The climate for foreign direct investments in Bulgaria has remained unchanged against the backdrop of economic slowdown and fiscal austerity in Europe. One of the most prominent aspects of favorable tax treatment - low tax rates - will continue to feature the Bulgarian incentives for foreign investments.

TAXATION OF FOREIGN DIRECT INVESTMENT IN BULGARIA

by Yassen Spassov and Viara Todorova[*]

Despite the continuous economic turmoil, Bulgaria has managed to lead a consistent policy of creating a favorable tax regime ever since its accession to the EU in 2007. The policy objectives aim to attract foreign capital investments and reduce the scale of the grey economy. Bulgaria is now considered a low tax jurisdiction as it generally applies a flat-rate tax of 10 % on capital and personal income. In terms of government revenue, the total tax burden is allocated as follows: 53.2% in indirect (i.e. consumer) taxes; 26.6% in social security contributions; and only 20.2 % of the burden is derived from direct taxes (i.e. taxation of direct economic activity). These figures place the country in second-to-last place in terms of direct taxation in the EU, followed only by the Slovak Republic. By comparison, the EU average for the share of direct taxation stands at 31.1%.[1]

Evidently, Bulgaria offers a very competitive tax treatment of businesses compared to other EU Member States. In times of economic slowdown, tax rates have not been increased in Bulgaria and they are expected to remain so unchanged.

1. Types of Investment in Bulgaria

The bulk of foreign investments in Bulgaria consist of acquisition of equity interest in local companies. Statistics reveal that foreign investors have been focused on transport, communications, consumer goods and services, energy and finance industries.[2] In times of economic crisis, investments in new undertakings have been limited. This tendency reflects the deficiency of borrowed capital. The year of 2011 however marks the undertaking of investments predominantly in expansion of existing enterprises. This clearly demonstrates that investors, already present in Bulgaria, perceive the country as a stable investment destination.

Bulgarian state officials have also recently reaffirmed that Bulgaria would pursue a policy on further infrastructure expansion. Motorways, *e*-government, energy efficiency, the water sector and state railways have been defined as 'absolute priorities for the country' in the years up to 2020.[3]

(a) Acquisition of Equity Interest

There are no restrictions as to the foreign participation in the capital of a Bulgarian company. In general, there is no requirement for prior authorizations in order to undertake, transform or liquidate an equity investment. By way of exception, acquisition of share interest in public companies, as well as companies

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[1] Statistics are reproduced from Eurostat, please visit the 'Publications' section at http://epp.eurostat.ec.europa.eu/

[2] Statistics disclosed by the Bulgarian National Bank for the year of 2011.

[3] A statement by Rossen Plevneliev, President of Bulgaria, at the 7th Annual Conference on 'Startegic Infrastructure, Bulgaria 2012'.

performing specific types of activities, such as insurance, banking, or investment services, is subject to prior approval or notification to competent authorities.[4]

From the upcoming privatization projects, the freight unit of the Bulgarian state railways (i.e. BDZ Tovarni Prevozi) will be the next on offer for sale (from mid 2012). This unit takes approximately 80% of cargo freight in Bulgaria. Another large upcoming sale of state-owned shareholding interest has also been announced in advance. The Bulgarian state is planning to dispose of its holding in the country's stock exchange (The Bulgarian Stock Exchange). Some details of the transaction have already been announced.

(b) Real Estate

The possibility for direct foreign ownership of real estate depends on the status of the individual or entity acquiring title of ownership. Certain restrictions have been instituted pursuant to the EU Accession Treaty of Bulgaria and the Constitution of Bulgaria. However, foreign individuals and entities have quickly found a solution to overcoming these restrictions as they undertook investments in real estate through the medium of local companies (i.e. companies registered in Bulgaria). A foreign person may become the sole, majority or minority owner of a locally registered company, which is not, in turn, restricted to acquire and/ or dispose of title of ownership over land or buildings.

(c) Securities

Bulgarian law allows securities to be purchased by local or foreign investors on an equal footing through investment intermediaries or investment companies. In addition to equity securities, the market in Bulgaria also offers corporate debt securities, limited number of derivative instruments, government debt and compensatory instruments of a broad variety.

Few announcements on major security transactions have been made this year as the Bulgarian government is currently planning to dispose 20 % of the state-owned Bulgarian Energy Holding. The transaction will be executed via stock exchange listing or directly with a strategic investor. The financial results of the holding are flourishing as it announced a 25% pre-tax profit in 2011. The government however needs extra funds to plug the gap in the state budget. Other disposals of state-owned assets via stock exchange will include the minority state holding in CEZ Distribution Bulgaria (i.e. distribution grid operator).

(d) Intellectual Property Rights

Bulgaria has ratified a number of international treaties and conventions governing intellectual property. After becoming a member of the WTO on December 1, 1996, Bulgaria has also become a party to the TRIPS Agreement. National legislation on intellectual property provides protection to a broad range of intellectual property rights (i.e. trademarks;[5] works of literature, including science and technical literature, etc). Furthermore, Bulgaria is a member of the Patent Cooperation Treaty, as well as a party to the European Patent Convention.

(e) Lending and Financial Leasing

Bulgarian law does not prohibit or create restrictions on lending and leasing to local borrowers on an offshore basis. In line with the *Law on Currency*, financial lending is subject to notification before the

[4] The provisions on approvals or notifications apply equally to foreign and local persons or entities.

[5] Pursuant to the EU Accession Treaty of Bulgaria as of the date of Bulgaria's accession to the EU (1 January 2007) all registered Community Trade Marks and Designs are effective on the Bulgarian territory without any additional registration.

Bulgarian National Bank, whereas commercial lending for import/export and financial leasing are subject to declaring before the respective customs authorities.

(f) Instruments for Security

Foreign investors enjoy the same access to instruments for establishing security interest, as do local investors. Debt may be secured with a mortgage on real estate or a pledge over movables, securities, equity interests, account receivables and intellectual property rights (including floating pools of such assets) or by financial collateral over securities, accounts receivable and receivables under credit agreements. Security can be granted either by the debtor itself or by a third party.

(g) Concessions

In general, the legal regime of concessions is in compliance with the principles of the Treaty on the Functioning of the European Union and secondary legislation.
Depending on the subject matter of the concession, the *Law on Concessions* distinguishes between three types of concessions, namely:

- Concession for construction (works concession);
- Concession for services; or
- Concession for extraction.

A concession may be awarded for a term not to exceed 35 years. Where a concession is awarded for an initial term of less than 35 years, under certain conditions the said initial term could be extended within the limits of the 35-year maximum term.

The two most recent announcements for larger concessions include Sofia and Balchik Airports. The Bulgaria airspace is generally expected to become a logistic hub for cargo air traffic between Europe and Asia in the foreseeable future. The formal beginning of tender procedures will be initiated in the next few months.

2. Special-Purpose Funds

Apart from traditional sources of financing, investors in Bulgaria may avail themselves to special purpose funds for the realization of their investments in the country.

(a) KIDSF Fund to Provide Additional Funds for Energy Projects

The Kozloduy International Decommissioning Support Fund (KIDSF) will disburse additional EUR 110 mln for projects in the energy sector. Eligible projects include high-priority projects in electricity, heating energy and gas supply sectors; energy efficiency projects for government or municipal buildings; and projects aiming to improve the energy efficiency of electricity and heat supply.

(b) Energy Efficiency and Green Industry Scheme

This is a pilot scheme that has been co-funded by the Operational Programme Competitiveness and the European Development and Reconstruction Bank. Beneficiaries of the programme may be small and medium enterprises investing in energy efficient technologies and technologies using renewable energy sources. The loans will be granted by six Bulgarian partner banks: Allianz Bulgaria, DSK Bank Bulgaria, MKB Unionbank, ProCredit Bank Bulgaria, Raiffeisenbank Bulgaria, and UniCredit Bulbank.

(c) European Investment Bank Funding

The European Investment Bank (EIB) has signed an agreement with a consortium, led by Societe Generale Expressbank, for the establishment of an urban development fund to invest in projects located in the cities of Plovdiv, Varna, Burgas, Ruse, Stara Zagora and Pleven.

Furthermore, the EIB and the Bulgarian government signed a memorandum of understanding (MoU) on technical assistance to support the implementation of EU projects in the country. (Bulgaria had signed a similar memorandum of understanding with the World Bank.) This agreement follows a similar MoU providing implementation support for pre-accession projects and will focus on increasing both the speed and quality of absorption of EU structural funds via assistance with project management and implementation. The EIB will provide support for priority projects to be financed in the 2007- 2013 programming period and help to develop the strategy for identifying and selecting projects to be financed in the upcoming 2014-2020 programming period.

Finally, the European Investment Bank (EIB) has revealed that it was considering to lend EUR 50 mn (USD 65.1 mn) to Bulgaria's UniCredit Leasing to support the financing of local small (SMEs) and mid-cap businesses. The loan would contribute to the development of term finance in Bulgaria by providing long-term funding for eligible leasing projects promoted by SMEs and midcaps, as indicated by the EIB in a statement posted on its website.

(d) Eleven LAUNCHub

European Investment Fund (EIF) has selected venture capital funds Eleven and LAUNCHub to manage a EUR 21 mln programme in Bulgaria under the Joint European Resources for Micro to Medium Enterprises (JEREMIE) initiative. The investment process is expected to start in the autumn of 2012. Eleven will manage EUR 12 mln, which will be invested in around 200 innovative young businesses. The EIF's new Entrepreneurship Acceleration and Seed Financing Instrument is unique for the Balkans and is expected to help to establish Bulgaria as the hub for innovation and start-up business on the Balkans.

3. Foreign-Investor-Specific Rights

Favorable tax treatment by itself is far from enough to promote economic development. For this reason, a special statute ensures the provision of certain incentives related to investments. The *Law on Investment Encouragement* purports to enhance the competitive edge of the Bulgarian economy. It has been designed to promote investments in research and development, innovations and manufactures of greater added value.

(a) The Concept of Foreign Investment

The *Law on Investment Encouragement* promotes certain investments in long-term tangible and intangible assets. This may include, *inter alia*, the setting up of a new enterprise, or extension of an existing one, diversification of output or fundamental change of manufacture. Recently, the notion of "priority investment projects" has been also introduced. Such projects need to be of particular importance to the economic development of the country or its regions.

(b) Specific Rules for Investments Encouragement

The major purpose of the *Law on Investments Encouragement* is to provide a legislative framework for improving administrative and information services, including financial support, provided to investors and to set forth specific measures on promotion of investments. The measures are differentiated according to the class of investment (i.e. the amount of investments).

On the other hand, Bulgaria has entered into bilateral treaties on mutual promotion and protection of investment with more than fifty countries. Under these agreements, investments and returns thereon may be repatriated freely upon payment of taxes. Also, it is very common for these agreements to include a "most favored nation" clause.

(c) Currency Control Issues

The *Law on Currency* provides for full currency control liberalization, including repatriation of investment. Thus, the effective currency control framework enables Bulgarian companies, including subsidiaries and branches of foreign companies, to export capital abroad and invest in other jurisdictions. This may be particularly useful in the process of establishing operations in the region through Bulgarian subsidiaries.

4. Taxation of Direct Foreign Investments

In Bulgaria, taxes may be classified as direct, indirect (transaction tax) or local taxes. They may be further differentiated on the basis of economic function: consumption; income; or capital. First, the category of direct taxes includes tax on corporate profits, withholding tax, tax on certain expenses and other taxes applied to specific activities (i.e. gambling, maritime shipping, etc). On the other hand, indirect taxes include value added tax on consumption, excuse duties and tax on insurance premiums.

In the context of foreign investments, there is a milestone consideration that most investors are bound to undertake - to fund a Bulgarian subsidiary by debt or equity. It is common for investors to provide funding to local subsidiaries through loans instead of equity capital in order to guarantee easier repatriation of proceeds, but also to reduce the tax burden. Some of the most significant factors that may be considered are the tax rates on direct economic activity (i.e. corporate income tax), dividends, interest and royalties (i.e. withholding tax). These have to be balanced against the flexibility of repatriating debt funding, thin cap restrictions and the concept of 'beneficial ownership' that has proven slippery in the past.

(i) Taxation of Direct Economic Activity

The profit of direct economic activity of local entities or foreign entities acting through a Bulgarian branch or a permanent establishment in Bulgaria is currently taxed at the flat rate of 10%. The taxable amount represents the corporate profits or the positive financial result. The transformation of corporate profits and losses into financial result are subject to statutory rules and procedures.

Although the *Law on Corporate Income Taxation* does not provide for any tax breaks or tax holidays, it introduces certain tax incentives in the form of tax remissions applicable under specific conditions compliant with the statutory regulations on state aid for regional development or on minimal aid. Tax incentives are not available to investors operating in certain sectors (such as coal output, steel production, shipbuilding, etc.), or in certain sectors, included in Annex I to the Treaty establishing the European Community, or for which some negative preconditions occur, such as liquidation proceedings. Tax remissions, representing state or minimal aid, cannot be used in case some of these negative preconditions occur during the time of the relevant initial investment or during the time of the whole investment.

(ii) Taxation of Incomes from "Passive" Investment

Withholding tax applies to a number of income sources that are considered sources of income from Bulgaria (i.e. dividends, winding-up/ liquidation interest, interests, royalties, etc). The payer of dividend income, for instance, withholds 5% of the dividend income distributed to shareholders out of taxed profits. A special exemption from withholding taxation is provided for dividends distributed to companies that are tax residents of an EU/ EEA member state. Also, tax on dividends is not payable when the dividends are distributed in favour of a foreign contractual fund. A double tax treaty relief might be available in cases where withholding tax is due and payable.

In this context, withholding tax on interest and royalty generally amounts to 10% or the reduced rate of 5% under the EC Interest and Royalty Directive. Capital gains from disposal of securities or real estates would be also subject to 10% withholding tax.

Regardless of the benefits conferred by EU legislation, foreign investments are commonly structured via jurisdictions that have signed an attractive tax treaty with Bulgaria.

(iii) Bilateral Treaties on the Avoidance of Double Taxation

Bulgaria has entered into bilateral treaties with more than sixty countries on avoidance of double taxation of income and property.

- Taxation of Direct Economic Activity

All treaties provide that the profits from direct economic activity made through a permanent establishment (i.e. a branch) in the other country shall be taxable only in the country where the foreign company would have its permanent establishment. Therefore, if a foreign entity would be taxed in Bulgaria on the profits of its local permanent establishment, such profits would not be taxable in the country of origin of the investment.

- Taxation of Incomes from "*Passive*" Investment

A comparative analysis of the relevant bilateral treaties shows that such treaties introduce rates of withholding tax no higher than 15%,[6] for the income from a number of sources, such as: dividends, interest (meaning any income generated by debt), royalties and capital gains income. Some treaties entitle an investor to a tax credit in its country of origin, for any taxes paid in Bulgaria on certain types of income, against taxes due on said income in the country of origin.

(iv) Other Considerations

The overall tax burden is certainly not the only consideration that comes into decisions on foreign investments. For instance, there are corporate restrictions on payment of dividends and reserve fund obligations (i.e. relevant to equity funding). Interim dividend distribution is not possible under Bulgarian law as distribution may be conducted only after expiry of the fiscal/ calendar year.

On the other hand, there are some interest's deductibility restrictions as deductibility of arm's-length interest expenses is limited by the thin cap rule (i.e. relevant to debt funding).

Another major issue is the fact that the benefits of a tax treaty on avoidance of double taxation may be conferred pursuant to a positive tax clearance from Bulgarian authorities. In practice, there have been a substantial number of refusals to recognize a foreign recipient of interest paid by Bulgarian debtor as a 'beneficial owner', therefore, creating a setback in tax clearance procedures.

In recent case law, the Supreme Administrative Court interpreted the term 'beneficial owner' in light of the OECD Commentary[7] and its international fiscal meaning overruling an appealed tax clearance refusal of tax authorities.[8] The OECD Commentary has been consistently used as a means for interpretation of

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6 If Bulgarian law provides for lower withholding tax rates of 10%/5%, there would be no reason to avail of treaty provisions.

7 Commentary on the Model Tax Convention on Income and Capital of the Organization for Economic Cooperation and Development (OECD Commentary)

8 Supreme Court Decision № 6153 of 2 May 2012 under administrative court case № 1359/ 2010; see also: Supreme Court Decision № 6106 of 2 May 2012 under administrative court case № 2852/ 2010

national law. The court has furthermore ruled on the burden of proof with respect to fulfillment of the conditions for ‘beneficial owner’, thereby, preventing misguided enforcement.

5. Conclusion

Favorable tax treatment and friendly legislation on investments have been conductive to the growth of the Bulgarian economy that has been driven mainly by foreign investors. The low corporate income and withholding tax rates have urged investors to reconsider the traditional method of debt financing. Nevertheless, courts of law strive to overcome deficiencies in national legislation so that neither method of financing would be disadvantaged by misapplication of statutory provisions. Evidently, the overall assessment has been positive as foreign investors continue to expand activities they have already started in Bulgaria.