
FINANCIAL INSTRUMENTS – FACTORING, CESSION, TAXATION

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Abstract: The article examines factoring and cession as financial instruments for short-term financing of companies experiencing liquidity difficulties, as well as their role in providing resources to achieve better liquidity.

The subject of the study is to outline specific actions and capabilities used for collecting receivables from debtors, as well as the similarities and the differences between factoring and cession in their operating activity and their VAT treatment.

The purpose of the paper is to clarify the place, role, and capacity of these instruments to release the working capital of companies “frozen by disloyal partners”, thereby enabling the reinvestment of the provided “fresh money” into their ongoing activities.

The author’s thesis is to emphasize factoring and cession as financial instruments, stressing their role and significance for economic agents. They are applied to overcome financial difficulties and strengthen business performance.

Key words: financial instruments, factoring assignment, taxation

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Introduction

In global financial literature the concept of financial instruments has long been established. Their purpose is to create conditions for the development of a fair, open and efficient financial instrument market while also maintaining stability and public trust.

According to Art. 4 of the Markets in Financial Instruments Act (MFIA)¹, financial instruments are listed below, including those issued through distributed ledger technology as follows:

1. transferable securities;
2. money market instruments;
3. units in collective investment undertakings;
4. options, futures, swaps, forward interest-rate agreements and any other derivative contracts relating to securities, currencies (with the exception of those identified in accordance with Article 10 of the Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organizational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (Delegated Regulation (EU) 2017/565) (OJ, L 87/1 of 31 March 2017), with interest rates or yield, with emission allowances or other derivative instruments, financial indices, or financial indicators, that may be physically settled or cash settlement may be effected;
5. options, futures, swaps, forward contracts, and any other derivative contracts relating to commodities for which cash settlement shall be made or cash settlement may be made at the request of one of the parties, except for in the cases of non-compliance or other grounds for termination of the contract;
6. options, futures, swaps, and any other derivative contract relating to commodities that may be physically settled when traded on a regulated market, multilateral trading facility (MTF) or an organised trading facility (OTF), except for wholesale energy products traded on OTF which must be physically settled, as determined in accordance with Article 5 of Delegated Regulation (EU) No. 2017/565;
7. options, futures, swaps, forward contracts, and any other derivative contracts relating to commodities that may be physically settled, other than those referred to in item 6, which are not intended for commercial purposes and have the characteristics of other derivative financial instruments under Article 7, paragraphs 1, 2 and 4 of Delegated Regulation (EU) No. 2017/565.
8. derivative instruments for the transfer of credit risk;
9. financial contracts for differences;
10. options, futures, swaps, forward interest-rate agreements and any other derivative contracts related to climate changes, freight rates or inflation rates or other official economic statistic indicators, for which cash settlement must be effected or for which cash settlement may be effected at the request of one of the parties (excluding the cases of non-compliance or other grounds for

¹ Markets in Financial Instruments Act (MFIA) - State Gazette No. 15 of August 16, 2018, as amended and supplemented in State Gazette No. 54 of July 4, 2025.

termination of the contract), and any other derivative contracts relating to assets, rights, obligations, indices and indicators, other than those referred to in this article, which have the characteristics of other derivative financial instruments, depending on whether they are traded on a regulated market, an MTF or OTF, and determined in accordance with Article 7, paragraph 3 and Article 8 of Delegated Regulation (EU) No. 2017/565;

11. emission allowances, consisting of any units recognised as conforming to the requirements of Directive 2003/87/EC of the European Parliament and of the Council of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Directive 96/61/EC (emission trading scheme) (Directive 2003/87/EC).

Financial instruments have existed since ancient times and continue to evolve today. They are becoming increasingly popular and widely used in financial markets. The markets, through their mechanisms, facilitate trading at low transaction costs, such as taxes, fees, commissions, etc. Financial markets are inherently volatile, i.e., characterized by fluctuating prices and quotations of financial instruments. Volatility can serve as a barometer of market sentiment – when it is high, uncertainty is usually greater, and when it is low, the market is considered more stable. The prices of traded financial instruments are influenced by many factors, including changes in the supply-demand ratio, dynamics in world trade, tax, monetary, and foreign policy of countries, changes in interest rates, operations of central banks, forecasts and expectations of market participants, and many others.

In this paper we examine in more detail what they represent in the financial market how they are used, and whether they are subject to taxation, focusing specifically on two of the most widespread instruments - factoring and cession.

I. FACTORING

What is factoring?

In the financial literature, there are many definitions of factoring and perhaps the most accurate is that it is: A short-term financial instrument for collecting monetary payments owed to creditors by their debtors, against which fresh financial resources are provided. “In factoring one entity undertakes the collection of receivables on behalf of another entity”.²

Graphically, factoring operations can be represented in the following way:

² Radkov, R., & Adamov, V. (1998). *Pari I banki*. Abagar, Veliko Tarnovo.

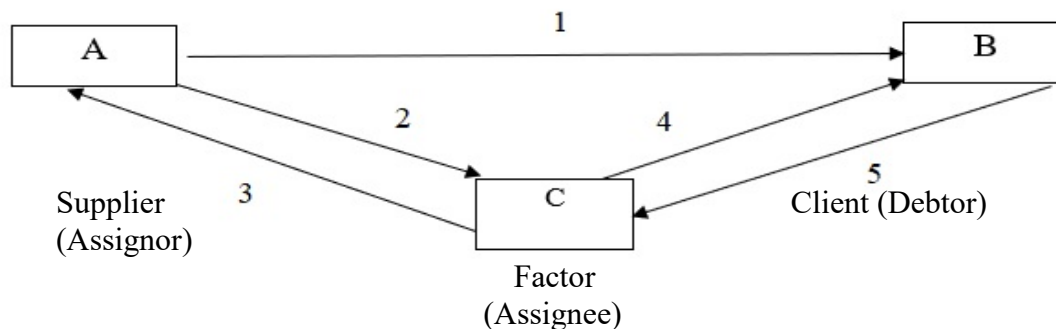


Figure 1

Operation 1 – The supplier A sells goods to the client B but encounters certain tax difficulties in collecting the amount due.

Operation 2 – The supplier enters into agreement with factor C to assist in collecting the amount owed by the debtor (B);

Operation 3 – The factor (C) provides a portion of the amount due to the supplier (A) in exchange for a certain fee;

Operation 4 – The factor (C) collects the amount due from the debtor (B);

Operation 5 – The debtor (B) reimburses the factor (C) for the amount owed.

Factoring operations constitute transactions involving the transfer of one-time monetary or non-monetary receivables. These operations are carried out following the conclusion of factoring agreements.

They are typically reciprocal, fee-based and long-term.

What are the obligations of the parties to the factoring agreement?

(A) The supplier/seller of goods and services on deferred payment (creditor):

The supplier transfers to the factor the receivables from the debtor through appropriate documentation. They do not receive the full nominal value of the receivable but typically around 90%, preferring this type of short-term financial transaction to receive immediate liquidity.

The amount and method of payment of the factor's remuneration are determined by agreement.

(B) The factor (a factoring company – a bank or a non-bank financial institution, intermediary, agent, etc.):

The factor provides immediate financing to the supplier and ensures a steady cash flow. Its obligations include to assess and assume the credit risk and to arrange an insurance against this risk; to provide all documents necessary to carry out the factoring operations; to receive the agreed remuneration, which consists of:

- a commission at a market rate of 1.5% to 2.5% of the transaction amount;
- 1% to 2% fee for early execution of the transaction;
- interest expenses for the credit if the payment is made to the supplier;
- insurance costs for covering the risk
- assessing the payer's counterparties and tracking their payment performance.

(C) The buyer (debtor)

The debtor must repay to the factor all obligations originally owed to the supplier.

Factoring operations resemble triangular transactions under the VAT Act³, and in both theory and practice various types of factoring arrangements exist. Understanding their differences is essential for selecting the most appropriate form of factoring.

The most common types include:

- open (disclosed) factoring – the debtor is informed that the claim has been transferred and pays the obligation to the factor.
- hidden (undisclosed) factoring – the debtor is not informed about the factoring operation and pays the amount owed to the supplier.
- true factoring – the factor assumes the risk of non-payment by the debtor and has no right of recourse against the supplier.
- non-true factoring – the factor assumes the risk by purchasing the claim, but the supplier remains the recourse debtor and may still be liable for claims by the factor.
- factoring with financing – the supplier receives over 80% of the claim amount upfront, with the remainder paid after the factor collects the debt.
- factoring without financing occurs when the supplier transfers a high-risk receivable to the factor and receives the amount due only when the payment becomes due.
- factoring with recourse – the factor does not assume the risk of non-payment by the debtor and has the right to charge back any overdue receivable to the supplier if payment is not made within a specified period after maturity.
- factoring without recourse – the factor covers losses up to a contractually agreed percentage of the value of the claim and up to a specified credit limit in the event of non-payment by the debtor.
- domestic non-recourse factoring – used by companies that make repeated domestic sales on deferred payment terms. The factor (e.g., CreditBox)

³ Value Added Tax Act, promulgated in State Gazette No. 26 of March 27, 2025

fully manages collections, ensuring a steady cash flow and saving time and administrative effort.

- export factoring – used by Bulgarian export companies through the services and networks of FCI (Factors Chain International - the global representative body for factoring and financing of open account domestic and international trade receivables). This allows revolving financing of advance payments up to 80% of the value of the transferred receivables, and up to 100% credit risk coverage, along with creditworthiness assessment of foreign buyers.

Banks in Bulgaria began offering factoring services on the money market after 2000.

The first bank to provide factoring services was Postbank in 2004, through the commercial representation of Eurobank EFG Factors. In 2024, UniCredit Bulbank established the first Bulgarian factoring company.

Although not very popular and still relatively unknown among business owners, factoring operations are becoming increasingly widespread in business circles with each passing year. There is growing interest in their use by small and medium-sized enterprises, which most often face temporary liquidity shortages. This is easily explained by the many advantages factoring offers, such as:

- unlike other types of financing factoring does not require collateral. A business can access the necessary funds without waiting for the payment deadline and without pressure from its suppliers;
- fast and flexible advance payments in exchange for transferring receivables without the need for additional security;
- provides instant access to various funds through the sale of receivables to meet short-term financial needs;
- allows businesses to offer longer deferred payment periods compared to competitors, which helps increase sales volumes; in comparison with overdrafts and other working capital loans, factoring offers many more advantages.

Taxation of factoring transactions

When it comes to the taxation of factoring transactions, both taxpayers and regulatory authorities often face various challenges, which stem from:

- a lack of understanding of the concept of factoring and its different types, and in what kinds of transactions it is used;
- uncertainty about the tax status of the participants in the transaction (whether they are registered under the VAT Act), and how such services should be treated for tax purposes.

Like all other financial instruments according to Art.13, para.1 of the PITA⁴ it is a non-taxable transaction.

However, for the purposes of VAT, factoring – like all other debt collection operations – is excluded from the category of financial services, which means it is subject to taxation as it does not qualify as an exempt supply under Art.46, para. 1, item 3 from the VAT Act.

There are two types of factoring transactions:

1. When a non-taxable supply is involved, the value of the receivable constitutes the relevant amount, since it has already been subject to taxation under the initial sale and purchase transaction.

2. When the supply is taxable, the taxable base consists of the remuneration (the factor's commission under the contract).

The taxable amount is the sum of:

- the remuneration under the contract, determined either as an absolute amount or as a percentage of the transaction value under the contract.
- the costs of any insurance against risk, as well as any interest income received.

When interest is included in the remuneration, the situation requires careful consideration, as in practice two types of interest commonly occur:

1. default interest arising from delayed payment by the debtor. In this case, it is undisputed that such interest should be included in the taxable base, as it is subject to taxation.

2. interest on advance payments – when amounts are transferred by the factor before the maturity date.

In this situation, the interest represents a credit component of the transaction and the price of a financial service; therefore, it is non-taxable and should not be included in the taxable base.

The transaction involving the one-time or periodic transfer of monetary receivables arising from the supply of goods or the provision of services - regardless of whether there is risk for the factor - constitutes taxable income from a source within the country and is subject to a flat corporate income tax under the CITA⁵ at the rate of 10 percent.

II. CESSION

Cession is an informal, causal, and consensual contract. It is the contract for the transfer of monetary and any other transferable rights from the supplier of the claim (the cedent) to a third party – the buyer (cessionary) of the claim.

The following rights cannot be transferred:

⁴ Personal Income Tax Act (PITA), SG, issue.26/27.03.2025.

⁵ Corporate Income Tax Act (CITA), SG, 26/27.03.2025.

- personal non-property rights; accessory rights when separated from the principal ones;
- the right to terminate bilateral contracts without the consent of both parties;
- rights the transfer of which is prohibited by law (such as wages, pensions, maintenance, scholarships, etc.)

If a claim prohibited by law is transferred, the cession is considered null and void.

A cession agreement may concern a specific claim in its entirety (global cession) or partially.

Under Articles 99 and 100 of the Law on Obligations and Contracts (LOC) of the Republic of Bulgaria, cession is regulated as the transfer of a claim from one creditor to another, as well as the liability of the cedent (the former creditor), who guarantees that the claim exists and is valid.

From a financial perspective two types of cession are recognised:

- a cession for consideration, when there is a sale or exchange of the claim. A discount from the nominal value is usually made, which may reach up to 70% in cases where the limitation period has expired or the claim has remained uncollected for a long period.
- gratuitous cessation – a transfer of claim without consideration, meaning it is essentially a gift.

Parties to the cession agreement and their rights and obligations are:

- Cedent – the supplier of the claim, the transferor, the original creditor. Upon the transfer of the claim the cedent is obliged to deliver to the cessionary all documents proving the claim; confirm in writing that the transfer has been completed; notify the debtor about the existence of the cession agreement, the identity of the new creditor, and the person to whom the debt must be paid (Article 99, paragraph 4 LOC). The cedent bears no responsibility for the solvency of the debtor.

- Cessionary – a natural or legal person who is the buyer and new holder of the claim, the acquirer, the second creditor. The cessionary must receive from the cedent all documentation certifying the claim; obtain all privileges, securities (pledge, mortgage), and shareholder rights attached to the claim.

All expenses related to the transfer and collection of the claim are borne by the cessionary, as well as the risk of underestimating the debtor's ability to pay.

- Debtor – the person who owes the claim and for whom it constitutes a debt. The debtor must pay the debt – the principal amount together with any due interest. The limitation period is three years, starting from the date on which payment would have been due (e.g. the date of the invoice). The cession neither

interrupts nor extends the limitation period, since it represents the sale of an obligation.

The debtor is not a party to the cession agreement but has the right to be informed of the transfer of the claim. Otherwise, the cession is considered invalid. The information that must be provided includes the name and the address of the new creditor, the amount of the principal and the interest due at the time of notification.

TAXATION OF A CESSION

The operations involved in a cession can be represented as follows:

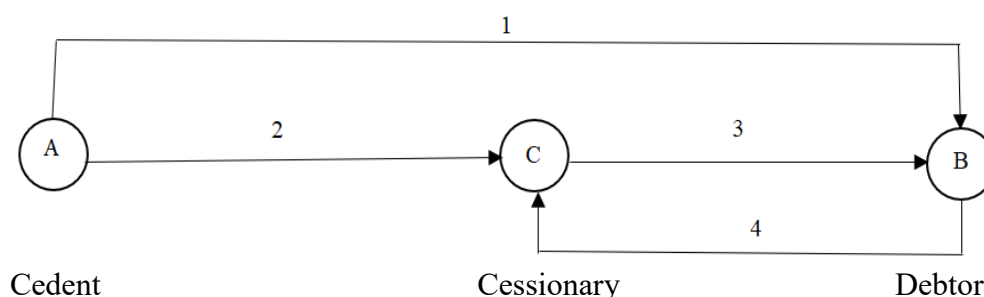


Figure 2

First operation – The cedent (A) extends credit to the debtor (B).

Second operation – The cedent (A) sells its receivable to the cessionary (C).

Third operation – The cessionary (C) collects the receivable from the debtor (B).

Fourth operation – The debtor (B) pays the receivable to the cessionary (C).

Cession, as a method of transferring a monetary receivable, constitutes the supply of a financial service which is treated as an exempt supply and is not subject to taxation. For VAT purposes, factoring and cession are treated differently, since factoring involves consideration, which is not present in the case of cession.

Let us examine the nature of the transaction under cession for the parties to the contract and how their actions are treated for tax purposes.

- The Cedent (the Seller of the receivable)

This is the person who transfers their monetary receivable to the cessionary and acts as its initial creditor. For VAT purposes, this party is treated as the supplier.

There are two types of supplies:

- The receivable is transferred free of charge. Such a transfer is not subject to taxation;
- The receivable is transferred for consideration. The taxable base is the market value of the receivable received by the cessionary upon the transfer.

The taxable event occurs on the date when the condition for the transfer of the receivable has been fulfilled. From the perspective of the VAT Act, the transfer of monetary receivables constitutes a financial service, which, as noted, is treated as an exempt supply and therefore is not subject to taxation.

- Cessionary

This is the person who acquires the monetary receivable from the creditor (the cedent). The taxable base is the price of the monetary receivable. If the transaction is taxable, the cession is taxed on the difference between the value of the receivable and the amount paid by the cessionary. An invoice is issued to the cedent if the latter is registered for VAT. The cedent charges VAT on it. The tax is borne by the cedent, who subsequently deducts it as an input tax credit.

- Debtor

The person who has not yet paid their monetary obligation is not a party to the contract and is not subject to taxation.

Many financial experts compare factoring and cession to “Siamese twins”. The comparison is somewhat acceptable, yet the differences between them are much more significant than their similarities.

Some of the main distinctions include:

- subject of the contract: While factoring is a specialized form of collecting receivables from debtors, in cession the creditor transfers their receivable from a third party to another (cessionary).
- transfer of the receivable: In factoring, receivables may be transferred only to financial and credit institutions, whereas in cession any person may transfer the receivable to other entities or individuals (e.g., collection agencies).
- consideration under the contract: In factoring, the factor (intermediary) receives consideration, whereas cession does not provide for such a payment.
- nature of the transaction: From a financial perspective factoring transactions are always for consideration whereas cessions may be either for consideration or gratuitous.
- VAT treatment: In factoring, the taxable supply is the factor’s consideration; in cession, it is the difference between the transaction value and the amount paid by the cessionary.

CONCLUSION

Factoring and cession are important elements of a company's financial policy, contributing to the improvement of its economic growth. Their use minimizes creditors' losses, releases working capital, ensures an effective operating environment, frees up cash flows, and facilitates the execution of financial operations without incurring debt.

Factoring and cession are still not well known among businesses and are not actively promoted by credit institutions. Wider promotion and application of these instruments in the future would create new incentives for development and contribute to overall economic growth.

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