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Turkey's New Inflation Accounting Adjustments Bring Positive Tax Results

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Turkey has published a draft law on inflation accounting adjustments for tax purposes that seeks to avoid unfair taxation and to increase the tax burden.

Two decades of high inflation in Turkey have damaged the financial statements of companies resident in Turkey. Because inflation accounting was not practiced, corporations were usually forced to pay taxes exceeding their nominal income. Many commentators believe that was an important factor in creating Turkey's large informal economy.

An analysis of operating and nonoperating expenses of companies in Turkey shows that financial expenses, including interest and foreign currency losses relating to loans, constitute a significant portion of corporate expenses. Many of the loans are intergroup loans and loans received from shareholders.

Most companies operating in Turkey are not strongly capitalized. They depend on external resources to finance their day-to-day operations and investment spending. Widespread use of intergroup loans decreases the corporate tax basis. In fact, the high inflationary environment results in the use of intergroup loans as a tax planning tool.

Intergroup companies feel free to charge each other interest rates, ranging from 60 to 90 percent over principal amounts in TL, compared to 12 to 15 percent for foreign currency loans. The nominal figures are not adjusted to reflect inflation, and the loans are considered financial expenses. The loans are often criticized by tax inspectors as disguised capital and profit distribution.

The new draft tax law on inflation accounting adjustments will limit this tax planning. Under the draft law, interest rates for TL loans will probably not be higher than 15 percent in real terms. Regarding foreign currency loans, the inflation adjustment will have an important effect on foreign currency losses and interest payments. Generally, the draft law will increase the corporate tax burden of Turkish companies with high debt/equity ratios.

Abolition

The draft law abolishes the revaluation application under article 298 of the Tax Procedures Code, "cost increase fund" application under article 38 of the Income Tax Code, "financial expense restriction" application under article 41/8 of the Income Tax Code and article 15/3 of Corporate Tax Code, and last in, first out (LIFO) application under article 274 of the Tax Procedures Code.

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The regulations are being applied with the intention of offsetting the effects of inflation. With the introduction of the inflation accounting adjustments, broader and more general inflation adjustments will replace the existing regulations.

Useful Life

In determining amortization periods, the draft law introduces the "useful life" concept, under which entities will amortize their assets in relation to rates and terms decided by the Ministry of Finance. Moreover, partial amortization will be permitted when the entities have to amortize their assets on a monthly basis.

Currently, taxpayers may amortize their depreciable assets over five-year terms, accounting for a depreciation expense of 20 percent of the economic value of an asset in each year, except for cars that are currently amortized on a monthly basis.

Under the draft law, taxpayers may choose the double declining depreciation method, in which economic assets are subject to 40 percent depreciation in the first year, which means the economic asset stays on the enterprise's balance sheet for only a single day.

Eventually, "useful life" and "partial amortization" will increase the tax burden because the depreciation terms will most likely be longer than five years, and annual depreciation will no longer be allowed.

Discounting

All receivables and payables with a maturity will be subject to "discounting," regardless of whether the receivables are attached to a promissory note. We expect the application will have a tax-neutral effect.

Purchase Price

Marketable securities under the draft law will be valued at their "purchase price," and amendments will be made to article 279 of Tax Procedures Code. Under the existing provisions of article 279, only stock and investment funds that have 51 percent of their portfolio in stocks of companies established in Turkey are valued at "purchase price."

The draft law distinguishes between monetary items and nonmonetary items in terms of the inflation adjustment. Accordingly, all marketable securities will be treated as nonmonetary items, and the inflation adjustment will be applied. That distinction will have both positive and negative effects on the tax burden because changes in the market prices of marketable securities will no longer be reflected in the corporate tax basis, apart from inflation adjustment.

Doubtful Receivables

The current practice for "doubtful receivables" will change to cover uncollected VAT from customers and advances given. We expect that the change will have a limited effect on the tax burden because uncollected VAT and advances play a minor role in determining the corporate tax basis.

Investment Allowance Rate

Under the draft law, the investment allowance rate will be applied over the fixed assets subjected to inflation adjustment, which will provide an opportunity to protect the investment spending from inflation in the related year.

Currently, the unused portion of the investment allowance is subjected to adjustment using revaluation rates in the following years. However, the draft law gives the right to adjust the investment spending on a monthly basis as well, which will help to decrease the tax burden.

Stock Market

Stock market in article 263 of the Tax Procedures Code is defined under the draft law to include all local, foreign, and international stock markets. The new definition will have a tax- neutral effect. Income tax tariffs for wage earners will be determined every six months based on the price index rate; the provision will help to decrease the tax burden.

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