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Strengths and Weaknesses of the Spain-Turkey Tax Treaty

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Investors and tax advisers that are interested in investing in Turkey inquire about the Spain-Turkey double tax treaty (DTT) before any other treaties. The Spain-Turkey DTT reduces dividend withholding as low as 5 percent, which is matched by only a few other treaties concluded by Turkey, and they are not as lucrative as the Spanish treaty for some business concerns.

However, it seems that this seductive tax rate is not freely available; rather, it is guarded by the wording of anti-abuse provisions in the treaty.

Increase in Withholding Tax

Last year, despite widespread opposition, Turkey increased the withholding tax on dividends to 15 percent from its previous rate of 10 percent. The move followed an astonishing reduction of the corporate tax rate from 30 percent to 20 percent. Those were part of an effort to overhaul the corporate tax system, dating back to the 1950s, which was failing to respond to Turkey's ever-changing economic and tax needs. Also, thin capitalization rules, which were the largest source of tax disputes because of their short and ambiguous wording, allowed for subjective interpretation and left room for tax inspectors to attack many intercompany borrowings. Corporate Tax Law 5520, enacted in June 2006, has introduced Turkey to some new concepts, including controlled foreign corporations, anti-tax-haven regulations, and underlining foreign tax credits.

The new rules, with their much lengthier wording, intend to remove subjectivity in the old rules. The new law clarifies such concepts as debt-to-equity ratio, the definition of related company, and exclusions of banks and other financial companies, and it clarifies the non-deductibility of foreign exchange differences. Another issue redrafted in the law, which is at least as important as thin capitalization, is transfer pricing. The rules in the old law, originally adapted from German laws, did not follow the OECD transfer pricing guidelines. To a large extent, the lack of transfer pricing methods was preventing tax inspectors from successfully challenging cross-border transfer pricing practices.

Therefore, tax inspectors were focusing on easy targets such as intracountry transfer pricing practices. Although usually overturned by the courts, tax inspectors continued to assess addi-

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tional amounts for transactions between related companies when no tax loss would arise if the other party made a corresponding adjustment. The assessments were a result of single-handed price adjustments. Hopefully, these approaches will end after the introduction of new transfer pricing rules. Turkey intends to adapt the rules and principles in the OECD transfer pricing guidelines. The new guidelines address major issues such as the arm's-length principle, related parties, transfer pricing methods, and the Ministry of Finance's authorization for advance pricing agreements. The Council of Ministers is authorized to issue a regulation further clarifying the implication of the new rules; however, it has not done so yet even though the new rules became effective as of January 2007.

Recovering Revenue Loss

It would not be wrong to say that the new corporate tax law is designed to improve competitiveness by cutting tax rates and introducing exemptions for some foreign income. It furnishes the tax administration with several anti-abuse measures to more effectively combat harmful tax competition and tax evasion. The MOF's dilemma was how to compensate for the inevitable short-term revenue loss due to the sharp cut in the corporate tax rate. One measure appeared to be increasing dividend withholding tax to offset the expected revenue loss, but it is doubtful that it would work. First, the dividend withholding tax is applicable when dividends are actually declared, so that is easily avoidable by postponing declaration. Second, most of the foreign investors have been going through the Netherlands to invest in Turkey, because of the favorable rates and other relief available through the DTT between the Netherlands and Turkey.

Withholding Tax on Dividends

The Turkish withholding tax is applicable to dividends received by resident individuals and nonresidents. Resident individuals qualify for a 50 percent exemption for the dividends they receive, but a full credit for the taxes withheld when they declare their dividend through annual tax filling. Resident corporations are exempt from withholding taxation of dividends. They also enjoy the participation exemption without requiring the fulfillment of a minimum participation. Branches of nonresident companies suffer the same level of branch profit tax on their profits repatriated to their head offices. Turkish DTTs have provisions that secure this taxation.

Dividend Tax in Treaties

In the majority of Turkey's DTTs, taxing dividends in the source country is reduced to between 10 percent and 15 percent (with the exception of a few treaties concluded in the 1970s). Over the years, the Netherlands became the best route for investing in Turkey, not only because the DTT provided a favorable 10 percent rate on dividends and almost fully exempted capital gains from source country taxation, but also for its international holding structure, which was favored with the extensive and uniquely advantageous treaty network.

Spain was one of the few OECD member countries that Turkey delayed in reaching an agreement with on double taxation. Both sides maintained their hard-line positions, deadlocking for many years. Thanks to the increased investment appetite of Spanish companies in Turkey, it became obvious that not having the treaty was no longer affordable and harmed the interests of both sides.

A DTT between Spain and Turkey was finally signed on July 5, 2002, and came into force on January 1, 2004.

Beneficial Ownership

Almost immediately after becoming effective, the DTT with Spain aroused great interest because of its low dividend taxation. At the beginning, many tax people, enticed by the low tax rate, have simply ignored both the anti-abuse rules and the change in the tax environment, which is more intolerant of the abuse of tax rules. The treaty introduces provisions to prevent the abuse of treaty rates. Although there are deficiencies in the wording and some ambiguous references, interpretation of the treaty with good faith "in light of the object and the purpose of it" does not leave too much doubt for the applicability of these provisions. Under article 10, paragraph 2(a), dividends to be paid to a resident of Spain will be taxed at 5 percent of the gross amount of the dividends to the extent they are paid out of profits that have been subject to tax as specified in paragraph 5 of the article when those dividends are paid to a company (other than a partnership) that holds directly at least 25 percent of the capital of the company paying the dividends and 15 percent of the gross amount of the dividends in all other cases.

The following conclusions can be drawn.

The recipient of dividend income can qualify for the treaty rates if he is the beneficial owner. However, the definition of beneficial ownership is not found in this treaty, any other treaty concluded by Turkey, or Turkish domestic law.

The lack of a definition makes interpreting the treaty provisions difficult. Some argue that beneficial ownership as an anti-abuse rule cannot apply simply because this concept does not exist in Turkish law. Considering the strong reliance of treaties on domestic law for the interpretation of terms that are not defined in the treaties, this argument appears rather convincing.

However, the approach of the MOF is different. The ministry has proved that it has taken the OECD commentary as a basis for the interpretation of tax treaties. Over time, the OECD commentary has become almost the sole source to be used in the interpretation of tax treaties.

However, in a securities taxation communiqué (No. 257, dated December 30, 2005), the MOF first used the beneficial ownership concept and determined that a nonresident investor claiming treaty benefits is required to prove that he is the beneficial owner of the securities income received. Beneficial ownership is not defined in the communiqué. Nonetheless, explanations and comments made in the OECD commentary will seemingly guide the domestic interpretation of beneficial ownership.

There is no court ruling on beneficial ownership. Furthermore, I am not aware of any tax treaty-related court ruling in which the OECD commentary was used as a basis for the decision concerned. The possibility is not high for Turkish courts using the OECD commentary regarding the definition of a term provided neither in the treaties nor in the domestic law. However, it can be assumed that the courts might attempt to develop their own definition, considering their generally negative approach against anti-abuse practices.

To sum up, it would not be a mistake to foresee that the Turkish tax administration will be inclined to interpret beneficial ownership within the context of the OECD commentary. Just because Turkey is one of the substance countries, the tax administration should not be expected to approach the issue from a different perspective.

According to the OECD commentary, it is not sufficient to claim treaty relief "merely because that income was immediately received by a resident of a state with which the state of source had concluded a convention." It goes on to state that:

> where an item of income received by a resident of a Contracting State acting in the capacity of agent or nominee it would be inconsistent with the object and purpose of the Convention for the State of source to grant relief and exemption merely on account of the status of the immediate recipient of the income as a resident of the other contracting states.

Moreover, any person or entity acting as a conduit for another person who ultimately receives the benefit of the income concerned cannot be regarded as the beneficial owner.

Substance-Over-Form Rule

Although beneficial ownership is not defined in Turkish tax law, another well-known anti-abuse rule serves a similar purpose as beneficial ownership. In Tax Procedure Law 213 (dated January 4, 1961), the substance-over-form rule is defined in article 3, paragraph B:

> B) Evidence: In taxation, true nature of taxable event and the transactions relating to this event is essential.
>
> Taxable event and the true nature of transactions related to this event can be evidenced with proofs except oath. In so far, witness testimony of which its relation to the taxable event is not natural and obvious can not be used as proof.
>
> In case that a claim is made which is not sound economically, commercially and technically or which is not normal and common with respect to its peculiarities, proof of burden lies on the person who makes such claims.

In the past, the substance-over-form rule, in spite of its existence in the law, did not matter too much, and the legal forms of the transactions were generally respected the way they were structured. In recent years, however, the tax authority in Turkey adopted more aggressive approaches against tax-motivated transactions. Eventually, the substance-over-form rule developed as an effective tool to combat schemes considered abusive in nature. It seems that 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 concerned will be rejected.

In Tax Procedure Law 213, guidelines are not provided for what constitutes substance in a transaction or structure.

When Turkey's tax experience is considered, it can easily be concluded that the substance test will not be simply dependent on the presence of factors such as an office, equity, employees, or local directors, but more on if the office, equity, employee, or organization is proportionate to the activities carried out and income derived through which these factors are employed.

Within this framework, it is worth exploring how Spanish holding companies known as ETVEs (Entidad de Tenencia de Valores Extranjeros) can be treated when the object and purpose of the tax treaty is respected. The ETVE company regime gives substantial tax advantages to multinational and Spanish groups for their income from foreign participations in the form of dividend and capital gains.

Discussing the most basic and common form of an ETVE as an international holding company can help us better understand the issue. Assume that the ETVE is incorporated with shareholders that are not Spanish residents, the participation in Turkey is the only investment made, and the investments are fully financed with the sources obtained abroad. Also, no staff, managers, or activity exists (except the participation).

It would not be surprising that Turkish tax inspectors would challenge -- under those facts and according to beneficial ownership and substance-over-form -- the benefit of the income concerned because it will be obtained by third-country residents, nor would it be surprising that the sole purpose of establishing the holding company is to achieve that result. The inspectors might claim that there are not any sound economic, commercial, or technical reasons to form the holding company in that way, other than tax saving to the shareholders that are eventually not the residents of the treaty country.

Minimum Taxation Requirement

A condition for qualifying for the 5 percent tax on dividends requires that the profits out of which dividends are paid must be taxed as specified in paragraph 5, which reads as follows:

> For the purposes of paragraphs 2 and 4, profits have been subject to tax in Turkey, where they have not been exempted and are subject to the full rate of corporation tax (Kurumlar Vergisi).

It is construed from this provision that dividends to be paid out of profits that are exempt from corporation tax will not be subjected to 5 percent tax, but to 15 percent tax. There are some exemptions in the corporate tax law that can be affected by the provision. The most common ones are:

- participation exemption for dividends from resident companies;
- participation exemption for dividends from nonresident companies and profits from foreign branches;
- capital gains from participation in nonresident companies;
- capital gains from disposal of long-term participations and disposal of long-term immovable properties;
- income from construction activities carried out abroad; and
- investment allowance carried forward from the years before January 1, 2006 (effective until the end of 2008).

In addition to the exemptions listed above, there are exemptions for profits of some capital market entities such as securities investment funds and corporations, gold and precious metal funds and corporations, venture capital funds and corporations, real estate funds and corporations, pension funds, mortgage funds, and asset finance funds. Some of these corporate entities are subjected to withholding tax on their income even though they are exempt from corporation tax. However, dividends that will be paid out by these entities will also not qualify for the 5 percent withholding because their income has not been subjected to the full rate of corporation tax as required by paragraphs 2 and 5 of the treaty.

Nevertheless, when dividends are distributed partly from exempted profit and partly from fully taxed profit, the 5 percent tax should be allowed for the portion of the dividends paid out from the fully taxed part of the profit.

Preventing Abusive Practices

Article 8 and article 22 of the protocol stipulate the prevention of treaty shopping and abuse of the treaty. The wording of this provision lacks clarity because of the confusing references made to the other articles. Protocol article 8 states:

> The exemption provided in sub-paragraph (b) of paragraph 1 of Article 22 shall not apply if it was the main purpose of any person concerned with the creation or assignment of the shares or other rights in respect of which the income is paid to take advantage of this provision by means of that creation or assignment. In that case, subparagraphs 10.2. a) ii) or 10.4 a) ii) shall apply. The provisions of subparagraph (d) of paragraph 1 of Article 22 shall cease to have effect after 10 years since the entry into force of this Agreement. After this period, the Competent Authorities will jointly consider an extension of the provisions hereinbefore mentioned.

This provision is intended to deny some treaty benefits to any person concerned with the creation or assignment of the shares or other rights for which the income is paid if the person's main purpose is to take advantage of this provision by means of that creation or assignment. Article 22 states that for Spanish residents, double taxation will be eliminated through the application of the exemption method if the income received from Turkey has been taxed according to article 10, paragraph 2a(i), which reduces tax on dividends to 5 percent. If the exemption method has been denied, double taxation for residents of Spain will be prevented through the credit method, in which the taxes paid in Turkey will be deducted from the Spanish tax.

What is interesting about this provision is that the advantages of the treaty that are intended to be prevented from abuse cannot be easily construed. At first instance, one may think that the purpose is to disallow exemption in Spain for the dividends received from Turkey. Yet we know that Spanish tax law already exempts dividends from foreign participations. As addressed earlier, conditions required to benefit from foreign participation exemption are rather light under Spanish law. Therefore, it may be misleading to consider that the purpose of this provision is only to prevent the residents of Spain from the unfair entitlement to exemption. In my opinion, the true purpose of this provision is to prevent those who receive dividends from companies in Turkey from taking advantage of the 5 percent withholding with the creation or assignment of the shares or other rights for which the dividends are paid as described in protocol article 8. If there is an abuse as defined in protocol article 8, Turkey holds the right to deny the application of the 5 percent tax on dividends and on branch profits received by Spanish residents. Turkey may deny the application of the 5 percent withholding even if Spain provides relief for dividends through the exemption method according to the treaty or to domestic law.

As a result of denial, the tax rate to apply on dividend and branch profits will be 15 percent as per article 10, paragraph 2a(ii).

Protocol article 8 defines two abusive practices. The first is the creation of a shareholding structure, under which a company is incorporated in Spain for the main purpose of benefiting from the treaty rates and other relief. This concept is different than the beneficial ownership concept. Not only can a company created by nonresidents of Spain come under attack, but also one created by residents of Spain, if the main purpose is considered to be abusive. Obviously, it is easier to assume that the main purpose is treaty shopping when the company in Spain has been established with nonresident shareholders. The rejection of treaty benefits to the third-country residents is understandable from a limitation on benefits viewpoint. However, it does not make sense when the shareholders are residents of Spain. How can it be substantiated that the main purpose of establishing a company in Spain with resident shareholders is to take advantage of the treaty? It would be logical to assume that residents of the third countries are the target, not residents of Spain.

The second abusive practice is the assignment of the shares and the other rights for which the income is paid. It concerns changing an existing shareholding structure of the company resident in Turkey. When the shares are originally held by the shareholders who are residents of a third country and subsequently the shares are transferred to a company resident in Spain, if the main motive in changing the ownership of the Turkish company is to qualify for treaty benefits, both the exemption method for elimination of double taxation for the residents of Spain and the applicability of the 5 percent tax on the Turkish-source dividend will be denied by the respective countries.

Only if the transaction's main purpose is tax motivated can it be considered noncompliant with protocol article 8. If the main purpose is business motivated and the tax motive is incidental, then there should be no problem regarding the tax relief claimed under the treaty.

Conclusion

The Spain-Turkey DTT is favorable when the beneficial owner of income is a Spanish resident. Residents of a third country that are attracted to the low withholding tax on dividends under the treaty should consider whether they would be able to have substance in Spain to successfully claim to be the beneficial owner of the income received from Turkey. Furthermore, it seems that even if substance exists, there is still a risk of denial of the treaty benefits if the main purpose is tax motivated and aims to take advantage of treaty benefits. The ambiguous wording and confusing references of the relevant articles may leave some room for challenging the anti-abuse provisions; nonetheless, relying only on that may not be a wise thing.

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