

Relations Between European Law and Taxation in Bulgaria

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To cite this article:

Ganeta Minkova. Relations Between European Law and Taxation in Bulgaria. *International Journal of Law and Society*.

Vol. 6, No. 1, 2023, pp. 16-22. doi: 10.11648/j.ijls.20230601.13

Received: December 2, 2022; **Accepted:** December 26, 2022; **Published:** January 9, 2023

Abstract: The Republic of Bulgaria joined the European Union (EU) in 2007. The aim of this article is to review the impact of European law on the Bulgarian tax system. As the topic is very broad, the study focuses on the Constitution on the one hand and certain tax statutes on the other. Attention is also paid to the latest challenges in the field of international taxation. First, the subject of the study is the amendments made to the constitutional provisions related to tax matters. In discussing them, it is necessary to use a broader concept of European law, since the European Charter of Local Self-Government was adopted by the Council of Europe. Articles 9 (1), 9 (2) and 9 (3) of the Charter set out important principles of self-government that influence the decision-making process on what amendments to undertake to the Constitution. Second, for the purposes of this article, the recent changes in the area of indirect taxation are taken into account, as indirect taxes have been harmonized with the VAT Directive transposed into the Bulgarian Value Added Tax Act (VATA). EU legislation also governs excise duties, which are levied on alcoholic beverages, tobacco and energy products. The provisions of Directive 2008/118/EC on the general arrangements for excise duty have been transposed into the Bulgarian Excise Duties and Tax Warehouses Act (EDWA). However, excise duties need a separate in-depth study. For this reason, they remain outside the scope of this article. Third, changes have been made in the area of direct taxation. A key objective of the EU is the creation of a common market, which implies the removal of obstacles to the free movement of goods, persons, services and capital between Member States. The Treaty on the Functioning of the European Union (TFEU) therefore contains provisions empowering the Union to introduce directives in the field of direct taxation. Nevertheless, as bilateral tax agreements also apply in the same area, the article sheds light on the conflicts between them and EU directives, as they are sometimes based on different legal principles.

Keywords: Constitution of the Republic of Bulgaria, Central and Local Authorities, Value Added Tax (VAT), Corporate Income Tax (CIT)

1. Introduction

As a result of Bulgaria's EU membership, new laws were adopted or provisions in existing laws were amended in line with primary and secondary European law. Although the relationship between the national legal systems of the Member States and European law has been the subject of research, [7, 9], there is no comprehensive study of the interaction between tax rules at European and national level in Bulgaria, as it is usually focused on general issues rather than tax problems.

The article deals with the question of whether the undertaken amendments to the legal framework are both timely and integrate seamlessly into the Bulgarian legal

system. Since the topic is wide-ranging, this article aims to provide an overview of several aspects of constitutional amendments, indirect and direct taxation. From the research perspective, only the latest developments in the field of indirect and direct taxation are reviewed. Attention is also drawn to the challenges arising in cross-border situations.

The study starts with the amendments made in 2007 to the constitutional provisions related to tax matters. Pursuant to Art. 5 (1), the Constitution is the supreme law, and no other law may contradict it. The provisions of the Constitution have immediate effect. Consequently, as the Constitution is supreme law, the conformity between its provisions and primary EU law - the EU founding Treaties - is an issue that may exist in Bulgaria as well as in other Member States. To

emphasize the problem, it is worth mentioning the decision of 7 October 2021 of the Polish Constitutional Court, [3] according to which certain provisions of the EU Treaties and certain decisions of the European Court of Justice (CEJ) are contrary to the Polish Constitution. Furthermore, under Bulgarian law, the EU's founding Treaties are international treaties to which Article 5 (4) of the Constitution applies. In the hierarchy of normative acts, the provision places international treaties on the same level as statutes, not the Constitution. Some authors express the view that it is incorrect to present the relationship between "EU law and national constitutions solely through the prism of the hierarchy between legal rules. Rather, we are talking about two complementary legal orders. In the rare case of conflict, one of the two must give way." [3] It should be noted that this topic is not covered in detail in the present study as it is more fundamental and not specifically related to taxation.

Second, subject of research are indirect taxes, which at EU level are VAT, excise duties and taxes on capital raising. There is no a tax on capital raising in Bulgaria, but there is an indirect tax on insurers. In considering indirect taxation, it is necessary to provide a background as to why the EU institutions can exercise powers in this area? The answer lies in Article 113 of the TFEU, which empowers the Council to adopt provisions to harmonize indirect tax legislation in so far as such harmonization is necessary to ensure the functioning of the Internal Market. In accordance with this provision, the Directives on the common VAT system and excise duties were adopted. Both directives have been transposed into Bulgarian legislation. Despite the high degree of harmonization of indirect taxes, rapid changes in international trade are leading to new developments in VAT legislation that need to be explored and addressed in the study.

Third, it should be stressed that although the EU Treaties do not explicitly confer legislative competence on the EU institutions in the area of direct taxation, the EU's main objective of creating a common market implies the removal of obstacles to the free movement of goods, persons, services and capital between Member States, including through the approximation of corporate taxation. Articles 115 and 352 of the TFEU are considered to empower the Union to introduce directives in the field of direct taxation. An analysis of the interaction between EU directives transposed into national laws on the one hand, and bilateral tax agreements on the other, leads to the conclusion that there may be contradictions between each of these parts of Member States' national legal systems.

The paper ends with its formal conclusions.

The article does not employ an empirical method as the analysis is conducted by doctrinal research and comparative study between EU law and Bulgarian tax law. Accordingly, the sources for analysis are limited to books, articles published in peer-reviewed journals and case law.

2. Amendments to the Constitution

Constitutions have been the subject of extensive research

for centuries. [12-14, 17] As a legal form for the organization of society, constitutions have a relationship with fundamental international instruments. For this reason, a broader notion of European law should be used when describing constitutional amendments. The European Charter of Local Self-Government [33] adopted by the Council of Europe guarantees the political, administrative and financial independence of local authorities and is therefore a tool for achieving appropriate solutions through the vertical distribution of the taxing powers between central and local authorities.

The Constitution of the Republic of Bulgaria [24] contains several provisions that regulate taxes. Article 60 (1) lays down the principle of the establishment of taxes by law [5, 6] and the ability to pay principle. It states that citizens shall be obligated to pay taxes and fees established by a statute in proportion to their income and property. However, the principle of ability to pay remains regulated only as a principle to be respected when taxing citizens and not entities. Therefore, from the ability to pay perspective, the legislative expediency by designing of direct taxes levied on companies is not yet in dispute.

The principle of the establishment of taxes by law, reiterated in Article 84, i.3 of the Constitution, provides for a horizontal distribution of powers among various authorities, reserving taxation of citizens and corporations in the exclusive competence of Parliament. During the 30-year-existence of the Constitutional Court of the Republic of Bulgaria, the principles of the legal state and of the establishment of taxes by law have been addressed in many judgments. [34-48] The reasoning of some of them [49, 50] are interesting as they shed light on the Court's view of the legislature's discretion in the area of taxation. The court concludes that the requirements for the establishment of taxes by law covers all their elements – tax object, tax base, tax rate, etc. If all these elements are established by statutory provisions, there is no constitutional violation. This well-known case law illustrates that the legislature is free, in accordance with the political views of the ruling party or parties, to adopt rules for taxation. However, these conclusions, drawn in 1996 and 1998, are open to revision, as the harmonization of indirect taxation entails constraints for national parliaments to exercise legislative expediency not only in relation to the principle of establishing indirect taxes by law, but also in relation to the ability to pay principle.

Article 141, paragraphs (3) and (4) of the Constitution set out the vertical distribution of powers between central and local authorities with respect to taxes and fees.

In 2007, articles 84, i.3 and 141 (3) and (4) have been amended with the intention of giving more powers to the local authorities, with the level of local taxation set in accordance with Article 9 of the European Charter of Local Self-Government. Local municipal councils were granted the competence to adopt ordinances in order to determine the rate of local taxes under terms, according to a procedure, and within a range established by the Local Taxes and Fees Act [27].

3. Indirect Taxation

3.1. Challenges for Value Added Tax in Relation to Globalization

As mentioned above, Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax [28] harmonizes VAT and is transposed in the Value Added Tax Act [25]. The purpose of VAT is to impose a broad-based tax on final consumption. Since businesses do not have to be burdened, the tax is collected along the supply chain, which includes every stage of production and distribution. The supplier shall charge VAT and submit an invoice to the recipient stating the amount of tax charged. The recipient may in turn deduct this tax from the sales tax charged. The taxable person must remit the balance to the tax authorities and obtain a refund where there is an overpayment. However, the end user pays the tax without being entitled to deduct the VAT charged.

The main difficulty in applying VAT lies in determining the jurisdiction where consumption takes place. The issue is whether the tax is collected in the jurisdiction of origin or destination. In the past, the place of taxation for VAT has traditionally been based on the location of the supplier (origin principle) as it was expected that the consumer would be located in the same country. In this sense, there was no difference which of the principles applies - the origin principle or the destination principle (the location of the recipient). However, the common market, globalization and technological changes have altered this situation as e-commerce and distance selling of goods have increased. Today, customers can shop online without the need for suppliers to be physically located in the customer's country of residence.

Because exports are not taxed and imports are taxed at the same rate as domestic supplies, the application of VAT rules in cross-border situations leads to a distortion of the staged tax collection process. Although the destination principle is well known in theory and practice, its application to international trade in services or online trade in goods results in complications. In these cases, the delivery is not subject to controls in the same way as when the goods cross the border. As a result, the tax authorities of the jurisdiction of destination may encounter some difficulties in taxing a foreign company that does not have a permanent establishment in their country. Since dealing with foreign companies is risky for tax administrations, the challenge for them is how to prevent revenue loss. In addition, there are difficulties faced by companies when applying the destination principle. Where a person registered in Bulgaria provides services to non-taxable persons established in several Member States, the supplier must be registered in all these jurisdictions and the tax rights are determined in accordance with the requirements of their tax legislation. This creates a compliance burden for businesses.

In order to avoid such situations and to simplify the registration, declaration and payment of the tax, the EU has adopted a new legal framework [30, 31] which governs:

supplies of services where the recipients are non-taxable persons; distance sales of goods imported from third territories or third countries in consignments of an intrinsic value not exceeding EUR 150; intra-Community supplies of goods from a taxable person not established in the Community to a non-taxable person. The new directives are transposed in different parts of the VAT Act. For example, in accordance with the registration rules, following provisions are introduced: a taxable person with costumers in many countries may choose to register only in Bulgaria and submit a return indicating all supplies to other jurisdictions; the taxable person must calculate the taxes in accordance with the legislation of each country, but pays a total amount for all taxes due; the Bulgarian tax administration allocates the tax due to each jurisdiction that has the taxing rights.

3.2. VAT and COVID-19 Pandemic

The COVID-19 pandemic resulted in a global health crisis and a sharp decline in economic activity. In recent history, only the global financial crisis in 2008 is comparable to the current situation. The recovery in many countries led to increased government spending. In the same time tax revenues have become significantly lower. Both processes have driven an increase in budget deficits and government debt.

Typically, tax policy-making is associated with the economically active part of citizens and businesses, as their activity is a source of tax revenue. Nevertheless, rising unemployment and at the same time rising prices, which have been observed since mid-2021, make it necessary to support economic activity rather than to consider it as a revenue generator for the budget. In addition to the temporary reduction of the tax rate [21] at which certain supplies are taxed, Bulgaria also raised the threshold for mandatory VAT registration. Any taxable person established on the territory of the Republic of Bulgaria with a certain turnover or more for a period not exceeding 12 consecutive months preceding the current month, is required to submit an application for VAT registration. In July 2022, the turnover amount was changed from BGN 50,000 to BGN 100,000.

Under Article 287 of the VAT Directive, Member States may exempt taxable persons whose annual turnover does not exceed amounts determined on the date of their accession. For Bulgaria this turnover was set at EUR 25 600, equivalent to BGN 50 000, and the new rule could not have entered into force before the decision of the Council of the European Union authorizing the Republic of Bulgaria to introduce a special measure derogating from Article 287. The request for derogation was sent to the Commission via the Permanent Representation of the Republic of Bulgaria to the EU on 13 May 2022 and its receipt was confirmed by the Commission on 23 May 2022. According to the final provision of the law amending the VAT Act, the turnover on compulsory registration shall enter into force on the first day of the month following the month in which the decision of the Council of the European Union authorizing the Republic of Bulgaria to introduce a special measure derogating from Article 287 of

Council Directive 2006/112/EC enters into force, but not earlier than 1 January 2023.

On 17 November 2022, the Ministry of Finance [22] announced that the Council of the European Union has authorized Bulgaria to introduce a special measure derogating from Article 287 of the VAT Directive. This allows Bulgaria to exempt from VAT persons with an annual turnover up to EUR 51 130, equivalent to BGN 100,000 at the exchange rate on the day of accession. The derogation is valid until 31 December 2024, by which time Member States should transpose Directive (EU) 2020/285 [29] and, accordingly, from 1 January 2025 they will be allowed to exempt from VAT supplies of goods and services made by persons whose annual turnover does not exceed the threshold of EUR 85 000. It is expected that from 1 January 2025 the turnover will exceed BGN 166,000 [23] since such a draft was introduced in April 2022.

Increasing the minimum threshold for VAT registration from 50,000 to 100,000 euro is a measure that will have a positive effect in the current difficult economic environment and will reduce the administrative burden for small businesses. Persons with a taxable turnover below BGN 100,000 can remain voluntarily registered for VAT purposes.

3.3. *Obligation for the Recipient to Pay the VAT in Cases the Supplier Did Not Pay It*

Although responsibility for another person's tax liabilities is a well-known technique [1, 8, 10] introduced in legislation for fiscal purposes, it has always been criticized. [4] Paragraphs 1-3 of Art. 177 of the VATA provide that the recipient shall be held liable for the payment of VAT if it was not paid by the supplier. The liability shall be enforced where the registered person knew or was obligated to know that the tax will not be remitted, and this is proved by the auditing authority. The rationale for this wording can be found in the desire to strengthen the fight against tax avoidance and tax evasion.

These provisions were challenged for the CEJ. However, the Court has already expressed the view [55] that such provisions are not in contrary to Art. 205 of the VAT Directive. In the same sense is the case law of the Bulgarian SAC. [51-54].

The SAC also referred for a preliminary ruling to the CEJ with the question: Is the recipient liable for interests in addition to VAT in the case of article 177 of the VAT Act. In the Judgment of 20 May 2021 [56] the court gives a positive answer to the question. The arguments are that, although the procedure laid down in article 205 of the VAT Directive, to concern only the payment of VAT, that wording does not preclude Member States from imposing on recipient all the obligations relating to the tax, such as the obligation to pay interests due.

So, the provision of Art. 177 led to some disputes, but in the end, it was decided that it is in line with the VAT Directive.

4. Direct Taxation

4.1. *Alternative Taxes*

The Council Directive of 12 July 2016 [32] lies down rules against tax avoidance and tax evasion allowing the Member State where a parent company is based to tax not only the profits of that parent company, but also the profits of its subsidiaries that do not pay sufficient corporate tax (or no tax) in their jurisdiction of residence. The anti-avoidance rules are transposed in Chapter Twenty of the Corporate Income Tax Act (CITA), [26] in connection with which EU Commission sent a letter of formal notice to Bulgaria drawing its attention to the tax treatment of undertaxed subsidiaries [18]. The Commission expressed the opinion that Article 47c, para. 4 CITA includes an undue exemption for subsidiaries, which are subject to "alternative forms of taxation", not to corporate income tax.

Article 47c, paragraph 4 states that the anti-avoidance rules shall not apply to: 1. any taxable person which is liable to tax for all or part of the activities thereof according to the procedure established by Part Five 'Alternative taxes' of the CITA; 2. any controlled foreign company which is: (a) a foreign entity and is subject to alternative forms of taxation for the activities thereof in the country where the said entity is resident for tax purposes or in another country; (b) a permanent establishment abroad which is subject to alternative forms of taxation for the activities thereof.

In fact, the provisions of the Directive themselves give rise to disputes. Article 1 sets out that the Directive applies to all taxpayers that are subject to corporation tax. In this regard, the question arises as to whether the provisions of the Directive can be extended to other types of taxes. For example, Art. 5 CITA regulates taxes alternative to corporation tax as the tax on the activity of organizing games of chance or on the vessels operation activity. With strict interpretation of Art. 1 of the Directive, the answer should be negative. However, in December 2021 the Council of Ministers submitted to Parliament a draft law amending and supplementing the CITA. The law was adopted by Parliament in February 2022 and Article 47c, paragraph 4 was repealed. As a result, in July 2022 the infringement procedure was closed.

4.2. *Attempts to Unify the Corporate Taxation*

Various OECD and EU initiatives have been taken to limit the cases of base erosion and profit shifting [15, 16]. Annually, a large part of the global corporate tax revenue is not collected efficiently as multinationals, through a wide network of subsidiaries, take advantage of the existing tax competition between countries. For this reason, there are constant attempts to unify the corporate tax systems of different jurisdictions.

The most significant project for approximation in the field of direct taxation was Commission's proposal for a Common consolidated corporate tax base (CCCTB). The objectives were the adoption of common rules defining the tax base of

companies, in order to reduce the compliance costs arising from the differences between the 27 national corporate tax systems, and the creation of a consolidation mechanism at European level, in order to permit cross-border compensation of losses and to avoid transfer pricing disputes. Such a reform raises a number of issues. Some of them are more technical, such as the relation between the rules for the determination of the tax base and the existing national or international accounting rules. Other issues are more political, for instance the unwillingness to accept further integration in direct tax matters. Member States should abandon their power to grant tax incentives in the form of a reduction of the tax base. Various Member States have clearly declared that they would not participate in such a project and it seemed that the CCCTB will never become acceptable.

From mid to late 2021, the OECD developed two interrelated documents, which were also discussed within the G20. The economies of the countries that joined the Declaration on the Introduction of a New Legal Framework for International Tax Reform produce about 90 percent of the world's gross domestic product. It is evidence that there is a global consensus on the need for reform in the taxation of multinational companies' profits. The OECD's 'Two-pillar Package' [2, 11] gives new input to the idea of creating a mechanism for determining the place where corporate tax should be paid. This shall be the place where the company's customers are, not the place where the permanent establishment of the company is.

Simultaneously with the work of the OECD, the European Commission published the proposal "Business in Europe: A Framework for Income Taxation" (BEFIT), [19] which includes recommendations for Member States to: allow loss carry forwards for businesses at least up to the previous financial year; allow the deduction of costs related to equity financing; require large companies to publish their tax rates; monitor shell companies. Another EU initiative is the Debt-equity Bias Reduction Allowance (DEBRA) [20]. In certain European Union countries, debt is treated more favorably than equity because these countries allow interest payments to be deducted from taxable income, while not offering the same relief for equity financing. This gives companies a strong incentive to borrow rather than finance new investment through capital increases. DEBRA proposes that equity should be tax treated in the same way as debt so that companies can consider both options on an equal basis and choose the source of finance that is most appropriate for their business model.

5. Conclusions

As a result of the research, following conclusions could be summarized:

- (i) The legislator has taken measures to ensure coherence between EU primary law and the Bulgarian Constitution. However, the question of the correlation between these legal acts has not been resolved in terms of the wording of Article 5 (4) of the Constitution,

although the same problem is faced by other Member States as described above.

- (ii) The view expressed in theory and in the case law of the Bulgarian Constitutional Court that the national legislator is free to adopt discretionary taxation rules may need to be reconsidered. The harmonization of indirect taxation implies limitations for national parliaments to exercise legislative expediency in designing VAT and excise duties. Only the design of direct taxes is subject to decisions to be taken by the national legislatures of the Member States, but this situation may well change following the signing of the Multilateral Convention, which will introduce the OECD's 'Two-pillar Package'. In this sense, but not only, indirect and direct taxes will converge.
- (iii) Although recent changes to EU VAT legislation were transposed into the Bulgarian VAT Act in a timely manner, the amendments to the turnover threshold for mandatory registration made in mid-2022 showed that the legislator had taken them earlier than it should have. For this reason, many companies believe that the turnover was changed before the change took effect. This legislative technique should not be encouraged, but our experience shows that in a difficult economic and political environment some rules are disregarded.
- (iv) It should be stressed that the implementation of the OECD's 'Two-pillar Package' may result in a loss of revenue for jurisdictions that tax MNC with alternative taxes rather than with corporate income tax, as the allocation of the taxing rights to the market country can be addressed with respect to the corporate tax but not with respect to the alternative taxes.
- (v) The OECD's 'Two-pillar Package', the EU BEFIT and DEBRA proposals should be coordinated as they are complex in content and inconsistencies between them can create compliance burdens for businesses and difficulties for tax administrations in implementing the rules.

Further research needs to be done on these OECD and EU proposals and initiatives in order to achieve coherence between them. Convergence of rules may prove difficult as there are significant differences between the tax systems in the countries around the world. Even within Member States, the variations are apparent, although there are more similarities. It is necessary to take into account as wide a range of tax systems as possible globally, when drawing up the rules, so that the interests of different jurisdictions can be best respected.

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