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Turkey's New Participation and International Holding Regime

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Turkey has been implementing important regulatory amendments that are intended to increase the amount of direct foreign investments. One of the most important amendments has been Law 5228 of July 31, 2004, which regulates the application of tax on Turkish companies' income from foreign participations and permanent establishments abroad and introduces a new holding regime in Turkey.

The law introduces three important concepts.

Participation Exemption

Before the promulgation of Law 5228, the dividend income derived by corporations resident in Turkey from their subsidiaries resident abroad was subject to corporation tax in Turkey, if the dividends were remitted to Turkey. Otherwise, Turkey did not tax subsidiaries' profits kept outside of Turkey.

Under Law 5228, Turkish companies' dividend income that is derived through participation in nonresident (foreign) corporations has been exempted from corporate tax effective January 1, 2005. Turkish companies' dividend income from nonresident corporations has been exempted from corporate tax if the following conditions are met:

- the Turkish company should participate in the capital of the nonresident subsidiary continuously for at least two years at a rate of at least 25 percent until the date that the dividend is distributed;

- the subsidiary should become subject to a corporate income tax at a rate of at least 20 percent under the legislation of the country where the legal or business headquarters of the nonresident subsidiary is located (subsidiaries whose main field of activities consist of financing and insurance should be subject to a corporate tax rate equivalent to the corporate tax rate in Turkey);

- at least 75 percent of the gains derived by the nonresident subsidiary should be commercial, agricultural, or service income (active income); and

- the income of the nonresident subsidiary should be transferred to Turkey until the filing date of the annual corporate tax return concerning the tax period in which the gains have been generated.

Dividend income received from subsidiaries whose main field of activity consists of financial leasing and investments in all kinds of securities (passive income) are outside the scope of the exemption.

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Basically, the regulations exempt only the dividend income derived from subsidiaries abroad. However, they do not exempt the capital gains derived by Turkish corporations from the sales of the shares of their subsidiaries abroad.

Branch Income Exemption From Permanent Establishments Abroad

Income derived by Turkish corporations through their permanent establishments or permanent representatives located abroad has been exempted from corporate tax if the following conditions are met:

- the permanent establishment or permanent representative should become subject to a corporate income tax at a rate of at least 20 percent (for corporations whose main field of activities consists of financing and insurance, the corporate income tax rate should be equivalent to the corporate tax that is applied in Turkey);

- at least 75 percent of the income should consist of commercial, agricultural, or service income (active income) (the permanent establishment or permanent representative should not deal primarily with financial leasing or investments in all kinds of securities); and

- the income should be transferred to Turkey until the end of the third month following the filing date of the annual corporation tax regarding the period in which the gains have been generated.

Turkish International Holding Status

Another regulation in the law is intended to make Turkey an alternative for structuring holding companies. According to the law, the gains derived by resident joint stock companies from their participation in the equity of their nonresident subsidiaries should be exempted from corporate tax if the following conditions are fulfilled:

- at least 75 percent of their total assets should consist of their equity participations in joint stock companies or limited liability companies whose legal or business headquarters is located outside Turkey (other than those companies whose main field of activity consists of financial leasing operations and investment in all kinds of securities);

- at least 75 percent of the Turkish corporation should consist of dividend income derived from those subsidiaries;

- the Turkish corporation should own an equity stake of at least 25 percent in the companies in whose capital it has participated;

- the subsidiary should become subject to corporate income tax at a rate of at least 20 percent (subsidiaries whose main field of activities consists of financing and insurance should be subject to corporate income tax at a rate that is equivalent to the Turkish corporate tax rate);

- at least 75 percent of the gains generated by the nonresident subsidiary should consist of commercial, agricultural, or service income (active income); and

- the gains derived by the nonresident subsidiary should be transferred to Turkey until the filing date of the annual corporation tax return for the tax period on which the gains have been generated.

Dividends to be paid by the Turkish holding companies over their tax-exempt gains to the shareholders that are in the nature of a joint stock or limited liability company should be subject to withholding tax with a maximum rate of 5 percent; the ordinary withholding tax on dividends is 10 percent in other cases. The Council of Ministers can reduce the rate to zero or increase it to the legal limit of 10 percent.

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