Comments on the amendments of the Corporate Income Taxation Act, in force as of 1 January 2006

In the State Gazette, issue 102 as of 20 December 2005, was published a Law on the Amendment and Supplementation of the Corporate Income Taxation Act (LASCITA). The most significant amendments and supplementations of the hitherto existing legal regulation made by LASCITA are related to:

1. Changes concerning the accounting of fixed assets for tax purposes

1.1. Grants related to depreciable assets

Part of the changes is conceptual and concerns the accounting of the fixed assets for tax purposes. The most significant new moments can be summarized as follows:

- In §1, i. 57 of CITA is implemented new letter “d”, which introduces a specific rule, that for tax purposes the depreciable amount of a fixed asset shall be reduced by the amount of the grant, which is related to this asset, and with this amount the asset shall be recorded in the Tax Depreciation Schedule (TDS). **That is, in TDS such assets are recorded at net value (after deducting the value of the grant).**

  In the cases when the entity accounts for financing related to depreciable assets that is gradually recognized in the income, this recognized income should be deducted from the taxable base, so that the double taxation of one and the same amount is avoided. That is why in the new i. 10g of Art. 23, para 3 CITA is envisaged decrease of the financial result with the income from financing with reference to grants, related to depreciable assets, which are included in TDS at depreciable amount, determined in accordance to §1, i. 57, letter “d” CITA.

- **In case the asset is related to received grant and the value of this grant is adjusted (i.e. increased/decreased)**, as exception it is allowed the tax indicators, with which the asset is recorded into TDS, to be changed. Adjustments, which correspond to the amendments in the value of the grants, have to be executed in the indicators “depreciable amount” and “allowed tax-deductible depreciation”, charged to the depreciable asset in TDS. The change is established with the amendment of Art. 22, para 10 CITA.

- **In case that the grant becomes refundable**, pursuant to the new i. 16d of Art. 23, para 2 CITA, the financial result **shall be increased with the expenses, charged as a result of the adjustment of the value of the grant**, related to a depreciable asset, which is included in TDS with its depreciable amount, determined in accordance to §1, i. 57, letter “d” CITA (i.e. depreciable amount, which is decreased by the value of the grant related to the fixed asset).

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1.2. Amendments related to the treatment of the non-depreciable fixed assets

Starting from 1 January 2006 the revaluation and impairment of non-depreciable assets will not be recognized for tax purposes. Till the adoption of the amendment the revaluation and impairment of non-depreciable assets, as are land and investment properties, were not regulated for tax purposes. Pursuant to the new rules, the financial result shall be increased in the annual tax return with the reported amounts, representing a decrease in the value of the non-depreciable fixed tangible and intangible assets and non-depreciable investment properties, as a result of accounted for revaluation and impairment of the assets. Art. 23, para 2, i. 21, letter "a" CITA is applicable.

The recognition of the effects from impairment and revaluation is allowed when refunding the impairment or when increasing the value of the assets, as well as when they are written-off from the entity. In this case the financial result is decreased by the accounted revenue under Art. 23, para 3, i. 13, letter "a" and by the non-refunded amounts (when writing-off the assets) under Art. 23, para 3, i. 21 CITA.

1.3. Tax treatment of assets, which are used simultaneously for the execution of an activity, which results are taxed with corporate income tax under the general procedures, and of activities, taxed under other tax mechanisms

The new para 14 of Art. 22 CITA introduces a specific treatment of the depreciable assets, which are used simultaneously for the execution of an activity, from which taxable profit is formed under Chapter Two of CITA, and of another type of activity, which results are taxed under another procedure within the Act (e.g. final one-off tax). This provision of the Act concerns the persons, taxed with final patent tax, the budget-funded enterprises and the municipalities, which income is taxed under a special procedure within the Act. The assets, used for the two types of activity (taxable/ non-taxable under the general procedure of the Act) have to be included into TDS with the full amount of the tax indicators, regulated by para 6 of Art. 22 of the Act. With regard to this type of assets, the following additional requirements have to be kept:

- The financial result in the annual tax return shall be decreased under Art. 23, para 3, i. 11 CITA, with the part of the annual tax-deductible depreciation, corresponding to the activity, for which the tax liable person forms its taxable profit (income) under Chapter Two of the Act.
- On the grounds of Art. 23, para 2, i. 24, letter "i" CITA the financial result shall be increased with the part of the revaluation reserve, which should have been included in TDS and corresponds to the reduction of the taxable profit in the current and the previous tax periods by increasing the tax-deductible depreciation expenses and the asset carrying amount for tax purposes, in case that the reserve has been established for an asset, which is used simultaneously for the execution of taxable with corporate income tax activity and of activities, which results are not taxed under Chapter Two of the Act (under the general procedure).
- When writing-off such an asset (used simultaneously for taxable activity under Chapter Two of the Act and another type of activity) from TDS, the financial result shall be decreased

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under Art. 23, para 3, i. 12 of the Act with the part of its carrying amount for tax purposes, determined by a coefficient, derived from comparing the tax-deductible depreciation expenses for the current and for the previous periods, and the tax-deductible depreciation expenses for the same asset, calculated under the general procedure.

1.4. Discontinuing of the accrual of depreciation in TDS

The provision of Art. 22, para 13 CITA is supplemented, and it regulates the cases, in which the accrual of tax-deductible depreciation expenses in TDS should be discontinued without writing-off the assets. Except for the cases of temporary withdrawal of assets from use (for a period not less than 12 months) and termination of the person through liquidation and insolvency, **the discontinuing of the accrual of tax-deductible depreciation expenses shall be done also in case that the assets "are classified as held for sale or are part of a disposal group, classified as held for sale" within the meaning of IFRS 5 "Non-current Assets Held for Sale and Discontinued Operations", i.e. those are the cases, in which the assets become non-depreciable (for accounting purposes as well).**

1.5. Changes in the tax treatment of amounts, resulting from adjustments of the values of depreciable assets

In CITA is included explicit provision, which settles the tax treatment of amounts, stemming from adjustments of the values of depreciable assets when there are changes in the applicable accounting standards for preparation and presentment of the financial statements. Pursuant to the new Art. 29c CITA these amounts shall not be tax regulated under Art. 29a and Art. 29b of the Act, in which the tax treatment of the effects from changes in the accounting policy and from the accounting for of fundamental errors, is stipulated. In addition, the amounts resulting from changes in the values of depreciable assets in relation to events that have happened after the date of the initial preparation of TDS are not regulated as well.

2. Rules for transforming the annual financial result for tax purposes and for calculating the taxable profit

- The amendment of Art. 23, para 2, i. 6 and 7 CITA regulates that the financial result shall not be increased with the expenses on shortage of assets (fixed assets and inventory) **due to force majeure**. Till now the specified expenses were not regulated if **they were caused by a disaster.** Similarly Art. 23, para 3, i. 6 CITA is amended, as from the regulation for tax purposes is excluded the income from shortage of assets, except for the cases of disasters, and by the amendment – in the cases of force majeure. Because the concept of "force majeure" [1] is broader than "disaster", the cited provisions will have greater practical application.
- Item 12 of Art. 23, para 2 CITA, which introduced a requirement for an increase of the financial result by the expenses accounted for in the conversion of temporary differences into

[1] In Art.306, para 2 of the Commercial Act is defined the term "force majeure", and it is every unforeseen or unavoidable event of extraordinary nature.

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permanent ones, was revoked. This change is related to the amendments of the National Accounting Standards and it is in compliance with the rules for accounting of the income taxes, embedded in NAS 12 "Income Taxes" and IAS 12 (with analogous title), where it is regulated that the tax effects from the conversion of temporary differences into permanent ones shall be accounted for as tax expenses and shall not affect the amount of the operating expenses and the profit before taxes.

3. Tax treatment of the expenses on transportation of the personnel

The amendment of para 12 of Art. 23 CITA as of 1 January 2006 introduces a conceptually new approach to the treatment of the expenses on transportation of the personnel. The following expenses **are not regulated for tax purposes and are not taxed with one-off tax under the Art. 36 CITA:** the expenses on transportation of the personnel (including the persons, employed under management and supervision contracts) from their place of residence to place of work and back, **incurred in relation to the use of railway transport, trams, trolley-buses, urban and inter-city bus transport on the adopted transport scheme, except for the additional transport lines.** The recognition of the expenses **depends on their proper reporting** in compliance with the requirements of the current legislation.

Only the expenses on transportation of the personnel as per the adopted transport scheme of the public transport, without the additional bus lines (route taxicab lines) are tax exempt under this procedure.

The approach for the recognition of the expenses on group transportation of the personnel, organized by the employer (under the requirements of Art. 23, para 11 CITA) is preserved, and the commented change in the legal provisions will not affect the companies, which have entered into fixed contracts with transport companies for the realization of such a transportation.

4. Tax treatment of losses, realized in member-states of the European Union

The general rule is that the deduction of losses, incurred while executing business activity in other states, from profits with source in Bulgaria is not allowed. Losses can be deducted only from profits, realized from the same source in these other states for a period of five consecutive years. The new para 2 of Art. 40 CITA introduces the possibility, as an exception, for deduction of losses, incurred in a member-state of the European Union (EU) from realized profits in Bulgaria. The goal of the change is the adaptation and harmonization of our tax legislation with the EU's one. At the same time the general rule for deduction of losses with source of states, which are not EU member-states, is preserved, as well as the methodology for calculating the amounts for deduction, when they are from several sources.

The provision of §31 of the Transitional and Final Provisions of LASCITA settles all the existing cases, namely the accrued losses, which are formed after 1 January 2001 (i.e. the losses with unexpired period of limitation) and are with source of EU member-state, and are not deducted till the adoption of the current amendments, can be deducted in the following periods in accordance with the rules of Art. 38 CITA.

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5. Obligations of companies in liquidation and insolvency

The amendments concern the obligations for filing a tax return and for final settlement with the central budget of the companies in liquidation and insolvency **in the period after the filing of an application for deletion to the moment of their deletion.** The most significant of them are:

- The amendment of para 10 of Art. 41 CITA regulates that the last tax period of the companies in liquidation shall encompass the time from the beginning of the calendar year, in which the application for deletion is submitted to the date of its submission. Till now this period continued to the deletion date of the companies. For this period the tax liable persons shall file a tax return with a standard form, with attached copy of the application for deletion. The taxes due for the last tax period shall be paid till the date of the filing of the application for deletion.

- For the companies in a process of insolvency the last tax period remains the beginning of the calendar year, in which the deletion of the company is done to the deletion date.

- Regardless of the way of determination of the last tax period, **in case that the tax liable person continues its business activity after the submission of the application for its deletion, it has to fulfill its obligations under the general procedure of CITA**, i.e. to file tax returns and to pay corporate income tax for this period. These obligations apply to the companies in a process of insolvency as well. The new para 11 of Art. 41 and para 4 of Art. 53 CITA are applicable.

6. Changes in relation to the taxation of foreign persons' income with source in Bulgaria with withholding tax

- Starting from 1 January 2006 **the foreign persons' income from all types of transactions with shares, securities and financial assets of local companies** will be subject to 15% tax. Till the amendment, only the foreign persons' income from sale of shares, stocks and other financial assets of local companies was subject to 15% tax.

- The amendment of Art. 12, para 5 CITA and §1, i. 5 CITA stipulates that **the foreign persons' income, received as a result of disposal with real estate in Bulgaria shall be subject to 15% tax** and not only in the cases of sale of real estate, as it was till the change.

- With the amendment of i. 9 of §1 CITA **the accounted expenses for training and professional qualification** under the procedure and the terms of Chapter 11 of the Labor Code **are excluded from the scope of the remunerations for technical services.**

- As a result of the amendment of Art. 12, para 1 CITA, **the amounts, which represent distribution of sources of shareholders' equity in the form of shares and stocks in behalf of foreign persons, shall be exempt from withholding tax.**

- The amendment of Art.12, para 4 CITA introduces a rule, that in the cases of financial lease contracts, signed with foreign persons when the interest rate is not explicitly defined in the contract, **the interest rate for tax purposes shall be determined on the basis of the market interest rate.** Item 29 of §1 of CITA, which has given a definition for "statutory interest rate", is amended, and now it gives a definition for "market interest rate".

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- Under the amended Art. 34, para 5 CITA, **foreign persons' income from transactions** with shares of public companies and with tradable rights over shares of public companies, as well as with **shares of collective investment schemes, is not subject to withholding tax.**

- The new para 5 of Art. 51 CITA regulates that **a tax declaration shall be filed within the terms for payment of the withholding tax.**

7. Amendments in the provisions for establishing of tax evasion in cases of related party transactions

The market interest will be used from now on as a basis for determination of whether there is a tax evasion when related parties enter into loan contracts, whereas the contracted interest rate is compared to the market interest rate for the respective period. This requirement is embedded into the amended Art. 15, para 3, i. 3 CITA. Till now the case of loan contracts between related persons, where the contracted interest rate deviated with more than ¼ from the statutory interest rate[2] was considered a tax evasion and the financial result had to be adjusted for tax purposes by an increase with the amount of the deviation.

8. Amendments concerning the tax treatment of amounts, accounted as a result of events from previous accounting periods, fundamental errors and changes of the accounting policy

- Article 27, i. 1 CITA is abolished. It introduced the requirement for an increase of the financial result with the expenses for undercharged or non-charged taxes on profits referring to prior accounting periods (incl. corporate income tax, tax on profit and municipal tax). According to the rules, embedded in the accounting standards (National Accounting Standards for Small and Medium-sized Enterprises and International Accounting Standards), income taxes are accounted as a tax expense and do not affect the accounting profit/loss, hence its regulation for tax purposes is unnecessary and illogical.

- There are supplementations in Art. 28a, para 1 and Art. 29b, para 1 and 5 CITA, which regulate that the effects from the accounting of fundamental errors shall be subject to tax regulation. The change includes the addition, that the same procedure will be applicable also for **the effects due to material errors** (within the meaning of IAS 8 in its 2005 edition). This change is rather editorial.

9. Changes concerning the tax base of certain types of expenses subject to one-off tax and reduction of the tax rates of the one-off tax

9.1. Tax treatment of the expenses for maintenance, running and repair of passenger cars

- Starting from 1 January 2006 subject to taxation with one-off tax will be the expenses for maintenance, running and repair of "motor vehicles" and not of the passenger cars only. Explicit definition for "motor vehicles" is included in CITA (in the new i. 76 of §1 CITA),

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stating that motor vehicles for the purposes of taxation with one-off tax **are the specified in Chapter Two, Section IV of the Local Taxes and Fees Act**[3]**, regardless of whether the motor vehicles have been entered into a register, kept in accordance with the Bulgarian legislation.**

- On the other hand, **the expenses on motor vehicles** (within the meaning of CITA), which are **explicitly related to the administrative activities of the company, are exempt from taxation with one-off tax. As of 1 January 2006 only the management expenses will be treated**[4] **as subject to one-off tax**. Till now the expenses for the two types of activity were subject to taxation.

  The changes, commented in this point are set in Art. 11b, Art 36, para 2 and in §1, i. 27 CITA.

9.2. Changes of the tax rates of the one-off tax, with which certain expenses are taxed (in force as of 1 January 2006)

- The one-off tax rate on the expenses for motor vehicles is reduced from 17% to 10%.
- The entertainment expenses shall be taxed with 10% one-off tax (till now they were taxed with 17% tax).
- **Two different tax rates** for the one-off tax on social expenses are introduced. In the general case the social expenses will be taxed with tax at the rate of 15%. Reduced tax rate of 12% is envisaged for the social expenses under Art. 294, i. 1 and 4 of the Labor Code (incl. expenses for organized meals, facilities for recreation, physical culture, sport and tourism), in case that the social benefits are given **in kind** by the employer.
- The expenses, specified in Art. 34, para 6 CITA for voluntary pension insurance, health insurance, voluntary insurance for unemployment and/or professional qualification (added in the legal provision), and/or life insurance and life insurance linked with investment fund, above the limit of BGN 40 for every insured person, will be **taxed with 12% tax** (till 31 December 2005 those expenses were taxed with 17% one-off tax).

10. Tax treatment of the transactions with shares of collective investment schemes

- The definition for “financial companies” in i. 47 of §1 CITA is supplemented. The scope of the financial companies includes also the collective investment schemes, licensed for public offering in the Republic of Bulgaria, as well as the licensed closed-end investment companies. Analogical amendment is made in i. 45, letter “b” of §1 CITA. In the scope of the

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[2] For tax purposes the statutory interest rate was defined in CITA as an interest rate, which for loans in BGN was the base interest rate, announced by BNB, increased by 10 points, and for loans in foreign currency was 6-month LIBOR for the respective currency, increased by 5 points.

[3] In Chapter Two, Section IV of LTFA are specified the motor vehicles, registered for operation on the road network of the Republic of Bulgaria, the ships, that are in the registers of the Bulgarian ports, and the aircraft, that are in the state register of civil aircraft of the Republic of Bulgaria.

[4] As such can be defined the activities directly related to the management and the supervision of the company, regardless of whether they are conducted by the management bodies or by persons to whom such functions are delegated.

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transactions, made on a regulated Bulgarian securities market, are included the transactions of the collective investment schemes, licensed for public offering in Bulgaria.

- Pursuant to the amendment of Art. 62a, para 1 CITA, the profit of the collective investment schemes (open-end investment companies and contractual funds), licensed for public offering in Bulgaria, is exempt from taxation with corporate income tax, as well as the profit of the closed-end investment companies, within the meaning of POSA.

  The distributed dividends to the shareholders are taxed under the general procedure of the Act (Art. 62, para 2 CITA).

- The financial result is transformed for tax purposes by the losses (under Art. 23, para 2, i. 17 CITA) and the profits (Art. 23, para 3, i. 3 CITA), realized from transactions with shares or tradable rights over shares, made on a regulated Bulgarian securities market, **as well as from transactions with shares of collective investment schemes.**

11. Final tax settlement of the budget-funded enterprises in the end of the accounting year

The supplementation of para 8 of Art. 51 CITA introduces the requirement for the budget-funded enterprises to perform a final settlement in the end of the accounting year, in case that a difference between the taxed monthly revenue and the annual revenue is established. This difference stems from the specific way of current determination of the tax base during the year. The adjustment shall be implemented in the annual tax return, regardless of whether it is positive or negative.

12. Amendments of the Accountancy Act and other Acts

12.1. Amendments of the Accountancy Act

The several amendments are in the following directions:

- The definition for “Small and Medium-sized Enterprises”, included in §1, i. 15 of the Accountancy Act, is changed.
- Article 15, para 2 of the Accountancy Act, which regulated the initial moment for accounting depreciation expenses for fixed assets, is abolished.
- The new para 4 of Art. 7 of the Accountancy Act stipulates that in the cases of payment of liabilities to budget-funded enterprises, arising on the grounds of and under the procedure stipulated by the law, the source document **shall be the payment document.**

12.2. Changes in the Non-profit Legal Entities Act and in the Co-operatives Act

Some quantitative criteria are changed, which shall be fulfilled, in order the financial statements of these entities to be subject to compulsory financial audit, as those criteria are increased (e.g. total assets, total operating income and average number of employees).

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13. Amendments of CITA, introduced with the Patronage Act (published in the State Gazette, issue 103, as of 23 December 2005, in force as of 23 December 2005)

- Art. 35, para 2 CITA that regulates the donation expenses, which are not taxed with one-off tax (if they are provided to the benefit of certain persons and organizations) is supplemented. **An additional relief is introduced, as the expenses on aids provided for free provided under the procedure and terms of the Patronage Act (PA), are exempt from one-off tax.**
- The expenses on aids provided for no consideration under the procedure and the terms of PA **are exempt from one-off tax and are tax-deductible, in case that their amount is up to 15% of the annual accounting profit of the companies.** The financial result shall be adjusted with the amount exceeding this limit in the annual corporate income tax return. The changes are introduced with the amendment of Art. 35, para 2 CITA and by the supplementation of Art. 23, para 2, i. 16c with new letter "c" CITA (the hitherto letter "c" becomes letter "d").
- We draw your attention to the fact that simultaneously with the adoption of the previously commented tax relief a limitation is introduced, that **the total amount of the donations, for which tax relief is provided, cannot exceed 65% of the accounting profit of the companies.** This requirement is introduced into Art. 23, para 2, i. 16c, letter "e" CITA.

The amendments of the legal provisions enter into force as of 1 January 2006, except for §30, i. 13 of LASCITA, with which amendments are made in relation to the legal definition for "financial entities" and the inclusion of the collective investment schemes within this group of companies, and for §33 of LASCITA concerning the changes in the Accountancy Act, which enter into force as of the day of their publishing in the State Gazette (i.e. 20 December 2005).

The information provided in this letter presents only a general view of the amendments and supplementations to LTFA and is not complete. Its objective is not to give answers to specific cases, which have to be solved after careful consideration of the particular facts and circumstances.

Should any questions arise, please do not hesitate to contact us at tel. 943 37 00 or through our e-mail address: office@afa.bg.

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