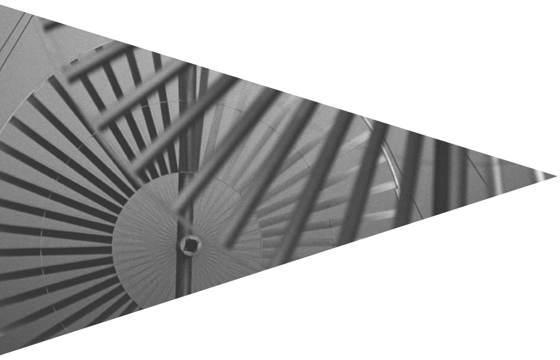

Turkey's New Debt Pushdown Rules

By A. Feridun Gungor

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Private equity funds have not been as available in Turkey as they were before the global financial crisis. In the early days of the crisis, government officials claimed that Turkey would be one of the least affected countries because of its previous experience in dealing with similar crises and the subsequent structural changes undertaken, particularly in the financial industry. At the time, many thought the claims were just political rhetoric, but this bold assertion has been proved. In the last couple of months, international rating agencies increased Turkey's rating in recognition of its economic recovery.

Although it seems as if there are now fewer private equity transactions, a ruling of the Ministry of Finance has brought attention once again to a prickly subject in Turkey: debt pushdown structures.

Background

During the hearings of the new corporate tax law (No. 5520, dated June 13, 2006) in the Turkish parliament, the business community vigorously lobbied to change the controversial provisions of the draft law that disallowed the deduction of financial expenses incurred for the acquisition of participation shares. The business community's efforts prevailed: The law now states that financial expenses relating to the acquisition of participation shares are allowable in calculating taxable corporate profits.

Private equity funds welcomed this new law and took it as parliament's endorsement of the deductibility of financial expenses when the well-known debt pushdown structure is employed to dump the acquisition cost of a subsidiary into this subsidiary through the merging of the subsidiary and the parent. However, tax advisers familiar with the Turkish tax environment were skeptical of the interpretation of the new deductibility rules. First, the general view on the deductibility of financial expenses of the share acquisitions under the provisions of the old corporation tax law (no. 5422, dated June 3, 1949) was not different. Although there were no explicit provisions for the deductibility, both in tax practice and in case law the financial expenses' deductibility in corporate tax calculations was accepted. However, this did not stop the tax inspectors from challenging the deductibility of losses and financial expenses of a parent transferred to its subsidiary through a merger. In a largely publicized tax investigation, one of the largest oil distribution companies in Turkey was subjected to a multimillion-dollar tax assessment after a downstream merger. The assessment was not brought to the court. The company preferred to settle with the Ministry of Finance. The terms of the settlement did reveal whose arguments prevailed during the negations since the settled amount, although reduced significantly, was still huge.

In the meantime, no one felt comfortable with a debt pushdown structure because the Turkish substance-over-form rules existed. These ambiguous and subjective rules could be turned into a fatal tool in the hands of aggressive and fully empowered tax inspectors. A debt pushdown structure, whose purpose is to gain tax deductibility for financial expenses related to an acquisition in the acquired company, would become an easy and lucrative target for inspectors.

In Tax Procedure Law 213 (dated January 4, 1961), the substance-over-form rule is defined in article 3, paragraph B. Accordingly, the true nature of a taxable event and the transactions relating to the event are essential. If a claim is made that is not economically, commercially, and technically sound, or that is not normal and common regarding its peculiarities, the burden of proof lies with the person who makes the claims. Recently, the tax authority in Turkey adopted a more aggressive approach against tax-motivated transactions. Eventually, the substance-over-form rule became an effective tool against abusive schemes. Any transaction, whatever its legal form, can be challenged according to article 3(B) if its economic, commercial, or technical substance is poor or nonexistent. In other words, if the sole purpose of a transaction is tax savings and the form of the transaction is designed merely to obtain the savings without having other economic, commercial, and technical motives, the legal form will not be sustained for taxation and the tax benefits will be rejected.

The Ruling

The ruling (no. 00390, dated January 12, 2009) was issued because of a request made by a special purpose vehicle (SPV) established for acquiring the majority shares of a state-owned electricity distribution company under the government privatization program. The ruling stated that the SPV planned to merge into the electricity distribution company and asked the tax administration about the deductibility of financial expenses for the loans obtained by the SPV for the acquisition of the shares of the electricity distribution company.

The tax administration stated that the financial expenses borne by the SPV for the acquisition of the shares of the electricity distribution company could not be deductible after the merger.

The ruling, a one-page letter, lacks a detailed analysis and evaluation. The opinion is based on two arguments. First, it states that the corporate tax law stipulates that financial expenses relating to the acquisition of participation shares can be deductible, but it lacks a provision allowing the deductibility of such expenses in the determination of taxable corporate profit after a merger. One would normally interpret the same provision on the contrary, claiming that if the law intended to restrict the deductibility for a merger, a specific provision would have been laid down. The nonexistence of such a provision actually evidenced the deductibility of financial expenses even for a merger.

Apparently, the Ministry of Finance does not agree. The second argument used against the structure is more technical. The ruling argues that after the merger, when the SPV was dissolved into the electricity distribution company, it cannot be mentioned that the electricity distribution company has financial expenses for the acquisition of participation shares. In other words, when the SPV is acquired and dissolved into the acquiring company, the participation shares with which the loan is connected disappears. The MOF thinks that the financial expenses would not be deductible when the related participation shares no longer exist in the balance sheet of the company.

The ministry has a point. But according to the tax-free merger rules in the corporate tax law, in a merger the acquiring company continues to carry out business under complete succession. Theoretically, tax attributes of the assets and liabilities transferred to the acquiring company should not be affected by the merger. Accordingly, tax attributes of the loans, irrespective of why they were obtained, should remain the same in the acquiring company, and the financial expenses should be deductible as they were before the merger.

However, the ruling is silent on the tax deductibility of financial expenses in an upstream merger. The ruling request explains that an upstream merger is not possible, because the electricity market regulations only allow a merger within the company that holds the electricity distribution license. Therefore, a downstream merger was intended when the SPV was merged in the electricity distribution company.

In an upstream merger, the SPV would acquire whole assets and liabilities of the electricity distribution company. In this case, the ministry's second argument would further weaken; although the participation share would disappear, it would be replaced by assets and liabilities of the acquired company that the loans are related to. Would the MOF's ruling be different then?

The chance is very remote that it would be different. The ministry probably would assert other arguments to reach the same conclusion. Apart from what the ministry rules, how things are evaluated by the tax inspectors is important. In Turkey individual rulings only protect taxpayers against tax penalties, and they may be easily challenged by tax inspectors during tax audits because the tax inspectors are not bound by the ministry's rulings.

Turkish tax inspectors challenge any tax-motivated transaction, and the substance-over-form rule is ambiguous enough to allow them to do whatever they wish.

So far there has been no court decision on the issue. The courts are generally reluctant to deal with the controversial and subjective interpretations of tax inspectors solely relying on the substance-over-form rule. Yet it should be recognized that a debt pushdown structure in its pure form would not be easy to defend.

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