МИНИСТЕРСТВО НА ФИНАНСИТЕ

TAX TREATMENT OF INTANGIBLE ASSETS

BULGARIAN EXPERIENCE

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FOCUS OF PRESENTATION

- This presentation focuses on :
  - the accounting and tax treatment of intangible assets in Bulgaria
  - the tax incentive adopted to stimulate the scientific research and development activities by means of which the intangible assets are formed
  - tax treatment of royalty payments

APPLICABLE ACCOUNTING AND TAX LEGISLATION

- The accounting and tax treatment of fixed intangible assets in Bulgaria is regulated by the following enactments:
  - Accountancy Act
  - International Accounting Standards (IAS)
  - National Standards for Financial Statements of Small and Medium Sized Enterprises
  - Corporate Income Tax Act
- The accounting treatment of fixed intangible assets is regulated by International Accounting Standard (IAS) 38 – Intangible Assets (applicable for multinational enterprises, financial institutions, etc.) and National Accounting Standard (NAS) 38 – Intangible Assets (applicable for SMEs)

Definition of intangible asset

- The concept of intangible asset is specified by the accounting standard as an identifiable non-monetary asset without physical substance
- The standard stipulates clearly those assertable resources without physical substance which shall not be treated as intangible assets (financial assets and expenditure spent on the development and extraction of minerals, oil, natural gas, and similar non-regenerative resources)

RECOGNITION OF INTANGIBLE ASSETS

- The IAS 38 stipulates in details the recognition, acquisition and measurement of the intangible assets
- In compliance with the provisions of the standard given intangible asset is recognised as being such in the event when:

- it complies with the definition of intangible asset (non-monetary asset without physical substance) and
- the criteria for recognition

✓ it is probable that the expected future economic benefits that are attributable to the asset will flow into the entity, and

✓ the cost of the asset can be measured reliably

TAX FIXED INTANGIBLE ASSETS

- Given intangible asset is recognised for tax purposes in the event when it complies with the criteria for tax intangible asset subject to the provisions of the Corporate Income Tax Act (CITA)

  <u>Definition of tax fixed intangible assets</u>

- Tax fixed intangible assets are acquired non-financial resources which:

- have no physical substance
- are used for a period longer than 12 months
- have a limited period of useful life
- have a value that either equals or exceeds the lower value of the following ones:

✓ the value threshold of significance of the fixed intangible asset specified in the accounting policy of the taxable person

✓ 700 BGN (350 EUR)

- In the event when a given intangible asset is not recognised as asset in the accounting statement, but meets the criteria for a tax asset, the reported accounting costs are not recognised for tax purposes in the fiscal year of their accounting

CLASSIFICATION OF INTANGIBLE ASSETS

- The intangible assets may be classified in the following main groups :
- arts-related : copyrights (photos, videos, audio materials)
- consumer-related: customer lists, contractual customer relationships, etc.
- contract-related: franchises, licensing agreements, broadcast rights, construction permits, exploration permits, import and export permits, service contracts, etc.
- goodwill (defined only with a business as a whole)
- market-related: trademarks, brand names, internet domain names, magazine mastheads, etc.
- technology-related: patents, trade secrets, computer programs, production formula, etc.

ACQUISITION OF INTANGIBLE ASSETS

- An intangible asset shall be measured initially at cost

  Acquisition of intangible assets

- The international standard considers the following means for acquisition of intangible assets:

- separate acquisition (purchase)
- acquisition as a part of a business combination
- acquisition by way of a government grant
- exchange of assets
- internally generated intangible assets

- The cost of separately acquired intangible asset comprises:
  - its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates; and
  - any directly attributable cost of preparing the asset for its intended use

- Examples of directly attributable cost are:
  - costs of employee benefits arising directly from the bringing the asset to its working condition
  - professional fees arising directly from bringing of the asset to its working condition
  - costs of testing whether the asset is functioning properly

ACQUISITION AS A PART OF BUSINESS COMBINATION

- The IFRS 3 defines a business combination as a transaction or other event in which an acquirer (entity) obtains control of one or more businesses
- In accordance with IFRS 3 Business Combination, if an intangible asset is acquired in a business combination, the cost of that intangible asset is its fair value at the acquisition date
- Fair value of an asset is the amount for which that asset could be exchanged between knowledgeable willing parties in an arm’s length transaction

ACQUISITION BY A WAY OF A GOVERNMENT GRANT

- An intangible asset may be acquired free of charge or for nominal consideration, by way of a government grant
- This may happen when a government transfers or allocates to an entity intangible assets such as airport landing rights, licences to operate radio or television stations, import licences or quotas or rights to access other restricted resources
- In accordance with IAS 20 Accounting for Government Grants and Disclosure of Government Assistance, an entity may choose to recognise both the intangible asset and grant initially at fair value
- If an entity chooses not to recognise the asset initially at fair value, the entity recognises the asset initially at a nominal amount plus any expenditure that is directly attributable to preparing the asset for its intended use

EXCHANGE OF ASSETS

- One or more intangible assets may be acquired in exchange for non-monetary asset or assets, or a combination of monetary and non-monetary assets
- The cost of such an intangible asset is measured at fair value unless

  (a) the exchange transaction lacks commercial substance or

  (b) the fair value of neither the asset received nor the asset given up is reliably measurable
- If the acquired asset is not measured at fair value, its cost is measured at the carrying amount of the asset given up

What does it mean that the exchange transaction lacks commercial substance ?

- An entity determines whether an exchange transaction has commercial substance by considering the extent to which its future cash flows are expected to change as a result of the transaction
- An exchange transaction has commercial substance if the configuration (risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred
- Example:

- It is sometimes difficult to assess whether an internally generated intangible asset qualifies for recognition
- To assess whether an internally generated intangible asset meets the criteria of recognition, an entity classifies the generation of the asset into:
  - a research phase, and
  - a development phase

INTERNALLY GENERATED INTANGIBLE ASSETS – RESEARCH PHASE

- In the research phase of an internal project, an entity cannot demonstrate that an intangible asset exists that will generate probable future economic benefits
- Therefore, this expenditure is recognised as an expense when it is incurred
- Examples of research activities are:
  - activities aimed at obtaining new knowledge
  - the search for, evaluation and final selection of, applications of research findings or other knowledge
  - the search for alternatives for materials, devices, products, processes, systems or services
- In the general case these costs are recognised for tax purposes in the fiscal year of making the accounting statement

INTERNALLY GENERATED INTANGIBLE ASSETS – DEVELOPMENT PHASE

- An intangible asset arising from development shall be recognised if an entity can demonstrate the following:
  - its intention to complete the intangible asset and use or sell it
  - its ability to use or sell the intangible asset
  - how the intangible asset will generate probable future economic benefits
  - the availability of adequate technical, financial or other resources to complete the development and to use or sell the intangible asset
  - its ability to measure reliably the expenditure attributable to the intangible asset during its development

Cost of an internally generated intangible asset

- The cost of an internally generated intangible asset comprises all directly attributable costs necessary to create, produce, and prepare the asset to be capable of operation in the manner intended by management
- Examples of directly attributable costs are:
  - costs of materials and services used or consumed in generating the intangible asset
  - costs of employee benefits arising from the generation of the intangible asset
  - fees to register a legal rights
  - amortisation of patents and licences that are used to generate the intangible asset

ACCOUNTING AND TAX DEPRECIATION RULES

ACCOUNTING DEPRECIATION RULES

- The accounting for an intangible asset is based on its useful life. An intangible asset with a finite useful life is amortised and an intangible asset with an indefinite useful life is not

<u>Intangible assets with finite useful life</u>

- The depreciation amount of an intangible asset with a finite useful life shall be allocated on a systematic basis over its useful life
- Amortisation shall begin when the asset is available for use
- The amortisation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity
- If that pattern cannot be determined reliably, the straight-line method shall be used

<u>Intangible assets with indefinite useful life</u>

- An intangible asset with an indefinite useful life shall not be amortised

TAX DEPRECIATION RULES

- In the Corporate Income Tax Act (CITA) provisions are stipulated on how to recognise for tax purposes the costs of depreciation of fixed intangible assets
- For tax purposes the companies are obliged to work out and to keep a tax amortisation plan
- The tax amortisation plan comprises a register in which data is filed on record about the process of acquisition, subsequent keeping, depreciation, and writing-off of tax depreciation assets
- When determining the tax financial result (the tax profit or tax loss) the annual tax depreciation is recognised
- The accounting costs of depreciation are not recognised for tax purposes
- The annual tax amortisation rate for the tax fixed intangible assets is up to 15 % (except in the case of software and rights of using software, in terms of which the annual amortisation rate is up to 50%)

- The law stipulates special provisions in connection with the tax recognised costs of depreciation of intangible assets, in terms of which there is a specified period of use on the authority of contractual relations or legal obligation
- This category includes also patents provided for use for a given period of time
- The annual tax amortisation rate is stipulated for the period of the legal constraint (thus for example if the contract of use of a patent is 5 years, the annual tax amortization rate will be 100/5 = 20 %), however this may not exceed 33,3 %

TAX INCENTIVE FOR FIXED INTANGIBLE ASSETS

TAX INCENTIVE FOR FIXED INTANGIBLE ASSETS

- In the Corporate Income Tax Act (CITA) the law provides a tax incentive to the fixed intangible assets formed as a result of research and development activities

  Art.69, Para.1 of CITA

- The company has the right when determining the tax financial result to decrease its accounting financial result by the historical value of a fixed intangible asset once in the year of its formation, in the event when all of the terms and conditions stipulated hereunder are complied with:

  - The asset is formed as a result of research and development activities;
  - The R&D activities are performed in connection with the main activities of the taxable person
  - The R&D activities are assigned by an order under market conditions to a Scientific and Research Institute or Higher Education Institution

- Objective of tax incentive – to stimulate research and development activities

WHAT DOES THE TAX INCENTIVE INCLUDE ?

General case

- In the general case to a regularly accounted fixed intangible asset have to be accrued accounting costs for depreciation
- In compliance with the tax legislation the above said accounting costs of depreciation are not recognised for tax purposes and they are used to increase the accounting financial result when determining the tax financial result
- In case the above said fixed intangible asset complies with the criteria of tax fixed intangible asset, it is accounted in a tax amortization plan with depreciation accrued thereto
- When determining the tax financial result the accounting financial result is decreased by the amount of the annual tax depreciation, that is the depreciation recognised for tax purposes

WHAT DOES THE TAX INCENTIVE INCLUDE ? (2)

Tax incentive case

- In the event when the company makes use of the tax incentive for R&D :
  - It shall file on record fixed intangible asset and shall report the accounting costs of depreciation not recognised for tax purposes and the latter shall be used to increase the accounting financial result in determining the tax financial result
  - It shall not file on record fixed intangible asset into its tax amortization plan and shall not accrue to its annual tax depreciation by means of deduction from the accounting financial result, but rather shall decrease the accounting financial result by the whole value of the asset when determining the tax financial result (100 % depreciation for tax purposes)

TAX INCENTIVE - EXAMPLE

- In the fiscal year 2010 Company A declares accounting financial result (accounting profit) to the amount of 1 000 BGN
- The company has formed intangible fixed asset to the amount of 600 BGN
- The accounting rate of amortisation is 20%
- The tax recognised rate of amortisation is 15%
- <u>The tax financial result will be:</u>

TAX INCENTIVE - EXAMPLE

Fiscal year 2010	**General case**	**Tax incentive case**
Accounting financial result (accounting profit)	1 000	1 000
Accounting costs of amortisation	+ 120	+ 120
Annual tax amortisation	- 90	0
Tax incentive	**0**	**- 600**
Tax financial result (tax profit)	1 030	620
Corporate Income Tax – 10 %	**103**	**62**

TAX TREATMENT OF ROYALTY PAYMENTS

TAX TREATMENT OF ROYALTY PAYMENTS IN CITA

- Definition of "Royalty" - §1, item 8 of Additional provisions of CITA

  The term "royalty" means payments of any kind received as a consideration for use of or the right to use any copyright of literary, artistic or scientific work, including films, any patent, trade mark, industrial design or useful model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience
- In compliance with the provisions of the Corporate Income Tax Act (CITA) the royalty payments, the beneficiaries of which are foreign legal entities, and when the income is not realized at the permanent establishment, are subject to withholding tax
- The withholding tax rate is 10 %
- In the event of applicable Double Tax Convention (DTC) in force between Bulgaria and the state of which the beneficiary is a resident, the tax rate of the applicable DTCs shall apply
- The rate of the withholding tax for royalty payments in the different conventions is 0 %, 5 % or 10 %
- For tax purposes the royalty payments made by a foreign legal entity are recognized to the payee – Bulgarian person, as costs

TAX TREATMENT OF ROYALTY PAYMENTS IN CITA (2)

- The tax deducted at the source of income is not recognised as cost
- In the event when the payee of the income has reported withholding tax, deducted for royalty payments as accounting cost, this cost is not recognised for tax purposes and is used to increase the accounting financial result
- In the event when a Bulgarian company is a beneficiary of income from royalty payments, this revenue is accounted in the form of income
- If withholding tax is deducted abroad from this income, the company has the right to a tax credit for the tax paid abroad

TAX TREATMENT OF ROYALTY PAYMENTS IN PITA

- In compliance with the provisions of the Personal Income Tax Act (PITA) the royalty payments, the beneficiaries of which are foreign individuals, are subject to withholding tax
- The withholding tax rate is 10 %
- In the event of applicable Double Tax Convention (DTC) in force between Bulgaria and the state of which the beneficiary is a resident, the tax rate of the applicable DTCs shall apply
- The rate of the withholding tax for royalty payments in the different conventions is 0 %, 5 % or 10 %
- For tax purposes the royalty payments made by a foreign individual are recognized to the payee – Bulgarian person, as costs

TAX TREATMENT OF ROYALTY PAYMENTS IN PITA (2)

- When the Bulgarian individual – sole proprietor, is a beneficiary of royalty payments, this revenue is accounted in the form of income
- If tax is deducted abroad from this income, unto stating the Bulgarian tax the sole proprietor has the right to a tax credit for the tax paid abroad
- In the event when a Bulgarian individual, except in the case of a sole proprietor, is a beneficiary of royalty payments, these payments are subject to taxation in terms of this individual
- The individual has the right to deduct with regard to this type of income, statutory recognised expenses to the amount of 40 %
- If withholding tax is deducted abroad from this income, the individual has the right to a tax credit for the tax paid abroad

TAX TREATMENT OF ROYALTY PAYMENTS IN PITA (3)

EXAMPLE

- Royalty Payments - 1 000 BGN
- Statutory recognised expenses 40 % - 400 BGN
- Tax base of PIT - 600 BGN (1000 - 400)
- PIT 10 % - 60 BGN
- Amount recognised for tax credit (deducted abroad withholding tax) - 50 BGN (5 % x 1 000)
- Final PIT - 10 BGN

THANK YOU FOR YOUR ATTENTION!

ANY QUESTIONS?