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Türkiye proposes new bill that clarifies the tax treatment of capital reduction

- *The Turkish Parliament is considering a new tax package (the Bill) that addresses exemptions, incentives and support for individual and corporate investors.*
- *The Bill under consideration proposes a new article to be incorporated in the Corporation Tax Code No.5520 to clarify and legalize the tax treatment on the capital reduction on the share capital that includes capital elements other than in-kind or cash capital. This Alert summarizes the proposal.*
- *The Bill will be enacted after it is discussed in the Turkish Parliament and will enter into force once approved by the President and published in the Official Gazette.*

On 7 October 2022, Turkish Parliament members submitted a new tax package (the Bill) to the Parliament. The Bill addresses crucial topics that includes, among others, tax exemptions, incentives and support for individual and corporate investors.

The Bill proposes a new article to be incorporated in the Corporation Tax Code No.5520 to clarify the order and tax treatment of the capital reduction on the share capital that includes capital elements other than in-kind or cash capital.

As background, companies established in Turkiye can freely increase their share capital for various reasons. The share capital is required to be deposited in Turkish Lira currency. The capital increase can be in the form of in-kind or cash capital deposited by the shareholders, as well as by transferring various resources to capital such as profits generated as a result of business activities, revaluation funds, funds arising from inflation adjustment, funds that must be allocated in accordance with specific laws, especially the Corporate Income Tax Code.

Companies established in Turkiye can also reduce their share capital for various reasons. If the capital includes elements other than in-kind or cash capital, there may be conflicts between the view of the tax administration and taxpayers about the order of the capital reduction. Since, there is no provision in the tax laws that regulates the issue clearly, the situation in question has been brought in front of the tax courts from time to time.

Accordingly, as noted, if enacted the new article will clarify the order and tax treatment of the capital reduction on the share capital that includes capital elements other than in-kind or cash capital. The clarification provides:

- In companies that have not made a capital reduction for five years from the date of transfer of various sources to capital, and if the capital has been reduced at the end of this period, the amount of capital elements subject to reduction will be determined and taxed by proportioning each of the capital elements to the total capital.
- In companies that made a capital reduction within five years from the date of transfer of various sources to capital, capital will be regarded as reduced in the following order:
    - Primarily from the capital elements whose transfer or withdrawal are subject to corporate tax and withholding tax due to profit distribution
    - Then only from accounts subject to withholding tax due to profit distribution
    - Finally, from non-taxable cash and in-kind capital
- If the capital includes elements some of which are added to the capital within the five-year time frame whereas some of which are added more than five years ago, it will be considered that the elements whose date of addition to the capital have not exceeded five years are withdrawn from the capital.

Thus, the resources added to the capital are encouraged to remain in the capital for at least five years, and the shareholders' equity of the enterprise is encouraged to remain strong.

The Bill also proposes provisions in cases of capital reduction by offsetting the previous years' losses.

The Ministry of Treasury and Finance will be authorized to determine the procedures and principles regarding the implementation of the article.

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