

# ITS in the News

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## Turkish Investors Awaiting Constitutional Court Ruling on Zero Withholding

by A. Feridun Güngör, Ernst & Young, Istanbul

*Turkish investors -- both resident and nonresident -- are anxiously awaiting a ruling by the Constitutional Court on whether an amendment to the law governing the application of the zero withholding rate for nonresidents is in violation of Turkey's Constitution.*

A tax court's ruling that an amendment to the law governing the application of the zero withholding rate for nonresidents is in violation of Turkey's Constitution has made headlines in the country's major newspapers in recent weeks. Turkish investors are happy that they now may be eligible for the zero withholding rate, while foreigners are concerned that they may lose the benefit.

### Background

Some significant amendments have been introduced since 2006 to Turkey's system for taxing income from marketable securities. On January 1, 2006, an amendment made by Law 5281 added Temporary Article 67 to Income Tax Law 193. At the beginning, it was stipulated that everybody would be subject to withholding tax at a single rate of 15 percent regardless of the type of income and whether the earner of the income was a resident or nonresident taxpayer. However, that system soon went through several amendments, and the withholding rate now varies, based on both the type of income and the type of tax liability.

In July 2006 an amendment to Temporary Article 67 introduced in Law 5527 reduced to zero the withholding rate on income derived from marketable securities and interest on bonds and Treasury bills derived by nonresident real persons

and corporations, with effect from July 7, 2006. Subsequently, the withholding rate for residents was reduced to 10 percent from 15 percent, effective from July 23, 2006.

### Turkish Withholding Taxation

The general characteristics of the Turkish withholding tax on securities introduced by Temporary Article 67 are as follows:

- Withholding liability is fulfilled by the banks and brokerage companies acting as intermediaries in the derivation of the income.
- The difference between the taxation of interest income and capital gains has been eliminated, so that capital gains from share certificates, bills, bonds, and similar marketable securities are taxed through withholding.
- Marketable securities issued by the public and private sectors are taxed at the same rate and through the same method.
- The earner of income is of no significance with regard to the application of the withholding tax. Withholding is levied on the income of nonresident corporations as well as on the income of resident and nonresident real persons.

Even if the earner of the income is not a taxpayer or is exempt from tax, or the income is exempt from tax, the application of the withholding tax is unaffected.

- The withholding rate is 15 percent for income in Turkish lira and foreign currency.
- The withholding tax is a final tax for resident or nonresident real person investors and nonresident corporate investors. A separate return is not required for the income under the scope of the withholding tax.
- Income from bonds and Treasury bills issued before January 1, 2006, is not subject to withholding.

Interestingly, Law 5527 also gave the Council of Ministers authority to reduce the statutory rate of 15 percent to 0 percent based on the type of income and the income earner, as well as authority to reinstate the 15 percent rate. Subsequently, the Council of Ministers decreased the withholding rate from 15 percent to 10 percent for resident investors. In other words, the withholding rate for nonresident investors was reduced by law, while the withholding rate for resident investors was reduced by way of a decree issued by the Council of Ministers.

From that point forward, there has been extensive debate about whether the differentiation of the withholding rate for resident and nonresident investors violates the constitutional provisions on equity and taxation according to financial ability.

### *Cases Before the Constitutional Court*

Article 10 of the constitution states that all individuals are equal before the law. The basic principle relating to taxation is explained in article 73: “Everyone is under obligation to pay taxes according to his financial ability, in order to meet public expenditure.”

Under article 150 of the constitution, the president, parliamentary groups of the party in power and of the main opposition party, and a minimum of one-fifth of the members of the Turkish Grand National Assembly have the right to apply for annulment action to the Constitutional Court based on an assertion of the unconstitutionality of a law in form and in substance, or of specific articles or provisions thereof.

The first court case was initiated by the Republican People’s Party on the grounds that the provision of the law concerning the decrease to zero of the withholding rate applicable to the income of nonresidents from marketable securities is contrary to constitutional provisions on equity and taxation according to financial ability. Given that the case was filed on August 2, 2006, that issue has already been before the Constitutional Court for a year and a half.

However, recourse to the Constitutional Court concerning the unconstitutionality of a law is not limited to the parties mentioned above. According to article 152 of the constitution, if a court that is trying a case finds that the law or decree being applied is unconstitutional, or if it is convinced of the seriousness of a claim of unconstitutionality submitted by one of the parties, it shall postpone consideration of the case until the Constitutional Court decides on the issue.

In reference to that provision, another case filed before the Ankara Third Tax Court has been referred to the Constitutional Court. In that case, tax authorities rejected a resident taxpayer’s application for a refund of withholding tax, and the taxpayer asked that the case be sent to the Constitutional Court with the request that the provision reducing the withholding rate of nonresidents to zero be declared unconstitutional and annulled. The tax court concluded that the taxpayer’s request was appropriate.

Because both cases deal with the same provision, the Constitutional Court may address the issue by combining the two cases.

### ***How Would an Annulment Decision Affect Investors?***

If the provision prescribing the zero rate withholding for non-residents is annulled, the statutory rate of 15 percent under Temporary Article 67 will take effect. Assuming that no other amendments are made after the annulment decision, the 10 percent rate applicable to resident investors would not be applicable to nonresident investors.

An annulment decision would not directly affect resident investors. If the Constitutional Court finds the application of the zero rate for foreigners unconstitutional, that would not necessarily mean that the zero rate would be applied to Turkish investors, as the Constitutional Court cannot usurp the role of the Grand National Assembly to make new rules. An indirect effect may be expected, however. The Council of Ministers might equalize the withholding rate for nonresident and resident taxpayers, in which case the 10 percent rate could be reduced. The government might adopt a rate that is not a deterrent for foreigners in order to avoid any adverse effects in the financial markets. In making a decision regarding that issue, however, Turkey's current budget balance and the extent to which tax revenue would be affected from the withholding tax decrease would be taken into account. It is unrealistic to expect that the withholding rate would be decreased to zero for everyone.

The provision of the law that would be annulled in line with article 153 of the constitution would be repealed on the date when the annulment decision is published in the official gazette. However, if necessary, the Constitutional Court may decide on the effective date of the annulment provided that it is within one year from the date when the decision is published in the official gazette.

If the date that an annulment decision is to take effect is postponed, the Grand National Assembly will decide with priority on a draft bill or law proposal to fill the legal void arising from the annulment decision. Annulment decisions cannot be applied retroactively.

If the application of the zero rate withholding for foreigners is annulled, because that decision cannot be applied retroactively, the 15 percent withholding will not be levied on the transactions that nonresidents perform before the decision. The annulment decision will be applicable either on its publication in the official gazette or on the effective date decided by the Court. In other words, if a new effective date is not determined by the Court, the 15 percent withholding rate will apply to income derived from the marketable securities transactions of nonresident taxpayers beginning from the date that the decision is published in the official gazette. If a postponement is granted by the Court and a different rate is established by the Council of Ministers during that time period, the withholding on foreigners' income will be applied at the new rate.

Income derived after the effective date of the decision from marketable securities that are already possessed by foreigners at the time of the effective date of the decision will be subject to the 15 percent rate or a new rate as explained above. Because the regulation stipulating the zero rate withholding would be eliminated by an annulment decision, it would not be possible to apply the zero rate during the disposal of the marketable securities included in the previous portfolio on the basis of a grandfathering clause. Furthermore, it is not likely that a retroactive regulation will be introduced to protect the grandfathering rights.

### ***How Likely is an Annulment Decision?***

Because resident and nonresident taxpayers are not operating under equal conditions, it cannot be argued that they must be taxed on equal terms. Nonresidents generally are taxed by the

source country, and most also are subject to tax on the same income on the basis of residency or citizenship in their own countries. Therefore, taxation by the source country usually is maintained at a limited level. In the taxation of interest income and capital gains, many countries abandon taxation at source and grant the tax right to the country of residence.

Turkey's tax treaties follow those principles as well, and the withholding rate for nonresidents is therefore lower than that for residents. Under certain conditions, taxation by the source country is entirely abandoned, as in the case of capital gains

derived from the sale of marketable securities held for more than one year or two years. There also are various cases in the Turkish tax system that require differentiation of the tax burdens of nonresidents and residents on the same income. It would not be reasonable to claim that those differences impose a constitutional problem. For that reason, the zero rate withholding applicable to nonresidents' income from marketable securities arguably is not contrary to the constitution. Of course, that does not mean that the Court decision is more likely to favor foreign investors.

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For additional information with respect to this Alert, please contact the following:

## **Ernst & Young, Istanbul**

A. Feridun Güngör

+90 212 368 5204

Feridun.Gungor@tr.ey.com

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