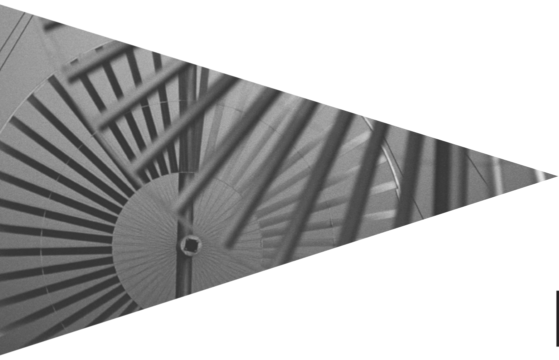

Likely Changes in the Netherlands-Turkey Tax Treaty

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A. Feridun Güngör writes about the efforts Turkey is making in negotiating its tax treaties, especially the treaty Turkey has with the Netherlands.

Turkey is in the process of revising its out-of-date tax treaties. It has started negotiations in recent years with a few countries, including Austria, the Netherlands, Germany, and Norway. So far only the treaty with Austria has been concluded, but it is still pending ratification.

Turkey's adventures in treaty negotiations began in the early 1970s, and the number of negotiations has increased since the mid-1990s. In the aftermath of the disintegration of the Soviet Union and the collapse of the Eastern Bloc, Turkey conducted negotiations with the newly independent states to promote and strengthen economic and political relations, and signed a number of tax treaties.

An Obvious Need for Change

Even though Turkey is a member of the OECD, in early treaty negotiations it largely followed the U.N. model treaty. From a policy point of view, source taxation seemed to be more important for Turkey; with its heavy reliance on foreign capital, the country was more concerned about the protection of its tax base when interacting with foreign countries. Over time Turkey brought its treaty policy closer to the OECD model. Although there are still some peculiarities in Turkey's model treaty, the number of reservations and observations Turkey once entered in the OECD model convention has now decreased significantly.

Recently, the tax environment has drastically changed. Many countries have overhauled their tax systems to cope with the increasing tax competition created by the former Eastern Bloc countries that are now part of the

European Union. Tax rates dropped, tariffs flattened, indirect taxation widened, and global taxation lost ground against dual taxation. Turkey was not an exception; these were exactly the changes its tax system experienced.

Eventually, developments in the domestic and international tax environment compelled Turkey to review and revise its early tax treaties.

The most significant and widely used among Turkey's treaties under negotiation is the one with the Netherlands. According to statistics issued by the Turkish Treasury, the Netherlands is one of the leading countries for direct investments made into Turkey. In 2006 and 2007 Dutch direct investment in Turkey amounted to US $10.7 billion out of a total US $36.8 billion in direct investments, while Turkish direct investment in the Netherlands amounted to US $3.6 billion in 2007 out of a total Turkish direct investment abroad of US $12.7 billion.

Most likely, little of the capital imported into Turkey is actually from Dutch sources. Likewise, the Netherlands is the ultimate destination for only a small portion of Turkish capital exported to that country. It is no secret why capital inflows and outflows are routed through the Netherlands -- its extensive treaty network, international holding regime, and friendly tax and legal environments make multinational companies prefer the Netherlands over its rivals as an international holding center.

Likely Changes

Until now, the Turkish Ministry of Finance did not disclose any information about the treaty negotiations with other countries, including the Netherlands. Yet, a few changes will likely occur.

The Dutch treaty is one of the few treaties Turkey concluded in which the method used for the prevention of double taxation for Turkish residents is the exemption method. Dividends received from companies resident in the Netherlands are exempted from income taxation in Turkey. It is likely that the credit method may replace the exemption method in the new treaty. If that happens, only the taxes paid in the Netherlands can be deducted from Turkish taxes assessed on the dividends received by Turkish residents. If the income of the Dutch company consists of capital gains and dividends received from subsidiaries in foreign countries, the company will likely enjoy the participation exemption of the Netherlands and pay no tax on its income. In that case, the only tax that can be credited by a Turkish resident on the dividends received from the Dutch company will be the 5 percent withholding tax (15 percent for individual shareholders) currently applicable on the dividends paid to the Turkish resident shareholder. Under the Turkish foreign tax credit rules, it is not permissible to get credits for the taxes paid by the subsidiaries of the Dutch company. Eventually, the change to the credit method will result in double taxation when a Dutch holding company is used to invest in a company in a third country.

Dividends distributed to the Dutch resident corporate shareholders of a Turkish company are taxed at 10 percent. In the new treaty, this rate might be increased -- or, more likely, will be subject to some conditions. Similar to conditions in the Spain-Turkey treaty, treaty benefits are not provided if the sole purpose of a third-country investor's forming the company in the Netherlands is treaty shopping.

According to the Dutch treaty, capital gains derived from the alienation of shares and bonds registered with stock exchanges are only taxable in the country in which the alienator is a resident. Turkey is not very happy with this provision because it greatly limits source country taxation; this exemption will likely be removed. However, this change will not have an adverse effect in the short run because the withholding tax on capital gains on the disposal of shares and bonds is nil for all nonresident investors.

Taxpayer's Rights Should Be Respected

If Turkey favors the changes discussed in the preceding paragraphs, it may cause trouble for many companies. Even though it may take one to two years to put any changes into effect, other measures are also needed so investors are not caught off guard. The views of the investors' associations likely to be affected by the changes should be noted and respected. Treaty polices and other priorities of the Ministry of Finance should be effectively communicated to taxpayers.

Most importantly, a grandfathering rule is needed for those investors who will be immediately affected by the changes. They should be granted a transition period during which they can restructure their investments and reorganize their holdings.

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