Building a better working world

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Does Turkey's digital economy taxation lead "protectionism?

The period that we're experiencing stands out as the "digital age". Having a "virtual environment" is just enough to sell goods and deliver services. A fixed workplace is not required to operate in another country today. Companies like AirBnB, Alibaba, Twitter, Facebook and Instagram are among examples. "Market values"of these companies are expressed in billions of dollars. Well, are digital companies easy to tax?

Let's take a quick look at the question"How are these companies perceived in the public?

1. Why do digital companies capture attention?

Digital companies do not derive their income solely from markets "legal or with business centers". Their access to online users proves sufficient to acquire income.

However, the debate starts when it comes to the "tax perception on digital companies". Tax authorities of the developed and developing countries and the public do not think that these companies are taxed enough. A survey covering the European Union (EU) indicates that 75 % of Europeans expect urgent EU action in the fight against tax avoidance and evasion caused by the digital companies. Because, 75 % of the participants think that companies that are dealing with activities based on "digital business models" hold their tax burden at low levels due to the existing international tax laws.

Digital business models allow digital companies to operate without "physical workplace". While the taxation rules based on physical workplace were applicable prior to the digitalization of economy, they are not efficient in understanding the digital company income since the value chain in digital economy has changed. For instance, you needn't buy any tapes or CDs to listen to music. Through a music application, meeting your need for listening to the music rapidly and at a low cost, even at no cost has become possible.

Many countries believe that digital companies derive high incomes within their markets and those companies should be taxed for that income as the country of origin. In that context countries, including Turkey, have been enacting tax regulations concerning the taxation of digital economy under the categories of "reverse charge VAT", "turnover" or "equalization tax".

2. Is there a global solution for the taxation of digital economy?

Governments are closely monitoring the tax burdens of digital companies. G20 countries including Turkey took action for the taxation of digital companies. The G20 conducted a detailed study called Base Erosion and Profit Shifting (BEPS) on the taxation of these companies with the leadership of the OECD. The OECD published an interim report indicating the taxation challenges of the digital economy. However, the OECD failed to offer a taxation method for member countries. OECD cannot develop a proposal since the member countries fall short of building consensus.

A policy note on the "assessment of taxation challenges of the digital economy" has been published by the OECD on 23 January 2019. In that note, the OECD has unveiled its target of "long term solution" with compromise in its final report in 2020 despite a solution from member analysis on digitalization seems distant. Member countries agreed to examine different concepts including "significant economic presence", "significant digital

presence” and “changes related to the threshold for workplace creation”. Member countries agreed to analyse the proposals objectively after holding debates on proposing “to grant more taxation right to the market or the user’s location” in the circumstance that “any value is created from a commercial activity formed with the participation of users” and which is focused on the “sharing of taxation right” including the matter of “connection / nexus”.

Final OECD proposal is expected with report in 2020.

3. At which stage is the regulation on “digital economy taxation” in Turkey?

Turkey has adopted a taxation strategy for the digital economy with indirect and direct tax regulations.

Regarding indirect tax, a regulation taking the services delivered to real persons electronically into the scope of VAT, through the VAT implementation no.3 was enacted by the Finance Ministry in 2018.

Concerning the taxes applied on income, amendments to the tax laws have been made through the Law no.6745 published in the Official Gazette dated 7.9.2016. The basis of the regulation was laid with the 7th clause added to Article 11 of the Tax Procedure Law (TPL) arranging the in responsibility of taxpayers. The Council of Ministers was also authorized to grant tax deductions to taxable persons or intermediaries for taxable transactions and to determine different rates under certain conditions.

The phrase of Council of Ministers existing in the Law No. 6745 was changed as President through the Article 46 of the Decree no.700 following the constitutional amendment.

So as to exercise the mentioned authorization, clauses for tax deduction were added into the Article 94 of the Income Tax Law (ITL) no. 193 and articles 15 and 30 of the Corporate Tax Law (CTL).

Finally, the Presidential Decision no.476 was published on 19.12.2018 concerning the implementation of withholding. Through the Decision, advertising services delivered via the internet were included into the scope of tax deduction and regarding the payments made to the service suppliers or the ones acting as mediators for those advertising services on the internet, tax deduction was started to be applied as of 1.1.2019 regardless of whether the people receiving payment are taxpayers or not.

Through the Presidential Decision no.476, sub-clause no.17 was added into the 1st clause of Article 1 within the Decision attached to the Council of Ministers Decision no. 2009/14592 which identifies the withholding to be applied on the taxable income of real persons subject to income tax liability as per the Article 94 of the Income Tax Law.

So, regarding the payments within the scope of sub-clause 7 of TPL Article 11 in relation with the advertising services on the internet, withholding at a rate of 15 % will be applied over the payments made to the service suppliers or the ones mediating for the delivery of advertising services on the internet as of 1.1.2019.

Similarly, sub-clause no.15 was added into the 1st clause of Article 1 within the Decision attached to the Council of Ministers Decision no. 2009/14593 which identifies the

withholding to be applied on the taxable income of the corporates subject to limited liability within Article 30 of the Corporate Tax Law. So, regarding the payments within the scope of sub-clause 7 of TPL Article 11 in relation with the advertising services on the internet, withholding at a rate of 15 % will be applied over the payments made to the service suppliers or the ones mediating for the delivery of advertising services on the internet as of 1.1.2019.

Sub-clause no.11 was added into the 1st clause of Article 1 within the Decision attached to the Council of Ministers Decision no. 2009/14594 which identifies the withholding to be applied on the taxable income of the corporates subject to full amenability within Article 15 of the Tax Procedure Law. So, regarding the payments within the scope of sub-clause 7 of TPL Article 11 in relation with the advertising services on the internet, withholding at a rate of 0 % will be applied over the payments made to the service suppliers or the ones mediating for the delivery of advertising services on the internet as of 1.1.2019.

By this regulation, withholding will be applied as 0 % over the payments for advertising services that will be made to the fully amenable taxpayers.

The reason of Article 11/7 of the Tax Procedure Law is "…to accelerate the transition to the registered economy in areas where information technologies are widely used and to fight effectively against informality…"

However, the question of "Does the deduction rates brought by the Decision serve to this purpose?" arises here. The reason for this is the 0% withholding rate applied to institutions subject to full liability. Will the fight against informality be effective under a withholding at 0 % on the income of fully amenable taxpayers in Turkey while a withholding at 15 % is applied on similar payments to the limited taxpayers?

Therefore, if the target of the regulation is taxation of advertising services on the internet or digital environment, the withholding rate of 0 % on payments made to fully amenable taxpayers should be an incentive and invitation to the limited taxpayer digital companies without a workplace in Turkey?

Now let's evaluate the regulaton in terms of tax technique.

4. Is Turkish type "digital economy taxation" protectionism?

The introduction of taxing the digital economy through deduction raised the debates on legality and contradiction to the constitution since it was enacted by amending the Article 11/7 of TPL arranging the taxpayers' responsibility but without any amendments to the TPL Article 156 containing the definition of a workplace.

In this context, I believe that the taxation of advertising services supplied through the internet with the method of withholding as of 1 Jan 2019 does not comply with Turkey's income and corporate tax laws and systematic of DTTs that Turkey sealed.

The reason for that is the "commercial" quality of earnings due to the provision of advertising services within the scope of commercial activity in our tax system. If the revenue in our Turkish tax system is commercial gain; the earnings obtained should be acquired by"a business vehicle and the income attributed to the workplace should be "net". Commercial gains are not subject to withholding tax in both the ITL and CTL systematic.

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Withholding on construction work over the years constitutes the exception of this implementation. However, withholding made for construction works for years will be deducted from the net corporate income and if the corporate income does not occur, the withholding will be returned to the taxpayer.

It's obvious that the income acquired in return for advertising services on the internet delivered by "full or limited taxpayers" to the Turkish resident taxpayers is "commercial income". In that case, income acquired in return for advertising services is not subject to corporate tax in Turkey unless obtained through a permanent establishment or permanent representative in Turkey.

The opinion on the withholding under CTL related to the payment of advertisement services from abroad released by the Revenue Administration through the ruling no. B.07.1.GİB.4.34.16.01-CTL 30-701 dated 23.2.2012 prior to the Law no.6745 is as follows: "Within the scope of the DTT between Turkey and Ireland, in the circumstance that the Irish resident company does not own a workplace in Turkey as per the Article 5 of the concerning Treaty and does not provide the advertising service through this workplace, solely Ireland is entitled to tax the commercial income to be acquired in return for the mentioned advertising service.

Another issue is the regulations on international taxation. The double taxation treaties signed by Turkey are mainly based on the OECD tax treaty model except the reservations put by Turkey. Within the explanations on OECD Model Treaty Guide" also, "by the rising electronic trade", whether the digital products" will be treated as "royalty" instead of "commercial income" is tied to the fundamental purpose of the payment. However, there is no such discussion in advertising services, because advertising services are considered as commercial income.

Pertaining to the hierarchy of norms, the double taxation treaties signed by Turkey are under the protection of our Constitution as a Law and an international treaty since they are enacted by Parliamentary approval. Therefore, pursuant to the Article 35 of KVK, the fact that provisions of DTTs are reserved is available in the text of the Law as well.

Within that context, the Treatys' Article 5 contains information on cases for a workplace to occur in Turkey. Therefore, since withholding on the commercial income will result in double taxation, it is contrary to the international tax agreements and international tax rules. So, it will lead controversy with the countries that we signed tax treaties.

At the beginning of these disputes, there will be the demands for refunds of withholding amounts based on the DTTs, because in the circumstance that a withholding is applied to the payments made to limited taxpayers in a situation that does not require deduction, as per the provisions of DTT, (In cases where commercial income could not be attributed to workplace, since Turkey is not entitled for taxing it), the limited taxpayers will apply for refund of the deducted taxes.

Another trouble to be caused by the aforementioned taxation is about its causing "double taxation". As we know, the withholding amount applied on commercial income will not be deducted in the country where limited taxpayer adversitising service supplier is resident "as a tax paid abroad" and the case would ultimately result in as "double taxation".

A significant problem arising in practice in addition to the challenges about tax technique is the additional cost it causes for the Turkish residents making payment, because the limited taxpayer digital companies supplying the advertising services may include the service fee as a net receivable from the contract (if it doesn't exist even, they may lead changes in new contract) and reject any tax liability. Therefore, the concerning tax deduction may be resulting in the transfer of resources abroad if additioal costs and tax refunds arise for the ones receiving those advertising services. So, income obtained through the collected taxes would be temporary for the Treasury. I believe that the introduced regulation does not entitle the right for taxation to Turkey.

Due to the challenges outlined above, other countries are creating new types of taxes under different names such as turnover tax with the purpose of taxing the limited taxpayer digital companies.

As an example, the European Union has proposed a "short-term" and a "long-term" solution to the digital economy taxation through a double stage draft. As a short-term solution, applying a fixed 3 % digital services tax on the turnovers of these companies as of 1 Jan 2020 is proposed. However, the EU cannot set a compromise even at a rate of 3 % among member countries since applying the proposed tax on the revenue turns it into an income tax. Since this tax is not a type of tax applied on the net income and its being applied on revenue will make it mandatory for the companies to pay it even they make a loss. Also, since the 3 % tax will not be considered as a tax paid abroad, the limited taxpayer's not being able to deduct it from corporate tax in its country of residence is stricty criticized.

In sum, the principle of legality is the basis of taxation. Does adding the tax regulations into the law texts gain them the qualification of legality? The fact that the advertising services supplied on the internet are commercial earnings does not comply with the double taxation agreements.

As indicated in Constitutional Court's decisions as well, the European Human Rights Court stresses that the law has to be in a quality to a certain extent in terms of meeting the principle of legality. Therefore, as per the tax technique, it would be in the interests of Turkey to amend the definition of workplace in TPL and perform the needed arrangements on income and corporate tax laws regarding the tax technique and quality of laws.

The matters to be subject to a long/term regulation is broad enough to be a topic for an article. However, to identify in short, a new model should be developed considering the digital companies' significant digital formation/presence as basis (such as the EU proposal based on parameters like yield curve, user number and number of subscribers) as basis. Turkey should closely monitor the 2020 report which will contain the OECD's final proposal and introduce a solid structure for the taxation of income acquired by the digital companies in Turkish market will remove the claims about "protectionism in taxation" as well.