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Turkey: Proposed Change to Withholding Taxation for Resident and Non-Resident Investors

On April 3, 2010, the Turkish Ministry of Finance announced a planned regulation change to the Income Tax Law. The proposed change would eliminate the taxation difference between Turkish residents and non-resident investors. The withholding tax applied to capital gains derived from share certificates will remain at 0% for both Turkish residents and non-resident investors. The withholding tax applied to interest income and capital gains derived from Government bonds and Treasury bills will be 0% for both resident and non-resident companies (investment funds) and 10% for other taxpayers (individuals and other bodies/institutions). Once the draft version of the planned regulation is announced, a detailed evaluation can be made regarding the withholding tax rate to determine whether a 0% or 10% rate is applicable for non-resident corporate investors of different forms. This would include equity companies, investment funds and other institutions. At this time, the planned regulation does not specify how to distinguish between equity companies, investment funds and other entities that will be taken into account in determining the withholding tax rate applied to Government bonds and Treasury bills. We will keep GWTR subscribers apprised as this situation develops.

Note that the Constitutional Court annulled the provision of the Income Tax Law which reduces the withholding tax rate to 0% on some types of income and capital gains derived by non-residents and corporations from marketable securities. The annulment decision was published in the Official Gazette on January 8, 2010 and will become effective on October 8, 2010.

As published in a previous alert dated 10/16/2009, the important aspects of the decision and potential implications of it have been summarized below.

1. Withholding rates applied on income from marketable securities in Turkey

Turkey made fundamental amendments in the taxation regime of income from marketable securities to be effective from January 1, 2006. Under this regime, banks and intermediary institutions in Turkey had to withhold taxes on the investors' profits derived through the marketable securities and other capital market instruments for which they acted as the intermediary, such as interest, capital gains and income from lending of these securities. This regime also ruled that income from bank deposits, repo transactions as well as forward and futures transactions were subject to withholding taxation.

Although the rate of this withholding tax had been determined as 15% initially, in time several changes were made in the rate of withholding tax depending on the type of the marketable securities.

One of these amendments was made with Law No 5527 and came into force on July 7, 2006, which reduced the rate of withholding tax to 0% on profits of non-resident corporations and real persons, which are derived through a bank or an intermediary institution in Turkey and which are mainly:

- capital gains derived from trading of share certificates,
- capital gains derived from trading of government bonds, treasury bills and private sector bonds,
- income derived from mutual funds, or
- profits derived from their transactions in futures exchange markets.

Another amendment in this area was made with the Council of Ministers Decree 2007/10731, which stated that withholding tax on the types of income listed above would be reduced to 10% to be effective from July 23, 2006. This amendment was followed by another one, reducing the withholding tax rate to 0% on the capital gains of resident real persons and corporations arising from trading of share certificates (excluding share certificates of investment trusts) to be effective as of 14 November 14, 2008.

2. Decision of the Constitutional Court

The Constitutional Court cancelled the regulation explained in the preceding section, which reduces the withholding tax rate to zero on some profits of non-resident real persons and corporations.

However, the decision for cancellation has not been published in the Official Gazette yet and the Constitutional Court decision states that it would come into force nine months after it is published in the Official Gazette. So, as of today, the rate of withholding tax rate has not changed.

3. What will be the rate of withholding tax to be applied on such income of non-residents when the decision comes into force?

Based on past experience, publication of Constitutional Court decisions including their preambles in the Official Gazette take some time. Furthermore, it is expected that new regulations on this issue would be enacted in the nine months following the publication of the "decision with preamble" in the Official Gazette.

If no regulations are made in this period, this would mean that the decision will be effective in its current form, and in this event the withholding tax rate to be applied on the eligible income of non-residents would be applied as 15%, instead of 10%. This is due to the provision of the Income Tax Law which states the rate of this withholding tax as 15%. Note that this rate was reduced to 10% only for some types of income of Turkish residents.

4. The withholding tax rate may be reduced to zero

The lawsuit leading to the decision of the Constitutional Court was claiming that the provision reducing the withholding tax rate on certain type of income derived by non-residents in Turkey was inconsistent with the articles of the Constitution, which state that the Government should levy tax based on the equality principle and depending on the financial situation of the public. Considering that this reduction in the withholding tax rate to zero was found to be inconsistent with these articles of the Constitution, we are in the view that reducing the rate to zero for non-residents again with a new regulation (either with a law or a Council of Ministers Decree) is not likely.

Therefore, the alternative of decreasing the 10% withholding tax rate on income of Turkish residents to 0% may become a topic of debate. Since the rate is already applied as zero on capital gains arising from the sale of share certificates, other types of income such as income from government bonds, treasury bills and private sector bonds, mutual funds and future contracts might also be taxed with zero withholding taxation. This potential policy decision of reducing the withholding tax rate to zero for all types of income should also be evaluated on other factors, such as the balance of the general budget.

When reviewing this alternative, one should not only consider the decrease in the tax collections on interest income or capital gains arising from government bonds or treasury bills. This rate reduction could also cause a shift from instruments, such as bank deposits and repo (which are currently subject to 15% withholding tax) and taxes to be collected on these types of transactions could face losses.

The Ministry of Finance would also consider the alternative of equalizing the rate both for Turkish residents and non-residents, to a region below 10% (such as 5%). However, this type of a rate reduction would not be reasonable policy choice for creating a trustworthy investment environment for the non-resident investors as well as the budget balance concerns.

In case the withholding tax rate is reduced to zero or it is reduced to some rate between zero and ten percent, it is also possible that the Ministry of Finance may change its taxation policy for the marketable securities and may choose to apply a different tax regime.

Although we still have quite a long time ahead of us until the decision of the Constitutional Court comes into force, we believe that the Ministry of Finance should decide which direction it will take on the issue as soon as possible and manage the process with integrity in order to prevent any uncertainty and ambiguity in the markets. Apparently, the statement of the Finance Minister today shows an intention to act as such and we assume that the necessary rules will be available soon.

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