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Global Tax Alert

Turkey's election regarding Article 5 of the MLI may impact certain tax treaties

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A *Draft Law on Multilateral Convention to Implement Tax Treaty Related Measures to prevent Base Erosion and Profit Shifting* (the MLI) was submitted to the Turkish Parliament Plan and Budget Committee (the Committee) on 2 June 2020, thereby officially starting the ratification process of the MLI.

Based on the draft law submitted to the Committee, Turkey has changed its first declaration and reservation status submitted to the Organisation for Economic Co-operation and Development (OECD) regarding Article 5 of the MLI. The Covered Tax Agreements (CTAs) that would be impacted by this election, including the Netherlands -Turkey Double Tax Treaty (the treaty), are listed. Option C, the election made by Turkey, includes the provision that the "exemption method" is completely replaced with the "credit method."

The 22 listed CTAs are:

- Albania
- Azerbaijan
- Bangladesh
- Belarus
- Belgium
- Croatia
- Estonia
- India
- Indonesia
- Kyrgyzstan
- Latvia
- Lithuania
- Macedonia
- Moldova
- Morocco
- Slovakia
- Sudan
- Sweden
- Thailand
- The Netherlands
- Turkish Republic of Northern Cyprus
- Turkmenistan

Impact of Article 5 on the Netherlands-Turkey treaty

Among the 22 listed CTAs, which are identified as impacted from such change, the treaty between the Netherlands-Turkey is particularly relevant due to the significant amount of Turkish investment made to/through the Netherlands.

The Netherlands has chosen Option A, which states that the exemption method within the CTA will not be applied for the purpose of eliminating double taxation if the other Contracting Jurisdiction exempts the income or capital from tax or to limit the rate at which such income or capital may be taxed.

In the explanatory statement, it is accepted that asymmetrical application concerning the "elimination of double taxation" is possible (one country chooses Option A, whereas the other chooses Option C), where the Contracting Jurisdictions to a CTA each choose different options, then by default, each Contracting Jurisdiction would be permitted to apply its chosen Option with respect to its own residents.

Additionally, according to Article 5 paragraph 9 (Article 5/9) of the MLI, a country, which chooses an option other than Option C, may reserve the right not to allow the other "contracting country" to apply Option C in relation to some or all CTAs. For example, the Netherlands that has chosen option A, would be able to not permit Turkey's choice for Option C, as per Article 5/9 of the Agreement.

In the instrument of ratification of the MLI that was deposited to the OECD by the Netherlands in 2019, there are no reservations against the countries that choose "Option C" within the framework of Article 5/9 of the convention.

Within the framework of these explanations, if "Option C" would be adopted by Turkey during the ratification process as offered by the bill of law by the Committee or General Assembly; the provision of the exemption method for the elimination of double taxation in the covered agreement will be replaced with "credit method."

Accordingly, the exemption method under the current Netherlands-Turkey treaty over the dividends distributed by a Dutch company to its Turkish shareholder will be eliminated. In such a case, the dividend income derived by a Turkish entity will be subject to corporation tax in Turkey, unless there is a 15% effective tax burden in the Netherlands to benefit from the Turkish participation exemption by fulfilling additional requirements. Therefore, a 20% corporation tax (applicable rate starting from 2021) would be due in Turkey without considering the underlying tax burden of the subsidiaries held by the Dutch holding companies.

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