Turkey’s approach to BEPS

Although no specific changes have been made to its domestic tax legislation in relation to the OECD’s base erosion and profit shifting (BEPS) initiative, Turkey generally supports the BEPS project, and existing legislation contains anti-avoidance measures that address BEPS and harmful tax competition concerns. These include specific measures addressing the tax deductibility of interest, transfer pricing rules and a general anti-avoidance rule (GAAR) that relies on the “substance-over-form” principle.

Rules governing deductibility of interest

General rules for tax deductibility of interest: An expense generally qualifies as a deductible expense for Turkish corporation tax purposes if it is directly related to the carrying on of business, the generation of revenue and, thus, the earning of business profits. In principle, interest paid on a loan is deductible if the funds borrowed are used to finance business operations. However, if income derived from a specific business operation is tax-exempt, interest incurred on a loan obtained to finance the business activity is nondeductible, since the general rule is that, where income is nontaxable, any expense (including financing costs) directly related to the income is nondeductible.

The following tests must be met to deduct interest expense:

- **Business purpose test**: The loan must be effectively connected with the operation of the business; in other words, the funds borrowed must be used to finance the borrower’s business.
- **Subject-to-tax test**: The business operation financed should aim to generate taxable income, rather than tax-exempt income. If interest is incurred related to a tax-exempt activity, it cannot be deducted from the income derived from nonexempt activities.

Where the lender and the borrower are related parties, and hence the loan qualifies as an intercompany loan, Turkey’s thin capitalization and transfer pricing rules also must be taken into account in determining the deductibility of interest.

General limit on deduction of financing costs: A provision intended to apply as from 1 January 2013 introduced a limitation on the deduction of financing costs arising from loans (regardless of whether the loans are from a related party). Under this rule, up to 10% of the financing costs (e.g. interest, commissions, foreign exchange losses, etc.) related to loans that exceed shareholders’ equity are nondeductible (except where the borrower is a bank or similar financing company, financial institution, leasing company or factoring company). The rule has not become effective, however, because the Council of Ministers has not issued the relevant decree determining the percentage of the limitation. The rule also has given rise to some questions regarding its application (e.g. regarding the definition of “shareholders’ equity,” whether financing gains may offset financing expenses and how the limitation rules will interact with the thin capitalization rules).

Thin capitalization rules: The thin capitalization rules apply where a Turkish taxpayer obtains one or more loans, directly or indirectly, from a shareholder or a party that is related to the shareholder and the total amount of such loans exceeds three times the shareholders’ equity
shown in the opening balance sheet (six times the shareholders’ equity for loans from related banks or financial institutions) at any time within an accounting period. Related parties for these purposes are defined as the following:

- Companies in which a shareholder holds, directly or indirectly, at least 10% of the share capital, voting rights or dividends; or
- Individuals and companies that hold at least 10% of the share capital, voting rights or profits in one of the corporate shareholders or companies that is considered a related party under the criteria in the bullet immediately above.

Where the thin capitalization rules apply, financing costs and charges (e.g. interest, foreign exchange losses and similar charges) incurred on the portion of a related party loan that exceeds the applicable debt-to-equity ratio (3:1) will be nondeductible for corporate tax purposes, and thus subject to the 20% corporate income tax. In addition, the excess financing expense amount (excluding the excess foreign exchange loss, if any) will be deemed to constitute a hidden profit distribution or a remittance of profits (in the case of nonresidents operating in Turkey through a permanent establishment) on the last day of the accounting period in which the conditions for application of the thin capitalization rules are satisfied. Such deemed distributions are subject to a 15% dividend withholding tax under Turkey’s domestic tax rules, although the rate may be reduced to 10% or 5% under one of Turkey’s tax treaties.

Transfer pricing rules: Turkey’s transfer pricing rules, which are based on the OECD guidelines, require that transactions between related parties (both residents and nonresidents) be on arm’s length terms. Otherwise, the relevant profits will be deemed to be hidden profit distributions (in whole or in part), and subject to both corporate income tax and dividend withholding tax, depending on the tax status of the recipient of the disguised profit. The term “associated person” or “related party” has a broader meaning under the transfer pricing rules than the concept “person related to the shareholder” does under the thin capitalization rules.

Related parties include the following:

- Shareholders of companies;
- Individuals or corporations that are related to the shareholders or to the company itself;
- Individuals or corporations that directly or indirectly control, or are under the control of, the company or its shareholders, through management, supervision or capital;
- Shareholders’ spouses and relatives of the shareholders or his/her spouse, including up to “third-degree” relatives through blood or marriage; and
- Individuals or corporations that are resident in countries or regions to be listed by the Council of Ministers as those engaged in “harmful tax competition” (tax havens) (however, the list has not yet been announced).

Other rules addressing BEPS concerns

Withholding tax on payments made to companies located in tax havens: A 30% withholding tax applies automatically on payments made to entities located in jurisdictions that engage in harmful tax competition or that do not participate in the exchange of information (tax havens). However, the withholding tax cannot be applied in practice because the Council of Ministers has not issued the decree providing a list of relevant jurisdictions. Entities located in
countries and regions that are engaged in harmful tax competition also are treated as related parties for the purpose of applying the transfer pricing rules.

**Controlled foreign company (CFC) rules:** Under Turkey’s CFC rules, the earnings derived by Turkish companies from foreign participations in which they hold at least 50% of the shares or voting power are subject to Turkish corporate tax (regardless of whether such earnings are distributed), provided the following conditions are satisfied:

- At least 25% of the gross revenue of the foreign participation is composed of passive income items (e.g. dividends, interest, rental income, license fees);
- The effective tax burden on the foreign participation is less than 10%; and
- The annual gross sales value of the foreign participation is more than TRY 100,000.

In such cases, the profits of the CFC are included in the profits of the Turkish company in proportion to the Turkish company’s share in the capital of the CFC, regardless of whether the profits are distributed, and are taxed currently at the 20% corporation tax rate.

**Turkish tax authorities’ approach to BEPS**

As a member of the OECD and the G20, and the current G20 president, Turkey generally supports the BEPS initiatives. Although the Turkish Revenue Authority (TRA) has not yet taken any specific action that would result in legislative changes within the framework of the BEPS action plan, it continues to apply the existing anti-avoidance rules summarized above, which serve as protective measures. In terms of priorities relating to the BEPS initiatives, given the increasingly high volume of transactions carried out through the internet, TRA officials appear to be particularly interested in the definition of “digital presence” and the development of the new rules for taxation of e-commerce within the BEPS framework.

Tax audits in Turkey have a strong focus on cross-border related party transactions. The TRA generally follows a risk assessment approach of its own during audits. There is increased scrutiny of all intragroup transactions in terms of tax deductibility and the arm’s length nature of intragroup services (especially management service fees).

The TRA appears to be waiting for the results of the OECD efforts on the BEPS project before deciding how to proceed, so changes might be expected in 2016 and thereafter, following the release of the OECD’s final conclusions scheduled to be completed in the coming months.

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