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## The Bulgarian Stock Exchange: Emerging in Emerging Markets

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### Background

The concept of organized securities market in Bulgaria was initiated at the very beginning of the economic transition. The stock exchange market emerged spontaneously under the general regulations of the Commercial Code. First Bulgarian Stock Exchange and Sofia Stock Exchange were the major players on the market and the first attempt to restore the trading tradition after fifty years of planned economy. The volume transactions was very low because of the delay in privatization and the lack of political will to stimulate a transparent capital market in the country.

In July 1995 the Law on Securities, Stock Exchanges and Investment Companies was adopted. A central institution for authorization, control and regulation of the activities of issuers, investors and stock exchanges was provided in the Law - the Securities and Stock Exchanges Commission (SSEC). Due to the stringent regulations, set in the act, and delayed privatization, the capital markets remained a good intention rather than reality.

On October 9, 1997 the Securities and Stock Exchange Commission granted license to the newly established Bulgarian Stock Exchange - Sofia (BSE - Sofia). It was founded as a joint venture between the state (with 49% of the shares), and the First Bulgarian Stock Exchange and Sofia Stock Exchange. The start of its operation was 21 October, when a "block trade" with shares of the companies privatized through vouchers began.

### Legal framework of the stock exchange market operation

The SSEC responsibilities and obligations will increase hand in hand with the capital market development in the following directions:-establishment of the rules of the game in the post privatization period and stimulation of portfolio investments. Another field of activity of the SSEC is regulation of financial intermediaries and investment funds. Until now 24 banks and 26 brokerage houses have obtained license for financial intermediaries, and most of the 81 registered privatization funds, participated in the mass privatization, will become investment funds. The Commission is now drafting an ordinance on the capital adequacy and liquidity of the investment intermediates.

The institutional structure of the capital markets is another important prerequisite for their further development. The Central Depository has a task to assure

a securities transactions through the clearing and settlement system. It combines several functions - registration of securities, organization of the relations among the members, and management of clearing and settlement systems. The Central Depository used to (and still does) register the transactions of the each company listed in the mass privatization program, and also open personal accounts for each individual shareholder who had acquired shares at the auctions.

### The Stock Exchange structure

The BSE - Sofia capital is BGL 199 mln., divided into 199,000 shares with par value of BGL 1000. According to the newly adopted internal regulations, if a financial intermediary wants to become member of the BSE - Sofia, it have to be member of the Central Depository, and should buy at least 1000 of the BSE - Sofia shares either from one of the contemporary shareholders, or through the further increase of its capital. Otherwise, it may become an associate member and will have to pay additional fee. The transaction fees as stipulated in the regulations are 0.2% for shares transactions, 0.02% for T-Bill transactions, and 0.001% for corporate bonds.

By November 18 the members of the BSE - Sofia are 29.

The trade will be basically divided in two market segment:

#### 1. Registered markets:

- official;
- parallel;
- temporary;
- bond.

#### 2. Non-registered markets:

- "free trade"

The requirements for listing shares in the different segments are as follows:

##### 1. Official market:

- at least 5 audited financial reports;
- market capitalization of the issue at least BGL 1 bn.
- at least 25% of shares should be publicly offered.

- at least 500 shareholders registered at the moment of the issue.

- profits for the last 3 years.

##### 2. Parallel market:

- at least 3 audited financial reports;
- market capitalization of the issue at least BGL 500 mln.
- at least 10% of shares should be publicly offered.
- at least 250 shareholders registered at the moment of the issue.
- profit for the last years.

##### 3. Temporary market:

- at least 1 audited financial reports;
- market capitalization of the issue at least BGL 100 mln.
- at least 10% of shares should be publicly offered.
- at least 250 shareholders registered at the moment of the issue.

##### 4. Bond market (for corporate bonds only):

- at least 3 audited financial reports;
- market capitalization of the issue at least BGL 100 mln.

All other shares will be traded on the "free trade" market. These will be mainly shares of companies in the mass privatization list as well as newly established companies.

### What's next?

1. At the moment the Stock Exchange is in a transitional stage of its development. The "block trade" which dominates the market now will be gradually replaced by real deals, and share prices will be determined by buyers and sellers negotiating at the Stock Exchange. Thus the "fundamentals" will start to influence the prices, replacing gradually the "feelings" of the brokers. Also, the number of the players will increase which will provide for transparency and liquidity on the market. By November 20 there were 24 banks and 26 brokerage houses licensed by the SSEC to act as financial intermediaries, and another fifty intermediaries are waiting to be licensed. There are no pension funds and insurance companies active on

the market so far. The reason for the low liquidity in the moment might also be the restricted number of the listed companies. For a certain period of time most of the shares traded on the market will be those distributed through the mass privatization. Until October 1998 they will be freely traded without a prospectus, approved by the SSEC, which is obligatory for all other companies. Due to the restrictive regulations of the BSE-Sofia bylaws the regulated segment of the market will remain underdeveloped in the foreseen future, and most of the companies will be listed for free trade on the non-regulated segment.

2. The successful start of the Stock Exchange is closely interrelated with the government commitment to put shares of the state-owned enterprises (SOEs) on the market. There are some legal problems to be solved with most SOEs. They are registered as "close-ended" companies, and their shareholders cannot offer their shares on the market without the permission of the remaining shareholders. These problems are going to be resolved through amendments in the Privatization Law and the Commercial Code. A clear definition of "public entity" will be provided, and shares of the public companies will be traded without any restrictions. The government plans to accelerate cash privatization through offering shares of 4 groups of enterprises on the Stock Exchange:

i) The first group comprises of profitable enterprises in sound financial condition, which do not need a strategic investor and outside know-how. Packages of more than 51% of the shares will be offered, and they will be listed with prospectus on the official segment of the market.

ii) Packages of less than 50% of enterprises which will remain state owned for a long period of time, mostly infrastructural enterprises.

iii) Shares of the some of the so-called "blue chips", like Bulgarian Telecommunication Company, National Electric Company, Bulgartabac, Bulbank. Packages of

10% will be offered on the BSE-Sofia, as well as on several foreign stock exchanges in the first half of 1998. Thus a market price of their shares will be established which will facilitate their further sale to a strategic investor.

iii) Minority shares of previously privatized companies.

The government plans to privatize 3% of the total state-owned assets in 1998 and another 1% in 1999 through the Stock Exchange. This is still a modest figure compared to the expected direct sales and tenders or sales with foreign consultants.

3. The bank privatization program does not suggest listing of bank shares on the Stock Exchange. As bank shares represent a significant segment of any stock market, they

The only bank to be listed is Bulbank (the biggest Bulgarian bank) but the issue is still under discussion.

4. At the moment the Central Depository (institution set to register transactions of securities) is also carrying out settlement and clearing operations. With the increase in volumes and diversification of the securities offered on the Stock Exchange, the necessity of separating these operations in a specialized institution will emerge.

5. Due to the stringent requirements of the Stock Exchange internal regulations, most of the companies will be initially listed on the free-trade segment. Even the so-called "blue chips", like the Neftochim oil refinery, Chimko carbide producer, suffered financial

shocks in 1996, declared losses for 1996, and do not comply with the requirements of the upper segments of the Stock Exchange market. This will prevent them from listing their shares on the official segment of the market, which by definition attracts more investors because of the high extent of informational disclosure and transparency. Moreover, some of the strategic investors who have acquired majority stakes in the so-called "blue chips" are not intending to list the shares of the companies on the Stock Exchange (the Union Miner - MDK case). Ironically, only shares of comparatively small companies will be listed on the official segment of the market in the foreseen future.

6. The idea of corporate financing through public offering of shares seems inapplicable at that stage of economic transition. The confidence in that kind of financial assets was seriously distorted by the collapse of the widely known "Ponzi schemes" operating in 1994 - 1996. The only companies able to attract new shareholders are pension funds, insurance companies and banks. The pension funds, if existing, are not active on the market because of the compulsory state social security system. The insurance companies should meet the new capital requirements set in the Insurance Law and will obviously have to increase their capital if they want to stay in the market. The problem is that the deadline for doing that coincides for the time necessary to draft a prospectus and to list the issue on the Stock Exchange. As for the banks, listing shares of the state-owned banks is not a priority in the bank privatization agenda for the next year. The only exception might be Bulbank, where a 10% package will probably be offered before its sale to a strategic investor.

Table 1 **Block trade on the BSE - Sofia 21.11.1997 - 21.11.1997**

Date	Number of deals	Number of shares transferred	Total turnover in BGL
21.10.97	6	172880	222353243
22.10.97	1	58074	1091019000
23.10.97	2	13888	173282480
24.10.97	1	12500	285000000
28.10.97	5	66813	454977363
29.10.97	6	68687	462877363
31.10.97	6	105025	245896396
3.11.97	4	56338	928235664
4.11.97	11	173496	1651272540
5.11.97	5	86457	748858287
6.11.97	3	66237	946820588
7.11.97	21	440429	1687723908
10.11.97	1	5556	34097172
11.11.97	6	126653	299714241
12.11.97	4	106289	2365274893
13.11.97	13	413436	7204186632
14.11.97	3	264124	1242010784
17.11.97	2	49282	239606294
18.11.97	5	46874	70238071
19.11.97	2	38610	219226177
20.11.97	1	35573	2465351192
21.11.97	11	393842	4513893194
<b>Total:</b>			<b>20,572,671,096</b>

# Legal Framework For Foreign Investment In Bulgaria

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## Introduction

This paper is intended to give an initial introduction to the legal framework for doing business in Bulgaria, mostly to readers who have not had an opportunity to inquire or learn about the basic elements of the legal setting. It does not serve the purpose either of exhausting its object in an abstract way, or of providing specific and reliable legal advice. Rather, it aims at mapping out the fundamental principles of the legal environment, and the major institutions of law governing the various fields of investment activity, enforcement of rights, repatriation of funds, and taxation.

The approach of this paper is first to address the institutional, contractual and regulatory framework for doing business, and thereafter to discuss the applicable institutions of taxation. The paper is based on the laws of Bulgaria as they exist as of the time of writing. It is the idea of the writers that this short paper serve mostly as background information for a detailed professional discussion. Also, we hope that the paper provides enough information to potential investors that they will not miss any body of law which they will want to study or verify in detail, pertaining to their specific projects.

## Constitutional Principles and Limitations

### *Principles Enabling Foreign Investment*

There are two constitutional principles that are worth mentioning in relation to the legal environment for business in Bulgaria: the principle of equal treatment of foreign and local investors and the principle of priority of international treaties over domestic legislation.

These two principles alone provide enough of a guarantee that the overall approach of the legislator towards foreign investments may not result in a discriminatory legal environment.

The effect of the first principle is that, pursuant to constitutional procedures, discriminatory legislation may be challenged before the Constitutional Court and repealed. Thus, although there is possibility for application of discriminatory legislative measures from time to time, the overall trend will be one of constitutional compliance. In addition, where legislation creates unfavorable conditions for foreigners to do business, existing international treaties provide a minimum of protective rules, which are sufficient for a foreign investor originating from a country which has entered into such a bilateral treaty, to be assured that such investor at least has a worthwhile exit strategy.

### *Restrictions*

In addition to the enabling principles discussed in the preceding paragraph, the Constitution imposes certain limitations which are worth mentioning. There is one foreigner-targeted restriction which prohibits the direct foreign ownership of land. While this restriction is controversial and there are debates as to whether it should be repealed, the relatively high stability of the Constitution makes us think that it will take quite some time before the restriction might possibly be repealed.

Addressing the macro-setting of the economy, the Constitution proclaims certain objects to be in the exclusive domain of the state. This restriction affects both foreign and domestic investors. If such investors want to commence a business venture based on or involving resources which are in the state's domain, they must follow the procedures of the institution of concessions (discussed herein below). The Constitution provides for yet another restricted list: the list of industries in which the law may provide for a government monopoly. Both foreign and domestic investors may find themselves limited in their potential activities by such monopolies. However, the legal institution of concessions provides for procedures, pursuant to which a private investor might be licensed to engage in activities which are otherwise under a government monopoly.

## Private and Regulatory Framework for Domestic Foreign Investment

### *Domestic Law*

#### (i) Types of Investment

##### (a) Equity

Foreign natural or juridical persons are free to invest in the equity of Bulgarian companies. The existing types of companies are joint stock companies, companies limited by shares, limited liability companies, limited partnerships and general partnerships. To become a general partner in a company, however, a foreign natural person must have

acquired permanent residence in Bulgaria. The relative share in a company's equity owned by a foreign person is not limited. No prior authorizations are required for making, transforming or liquidating an equity investment.

#### (b) Real Estate

Direct foreign ownership of real estate is provided for in a diversified manner. Foreign persons may not own land. However, foreign persons may become the owners of buildings without owning the land on which such a building is constructed. Foreign persons may also acquire the "right to use" land or buildings, which is similar to a lease, for a limited term or as long as the "user" exists as an individual or entity. Such a lease, however, is non-transferable and does not entitle its beneficiary to develop the "used" property. A foreign person may also acquire the right to develop land, and thus become the owner of buildings constructed in exercising this right, without receiving title to the underlying land. The right to develop is transferable. So is any building acquired by exercising the right to develop. A foreign person may acquire ownership of real estate or the right to use or develop real estate only after prior permission by the Minister of Finance. The same permission is required before rights so acquired may be transferred to a third party.

An entirely different concept governs the indirect holding of real estate rights by a foreign person. A foreign person may become the sole, majority or minority owner of a locally registered company. Regardless of whether a foreign person is the sole, majority or minority shareholder in a local company, such a company is not in any way restricted in acquiring and transferring title to land or buildings or rights to use or develop real estate. The underlying theory is that the constitutional and other legal restrictions apply only to foreign persons, which a local subsidiary of a foreign person is not. As a consequence, no permissions are needed for a local company (partly)

owned by foreigners, for it to engage in any real estate transactions.

#### (c) Securities

Bulgarian law allows securities to be purchased by local or foreign investors on an equal footing. In addition to equity securities, the market in Bulgaria also offers corporate debt securities and government debt instruments in a broad variety. A special right attached to a number of government securities is the option for their holder to use them as payment instruments in privatization, thereby achieving substantial discounts. However, the new Law on Foreign Investments imposes restrictions for the repatriation of proceeds from debt securities investments, when the object of the investment is a debt security, which at the time of investment, has a residual period to maturity of less than six months.

#### (d) Intellectual Property Rights

Bulgarian law recognizes both industrial property rights and copyrights. Patents and copyrights are provided for by modern legislation. Trademark law reform is underway, but current law still offers sufficient protection to trademark owners. Bulgaria is also a member of the major multilateral conventions governing industrial property and copyrights.

#### (e) Lending and Financial Leasing

The law does not prohibit lending or leasing to local borrowers on an off-shore basis. Foreign lenders must be advised, however, that a foreign person may lend to a local person only after the Ministry of Finance has approved the loan agreement between the parties. Failure to obtain Ministry of Finance approval (which approval is normally granted without difficulty) results in the invalidity of the loan transaction. In case of invalidity, the "lender" may still claim its money on the basis of the unjust enrichment doctrine, but all security of the "loan" is rendered invalid by the invalidity of the underlying transaction. This procedure does not apply to financial leasing on an off-shore basis.

#### (f) Securitization

Foreign investors enjoy the same access to securitization vehicles as local investors. Debt may be secured with a mortgage on real estate, granted by the debtor or a third party. A mortgage is created by way of executing a notarized deed between the mortgagor and the mortgagee and recording the mortgage in the relevant real estate registry. A mortgage authorizes the mortgagee to cause the judicial sale of mortgaged property, and provides the mortgagee with priority on the proceeds, after claims for judicial expenses. In a bankruptcy setting, a mortgage ensures a first priority on the proceeds, even before bankruptcy expenses. To create a mortgage one must pay fees of 2% on the value of the secured debt.

A creditor may decide to secure its debt with a pledge (security interest) in personal tangible property, accounts receivable, or the debtor's enterprise in its capacity as a going concern. The creation of a floating security interest on a changing pool of assets is also authorized by law. A debtor need not transfer possession of the pledged assets to the creditor or a third party. A pledge is registerable in a Central Pledges Registry. Registration establishes the priority of security interests for the same pledged property. A pledgee enjoys the same priorities on proceeds as a mortgagee. What makes a pledge especially attractive is the possibility for non-judicial foreclosure by way of the sale of pledged property directly by the creditor. A pledge costs very little to create: a flat fee in the range between \$5 to \$10 USD is payable, depending on the number of pages filed for registration.

#### (g) Concessions

As mentioned in the foregoing discussion, a concession is a special arrangement between a private contractor and the central or a municipal government, whereunder the private investor acquires the right to utilize certain natural resources or real estate otherwise in the exclusive domain of

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the government, or to engage in certain activities on which otherwise the government has a monopoly. A concession on behalf of the state is granted by the Council of Ministers for a term not to exceed 35 years, or a total of 50 years, pursuant to extension. The possible objects of a concession are: underground resources, with regard to the identification, exploration and extraction thereof; the seashore beach; the biological, mineral and energy resources of the continental shelf and the exclusive economic zone in the sea, with regard to the exploration, development, extraction and utilization thereof; the radio frequency spectrum and the geostationary orbit positions assigned to Bulgaria by international treaties; national post and telecommunications networks; the national road network; ports used for public transportation and civil airports; waters, inclusive of mineral waters, which have a national significance; irrigation and water supply systems and facilities, provided they are in the exclusive domain of the state; power plants for the production of electric and heat energy; distribution or transit electric networks; main pipelines for the transit of energy resources and products, provided they are in the government domain; forests and parks of national importance; nuclear facilities; and natural and archeological reserves. A concession on behalf of a municipality is granted by the municipal council, for a term not to exceed 15 years, or 25 years by way of extension. The objects of municipal concessions are defined by law.

## (ii) Regulatory Framework

### (a) Banking

Banking is one of the industries where the principle of freedom of the market is combined with strict regulatory procedures. Banking activities may be conducted only by a bank registered in Bulgaria or by a Bulgarian branch of a foreign bank. Only joint stock companies may register as banks. A banking license is granted by the Bulgarian National Bank, pursuant to detailed procedures provided for by the law.

Minority ownership in the equity of banks not exceeding 3% is not subject to disclosure. Ownership in excess of 5% of the equity may be acquired by one person with the approval of the Bulgarian National Bank. Banks may issue only registered shares. The law treats local and foreign ownership of banks on an equal footing.

### (b) Insurance

The insurance industry is regulated in a fashion similar to banking. Insurance activities may be conducted only by an insurance company registered in Bulgaria, or by a Bulgarian branch of a foreign insurance company. Only joint stock companies may register as insurance companies. Licenses for insurance activity are granted by the National Insurance Council, pursuant to detailed procedures provided for by the law. Minority ownership in the equity of insurance companies not exceeding 1% is not subject to disclosure. A single person may acquire ownership in excess of 5% of the equity of an insurance company only with the approval of the National Insurance Council. Insurance companies may issue only registered shares. The law treats local and foreign ownership of insurance companies on an equal footing.

### (c) Securities Trading

A third industry with a relatively high degree of regulation is securities trading. Securities trading as a dealer or broker may be carried out only by licensed investment intermediaries. Investment intermediary capacity may be acquired by a Bulgarian joint stock company or limited liability company. A license for investment intermediary activities is granted by the Securities and Stock Exchange Commission, pursuant to detailed procedures provided for by the law. Minority ownership in the equity of insurance companies not exceeding 10% is not subject to disclosure. Investment intermediaries may issue only registered shares. The law treats local and foreign ownership of investment intermediaries on an equal footing.

Investment intermediary activities may be carried out by Bulgarian banks or

Bulgarian branches of foreign banks, provided the banking license issued by the Bulgarian National Bank provides for securities trading.

## (iii) Enforcement of Rights

### (a) The Judicial Process

The judicial process in Bulgaria, as of these days, is notoriously slow and inefficient. Obtaining a final court judgment in Bulgaria usually takes years. If a foreign person should decide, or be obliged, to submit his dispute to the jurisdiction of the local courts, such a litigating foreign person would enjoy the same rights and protections in court as would a local party to the procedure.

### (b) Arbitration

Bulgarian law recognizes the rights of any two parties to enter into an arbitration agreement, thereby excluding the jurisdiction of Bulgarian courts, and submitting their potential dispute for resolution by an institutional or ad-hoc court of arbitration. However, disputes involving rights in real estate, labor contract rights, or matrimony or child support are not arbitrable. In general, disputes over rights which do not have an economic or property dimension, such as disputes over internal corporate governance matters, are also not arbitrable. Any two parties may submit their dispute for resolution to an arbitration court in Bulgaria. If one of the parties is a foreign person, the arbitration agreement may provide for arbitration to take place outside Bulgaria.

### (c) Recognition and Enforcement of Court Decisions and Arbitration Awards

A final Bulgarian court decision is directly enforceable without any need for recognition. The courts issue a writ of execution based on any such final court decision. It is the writ of execution that unlocks the judicial foreclosure process to a victorious litigant. Where a party has been able to produce a final foreign court decision, it must go through a process of recognition of the decision by Bulgarian courts. Recognition is slow and uncertain, for Bulgarian law is based on the

principle of mutuality of recognition of other nations' court decisions. Mutuality may easily be found not to exist. Still, where the courts would take the position that recognition is admissible in principle, they would not re-examine the position of the foreign court. The defendant may only raise objections that subsequent facts have terminated the defendant's obligation, or that the foreign decision has formal defects. Once a foreign court decision is recognized, enforcement follows the procedures for enforcing Bulgarian court decisions.

A Bulgarian arbitration award is subject to immediate enforcement, just like a Bulgarian court decision. The courts issue a writ of execution based on the simple fact that there is an arbitration agreement, on the basis of which a court of arbitration has issued an arbitration award. Foreign arbitration awards are easy to enforce, for their recognition in Bulgaria is governed by the New York Convention on the Recognition of Arbitration Awards. That makes recognition quick, standardized and certain, should there not exist any of the few grounds for refusal defined in the New York Convention. A recognized foreign arbitration award is enforced in the same manner as a Bulgarian court decision or arbitration award.

#### (d) Foreclosure

Foreclosure in Bulgaria, as a general rule, is performed through the court system. Foreclosure is open to any creditor who has obtained a writ of execution based on a final Bulgarian court decision, a Bulgarian arbitration award, or a recognized foreign arbitration award or court decision. In addition, secured creditors may commence foreclosure after obtaining a writ of execution based solely on their mortgage or pledge agreement. Commercial paper — such as checks, promissory notes or bills of exchange — is also the basis for issuance of a writ of execution, and may be collected on by way of immediate foreclosure. Regardless of what entitled a creditor to commence foreclosure, it is, like any court process in Bulgaria, slow and extremely inefficient. Foreclosure

costs a lot in judicial fees and might easily just fade away after years of useless effort.

Where a creditor has secured its debt by way of a registered pledge, such a creditor has accomplished a lot towards collection of the amounts owed it. Upon default, a creditor is entitled to obtain possession of the pledged property and sell it in a commercially reasonable manner. Where the debtor fails to surrender collateral, the creditor is entitled to assistance by the court enforcement officers, who forcefully take possession of the collateral and turn it over to the secured creditor. Thus, creditors may avoid a lot of costs for judicial fees, and are certainly not held hostage to anyone's unwillingness or inability to act.

#### (iv) Foreign-Investor-Specific Rights

##### (a) Domestic Law Concept of Foreign Investment

Bulgarian law is liberal in defining foreign investment. Under the law a foreign investment is any investment by a foreign person in: (i) equity in commercial companies; (ii) ownership of buildings or any other rights in real estate; (iii) ownership of tangible personal property held as long-term assets; (iv) ownership of debt securities with a residual period to maturity exceeding six months, and equity securities, or derivatives thereof; (v) a loan extended to a local person for a term not less than twelve months; (vi) intellectual property rights; (vii) rights under concession contracts; (viii) rights under management contracts. However, there are still certain objects of foreign investment that are defined by the law in a more restricted way. For example, ownership of debt securities with less than six months to maturity, or a loan for a term of less than twelve months are not recognized as foreign investment. As a matter of fact, the bilateral treaties to which Bulgaria is a party, broaden the domestic-law-given definition of a foreign investment.

##### (b) Registration

Foreign investment is not subject to any special registration requirements, other than the national statistics report-

ing requirements which would apply to Bulgarian investors as well.

#### (c) Conversion and Repatriation Rights

Once an investment qualifies as a "foreign investment," it entitles the investor to (convert into hard currency and) repatriate abroad: (i) the income/profit from the investment; and (ii) the proceeds from the sale/liquidation of the investment. Repatriation is done by commercial banks which are under obligation to control whether the foreign investor has paid all taxes associated with the repatriated amounts. To accomplish that, banks require formal statements by competent tax authorities. The new Law on Foreign Investment provides for severe penalties for banks if they repatriate their clients' moneys without complying with the rules provided for by the same law.

#### ***Bilateral Treaties to which Bulgaria is a Party***

Bulgaria has entered into Mutual Encouragement and Protection of Investment Treaties with more than thirty countries. A comparative analysis, based on bilateral agreements for the mutual encouragement and protection of investments which Bulgaria has entered into, shows that the definition of an "investment" in such agreements is broad enough, and basically covers the concept of investment in its entirety. There is hardly anything which could not be considered as an "investment" and which would not qualify as an "investment" under these agreements. Under these agreements, "investments" and returns thereon may be freely repatriated after payment of taxes. In this respect, we consider that any Agreement is likely to supersede the requirement set forth in the new Law on Foreign Investments, whereunder only debt instruments with maturity of more than six months, and credits for more than one year are recognized as a "foreign investment." It is also very common for these agreements to include a "most favored nation" clause. The said treaties also contain provisions on (i) fair procedures for expropriation of the objects of investment; and (ii) repatriation rights.

## Taxation

### Domestic Law

#### (i) Taxation of Direct Economic Activity

The profit from direct economic activity of local entities or foreign entities acting through a Bulgarian branch or place of business in Bulgaria, is taxed at the rate of 40.16%. However, if the tax obligor is a local company which has become less than 33% owned by the central or municipal government as a result of privatization, there is a five-year tax break. During the period of such a tax break, all or part of the profit tax owed by the company is reassigned to it, provided the company sticks to a certain investment program, as prescribed by the law. In addition, the law provides for a different type of tax break for companies in which a foreign person has invested USD \$5,000,000 or more in long-term fixed assets. During such a tax break, all or part of the profit tax owed by the company is reassigned to it, provided the company sticks to a certain investment program, as prescribed by the law. Finally, pursuant to the new Law on Foreign Investments, a foreign person may apply to the government with an investment project, for obtaining a "priority investment project" status for its economic activity. To qualify, a project must provide for (i) investment of USD \$5,000,000 or more, (ii) create 100 or more jobs, (iii) investments in regions defined by the Council of Ministers as having a high degree of unemployment. A qualifying company gets a ten-year tax break, resulting in a 50% reduction of the profit tax owed to the central government (currently, 36% after deduction of a 6% profit tax owed to municipality), provided it sticks to its investment program. However, it is not quite clear who shall have the discretion of determining which investment projects qualify.

#### (ii) Taxation of Incomes from "Passive" Investment

As a general rule of Bulgarian law, dividend income is not included in the tax base of an entity for profit tax purposes. Such income is taxed on the level of the payor of the income, by withholding

15% of its after-tax profit which is distributed among its shareholders. The withholding taxation of dividends applies to both the income of local and foreign payees.

While all other "passive" income of local entities is included in their tax base for profit tax purposes, the law treats foreign persons' income differently. Incomes from rent, interest, fees for technical services, yields from the sale of fixed or financial assets and royalties from licenses to use intellectual property rights, are taxed at the rate of 15%. Taxation occurs on the level of the payor of income, who is under obligation to withhold 15% of the income and pay withheld amounts to the government.

In all cases of withholding taxation, the foreign recipient of income is under no technical obligation to comply or make payment of taxes. Failure by the payor of income to withhold and pay withheld tax results in the payer's obligation to pay owed amounts to the government.

#### (iii) Value Added Tax (VAT)

The applicable VAT rate in Bulgaria is 22%. VAT is charged on all transactions for transfer of title to goods and provision of services, except for the cases provided for by law. VAT may be charged only by entities which have registered for VAT purposes (entities which have an annual turnover of BGL 75,000,000 (DEM 75,000) from taxable transactions). Still, in case of import, VAT is always charged on the value of imported goods, as such value has been increased with owed customs duties and fees. To the contrary, export transactions entitle an entity registered for VAT purposes to a VAT credit. Where a foreign investor would make a certain qualifying in-kind contribution to the capital of a local company, the object of the in-kind contribution may be imported into the country exempt of import VAT and customs duties and fees. For the investor to be able to use the mentioned tax breaks, the object of contribution must represent equipment or machinery qualifying under various criteria of law. The object of the in-kind contribution must exceed USD \$100,000 in value. In addition, the

investor commits to not cause the investee company to transfer the title to property so contributed for a term of five years.

From the moment the object of the in-kind contribution is released from customs, by law it becomes a security for the amount of duties, VAT and fees potentially due to the Ministry of Finance. The security interest created by law terminates upon the expiration of the five-year term, as of the date of issuance of the court decision for the in-kind contribution to the capital of the investee company.

### Bilateral Treaties on the Avoidance of Double Taxation of Income and Property to which Bulgaria is a Party

Bulgaria has entered into Bilateral Treaties on the Avoidance of Double Taxation of Income and Property with more than thirty countries.

#### (i) Taxation of Direct Economic Activity

All treaties provide that the profits from direct economic activity realized through a place of business or a branch in another country shall be taxable only in the country where the foreign company would have its place of business. Therefore, if a foreign entity would be taxed in Bulgaria on the profits of its local establishment, such profits would not be taxable in the country of origin of the investment.

#### (ii) Taxation of Incomes from "Passive" Investment

A comparative analysis of the relevant bilateral treaties shows that such treaties introduce rates of withholding tax no higher than 10%, for the income from a number of sources, such as: dividends; interest, meaning any income generated by debt; and yields, meaning income from certain property transfers.

Some treaties entitle an investor to a tax credit in the country of origin, for any taxes paid in Bulgaria on certain income, against taxes due on said income in the country of origin.