

ITS in the News



Turkish Tax Communiqué Clears Way for Interim Dividend Distribution

by A. Feridun Güngör

Communiqué No. 1 of Corporation Tax Law 5520, published in Turkey's official gazette on April 3, includes unexpected explanations for interim dividend distributions, implying that those distributions are permitted under Turkey's Commercial Code.

The text of the communiqué is nearly 200 pages, making it the lengthiest tax communiqué ever issued and for the first time bringing the entire Corporation Tax Law under a single communiqué. Some of the explanations are adopted from communiqués issued in previous years for Corporation Tax Law 5422, which was abolished and replaced by Law 5520 on January 1, 2006. Most of the explanations, however, are disclosed in this new communiqué for the first time.

Many issues may interest the international tax community, but interim dividend distribution appears to be the most surprising one, because it was not included in the drafts of the communiqué that were posted on the Revenue Administration's Web site before it was issued, and also because there is no specific provision concerning interim dividend distribution in Law 5520.

Legal Background for Interim Dividend Distribution

The Turkish Commercial Code also does not address interim dividend distribution, but the explanations in section 15.6.6. of Communiqué No. 1 are in line with regulations issued by the Capital Markets Board (CMB) in its Communiqué Serial No. IV and No. 27.

However, although interim dividend distribution has been regulated for listed companies since 2001, it has not been effectively used by those companies because of uncertainties about the related tax treatment. For companies that are not listed with a stock exchange and are therefore not subject to the CMB regulations, the uncertainty involved not only the tax treatment, but also the applicability of interim dividend distribution.

Communiqué No. 1, without referring to either the capital markets legislation or the Commercial Code, says corporations can distribute interim dividends out of their commercial profit during temporary tax periods (quarterly). The style and language of the explanations in the communiqué sound more like Commercial

Code regulations than an interpretation of tax rules. Of course it is not legally possible to introduce new rules and procedures in the Commercial Code through a communiqué issued by the Revenue Administration. Although the missing references to the relevant legislation is arguably a major deficiency, the communiqué can nevertheless be construed as an implicit confirmation of the Revenue Administration's view that interim dividend distribution is permitted in the Commercial Code.

Calculation of Interim Dividends

According to the communiqué, the amount of interim dividends to be distributed cannot exceed 50 percent of the profits reported in the financial statements as of the temporary (quarterly) tax periods after deducting legal reserves, tax payments, and previous years' losses. Moreover, the amount of interim dividends to be distributed, as calculated above, cannot exceed 50 percent of the previous year's profit after deducting legal reserves, tax payments, and previous years' losses.

Interim dividend distributions can be made more than once in a tax period. In that case, when calculating the amount of the interim dividend, the amount that has been distributed in previous temporary (quarterly) tax periods must be deducted.

Interim Dividends in Multiyear Construction Projects

Construction companies likely will be the happiest group of taxpayers concerning the explanations for interim dividend distributions. For many years, they have been emphasizing the importance of this issue to their industry and asking for answers.

In multiyear projects, tax is not levied on an annual basis, but rather, at the end of the project, even though completion of the project takes more than one year. Meanwhile, a 3 percent withholding tax (recently reduced from 5 percent) is imposed on progress payments. For that reason, companies were not able to declare dividends during the project period because the dividends would be regarded as a distribution of disguised profit, as the profit from the multiyear project could not yet be ascertained.

According to Communiqué No. 1, the amount of interim dividends to be distributed in multiyear construction projects will be calculated as half of the positive difference between the progress payments collected and the cost of the project incurred after deducting any taxes withheld, previous years' losses, and legal reserves.

Amendments to the Articles of Association

Companies now also are required to have provisions in their articles of association governing interim dividend distributions. For example, it is compulsory to establish in the articles of association:

- that interim dividend distribution is permitted;
- that the board of directors can be authorized by the general assembly to declare interim dividends to be limited to the relevant year; and
- the procedure for recalling dividends if the year ends with losses or profits fall too short to cover the interim dividends distributed.

However, that rule is likely to cause some problems in practice. The trade registries may hesitate to accept or reject amendments to the articles of association because there are no provisions in the Turkish Commercial Code governing the issue. To achieve integrity in the legislation, the Ministry of Trade and Industry should confirm its view by issuing a communiqué or a circular.

Withholding Taxation on Interim Dividends

Dividend withholding tax will be withheld on interim dividends distributed in accordance with the tax status of the recipient. Interim dividends paid to resident individuals and nonresident individuals and corporations will be subject to a 15 percent withholding tax, whereas no withholding tax will apply to interim dividends paid to resident corporations.

When an interim dividend is distributed, the income will be regarded to be earned by individual shareholders not in the year in which the interim dividend is declared, but in the year in which the company profit corresponding to the interim dividend is actually distributed as a dividend. However, the deadline cannot exceed the end of the tax year in which the corporate tax return for the relevant tax year is filed with the tax office.

Recall of Interim Dividends

The communiqué says interim dividends will be recalled if an excessive payment has been made. If a company has losses in the tax year in which the interim dividend is declared, or the profit for that year is not sufficient to cover the amount of the

interim dividend distributed, the difference between what could be distributed and what actually has been distributed will be the excess amount to be recalled. This recall must be done by the end of the corporation tax return filing period of the tax year concerned.

In the CMB communiqué, there is no obligation to recall interim dividends. In the case of losses or insufficient profits, the excess interim dividend payments can be offset through the extraordinary reserves.

It appears that the different approaches of the tax rules and the capital market rules may create problems in the practice of recalling interim dividends.

Withholding taxes paid on interim dividends that are recalled can be claimed for refund, or can be offset against other tax liabilities of the corporation.

According to the communiqué, even if interim dividends are recalled because of losses or insufficient profits, the transfer pricing rules will not apply to the excess recalled by companies. However, an adjustment under the transfer pricing rules will be needed if the interim dividends are recalled when there is actually sufficient profit to declare an interim dividend. In that case, the interim dividends will be treated as an interest-free loan to shareholders, and an arm's-length amount of interest will be deemed to be earned by the shareholders.

For additional information regarding this *ITS in the News*, please contact the following advisor:

Ernst & Young, Istanbul

A. Feridun Güngör

+90 212/368/5204

Feridun.Gungor@tr.ey.com

© 2007 Ernst & Young LLP.
All Rights Reserved.
Ernst & Young is
a registered trademark.

International Tax Services

Global ITS

Jim Tobin, *New York*

Asia Pacific

Philip Anderson, *Shanghai*

Central Europe

Ton van den Hoven, *Rotterdam*

Central Western Europe

Frank Muntendam, *Luxembourg*

Latin America

Manuel Solano, *New York*

Northern Europe, Middle East, India & Africa

Jonathan Fox, *New York*

Argentina

Carlos Casanovas, *Buenos Aires*

Australia

Ian Scott, *Sydney*

Belgium

Herwig Joosten, *Brussels*

Brazil

Carlos Romero, *Sao Paulo*

Canada

Trent Henry, *Toronto*

Chile

Sergio Sapag, *Santiago*

China

Youngjin Peter Ni, *Shanghai*

Colombia

John Guarin, *Bogota*

Costa Rica

Rafael Sayagues, *San José*

Denmark

Niels Josephsen, *Copenhagen*

France

Eric Fourel, *Paris*

Germany

Stefan Koehler, *Frankfurt*

Hungary

Botond Rencz, *Budapest*

India

Srinivasa Rao, *Bangalore*

Ireland

David Smyth, *Dublin*

Italy

Gérard Prinsen, *Milan*

Luxembourg

Frank Muntendam, *Luxembourg*

Malaysia

Hock Khoon Lee, *Kuala Lumpur*

Mexico

Federico Aguilar, *Mexico City*

Middle East

Gurdeep Randhay, *Dubai*

Netherlands

Ton van den Hoven, *Rotterdam*

Panama

Luis Ocando, *Panama*

Poland

Lukasz Ziolek, *Warsaw*

Russia

Stephan Beck, *Moscow*

Singapore

Chong Lee Siang, *Singapore*

South Africa

Rendani Neluvhalani, *Johannesburg*

Spain

José L. Gonzalo, *Madrid*

Sweden

Maria Landen, *Stockholm*

Switzerland

Markus F. Huber, *Zurich*

Peter Athanas

United Kingdom

Tim Steel, *London*

United States

Scott Hill, *New York*

Venezuela

Patricia Ferrer, *Caracas*