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New Corporate Tax Code Enters into Force in Turkey

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A new Turkish Corporate Tax Code entered into force on June 21, replacing the version that dated back to 1949 and had been amended many times to keep up with domestic and global business and tax developments. (For prior coverage, see Tax Notes Int'l, Feb. 20, 2006, p. 614, 2006 WTD 32-1, or Doc 2006-3029.)

Besides making changes to the existing transfer pricing and thin capitalization regimes, the new Corporate Tax Code:

- reduces the corporate tax rate;
- increases the dividend and branch remittance withholding tax rate;
- provides for a participation exemption for Turkish corporate taxpayers' dividend income from foreign subsidiaries and PEs;
- reduces the CGT on shares and immovable property; and o revises the foreign tax credit regime.

It also introduces, for the first time in Turkish tax law, controlled foreign corporation regulations, antiabuse provisions for transactions performed by persons resident in offshore jurisdictions, and cost allocation rules for Turkish permanent establishments of foreign parent companies.

Its provisions have retroactive effect to January 1, 2006, with some exceptions, such as the transfer pricing regulations, which will enter into force on January 1, 2007, and provisions to reduce the capital gains tax, which entered into force on June 21.

Corporate Tax Reduction

The corporate tax rate has been reduced to 20 percent from its previous level of 30 percent. The new rate applies to corporate income generated as of January 1, 2006. The temporary tax (advance corporate tax), which is paid on a quarterly basis, also has been reduced to 20 percent from its previous level of 30 percent.

Increase in Dividend Withholding Tax

The withholding tax rate on dividends distributed by fully liable taxpayers to nonresident shareholders (with the exception of

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nonresident shareholders that receive dividends through a PE or a permanent representative in Turkey) and the withholding tax on branch profits that are remitted to headquarters both have been increased to 15 percent from the previous rate of 10 percent.

Thin Capitalization

Loans from shareholders and related parties that exceed a debt-to-equity ratio of 3-to-1 will be deemed disguised capital. For loans from related-party banks and financial institutions, the debt-to-equity ratio is 6-to-1. For purposes of determining the extent of related-party borrowing, loans from all related parties will be treated collectively. For purposes of the Corporate Tax Code, "related party" is defined as persons that have a direct or indirect shareholding or voting right of at least 10 percent.

The opening equity at the beginning of the taxpayer's accounting period will be the equity considered for thin capitalization purposes. The interest paid or accounted and foreign exchange differences exceeding the debt-to-equity ratio are considered nondeductible expense. Disregarding foreign exchange differences, interest paid that exceeds the debt-to-equity ratio is considered a dividend distributed and is subject to dividend withholding tax. The debt-to-equity ratio is applicable for Turkish PEs of foreign parents, as well as their Turkish subsidiaries.

Transfer Pricing

Traditional transfer pricing methods mentioned in the OECD transfer pricing guidelines will be used as the basis for commercial transactions conducted between related parties.

The Tax Code stipulates that commercial transactions undertaken by persons resident in low-tax jurisdictions should be treated as transactions between related parties. The new law also calls for a 30 percent withholding tax on payments made in cash or on account to nonresident real and legal persons in transactions the Ministry of Finance maintains are not at arm's length, based on the payee country's tax capacity as compared with the Turkish tax system, and consideration of the exchange of information with that jurisdiction.

According to the new provisions, taxpayers must decide between the comparable uncontrolled price, cost-plus, or resale price methods to determine whether their commercial transactions with related parties are at arm's length. Taxpayers have a right to use transfer pricing methods other than the traditional methods mentioned above if they can show that the traditional methods are not suitable for their transactions. After deciding which method to use, taxpayers must provide sufficient documentation.

Transactions between related parties that have not been executed in compliance with the transfer pricing methods mentioned above will be treated as disguised profit distributions and will be subject to dividend withholding tax.

A new concept introduced in the Tax Code is the advance pricing agreement, which taxpayers can conclude with the Ministry of Finance. The transfer pricing method approved by the Ministry of Finance will be applicable for three years, assuming that the conditions effective in the determination of the transfer pricing method remain stable. The new transfer pricing rules apply to both domestic and foreign transactions.

Participation Exemption

The new Corporate Tax Code eases the conditions for application of the participation exemption to Turkish corporate taxpayers' dividend income from their foreign participations. Accordingly:

- the minimum shareholding requirement in the foreign participation has been decreased from 25 percent to 10 percent;
- the minimum holding period of the participation share has been decreased from two years to one; and
- the minimum tax burden on the foreign participation has been decreased from 20 percent to 15 percent.

The new Corporate Tax Code retains the conditions established in the previous tax code for transfers of dividend income or branch profits from foreign participations or foreign PEs to Turkey, as well as the requirement that the minimum corporate tax burden equal the rate applied in Turkey for foreign participations engaged in financial leasing, finance, and insurance activities.

The participation exemption has been extended to include companies established in foreign countries with the main purpose of construction, repair, assembly, and technical services. Accordingly, if, under the provisions of the respective country, the establishment of a corporation is necessary to undertake the above-mentioned construction activities, the dividend repatriated by the foreign subsidiary to the Turkish parent will benefit from the participation exemption without consideration of the conditions set forth for its application.

Reduced Capital Gains Taxation

With the exception of capital gains actively used in the trading of marketable securities and investment in immovable property, 75 percent of the capital gains derived from the disposal of participation shares and immovable property that has been held by the corporate taxpayer for at least two years is exempt from corporate taxation.

Based on the new corporate tax rate of 20 percent and the 75 percent corporate tax exemption on capital gains derived from disposals of participation shares and immovable property, the effective corporate tax rate on capital gains will be 5 percent. Under the new rules, capital gains must be kept in a special reserve account for a minimum of five years, with no further obligation to add the capital gains into company capital.

Foreign Tax Credit

Under the new Corporate Tax Code, Turkish fully liable corporate taxpayers with foreign subsidiaries in which they have a minimum (direct or indirect) participation (in shares or voting rights) of at least 25 percent have the right to a tax credit for the corporate or income tax paid by those foreign subsidiaries that have made dividend distributions to the Turkish fully liable corporate taxpayers.

The tax paid in foreign jurisdiction that cannot be credited against the corporate tax base in Turkey because of a lack of corporate income can be carried forward for a period of three years. The tax credit can also be used on temporary (advance) tax return filings.

Controlled Foreign Corporation Regulations

For the first time in Turkish corporate tax practice, the CFC concept has been put into effect. According to the provisions of the new Corporate Tax Code, CFC regulations will be applicable when fully liable real persons and corporate taxpayers have a minimum 50 percent direct or indirect participation in the shares, dividend rights, or voting rights of companies that have been established abroad, provided that the foreign corporation concurrently satisfies all the following conditions:

- at least 25 percent of the foreign company's income should be of a passive nature (portfolio investments);
- the foreign company must be subject to taxation of less than 10 percent on its corporate income; and
- the gross revenue of the foreign company must exceed the foreign currency equivalent of TRY 100,000.

If the foreign corporation falls within the Turkish CFC regulations, Turkish resident taxpayers must declare the corporate income of the foreign company in proportion to the amount attributable to each Turkish resident shareholder, regardless of whether the foreign company makes a dividend distribution.

Antiabuse Provisions

As mentioned earlier, there will be a 30 percent withholding tax on all transactions involving payments made in cash or on account for services, commissions, interest, and royalties to nonresident real and legal persons if the Council of Ministers determines the transactions are not at arm's length, based on the payee country's tax capacity as compared with the Turkish tax system, and consideration of the exchange of information with that jurisdiction.

However, if the transactions involve the importation of a commodity or the acquisition of participation shares or dividend payments, the withholding tax will not be applicable as long as the pricing is considered to be at arm's length. Interest payments made on loans from financial institutions abroad are not be covered under these provisions.

Cost Allocation for Turkish PEs of Foreign Parent Companies

Turkish branches of foreign companies may treat costs incurred at the headquarters or at the level of group companies resident abroad as deductible items for corporate tax purposes, provided that the expenses incurred abroad are directly connected to the commercial operations of the Turkish branch, and that the costs have been allocated to the Turkish branch through cost allocation keys determined at the headquarters in compliance with arm's-length pricing principles.

The new Corporate Tax Code is expected to bring Turkey into line with other OECD countries, and to make it more competitive with other Eastern European countries in attracting foreign direct investment.

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