

## BULGARIAN TAX EXEMPTION FOR INTEREST AND ROYALTY PAYMENTS – A BOOST TO A DEVELOPING SOFTWARE & DEVELOPMENT SECTOR

New amendments to the Bulgarian Corporate Income Tax Act on the taxation of income from interest and royalties entered into force as of 1 January 2015, implementing the requirements of the EC Interest and Royalties Directive<sup>1</sup>.

Income from interest or royalty payments, arising in Bulgaria in favor of an associated company located in another EU Member State (subject to 5% withholding tax until 31 December 2014), is now exempt from taxation.

The exemption increases the flexibility in structuring European Union investments in the country without necessarily seeking a favorable location for the establishment of the holding company. It enables tax efficiency in the loans and royalty payments within EU groups of companies and facilitates implementation of internal mechanisms for liquidity improvement such as cash pooling arrangements.

### *Requirements for the application of the tax exemption*

*The beneficial owner will qualify for tax exemption if it meets the following requirements:*

- a. the legal form of the beneficial owner is one of the forms set out in the annexes to the CITA<sup>2</sup> which include capital corporations;
- b. the beneficial owner is a tax resident in an EU Member State according to the tax legislation of the Member State and is not, considered under any act<sup>3</sup>, as being tax resident outside the European Union;
- c. the beneficial owner is subject to one of the corporation taxes set out in the CITA<sup>4</sup> or other similar or identical taxes with no exemption rights;
- d. the beneficial owner acts for his own benefit and not as an agent or intermediary;  
and
- e. the payer of the income and the beneficial owner qualify as associated

<sup>1</sup> Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States

<sup>2</sup> The relevant corporations that may benefit from the exemption are listed in Annex 5 to the Bulgarian Corporate Income Tax Act ("CITA").

<sup>3</sup> e.g. under any applicable Double Tax Treaty.

<sup>4</sup> The relevant corporate taxes are set out in Annex 6 to the CITA.

companies.

The criteria for companies to qualify as associated companies are as follows: (i) one of the companies holds at least 25% of the shares in the other company for a period of at least two years; or (ii) a third person located in an EU Member State holds at least 25% of the shares in both the beneficial owner's capital and the payer's income.

The exemption will still apply before the expiration of the two years' period above, provided that the minimum shareholding has been in place continuously until the time of the income's accrual. However, in case the exemption is applied but the shareholding is interrupted prior to the above two-year period expiration, a withholding tax of 10% and a default interest is due.

### ***Permanent establishment***

A permanent establishment of an entity situated in a EU Member State may classify as beneficial owner and thus benefit from the tax exemption option if (a) the debt-claim, the right or use of information in respect of which interest or royalties payments arise is effectively connected to the permanent establishment; and (b) the permanent establishment is subject to taxation with a corporation<sup>5</sup> or a similar tax for the income from interest and royalties in the EU Member State where it is situated.

### ***Restriction for certain incomes***

The application of the tax exemption is restricted for certain types of income such as profit distributions, repayments of capital, income from transactions considered as tax evasion, and income from debt-claims, giving creditors the right to participate in the profits of the debtor, etc.

### ***Tax refund in case of undue payment***

If income from interest and royalties subject to exemption has been taxed from 1 January 2015 onwards, the beneficial owner is entitled to a tax refund to be processed by the revenue authorities no later than one year after being requested.

### ***A boost to Bulgaria's developing IT & software sector***

The implementation of the EC Directive into Bulgarian law adds flexibility in structuring investments and debt arrangements for entities in Bulgaria.

It is perhaps particularly relevant to companies in the rapidly developing Bulgarian software sector which have European and global sales and international development offices. The removal of an unnecessary tax loss will allow companies to put in place appropriate software licensing and royalty arrangements that better reflect the

<sup>5</sup> The taxes are set out in detail in Annex 6 to the CITA and also include with regard to Belgium "impôt des non-résidents/belasting der niet-verblijfhouders" and Spain "Impuesto sobre la Renta de no Residentes" or identical or similar taxes which are imposed in addition to or instead of those taxes.

complexities of collaborative and multi-jurisdictional development teams.

In turn, such professional corporate structuring will boost those companies that will be seeking external capital and financing to structure for future growth or, indeed, to exit.

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