

# ITS in the News



## Turkish Finance Ministry Rules on Securities Taxation

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The Turkish Ministry of Finance has drafted Communiqué 263 to eliminate as of January 1, 2007, the requirement that nonresident investors with income from securities submit tax residency certificates.

During 2006 the securities market was booming in Turkey. At the beginning of the year, a new withholding tax regime was introduced in temporary article 67 of Income Tax Law 193 (added by Law 5281 (Dec. 30, 2004)), which subjected securities income of resident and nonresident investors alike to a flat 15 percent withholding rate.

A series of changes then followed. Fierce criticism largely directed at the high withholding rate led by fixed-income securities investors resulted in a reduction in the middle of the year, following a series of “mini crises” in May that demonstrated the Turkish economy’s vulnerability. First, the rate was reduced to 0 percent for nonresidents, and then to 10 percent for resident investors by Law No. 5527 (June 27, 2006). The rate reduction was introduced for stocks and fixed-income securities alike, a development that opened the door for a new set of investor concerns.

To prevent Turkish investors from using offshore centers to take advantage of zero taxation, the Ministry of Finance (MOF) in Communiqué 258 (September 30, 2006) required nonresident

investors who want to benefit from zero withholding to prove their residency by submitting tax residency certificates. Apart from the difficulty of providing that certificate to tax authorities by January 1, 2007, there were some other problems that investors could not so easily tackle. In many offshore financial centers, obtaining the tax residency certificate was not practically possible because of the nonexistence of a tax authority.

Another problem was the existence of many investment funds in different status, because a large number of them, such as those under Luxembourg SICAVs (Société d’investissement à capital variables), were unable to obtain separate tax residency certificates. Following many letters, talks, and meetings with the MOF, Communiqué 263 (February 5, 2007) was drafted to eliminate the requirement to submit tax residency certificates as of January 1, 2007. No change is expected regarding the issue in the final communiqué.

### *Qualifying as OTC Securities Lending*

Income from securities lending is in the scope of withholding taxation. Banks and brokerage houses are responsible for withholding tax and paying it quarterly to the tax office. That responsibility was transferred to custodians for the transactions of nonresident investors because the information needed for accurate and timely calculation of tax resided with the local custodians of the nonresident investors. The withholding rate

is 0 percent for nonresidents and 10 percent for residents. In Communiqué 257 (Dec. 30, 2005) addressing the tax treatment for securities lending, along with other issues, there was no mention of whether over-the-counter securities lending among nonresident investors would be treated in the same way. That was a crucial question because it would mean a simpler and less expensive way of entering into the lending transactions on the Turkish securities.

After a long wait, the MOF finally issued Individual Ruling 9376 (Feb. 2, 2007) and Individual Ruling 9375 (Feb. 2, 2007) to the largest custodian banks in Turkey. Both rulings have parallel contents and conclusions.

The rulings first summarize the letter received from the Capital Market Board (CMB). Referring to its Communiqué 31 (July 14, 2003) concerning the securities lending in an organized market, the CMB concludes that the conditions set forth in the communiqué do not serve to make a transaction a securities lending or not, and even if the conditions relating to the form were not fulfilled, it would not affect the nature of securities lending when it is securities lending in substance. Based on the CMB's views, the MOF made the following remarks in the rulings:

Therefore, the securities borrowing and lending transactions, performed through the banks providing custody services in Turkey with the agreements concluded between non-resident corporations, mostly upon declarations without any agreements, or with the explanation "SECL", which refers to a borrowing transaction in the SWIFT [Society for Worldwide Interbank Financial Telecommunication] message, not complying with

any general and special conditions set forth in the said Communiqué (such as preparation of a framework agreement, providing equities in return for the capital market instruments borrowed, etc.) would have to be considered as borrowing and lending of capital market instruments.

Surprisingly enough, both the view of the CMB and the MOF is liberal regarding the form and the documentation of the OTC lending transactions. The MOF seems to accept as sufficient any description in the SWIFT message stating that the transaction is securities lending.

### *The Withholding Taxation of OTC Securities Lending Income*

Subsequently, the rulings make clear the following points:

- income from OTC securities lending is in the scope of the withholding tax regime;
- the withholding agent who is responsible for withholding tax would be the custodian for the transactions entered by nonresident investors; and
- the withholding tax rate is 0 percent on the income derived as of July 7, 2006, forward.

One important point that investors should keep in mind is that the withholding regime applies only to securities issued or acquired after a specific date. Article 67 of the Income Tax Law states that for income earned from disposal or from holding of all types of bonds, treasury bills, and similar securities issued

before January 1, 2006, is subject to the former taxation regime. Similarly, income earned from disposal or from holding of all types of securities (that is, stocks) and other capital market instruments acquired before January 1, 2006, also is subject to the former taxation regime.

Nonetheless, it is still welcome from an investor point of view that nonresident investors would only have to comply with the new withholding regime for lending on securities issued or acquired after January 1, 2006.

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