

Should tax be paid on default interest?

The formation of a product or service in economic activity depends on the combination of production factors. Inherently, the factors used in the production process take a share from the production according to their types. For example, while the return on capital used as a debt or loan in the production process is called “interest”, the return of the capital owner from production may differ depending on the way the capital is used.

According to Turkish Income Tax Law, income from movable capitals including payment is defined as “dividend, interest, rent and similar income” obtained by the capital owners consisting of values represented by cash capital or money.

So, what is the default interest and why is it paid? In the dictionary of the Turkish Language Institution, the term of “default” is described as “resisting to pay the debt without any reason”.

When looking through the Constitutional Court (“AYM”) annulment decision regarding the “Law on Legal Interest and Default Interest” dated 4.12.1984 and numbered 3095, E: 1997/34, K: 1998/79; interest is described as a civil “consequence or equivalent” in favour of the owner of the capital against the cash capital allocated to the use of individuals or institutions.

Both the will of the legislator and in court decisions regarding the disputes that are reflected in the judiciary; the default interest is based on the understanding that the “creditor's loss” is due to the fact that the money debt representing the capital is not paid in the due period as it's not “an income or revenue” and this loss will be at a certain rate by taking into account the economic conjuncture of the country. Therefore, the justification for the payment of the “default interest” consists essentially of the compensation of the loss incurred by the creditor.

On the other hand, the Revenue Administration tends to tax the default interest payments based on court decisions within the scope of the “interest receivable”. However, as understood from the will of the legislator mentioned above and the reasons of the decision of the Constitutional Court, the “default interest” is paid for the loss provision that the person suffers due to the failure to receive the money in the ownership on time. For those reasons, we are of the opinion that default interest is not an income included in the tax base. Naming the payment as “default interest” should not result in taxation of it.

We recommend that owners of default interest consider this issue with their own tax advisors against the administration's approach to consider default interest payments as “interest receivable”.

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