

# Corporate Tax Changes Implementing the EU Anti-Tax Avoidance Directive (2016/1164) and Other Developments

**This note discusses changes to the Corporate Income Tax Act in respect of the introduction of new tax rules for certain operating lease agreements, a new interest deduction limitation rule, amendments to the thin capitalization rule and the controlled foreign company (CFC) rule, and other amendments relating to implementation of the EU Anti-Tax Avoidance Directive (2016/1164).**

## 1. Introduction

The Bulgarian parliament adopted various amendments to the Corporate Income Tax Act (CITA)<sup>1</sup> effective 1 January 2019, which are discussed herein.

## 2. Amendments Introducing New Tax Rules for Certain Operating Lease Agreements in Accordance with New IFRS 16

The amendments consist in new rules governing the tax treatment of the expenses/income of a lessee under operating lease agreements to which IFRS 16<sup>2</sup> applies effective 1 January 2019 in both Bulgaria and other EU Member States.

The goal of the new rules is to no longer recognize such income/expenses for corporate income tax purposes. Instead, the income/expenses determined as per National Accounting Standard 17: Leases applied to these agreements will be recognized for corporate income tax purposes.

This is achieved through the following amendments to the CITA:

- new article 11a provides that:
  - income and expense related to operating lease contracts and recorded in the accounts of the lessee will not be recognized for tax purposes;
  - right-of-use assets in connection with operating leases recognized by a lessee are not included

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1. BG: Act Supplementing the CITA, State Gazette No. 15/2018 (16 Feb. 2018), State Gazette No. 91/2018 (2 Nov. 2018), State Gazette No. 98/2018 (27 Nov. 2018) and State Gazette No. 103/2018 (13 Dec. 2018).  
2. Commission Regulation (EU) 2017/1986 of 31 October 2017 amending Regulation (EC) No 1126/2008 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council as regards International Financial Reporting Standard 16, OJ L 291 (9 Sept. 2017).

in the tax depreciable value of a tax depreciable asset; and

- income and expenses relating to operating leases will be recognized for tax purposes for leases of right-of-use assets when determined in accordance with National Accounting Standard 17: Leases;
- new article 50(2) of the CITA provides that taxable fixed tangible assets from a lessee are those amounts that meet the requirements regarding depreciable fixed tangible assets with right of use in connection to a finance lease governed by international accounting standards; and
- the rules on changing the accounting policy (article 82 of the CITA) no longer apply where the change in the accounting policy concerns the application of IFRS 16 in Bulgaria.

In addition, right-of-use assets in relation to operating lease agreements under IFRS 16 will not be recognized as tax depreciable assets of the lessee.

## 3. Amendments Ensuing from the EU Anti-Tax Avoidance Directive (2016/1164)

### 3.1. In general

The measures provided for in the EU Anti-Tax Avoidance Directive (2016/1164)<sup>3</sup> are binding for all Member States. The idea is to transpose the measures in stages – from 1 January 2019 and from 1 January 2020. Based on this possibility, the Bulgarian CITA introduces the following three measures as of 1 January 2019: the interest limitation rule, the controlled foreign company (CFC) rule, and the general anti-abuse rule.

### 3.2. Interest limitation rule

This rule limits the amount of borrowing costs recognized for tax purposes. This implies that the exceeding borrowing costs are deductible in the tax period in which they are incurred only up to 30% of the taxpayer's earnings before interest, tax, depreciation and amortization (EBITDA rule). The CITA provides for a formula to determine EBITDA. Under the interest limitation rule, excess borrowing costs are not recognized for tax purposes in the year in which they are accounted for. The amount is calculated as follows:

3. Council Directive 2016/1164 of 12 July 2016 Laying down Rules against Tax Avoidance Practices that Directly Affect the Functioning of the Internal Market, OJ L 193 (2016), EU Law IBFD.

UEBC = EBC – 0.30 × TFRITA, where UEBC, i.e. the unrecognized exceeding expenses of borrowing costs is the amount by which the total amount of borrowing costs exceeds the total amount of taxable interest.

TFRITA is the tax financial result (TFR) prior to any interest, tax and annual tax amortization deduction determined in accordance with the following formula:

$$\text{TFRITA} = \text{TFR} + \text{ATA} - \text{ARI} + \text{EBC}$$

TFR being the tax financial result before deduction of tax losses and before the application of the interest limitation rule described above, ATA being the amount of annual tax amortization, ARI being the total amount of recognized interest and EBC being the amount of excess borrowing costs before the application of the interest limitation rule described herein.

The new interest limitation rule will not be applied where the exceeding borrowing costs in the current year are not more than the BGN equivalent of EUR 3 million calculated using the official BGN/EUR exchange rate. It is expected that this threshold will exclude from the new regime a significant number of Bulgarian companies and that it will be applied to a limited number of taxable persons.

With the introduction of the interest limitation rule, the CITA has expanded the scope of regulated borrowing costs. The following expenses are added to those that were previously recognized:

- interest expenses on all forms of debt;
- other costs economically equivalent to interest; and
- expenses incurred in connection with the raising of finance.

In order to facilitate the application of the provisions of the CITA, a list of possible borrowing costs is included, as follows:

- payments under profit participating loans;
- imputed interest on instruments, such as convertible bonds and zero-coupon bonds;
- amounts under alternative financing arrangements;
- the finance cost element of finance lease payments;
- capitalized interest included in the balance sheet value of a related asset for tax purposes;
- amounts measured by reference to a funding return under transfer pricing rules;
- notional interest amounts under derivative instruments or hedging arrangements related to borrowings;
- foreign exchange gains and losses on borrowings and instruments connected with the raising of finance;
- guarantee fees for financing arrangements; and
- arrangement fees and similar costs related to the borrowing of funds.

Costs paid for penalty interest for overdue payments and forfeits remain outside the scope of the new rule, but only if such costs do not relate to loans.

The CITA provides for the opportunity to carry forward, without time limitation, exceeding borrowing costs that cannot be deducted in the current tax period.

The new interest limitation rule will not be applied to credit institutions listed in item 86(1) of the Supplementary Provisions of the CITA.

### 3.2.1. Thin capitalization rule

The CITA foresees that, when applying the thin capitalization rule (article 43 of the CITA), unused interest capacity from previous years can be recognized for tax purposes without time limitation.<sup>4</sup>

### 3.3. Controlled foreign company rule

This rule is one of the EU measures to counter aggressive tax planning in the internal market. The Bulgarian CITA does not contain rules to determine the taxable profit of a CFC and, therefore, a new chapter 9a was enacted. According to the new rule, a taxable person in Bulgaria is required to do the following:

- determine its associated enterprises – i.e. entities in which the taxable person holds directly or indirectly a participation in terms of voting rights or capital ownership of 25% or more or is entitled to receive 25% or more of the profits of those entities;
- determine whether or not it has a participation in a CFC. According to the CITA, the definition of a CFC includes a foreign entity (a legal person or a legal arrangement, including a commercial company, partnership, trust or foundation) or PE abroad in which a Bulgarian taxable person itself or together with its associated enterprises holds a direct or indirect participation of more than 50% of the voting rights, or owns directly or indirectly more than 50% of the capital or is entitled to receive more than 50% of the profits of that entity;
- compare whether or not the actual corporate tax paid on its profits by the entity or PE is lower than the difference between the corporate tax that would have been charged on the entity or PE under the CITA and the actual corporate tax paid on its profits by the entity or PE;
- after it is established that the Bulgarian taxable person has a participation in a CFC, this person must add to its taxable profit the profit of the CFC in compliance with the rules provided for by law.

The law provides for a procedure for the tax treatment of the undistributed profits of the foreign entity and of the PE. With a view to avoiding double taxation, the right to a tax credit has been introduced. The tax credit may be used by the Bulgarian taxpayer for the tax paid abroad by the CFC on profits that have been included in the taxable profit of the Bulgarian taxable person.

4. This was widely discussed, for example, in Aug. 2018. The Ministry of Finance proposed to abolish the thin capitalization rule, but subsequently decided to keep it. Instead, an amendment was introduced such that restricted interest expenses could be carried forward indefinitely (previously, this was only possible for a period of up to 5 years).

The CITA introduces an obligation for taxable persons to maintain a register with specific details on the CFCs in which they participate. This register should be provided to the tax authorities upon their request.

### 3.4. General anti-abuse rule

The CITA states that the general anti-abuse rule is applicable where one or more transactions, including those between unrelated persons, have been effected under conditions the fulfilment of which results in tax evasion.

In such instances, the tax base is determined without taking into consideration the said transaction, the conditions thereof, or the legal form thereof. What is taken into consideration is the tax base that would have been obtained had a customary transaction of the respective type been undertaken at market prices. The tax authorities look to a transaction aimed at achieving the same economic result without resulting in tax evasion.

According to the Bulgarian legislator, the following shall also be regarded as tax evasion:

- the purchase of excessive quantities of materials and raw stuff used in manufacturing, as well as other excessive manufacturing expenses in comparison with usual expenses employed by the person in the activity he carries out, provided that there are no objective reasons for the excess;
- contracts for interest-free loans or the gratuitous granting of the use of tangible or intangible assets;
- the receipt of or provision of credits at an interest rate that differs from the market rate at the time the transaction takes place, including interest-free loans or other gratuitous temporary financial aid, and remission of credits or repayment of credits on one's own account, such credits not being connected with the activity; and
- the accrual of remuneration or compensation for services that have not been provided.

The CITA explicitly states that in situations in which there are two transactions, i.e. the transaction reported to the tax authorities and the unreported covert transaction, tax liability is determined based on the covert transaction.

### 4. Amendments Ensuing from Regulation (EC) No 1303/2013 Concerning Collective Investment Schemes

The CITA provides that, from 1 January 2019, an exemption from corporate income tax will be available for alternative investment funds created for the purpose of imple-

menting financial instruments on the basis of financing agreements within the meaning of article 38(7) of Regulation No 1303/2013<sup>5</sup> of 17 December 2013. This provision deals with investments in certain newly created entities.

### 5. Amendments Regarding the Filing and Payment of Corporate Tax

In the event a company is terminated during the current year,<sup>6</sup> due to liquidation or insolvency, the company's last taxation period begins on 1 January and ends on the day of deregistration. Pursuant to the CITA, the deadline for filing the last tax return is 30 days after the date of the company's deregistration. The tax payable is due within the same time frame.

The same rules apply when terminating a PE or an unincorporated association.

An obligation to file an annual tax return pursuant to the CITA has been introduced for companies that did not perform activities during the year or that wish to report any losses incurred or hidden profit distributions.

### 6. Amendments Concerning Food Vouchers

The operators of food vouchers may use the amounts received from employers to pay the VAT included in the face value of the food vouchers.

Provisions have been made for new content with regard to food vouchers. All operators of food vouchers are obliged to provide only the new vouchers to employees. If they fail to comply with this obligation, they will be fined at least EUR 1,000.

### 7. Conclusions

In conclusion, it can be said that the amendments to the CITA have effectively transposed the requirements of the ATAD. The efficiency of their application remains to be seen.

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5. Regulation (EU) No 1303/2013 of the European Parliament and of the Council of 17 December 2013 laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund and laying down general provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund and the European Maritime and Fisheries Fund and repealing Council Regulation (EC) No 1083/2006, OJ L 347, pp. 320-469 (19 July 2016), available at <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32013R1303>.
  6. In Bulgaria, the financial year begins on 1 Jan. and ends on 31 Dec.