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LBO and "Debt Push Down" instruments and assessment on them within the context of Turkish tax laws

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I. Introduction

Leveraged Buyout (LBO) in other words a leveraged buying method and the Debt Push Down integrated into this transaction is a much preferred transfer/acquisition and subsequent merger method resorted by foreign investors intending to keep the debt down and financial profitability at the highest level.

As will be explained in details with this article, the use of foreign resources is at stake in a large portion of LBO financing and there are three main instruments such as Private Equity Fund (PEF), Special Purpose Vehicle (SPV) and target company in international terms.

Private equity fund (PEF)

PEFs are fund companies established for specific purposes and financed by many investors to invest in companies to generate high profits within an average of 4-7 years.

Special purpose vehicle (SPV)

SPV is a special purpose vehicle company which will take over the company to be invested, established directly by PEF or other companies of PEF in accordance with the investment policy in the country where PEF is resident in which PEF aims to invest, under the LBO.

Target company

Target companies to be invested by the PEF are companies with a healthy growth trend and a solid international market share in the country of residence and internationally. They are the companies with a high corporate tax base and ability to increase profitability periodically or having the potential to increase it.

II. Leveraged buyout and debt push down

In this method, which is generally applied by PEF, it is possible to buy the shares of the target company with the financing provided by external loans through SPV and then to transfer the target company to SPV and to cover the financial expenses through the strong financial structure of the target company.

1. Assessment within the context of Turkish tax legislation

On the evaluation of sub-clause (a) of 1st paragraph within the Article 5 of Corporate Tax Law (KVK) titled as "Exceptions", 3rd paragraph of the aforementioned article and section no.5. 17 of Corporate Tax General Communique series no.1 titled "The inability to deduct expenses corresponding to the incomes that are exempt from corporate tax from other income" altogether, excluding financing expenses related to the purchase of subsidiary shares; it is concluded that the expenses of the corporations related to the profits exempted from the corporate tax or the losses arising from the activities within the scope of the exemption cannot be deducted from the non-exempt corporate earnings.

In other words, although the participation earnings are exempted from corporate tax pursuant to the sub-clause (a) of the 1st paragraph within Article 5 of KVK and therefore losses on affiliate earnings cannot be subject to deduction, through the 3rd paragraph of the same article, it is legally permitted to deduct the financial expenses incurred from the purchase of subsidiary shares from commercial gain and this is clearly regulated in the Law.

2. Opinion of the Turkish tax administration

The tax administration is of the opinion that capital and other expenses of foreign funding used for purchases through LBO and debt push down cannot be deducted from the net corporation profit after the merger transaction.

Within the ruling of the Office of Large Taxpayers dated 22.07.2014 no.64597866-125[19-2014]-117, the Revenue Administration bases its opinion on these two factors: the lack of a provision indicating that the financial expenses incurred for the acquisition of the shares of the company taken over after the merger transaction can be deducted from the corporate income by considering it as an expense in the detection of the corporate income within the Law and in the circumstance of the acquisition of the affiliate, any financial expense incurred in connection with the purchase of affiliate shares is not in question.

However, since there is not an explicit provision in the legislation indicating that the financial expenses arising from these transactions cannot be deducted; this opinion of the Administration is open to criticism within the context of Article 73 of the Constitution regulating the legality of tax and Article 35 which arranges the property rights.

While the corporate expenses which are not explicitly listed among the expenses that cannot be deducted in the Law, should be considered as “expenses to be deducted”, the transactions established by the Administration in the opposite direction and against the taxpayer may result in the limitation of the property rights of the taxpayers. Therefore, in practice, the opinion of the Administration stating that the financial expenses incurred cannot be deducted and the transactions established on this basis may cause disputes between the taxpayer and the tax administration.

III. Conclusion

Applicability of the structuring and financing transaction and the financing expenses pushed down according to the Turkish tax laws, the opinion of the Administration indicating that financial expenses cannot be considered as expenses in the detection of net corporate income, and also the compliance of this opinion with the Constitution and tax legislation has been discussed; the Administration’s opinion indicating that the concerning financing expenses cannot be subject to deduction despite it is contrary to the Constitution provisions and tax legislation, causes controversy between the tax administration and taxpayers in practice.

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