rules, which among others do not allow the base to be lower than the acquisition price of the real estate or its cost price. Another step resulting from EU accession undertakings is the repeal of the provision pursuant to which the local tax due upon transfer of real estates (at the rate of 2%) was to be deducted from the VAT amount due.

Further, a new provision of the LVAT expressly specifies that the creation or the transfer of a limited *in rem* right to construct (*superficies*) shall be considered a VAT exempt supply only until the stage of the rough completion of the constructed edifice. Thus, if the *in rem* right to

construct is transferred together with an edifice or a part thereof following its rough completion the transfer of the *in rem* right to construct shall be considered a VAT taxable supply.

• *Miscellaneous*

As of the beginning of next year the exception allowing the VAT tax base of weekly periodicals to be lower than their cost price shall apply to the sales of any and all magazines.

The import by the Bulgarian Defense Ministry of military motor vehicles shall be exempt from VAT taxation in 2006.

In the light of some amendments of the *Law on Public Offering of Securities* made in 2005 and introducing regulation of contractual funds created as a form of collective investment scheme, the LVAT has been also amended to provide that management of such collective investment schemes, closed investment companies, pension funds and rendering of investment consulting with regard to securities shall be considered a financial service, which is a VAT exempt supply.

CHANGES IN TAXATION AT MUNICIPAL LEVEL

The *Law on the Local Taxes and Fees* ("LLTF") has also undergone some amendments, as promulgated in State Gazette issue #100 of 13 December 2005, to be applied as of beginning of 2006.

The amendments could be summarized in brief as follows.

● *Municipal Officials Collecting Tax*

The amendments of the LLTF remove the discrepancy between the nature of local taxes as payment to the municipal budget and the current procedure for their establishment and collection. In result, the party to all relations arising with regard to local taxes and fees will become the municipality represented by municipal officials. Thus, in future all declarations of circumstances required under the LLTF, such as reporting of acquisition of real estate or vehicles, etc., shall be made to the respective municipality and not to the territorial tax office, as is required at present. Further, the tax base and tax evaluation for the purposes of computing tax on real estates shall be determined by municipal officials who also shall notify obligors for the amount of the tax due in the cases provided for by the law. Municipal officials shall be responsible for the overall establishment, securing and collection of municipal taxes with powers as vested into tax administration pursuant to the *Tax Procedure Code*. Municipal officials will also issue all acts for establishing of administrative offences under the LLTF and the mayor will impose administrative sanctions in respect thereof.

● *Real Estate Tax*

As of beginning of 2006 no real estate tax will be due for real estates the tax evaluation of which does not exceed BGN 1,400.

Of significance are the amendments introduced in the norms, on the basis of which tax evaluations of real estates are calculated. It is clarified that in order for a tax evaluation of an uncompleted construction to be issued an act for findings establishing the level of completion of the construction shall be submitted to the evaluating municipal official. The coefficients for situation of the real estates, as well as some other adjusting coefficients have been also increased. The base tax value of land in most parts of the territory of the country is also increased. Further, the reaction to the booming construction of buildings for the last years also has covered the tax evaluation of unfinished constructions, which will be significantly increased too. The value of unfinished buildings completed up to zero stage is raised from 15 up to 37 % of the tax evaluation of the building pursuant to the designs and the tax value of unfinished buildings completed up to the level of roughly constructed edifice will be raised from 50 up to

63 % of the tax evaluation of the building.

● ***Tax on Owned Vehicles Goes Up***

Next year owners of passenger cars will pay a higher tax, again determined on the same basis according to the power of the engine. The tax due for tractors shall be computed pursuant to detailed rules depending on maximum permissible weight, the number of axes and the type of suspension in difference to the current fixed amount tax. To that end owners of tractors shall report the relevant features of their vehicles to the municipality not later than 15 February 2006.

Amendments are adopted also with respect to the rules for calculation of the tax on cargo vehicles with maximum permissible weight exceeding 12 tones, which tax

continues to be dependant on the maximum permissible weight, the number of axes and type of suspension, whereas the amount of local tax due is increased only for some categories of heavy trucks.

● ***Miscellaneous***

The law requires from municipal councils to determine the annual amount of waste disposal fee for 2006 for respective municipality until 31 January 2006. Until such determination waste disposal fee is due at the rates applicable for 2005.

Although all functions relating to local taxes and fees have been vested in municipal officials, for the year 2006 as a transition period the notifications for due real estate tax and waste disposal fee shall be prepared and sent by the officials of the National Revenues Agency.

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An update on the amendments in the *Law on Personal Income Taxation*, the *Law on Excise Duties* and on the new *Tax and Social Security Procedure Code* will follow in January 2006.

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NOTE: This newsletter has been prepared by DJINGOV, GOUGINSKI, KYUTCHUKOV & VELICHKOV for informational purposes only and does not constitute legal advice. Readers should not act upon this without seeking professional counsel. We would be pleased to answer any questions you may have.