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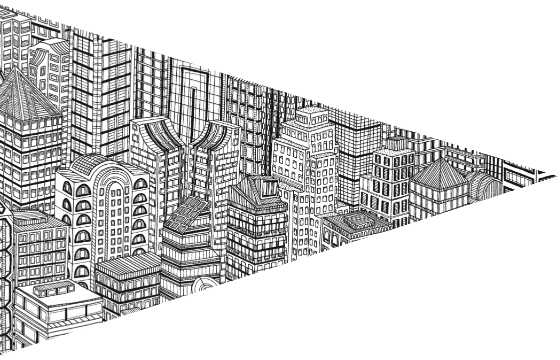
International
Tax Alert



Turkish courts rule on taxation of capital replenishment funds

The Turkish tax system is based on the self-declaration of taxpayers. The tax authority, structured under the Ministry of Finance, is authorized to conduct tax inspections to determine the correct amount of tax to be paid and enable its payment.

A few years ago, inspectors initiated a series of tax inspections of the pharmaceutical industry, targeting originator companies (i.e., the original developers of the drugs) as well as generic companies. The result was criticism, from the point of view of corporate tax, advance corporate tax and value added tax (VAT), of subsidies, known as capital replenishment funds, sent from shareholders resident abroad to local entities. Such funds were sent to both replenish the share capital lost in the shareholders' equity and avoid technical bankruptcy situations.

Capital replenishment funds are regulated by Article 324 of the Turkish Commercial Code (TCC), which sets out the legal remedies in case the capital of the companies does not retain in the shareholders' equity. According to this Article, if two thirds of a company's share capital is depleted – which is to say, the total equity of the company falls below one third of the paid in capital – the shareholders must either replenish the capital or decrease the share capital to one-third its former amount. Otherwise, the company is deemed dissolved. Furthermore, if the share capital is totally lost – i.e., the shareholders' equity is negative – it should be applied to the court and court declare the company bankrupt.

To deal with this legal obligation, and for reasons of financing, foreign capital companies frequently received capital replenishment from their shareholders during the financial crisis that began in 2001.

This alert provides an update regarding tax inspections, pending cases and the approach of the tax courts and the Council of State regarding these funds. The issue grows more significant, as what was initially a matter affecting only the pharmaceutical sector has now expanded to all other industries.

Introduction of capital replenishment fund inspections

As a result of the tax inspections of capital replenishment funds, the tax authority has imposed additional corporate tax, advance corporate tax and VAT on companies, with accompanying tax loss penalties.

In the inspection reports, inspectors claimed that Turkish taxpayer companies were acting as local marketing companies of their shareholders resident abroad (the headquarters). Accordingly, the Turkish companies (local subsidiaries) were considered to be providing marketing services to their shareholders, enabling products to be traded in the Turkish market. Accordingly, the funds received from those shareholders as capital replenishment funds were viewed as actually being compensation for services provided. The tax inspectors thus alleged that the capital replenishment funds should be deemed service income and therefore subject to corporate tax as well as VAT.

Considering that the companies had incurred continuous losses for more than a couple of years which is argued to be beyond the reasonable period of time for commercial purposes, the inspectors also argued that, if the companies had recorded their capital replenishment funds properly, as the income they are believed to truly represent, they would not have incurred the losses claimed.

Approach of the tax courts

Following the additional assessments imposed on companies as a result of inspections, the companies applied for the settlement of taxes before litigation. Yet very few companies settled with the Ministry of Finance regarding the assessments and paid the settled amounts, and many others found themselves in litigation.

This has, if nothing else, provided plenty of cases.

At this point, there have been cases concluded at the first tax court level, some totally in favor of the taxpayer, others only partially so, and others still totally in favor of the tax authority.

These decisions can be summarized as follows:

1. In cases where the tax inspector alleged that the capital replenishment funds should be added to the corporate tax base, the courts tended to examine the procedural requirements. If the procedures (such as for a Board of Shareholders' resolution for the application of Article 324 of the TCC) were not met, the funds were characterized as service income and taxed accordingly.

   With this approach, tax courts checked for conformity between the date and amount of the fund written in the Board of Shareholders' resolution and the actual date and amount of the fund received from abroad. If the amount did not match, the funds were not viewed as capital replenishment and were thus to be included in the corporate tax base as service income. Even in doing this, however, the decisions fail to indicate the details of such service.

   In those decisions in which the funds received were accepted as capital replenishment, VAT issues were concluded similarly to corporate tax issues: in the taxpayer's favor.

2. In some cases the tax courts ruled in favor of the taxpayer on the grounds that the tax inspection report was based on insufficient inspection. In these cases additional assessments were cancelled.

3. In some cases, while the corporate tax cases were concluded in favor of the taxpayers, when it came to the issue of VAT the same tax courts ruled that the companies rendered services related to the sale of pharmaceuticals of the parent company in the Turkish pharmaceuticals market. Therefore, the funds were again viewed as received from abroad in return for these services. As the funds were then recharacterized as service income, they should have been subject to VAT.

Approach of the Council of State

Cases concluded unfavorably to either side were appealed by the losing party to the Council of State.

While other cases' appeals are still pending, the Council of State has recently ruled against the taxpayers.

In one case, the tax court had ruled that the funds were not capital replenishment funds based on the fact that the Board of Shareholders' Resolution and the amount sent from the shareholders did not match.

The Council of State approved the lower decision due for the following reasons.

The Council of State first referred to Article 3/B of the Tax Procedure Code, which states the substance over form rule with the following provision: "the event giving rise to taxation and the true nature of the transactions related to such an event are essential." The Council went on to state that the company incurred losses for twelve years, and that to bear such losses with the aid of money transfers from abroad in order to avoid bankruptcy is not in line with sound economic and commercial practice.

As the company was the sole seller of the products of its shareholder company in Turkey, the Council determined that the purpose of the company was to sell the products of the parent company in the Turkish market. Accordingly, the parent company profited from the sales of its products. As such, it was not contrary to law to include the funds in the corporate income of the Turkish company.

Having ruled, the Council of State then denied the taxpayer's appeal request.

In those cases where the proper legal procedures were followed, the tax court accepted the amounts as capital replenishment. Nevertheless, the Council of State, on appeal, also ruled *against* these taxpayers on grounds similar to the case above.

Evidently, the Council of State is more focused on the long term (i.e., 12 years) loss situation of the Turkish subsidiary, while the tax court's primary interest is in the procedural requirements for capital replenishment funds.

On the other hand, the Council of State also decided that if shareholders bear the loss of a Turkish company for a *reasonable* period in expectation of profiting in a future period that *would* be in line with sound economic and commercial practice.

The Council of State stressed the following factors in its decision:

- Companies are established to profit and to distribute the profit from their commercial activities to their shareholders.
- A period of time may be required to obtain market share and begin to profit after the establishment of the corporation (but such period must be *reasonable*).

Although there is no specific determination or reference to it in the tax inspection report or the Council of State's decision, the decision seems to turn on whether the transfer pricing of the transaction is proper. (not documented or argued in writing). Even lacking a specific reference, there is, however, a dissent from a judge of the Council of State arguing that the inspection report did not cover the specific determination of the transfer pricing adjustment (i.e., the details of the loss). Thus, in the dissenter's view, the assessment was based on assumption and not concrete findings. Such findings should have been present, as they are a legal requisite for tax assessment upon inspection.

These decisions by the Council of State are significant as they are the first indication of the approach of the Council in these matters, as regards corporate and advance corporate tax. The Council has not rendered any decisions for the cases related to VAT, as a separate chamber in the Council has the responsibility for that particular issue.

These decisions suggest that the Council of State is prone to consider capital replenishment funds as service fees. Nonetheless, there are still pending cases on appeal. The Council may well consider the differing facts of each case in turn, taking account of issues such as the OECD Guidelines' reference to valid business reasons for consistent losses, such as the market practice, penetration cost, start-up costs, inefficiency, etc.

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