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Tax News

KPMG in Bulgaria

Amendments to the Corporate Income Tax Act

December 2019

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In the December issue of Tax News 2019 we summarize the more substantial amendments introduced by the Act Amending and Supplementing the Corporate Income Tax Act, published in the Bulgarian State Gazette, issue 96 dated 6 December 2019. The amendments enter into force as of 1 January 2020.

Most of the amendments to the Corporate Income Tax Act (CITA) transpose to the Bulgarian tax legislation the provisions of Council Directive (EU) 2016/1164 laying down rules against tax avoidance practices that directly affect the functioning of the internal market and Council Directive (EU) 2017/952 (EU) amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries. In addition to the provisions transposing EU directives into the Bulgarian law other changes to the CITA were made.

Tax rules aimed at neutralizing hybrid mismatches

The new rules aim to neutralize two types of mismatches resulting in tax avoidance in one or more jurisdictions. Hybrid mismatches are mismatch arrangements which involve hybrid entities and hybrid instruments which may lead to:

- *Deduction without inclusion* - accounting expenses/amounts leading to decrease in the tax result in the payer jurisdiction without a corresponding inclusion in the taxable income in the jurisdiction of the income recipient, or
- *Double deduction* - accounting expenses/amounts which leading to decrease in the tax result in the jurisdiction of the payer and in the jurisdiction of the investor.

A hybrid mismatch arises (i) between a taxable person and its associated enterprise, (ii) between associated enterprises, (iii) between the head office of an entity and a permanent establishment (PE) of that entity, (iv) between two or more PEs of the same entity or (v) as part of a structured arrangement.

The law lists the hybrid mismatches which result in deduction without inclusion: for example, a payment under a financial instrument, a payment to and from a hybrid entity, a payment to an entity with one or more PEs or to a disregarded PE, a deemed payment between a head office and its PE or between two or more PEs of the same entity.

In the case of payments under hybrid mismatches, the financial result is adjusted for tax purposes by the accounting income and expenses or by the amounts (when no accounting expenses or income were accrued) which would have been treated as taxable income or tax non-deductible expenses. The application of the rules depends on circumstances such as whether the tax liable person is the investor or the payer, whether the tax result in the other jurisdiction was adjusted due to the hybrid mismatch, etc.

The law introduces rules on mismatches related to tax liable persons which are residents of more than one jurisdiction.

There are definitions of 'hybrid entity', 'double deduction', 'deduction without inclusion', etc.

Transfers between divisions of one and the same enterprise inside and outside the country

Scope of tax rules on transfers

The new provisions apply in the cases of cross-border transfers of assets or activity performed between an enterprise and other parts of the same enterprise when Bulgaria wholly or partially loses the right to tax the result of any subsequent disposal of the transferred assets/activity.

The following types of transfers fall within the scope of the new provisions: (i) transfer of assets or activity from the head office in the country to a PE outside the country; (ii) transfer of assets or activity from a PE within the country to the head office or another PE outside the country; (iii) the tax liable person becomes a tax resident in another jurisdiction; (iv) transfer of activity performed through a PE in the country to another jurisdiction.

The law makes a distinction between 'whole' and 'partial' loss of taxing rights of Bulgaria over the result from subsequent disposal of assets or activity. One of the differences is related to the method for elimination of the double taxation of profits derived by a PE provided for in the Double Tax Treaty with a jurisdiction to which the tax liable person transferred its assets/activity.

Transfer of assets

When a *transfer of assets* is performed, the financial result: (i) is increased by the positive difference between the market value of the transferred assets and their value for tax purposes; (ii) is decreased by the negative difference between the market value and the value for tax purposes of these assets.

The tax value of the assets is determined depending on the type of assets. The tax depreciable asset's value is its tax value (as per the Tax Depreciation Schedule) at the time of the transfer. In respect of assets other than tax depreciable assets, the tax value at the time of transfer is the accounting book value of the asset adjusted by the existing temporary tax differences which would have been recognized/reversed, had the tax liable person disposed of the asset (the same rule applies in respect of positive or negative reserve from subsequent valuation of assets which would have been deducted from or added back to the financial result for tax purposes should a disposal of the asset had occurred).

CITA introduces rules for adjustments of the financial result for tax purposes and for correction of the assets' values for tax purposes depending on whether the transferred assets are *disposed of/written off* or not. These rules are related to the new provisions on the determination of the tax value of the assets at the time of their transfer.

The rules for adjustment of the financial result do not apply in the cases of *temporary* transfer of assets. A transfer is deemed to be temporary if it does not last more than 12 months and it takes place for the purpose of liquidity management or when it comes to the financing of securities.

Transfer of activity

When a transfer of activity is performed, the financial result for tax purposes is increased by the positive difference and is decreased by the negative difference (whichever of the two occurs) between the market value of the transferred activity and the tax value of the transferred assets less the tax value of the transferred liabilities at the time of the transfer.

The tax value of the assets is determined by the above rules (as noted in the previous section). The tax value of the liabilities is determined by applying the same principles, i.e. net of existing tax temporary differences. The law introduced the principles stated above in respect of correction of the values of the assets/liabilities depending on whether they are disposed of/written off or not as a result of the transfer of activity.

Definitions of 'asset' and 'activity' are introduced to apply in the cases of transfer of assets and transfer of activity.

Rules for deferred payment of the corporate income tax liability related to transfer to EU member states or countries in the EEA

The law provides for an opportunity for a deferred payment of the amount of the corporate income tax liability due as a result of transfers of assets/activity to an EU member state or to a country in the EEA (These provisions apply to other countries which are members of the EEA only if there is an effective agreement for mutual assistance for the recovery of claims relating to taxes, duties and other measures equivalent to Council Directive 2010/24/EU.). One of the conditions for the deferred payment in installments is that transfers should have an incidental and irregular character, however, no definitive criteria are set out in this respect.

The amount which can be paid in installments cannot exceed the corporate income tax due for the respective calendar year. The amount is divided into five equal installments, each of them due annually over the next 5 years. The tax liable person exercises the right to payment in installments through the annual corporate income tax return submitted for the respective calendar year. The tax liable person which chooses payment in installments is subject to penalty interest in accordance with the Interest on Taxes, Fees and Other State Receivables Act.

The total amount paid in installments falls due with an immediate effect if one of the conditions set in the law occurs, for instance if the person sells or otherwise disposes of a transferred asset/activity. Should the amount fall due immediately, the tax liable person has to notify the Bulgarian revenue authorities within 14 days from the date of the respective event. Failure to fulfill this obligation or providing incorrect information is subject to an administrative penalty of BGN 3,000 - 5,000 and of BGN 6,000 - 10,000 in case of repeated breach.

Transfer of assets from another part of the enterprise located outside the country

The law implements rules in respect of assets transferred from one part of the enterprise outside the country to another part of the same enterprise within the country. These assets' values for tax purposes after the transfer have to correspond to the market values as at the time of the transfer.

Further specific rules apply in respect of assets which are available at the time of the transfer with the receiving part of the enterprise (i.e. the assets were not written off by the tax liable person at the time of a previous transfer to an EU member state). The values of these assets in the Tax Depreciation Schedule (if the assets are tax depreciable assets) or for accounting purposes (if the assets are non-depreciable) are to be adjusted to their market values as at the time of the transfer to Bulgaria. Such adjustments of non-depreciable assets' values may give rise to tax temporary differences or may affect existing tax temporary differences.

Transfer of services

According to the new rules, the tax liable person needs to recognize for corporate income tax purposes market-based income or expenses arising from transfer of services between one part of an enterprise in the country and another part of the same enterprise outside the country. The concept of 'service cost' is introduced in the law.

The new tax provisions apply if the transfers of services to/from the part of the enterprise in the country coincide with the ordinary transactions or the ordinary activity of the party initiating the transfer or if the service is to be realized in an altered or unaltered form to a third party.

Specific rules apply when an asset is derecognized as a result of a transfer of services as well as when amounts are capitalized in an asset's value.

Withholding tax on income accrued by a PE within the country to another part of the enterprise outside the country

The existing CITA provisions for withholding tax on income accrued by a PE within the country to the head office or another PE outside the country are amended. Withholding tax is levied on the income of the head office or the PE outside the county if (i) it arises from transfers which coincide with the ordinary transactions of the head office or the PE outside the country with third parties, or (ii) the ordinary activity of the head office or the PE outside the country comprises similar transfers, or (iii) the subject of the transfer is to be realized in altered or unaltered form to a third party.

Expenses for repair services, construction or improvement of elements of state or municipal infrastructure

The newly implemented rules aim to remedy the contradictory treatment under the CITA of the expenses which tax liable persons incur at construction, improvement and repair of elements of technical infrastructure, that are public state or public municipal ownership.

According to the new rules, when a tax liable person carries out repair work/services of elements of such infrastructure and the accounting expenses are related to the activity of that person, these expenses are recognized for tax purposes. This rule applies also in the cases where the infrastructure is accessible for use by third parties. The general CITA provisions apply when the tax liable person is entitled to a contractual remuneration for its works/service.

When a tax liable person constructs or improves elements of state or municipal infrastructure, the respective costs arising from that activity represent tax depreciable assets. The accounting expenses incurred are tax non-deductible. Where expenses are capitalized in an existing/new asset for accounting purposes, the CITA provisions in respect of tax depreciable assets apply. If the expenses are not capitalized in an existing/new asset, they are treated as an individual tax depreciable asset of the tax category in which it would have been allocated, had it been owned by the tax liable person. That asset is written off from the tax depreciation schedule only when it is fully depreciated for tax purposes. The general CITA provisions apply, in the case that remuneration for construction and improvement is due to the tax liable person.

According to the Additional Provisions of the CITA, the expenses related to construction, improvement or repair work, which were treated for tax purposes as not related to the business activity of the tax liable person or as tax non deductible donation expenses in the period from 1 January 2015 to 3 December 2019, can be treated as an individual tax depreciable asset. The asset is to be recorded in the tax depreciation schedule from 1 January 2020.

According to the newly introduced definitions 'elements of technical infrastructure' are those within the meaning of the relevant provisions (art. 64) of the Spatial Development Act. The scope of 'repair work', 'improvement', and 'construction' in relation to elements of technical infrastructure is also defined.

Thin capitalization rules in respect of interest on bank loans/finance leases, partially guaranteed by the debtor/lessee

An addition to the provisions for the regulation of thin capitalization is made.

According to the amended provisions, the tax liable person can treat as tax deductible certain portion of interest expenses arising under a finance lease or a bank loan which are simultaneously guaranteed by the tax liable person itself and its related party. The tax deductible amount which is not subject to the thin capitalization rules is determined based on the ratio between the tax liable person's own collateral and the total amount of the finance lease/loan. When the ratio is higher than 1, the whole amount of the interest expenses arising under the respective finance lease/loan are treated as tax deductible in the year of their accrual.

For the purposes of the ratio calculation, the market value of the collateral at the time it is pledged by the tax liable person is taken into account. When an existing ratio changes (as a result of changes in the size of the collateral itself or of the amount of the loan/lease), the new ratio is applied as from the moment the change has taken place.

Other amendments

Controlled foreign company (CFC) rules

The changes in the law affect the CFC criteria. According to the updated criteria, local entities, foreign entities and PEs outside the country, all of which are subject to alternative types of taxation, are not considered as controlled foreign companies within the meaning of the CITA.

Provisions in respect of forecast tax profit and annual corporate income tax

Forecast tax profit and penalty interest for insufficient advance installments for corporate income tax (CIT) are not affected by:

1. tax profit relating to a CFC

2. the excess of the tax add-backs over the tax deductions relating to transfer of assets/activity where the corresponding amount for corporate income tax is paid in installments.

Noncompliance with the requirements for CIT retention or exemption from CIT

The retained CIT amount is due in full in case of noncompliance with the requirements of the CITA. New provisions are implemented relating to the CIT liability of agricultural producers who were not entitled to tax benefits under the conditions of de minimis aid and State aid for agricultural producers.

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