

Tax measures against inflation and recession

Inflation or recession especially weakens the solvency of taxpayers. Because inflation actually results in “hidden tax” and taxation of unrealized (fictitious) earnings. It erodes their working capital.

Are there shields protecting enterprises?

With the amendment made in the Tax Procedure Law with the Law No. 5024, the provision regarding "inflation adjustment in tax", which is valid for commercial earnings, entered into force on 1.1.2004. With the same regulation, the "inflationary" provisions in the legislation have been reduced to the "inflation adjustment" and the following provisions of the TPL have been repealed:

Repealed Article	Regulation
Article 274 of TPL	“Inventory valuation” method, “last in first out method” (“LIFO”)
repeated Article 298/B of TPL	“Re-valuation” in terms of depreciable economic assets
Article 38/4 of TPL	Cost Increase Fund (“CIF”)

As you may recall, the inflation adjustment was applied once in 2004 and it was not applied in the subsequent years since the conditions (the PPI increase exceeded 100% in the last three years and 10% in the last twelve months) were not met. As of 31.12.2021, inflation adjustment conditions were re-established, but with the provisional article 33 added to the TPL with the Law No. 7352; financial statements are excluded from the scope of inflation adjustment in taxation whether or not inflation adjustment conditions are met in the advance tax periods of 2021 and 2022 and 2023, including the advance tax periods.

On the other hand, the financial statements dated 31.12.2023 will be subject to inflation adjustment whether or not the inflation adjustment conditions are met, but the profit/loss difference arising from this adjustment will be demonstrated in the previous years' profit/loss account; the calculated “retained profits” will not be taxed, and “retained year losses” will not be accepted as financial losses and the adjustment will remain as a window-dressed balance sheet, perhaps making companies “excess of liabilities over assets”.

While the inflation adjustment was postponed, taxpayers were allowed to re-valuate their immovables and other depreciable economic assets which are recognized in their balance sheets.

Why should LIFO come back?

In the light of above information, in 2004, while “revaluation” (even by paying taxes) came back from the regulations in the tax legislation before the inflation adjustment provisions, the failure to adopt the “LIFO” and “CIF” application results in taxpayers paying taxes (inflation tax) on “non-real income”. Therefore, the “LIFO” and “CIF” regulations, which were repealed in 2004, should be put into effect, at least during the period when inflation adjustment is delayed. Because with LIFO, the last entry cost will be taken into account in

the cost of goods sold, so the taxation of the fictitious income of the enterprises will be avoided.

Taxation challenges in terms of inflation and recession

Besides the global inflation wave, another problem that emerged in the second half of 2022 is the fluctuation in commodity markets due to recession concerns. The risk of countries' fight against inflation (interest rate increases) and geopolitical developments dragging their economies into recession is increasing. "Recession concerns, dollar demand clamp down on commodity market" according to the news on AA on 18.7.2022 (<https://www.aa.com.tr/en/economy/recession-concerns-dollar-demand-clamp-down-on-commodity-market/2639396>).

The expectation of recession, price fluctuations and/or general economic conditions create great depreciation in commodity prices. This is observed in some commodity prices by the third quarter of 2022. For this reason, significant decreases (10% and above) occur in some commodity prices. Therefore, the "impairment" in the inventories of businesses causes problems in taxation.

Article 274 of the TPL allows "decreases in commodity value" to be taken into account in taxation in order to eliminate the negative effects of the economic recession. According to the article, "commodity is valued at cost". The above principle is also applicable for "goods" (including finished or semi-finished goods. According to the regulation, if the sales price of the commodity on the valuation day decreases by 10% or more compared to the cost value of the commodity, taxpayers can use "arm's length value determination methods" other than the "cost basis" method.

Therefore, according to the principles in Article 267 of the TPL, taxpayers must first identify those with 10% or more depreciation in their commodity stocks (including semi-finished products) and taxable income (tax assessment) should be reached through determining registered values of depreciated commodity stocks according to impairment.

Despite the regulation in the law, secondary regulations of Ministry of Treasury and Finance that will guide the relevant practices regarding this case have not been made. In the case of price fluctuations in the third quarter of 2022 and possible recession scenarios, rapid secondary regulation is a requirement of the "Clarity" principle. Otherwise, taxation of fictitious income will be inevitable in violation of the principle of solvency and enterprises may face loss of labor and working capital.

This is the summary of the article published in the Ekonomist magazine's issue 2022/17, dated 21.08.2022.

Explanations in this article reflect the writer's personal view on the matter. EY and/or Kuzey YMM ve Bağımsız Denetim A.Ş. disclaim any responsibility in respect of the information and explanations in the article. Please be advised to first receive professional assistance from the related experts before initiating an application regarding a specific matter, since the legislation is changed frequently and is open to different interpretations.