INTERNATIONAL
TAX SERVICES

MAY 1, 2003

ITS in the News

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New Turkish Law Targets INvestment, Dividend Taxation

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The Turkish Parliament on 9 April ratified a new tax law that significantly changes the investment tax allowance and the dividend tax system. The law was prepared in cooperation with IMF officials and complies with the fiscal policies Turkey has been implementing in accordance with the IMF standby agreement.

The new regulation redefines the basic application of the investment tax allowance. Specifically, it sets the investment allowance rate at 40 percent and eliminates the 19.8 percent withholding tax that previously applied to that allowance. It also eliminates the investment incentive certificate that was mandatory under the old application. Those changes will be valid from the date the law is published in the official gazette.

The following table illustrates the net effect of the new practice:

	Old System	*New System*
Allowance rate(s)	40%, 60%, 100%, 200%	40%
Investment amount	100	100
Withholding tax rate	19.8%	0%
Corporate income tax rate	33%	33%
Deduction from taxable corporate income	40, 60, 100, 200	40
Tax effect	-13.2, -19.8, -33, -66	-13.2
Withholding tax	7.92, 11.88, 19.8, 39.6	0
Net tax effect	-5.28, -7.92, -13.2, -26.4	-13.2

As shown in the table, the net tax effect on the investor is the same as the old system as applied with a 100 percent allowance rate.

1. This article originally appeared in the April 21, 2003, issue of *Tax Notes International*, Number 30, page 233.

The law also takes a new step in the integration of personal and corporate income tax, introducing a 50 percent dividend deduction at the personal level to offset taxes paid at the corporate level. That deduction, applicable only for Turkish residents, will be effective from 1 January 2004. The following table illustrates the net tax effect of the new regulation:

	Old System	*New System*
Corporate income	100	100
Corporate income tax rate	33%	33% (expected)
Corporate income tax	33	33
Net dividend distributed	67	67
Income tax withholding (16.5%/expected)	10	10
Personal income tax base	67	33.5
Personal income tax (45% maximum	30	15
Total tax burden on the investor	63%	48%

There are two important concerns arising from the new regulation. First is the possibility of offsetting at the personal level taxes that have not been paid at the company level. This concern is based on the fact that no corporate tax is paid if the company distributing dividends had a tax loss, which can result from investment tax allowances and other deductions from before-tax profits. The second concern is that the new regulation does not seem to conform with the nondiscrimination rule in Turkey's double tax treaties, as it acknowledges a different dividend withholding tax on nonresidents. The new tax law also establishes that:

! equity shares of resident companies held for more than 12 months are exempt from CGT, as are equity shares that are traded on Turkish stock exchanges and held for more than three months;

! effective from 2004, an integrated income tax credit system will replace the special deduction and expenditure system for wage earners, and the tax schedule for nonwage income will change, resulting in a 5 percent increase in income tax rates;

! health and education expenses will be deductible on tax returns, provided that the expenses belong to the taxpayer or the spouse and/or children of the taxpayer, that they do not exceed 5 percent of the declared income, and that they are spent in Turkey and supported by necessary documentation; and

! the Defense Industry Supporting Fund contribution, which is 10 percent of the calculated tax, no longer will be levied in corporate and income tax returns submitted after 1 January 2004 (for the 2003 tax period).

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