Turkish Corporate Tax Regime: An International Perspective

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TABLE OF CONTENTS

ABBREVIATIONS

AOA : Authorized OECD Approach

ACE : Allowance for Corporate Equity

BEPS : Base Erosion and Profit Shifting

CBIT : Comprehensive Business Income Tax

CITA : Corporate Income Tax Act

CITR : Corporate Income Tax Rate

DITA : Draft Income Tax Act

DTC : Double Tax Convention

FCWG : Fiscal Commission Working Group

GAAR : General Anti-Avoidance Rule

OECD : Organisation for Economic Co-operation and Development

TPG : Transfer Pricing Guidelines

PE : Permanent Establishment

PITA : Personal Income Tax Act

TPA : Tax Procedure Act

TRA : Turkish Revenue Authority

SAC : Supreme Administrative Court

WTR : Withholding Tax Rate

1. INTRODUCTION

Turkey being classified as a newly industrialized country (NIC)[1] is among developing countries closest to the league of developed nations. Turkey is classified as an emerging and developing economy in Euro zone by International Monetary Fund (IMF).[2] On the other hand, the World Bank categorizes Turkey as an upper-middle income country with similar characteristics to Mexico and Brazil.[3] Turkey has been a founding member of Organisation for Economic Co-operation and Development (OECD) since 1961 and a member of Council of Europe since 1949. Turkey has also been an associate member of European Union since 1963.[4]

The modern Turkish tax system has its roots established in 1950's. Ali Alaybek, the founder of Tax Inspectors Board, and Prof. Fritz Neumark, a German economist taking refuge from Germany in Turkey just before the 2nd World War, worked together in the great tax reform of young Republic of Turkey. Tax acts written in that period such as Tax Procedure Act (1961) (TPA) and Personal Income Tax Act (1960) (PITA) are still effective; however, Corporate Tax Act (1949) (old CITA) was replaced with Corporate Tax Act (2006) (CITA). 'Neumark effect' in Turkish fiscal history is huge, which also explains the footprints of German approach in Turkish tax jurisdiction.

Despite some tax statues written more than 50 years ago, Turkish tax law has evolved considerably in time. Turkish Revenue Authority (TRA) always tried to modernize Turkish tax system through some reform packages in the past. As for corporation tax, the

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[1] The category of NIC is a socioeconomic classification applied to several countries around the world by political scientists and economists. NICs are countries whose economies have not yet reached developed country status but have, in a macroeconomic sense, outpaced their developing counterparts.

[2] IMF, *World Economic Outlook-Recovery Strengthens, Remains Uneven*, (Washington, 2014)

[3] Laura Abramovsky, Paul Johnson and David Phillips, 'Tax Design in Turkey and Other Middle Income Countries: Lessons from Mirrlees Review' (TUSIAD 2013) 20
< http://eaf.ku.edu.tr/sites/eaf.ku.edu.tr/files/erf_rr_1301.pdf> accessed 24 July 2014

[4] Turkey was officially recognised as a candidate for full membership to European Union at the Helsinki Summit of European Council 1999.

greatest reform took place in 2006, through which new CITA replaced the old CITA. Nowadays, Turkish corporate tax regime is getting prepared for another fundamental reform. Draft Income Tax Act (DITA), which will bring PITA and CITA together, was published in 2013 and is currently waiting before the Parliament.

Leaving the membership process aside, the current relationship between the European Union and Turkey established by the Turkey-EU Association Agreement (AA) continues to exist. AA contains explicit provisions on the customs union and indirect taxation. However, the provisions which might be relevant to direct tax issues are not so clear. As a result there has been no implications with regard to direct taxes.[5] That is why we omitted EU implications of Turkish corporate tax regime from the scope of this study.

In this study, we will shed a light on Turkish corporate tax regime from an international perspective. Within this context, first, we will have a brief outlook on Turkish corporate tax regime, corporation tax reform 2006 and pending income tax reform. Secondly, we will try to put forward the main trends in the modernization process of corporate tax regimes around the world, and answer the question of where Turkish corporate tax regime stands in this process. Thirdly, we will have a general overview of Turkish DTC network and try to pinpoint the peculiarities therein. Finally, we will very briefly mention about BEPS and Turkish corporate tax regime interaction.

2. TURKISH CORPORATE TAX REGIME IN BRIEF

In Turkey, corporate income tax is the main tax charged on the business income and capital gains of companies. In general, three statues regulate Turkish corporate tax regime: CITA, PITA and TPA.[6]

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[5] Billur Yalti, 'Turkish Courts and Application of EU Tax Law' in Daniel Sarmiento and Domingo J. Jimenez (eds), *Litigating EU Tax Law in International, National and Non-EU National Courts* (IBFD, 2013)

[6] Billur Yalti, 'Turkey: Corporate Taxation' (Country Analyses, IBFD 2014) 28 <http://online.ibfd.org/document/cta_tr_chaphead> accessed 18 July 2014

The main act regulating Turkish corporate tax regime, CITA, is a short and principle-based act including just 36 articles. However, secondary legislation is relatively larger. TRA guides the practice via General Communiqués and advance rulings. CITA mainly refers to PITA in relation to measurement of taxable income. Taxpayers find relevant accounting, valuation and bookkeeping principles in TPA.

The Turkish tax system follows the classical system. The income stream is taxed at corporate and shareholder level separately. Companies are required to withhold tax at dividend distribution stage. For individual shareholders, half of dividend income is exempted while the withholding tax is credited in full.[7]

As for eliminating juridical double taxation, domestic rule carries a hybrid character, namely both credit and exemption method are applied depending on circumstances.

3. TURKISH CORPORATE TAX REFORM 2006

The biggest reform in corporate tax regime took place in 2006. The old CITA had been enacted in 1949 and it was far from meeting the needs of changing and developing Turkish business environment. Introducing new corporate taxation concepts, the 2006 reform dealt with areas which were not regulated before.[8]

In the preamble of CITA, two problems were listed as the core reasons for corporate tax reform. First, having been prepared for a closed economy model, old CITA could not answer the needs of taxpayers and international tax competition after the liberalisation of capital movements. Second, with the addition of provisional articles, old CITA had become more complex and difficult to comply with for taxpayers. It had also diminished the legal certainty, which in turn decreased direct investment and employment in the economy.

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[7] ibid 28.

[8] Caroline Otonglo and Tea Trumbic, 'Giving a facelift to the Turkish Tax System' (Doing Business Reform Case Studies, The World Bank 2008) 69 <http://www.doingbusiness.org/~/media/FPDKM/Doing%20Business/Documents/Reforms/Case-Studies/2008/DB08-CS.pdf> accessed 18 July 2014

The lawmakers aimed to design a new CITA which will encourage growth, promote taxpayer compliance, broaden tax base and fight against tax-avoidance effectively. Articles related to the taxation of non-residents are grouped under a specific part while those were scattered in old CITA. New CITA also stopped referring to PITA for withholding tax requirements and included its own rules.

Corporate tax rate was reduced from 30% to 20% to keep pace with tax competition in tax rates, while WTR on dividend distribution increased from 10% to 15%. Tax rate reduction was explained as a policy choice to increase competitiveness and to attract foreign direct investment. Exemptions and tax incentives were curbed both to broaden the corporate tax base and to promote also smooth working of free market economy. Transfer pricing legislation was brought in line with OECD Transfer Pricing Guidelines (OECD TPG). Thin cap legislation was also modernized. Controlled foreign company (CFC), as a specifically-designed anti-avoidance rule, was inserted into CITA. Payments to low-tax jurisdictions[9] were required to be subject to withholding tax at a rate of 30%.[10]

4. PENDING INCOME TAX REFORM

The Turkish government completed the draft of a Unified Income Tax Act replacing both PITA and CITA in 2013. The Draft Income Tax Act (DITA) was subsequently sent to the Parliament on 12 June 2013 and is now pending before the Parliament's Planning and Budget Committee. It is expected be enacted in the year 2015.

The pending income tax reform is described as the government's latest and longest endeavour to bring Turkish income tax regime in line with recent international best practices.[11] It has been reported that reform is a response to a sense of urgency signalled by

[9] New CITA authorized the Council of Ministers to determine low-tax jurisdictions. Yet, Council has not used that authorization.

[10] Preamble of CITA 1

[11] Diyadin Yakut, 'The Draft Income Tax Law' (2014) European Taxation 104

the low rate of direct taxes relative to GDP, one of the lowest among OECD members, in Turkey.[12]

The biggest change in the pending reform is the unification of PITA and CITA under a single unified act. The current dual act structure, effective since 1949, has been criticized due to overlapping articles and resulting controversy. Thus, simplification of legislative structure and ease of understanding with an emphasis on plain language have been major concerns in the drafting process. While there are a total of 255 articles in the PITA and CITA, DITA contains only 92 articles.[13]

In the preamble to DITA, the fundamental objectives of pending tax reform are stated as follows:

– Strengthening the roots of public finance by creating an effective, simple, plain and fair tax system;

– Reinforcing sustainable growth and development;

– Boosting economic activity; and

– Promoting voluntary tax compliance[14]

It is early the discuss the merits and deficiencies of DITA at this stage. The trend in the world is towards corporate income tax codes of larger sizes, which makes tax codes more complex and unreadable by non-tax specialists. The main reason behind that trend is shown as the increasing number of provisions aiming to prevent tax avoidance.[15] Within this context, the size shrinkage in DITA could be seen affirmative as long as lawmaker does not skip important anti-avoidance mechanisms for the sake of simplicity.

[12] ibid 104.

[13] ibid 105.

[14] ibid 104.

[15] Paulus Merks, 'Corporate Tax and the OECD' (2007) Intertax 323

5. MODERNIZATION OF TAX SYSTEMS AND TURKISH CORPORATE TAX REGIME

Corporation tax systems vary depending on many factors such as economic structure, policy choices, history, tax structures found in neighbour countries etc. It does not seem possible to say that one single tax structure is the best and meets the necessities of every country.[16]

There are variety of descriptions regarding the principles of a good tax system. Simplicity, neutrality, balance between stability and flexibility, predictability are denoted as desirable characteristics in the design of tax systems.[17] Adam Smith, in his famous *Wealth of Nations,* set out four maxims of a good taxation system: burden proportionate to the ability to pay, certainty, convenience and efficiency of collection.[18] Similarly, Mirrlees Report characterizes a good tax system as follows: single rate of corporation tax with no tax on the normal return on investment, equal treatment of income from employment, self-employment and running a small company, and no tax on intermediate output.[19]

However, the countries pay different attention to each of above-mentioned characteristics, which results in a variety of tax systems across countries. Countries design their tax systems based on their economic realities, administrative capacity and budget requirements.[20] Sometimes tax systems can also be designed with specific policy

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[16] Richard M. Bird and Eric M. Zolt, 'Introduction to Tax Policy Design and Development' (Draft prepared for a course on Practical Issues of Tax Policy in Developing Countries, The World Bank 2003) 5 <http://www.gsdrc.org/go/display/document/legacyid/778> accessed 28 July 2014

[17] Fiscal Commission Working Group (FCWG), *Principles for a Modern and Efficient Tax System in an Independent Scotland* (Scottish Government 2013) para 3.2 < http://www.scotland.gov.uk/Resource/0043/00434977.pdf> accessible 28 July 2014

[18] ibid para 3.12.

[19] James Mirrlees and others, 'The Mirrlees Review: Conclusions and Recommendations for Reform' (2011) The Journal of Applied Public Economics 339

[20] Bird and Zolt (n 16) 5.

objectives, such as the Irish tax system with a 12.5% corporation tax rate aiming to attract foreign direct investment.[21]

Optimal tax system is a utopia to which countries try to reach through the modernization of their tax systems. In this respect, modernization of tax systems is an ongoing process adapting to changing economic, social and political circumstances. Development level is another key factor in the determining the context of tax system modernization. Emerging economies differ from developed economies for several reasons. Emerging economies are smaller and have more elastic supply of international capital. Larger underground economy, more limited tax administration and enforcement capacity and higher appetite for attracting foreign direct investment are other key characteristics shaping the modernization efforts of developing countries.[22]

There are a variety of tax systems internationally and each mirrors choices and unique circumstances of different countries. Whilst no two countries have precisely the same tax system, it is still possible to categorize tax systems based on their common characteristics. Within this respect, tax systems across the world are categorized under three different classes: broad base/low rate model, dual income model and flat tax model.[23]

In broad base/low rate systems, most activities are subjected to taxation with minimum number of exemption and incentives. The low tax rates compensate the negative effect of minimal tax allowances from taxpayer perspective. It is asserted that this system makes revenue stream more resilient and also reduces efficiency losses, compliance burden and administrative costs.[24]

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[21] FCWG (n 17) para 4.63.

[22] Ali Abbas and Alexander Klemm, 'Partial Race to the Bottom: Corporate Tax Developments in Emerging and Developing Economies' (2012) International Monetary Fund Working Paper WP/12/28, 4 < https://www.imf.org/external/pubs/ft/wp/2012/wp1228.pdf> accessed 21 July 2014

[23] FCWG (n 17) para 4.52.

[24] ibid paras 4.53-55.

Dual income tax systems, known as Nordic income tax models due to its Scandinavian origin, differentiate personal income tax base and more mobile capital and corporate income bases. The former is taxed at a higher rate on a progressive scale, while the latter is taxed on a proportional scale. Administrative costs are relatively higher in this model, as taxpayers always have the motive to shift income between categories in order to enjoy the benefits of lower tax rates.[25]

Flat tax systems use a single rate for all type of taxes. That structure minimizes administrative and compliance costs and maximizes efficiency. However, flat systems are criticized as being regressive in nature, namely tax burden is higher for the least well-off.[26]

However, we should note that most systems across the world are a hybrid of the above-mentioned approaches and apply a wide variety of alternative models and frameworks in order to design a system that best suits their needs.[27] It should also be noted that design of a tax system in isolation is almost impossible in today's globalized world.[28]

Over the last two decades, almost all OECD Member States have gone through structural changes, in which corporate income tax rate (CITR) reductions have been coupled with base broadening measures. As a consequence, the corporate tax systems currently effective in OECD member countries are fundamentally different from those of mid-1980s.[29]

Reformation of corporate tax systems has also been on the agenda of supra-national organizations. European Commission, in its 2012 Annual Growth Survey, presented its tax-related priorities as follows:

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[25] ibid paras 4.59-60.

[26] ibid para 4.61.

[27] ibid para 4.64.

[28] Bird and Zolt (n 16) 36.

[29] Merks (n 15) 322.

- Shifting taxation away from labour, in countries where it is notably high and limits employment opportunities;

- Boosting tax revenues by broadening tax bases rather than increasing taxes or creating new ones; and by improving tax compliance;

- Diminishing corporate tax debt bias[30]

Identifying driving forces behind tax reforms is also important for understanding the main trends in taxation. OECD defines common factors behind recent tax reforms as below:

- The need for providing a fiscal environment encouraging investment, risk-taking and entrepreneurship,

- The globalisation which made capital more internationally mobile and significantly increased cross-border ownership of business,

- The increased perception of tax competition which induced countries to make their corporation tax regime relatively more attractive,

- The promotion of fairness, simplicity and transparency in order to maintain taxpayers' confidence into integrity of tax system.[31]

While the globalization is a major driver of corporate tax reforms, policy makers are still highly concerned about more traditional goals such as designing a corporation tax that

[30] Gaëlle Garnier and others, 'Recent Reforms of Tax Systems in the EU: Good and Bad News' (2013) European Commission Working Paper N.39, 3 <http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_papers/taxation_paper_39.pdf> accessed 21 July 2014

[31] Bert Brys, Stephen Matthews and Jeffry Owens, 'Tax Reform Trends in OECD Countries' (2011) OECD Taxation Working Papers No.1, paras 26-31 < http://dx.doi.org/10.1787/5kg3h0xxmz8t-en> accessed 21 July 2014

is neutral against corporate investment/financing decisions and the choice of organizational form, and can also serve a backstop to personal income tax.[32]

In the following subsections, we will deal with the major trends in the modernization of corporation tax systems in greater detail.

5.1. Declining Statutory Corporate Income Tax Rates

Statutory tax rate is the most basic measure of a corporate income tax system. Though being widely used as a comparator, defining a single rate for a system might be more complicated than expected. Because corporate income tax could sometimes be applied at more than one level of government, or there may be temporary or permanent supplementary taxes and special tax rules for enterprises of different scales.[33]

Statutory CITRs have declined in many countries since the beginning of the 1980s.[34] It has been evidenced that governments do take account of the statutory CITRs in other countries when setting their statutory rates and this suggests that the main factor in lowering statutory CITRs has been tax competition.[35]

Tax reforms in the United Kingdom and the United States starting during mid-1980's took the lead in the trend of declining corporate income tax rates. Reform efforts have been coupled with base broadening measures.[36]

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[32] Michael Devereux and Peter Birch Sorensen, *The Corporate Income Tax: International Trends and Options for Fundamental Reform* (European Commission 2006), 15 < http://ec.europa.eu/economy_finance/publications/publication530_en.pdf> accessed 21 July 2014

[33] ibid 5.

[34] Bert Brys, *Making Reform Happen Lessons from OECD Countries* (OECD 2010), ch 4, 102 < http://www.oecd.org/inclusive-growth/Making%20Reforms%20Happen%20Lessons%20from%20OECD%20Countries.pdf > accessed 21 July 2014

[35] Devereux and Sorensen (n 32) 6.

[36] Brews, Matthews and Owens (n 31) 5.

Between 2000 and 2013, 31 of 34 OECD members reduced their top statutory CITR. The average headline CITR fell from 32.6 per cent to 25.5 per cent in this period.[37]

Below table summarizes the trend in statutory CITRs of EU countries and Turkey.[38] The trend in statutory tax rates across the Europe has been downward in the last two decade. The magnitude of decline in tax rates varied depending on fiscal policy choices of states. As of 2013, France and Belgium take the lead in adjusted top statutory tax rates, 36,10% and 34% respectively. Ireland, with its special regime, has the lowest rate across the Europe.

Table 1: Trend in Adjusted Top Statutory CITRs - EU and Turkey (in %)

Country	1995	2000	2005	2010	2013
Belgium	40.20	40.20	34.00	34.00	34.00
Denmark	34.00	32.00	28.00	25.00	25.00
Ireland	40.00	24.00	12.50	12.50	12.50
Germany	56.80	51.60	38.70	29.80	29.80
Spain	35.00	35.00	35.00	30.00	30.00
France	36.70	37.80	35.00	34.40	36.10
Italy	52.20	41.30	37.30	31.40	31.40
Netherlands	35.00	35.00	31.50	25.50	25.00
Austria	34.00	34.00	25.00	25.00	25.00
Portugal	39.60	35.20	27.50	29.00	31.50
Sweden	28.00	28.00	28.00	26.30	22.00
United Kingdom	33.00	30.00	30.00	28.00	23.00
Turkey	**33.00**	**33.00**	**30.00**	**20.00**	**20.00**

Source : Eurostat Statistical Books by European Commission

In the same period, Turkish statutory CITR followed a similar pattern. The 2006 reform curbed CITR from 30% to 20%. In 2009, a new investment incentive provision, which lowers CITR between 30%-90% depending on circumstances, was inserted into CITA. As of 2013, Turkey has the second lowest statutory CITR in the European region.

[37] FCWG (n 17) para 4.21.

[38] Table includes only the basic (non-targeted) top rate. Existing surcharges and averages of local taxes are also included.

In the preamble of CITA, the lawmaker mentioned the fact that all countries are in a competition in order to attract foreign investment and become a hub for international business activities and underlined the importance of statutory CITRs in that fierce competition. Considering the trend in CITRs in Central and Eastern European countries, the lawmaker added that it would be inevitable and irrational to remain oblivious to that trend.

Statutory CITR is the most obvious element implying the effective tax rate in any corporate tax system.[39] However, it in itself does not necessarily signify the tax burden. Effective tax rates, which are the product of statutory rate and the rules governing the computation of the tax base, tell more about tax burden in a specific jurisdiction.[40] But the computation of effective tax rate is a difficult task, that is why the data on effective corporate tax rates across countries is very rare.

5.2. Broadening Corporate Income Tax Base

Despite the decline of statutory CITRs, the share of CIT in total tax revenues has increased significantly in the majority of OECD countries.[41] Although a variety of explanations, such as increasing firm profitability, the rising share of financial sector, growing share of corporate pre-tax profit in total economy, have been put forward to explain this fact pattern, most academics take the view that base broadening measures coupled with statutory CITR reductions are the main key factor behind that trend.[42] Tax expenditures were cut and the fight against black-market economy was intensified.[43] Base broadening policies included measures such as reduced depreciation allowances, tightened

[39] Merks (n 15) 324.

[40] ibid 326.

[41] Brys (n 34) 102.

[42] Christoph Spengel and Benedikt Zinn, 'Non-profit Taxation on Corporations in the EU' (2011) Intertax 496

[43] Garnier and others (n 30) 15.

loss offset and trafficking rules, interest deduction regulations, or the introduction of thin capitalization rules.[44]

Overall, the broadening of the tax base not only aims for the compensation of revenue loss due to declining CITRs but also the simplification of the tax system. It is certain that extensive use of 'tax expenditures', such as exemptions, allowances, reduced rates and other specific regimes, makes the tax system more complicated and also harms the perceived fairness of tax system.[45] Thus, base broadening measures are highly appreciated for decreasing compliance and administrative costs and increasing fairness of tax systems as well.

It is difficult to measure the success of base broadening efforts. It requires a periodic assessment of tax expenditures, which was carried out only in a limited number of states. Austria, Belgium, Finland, France, Germany, Greece, Italy, Netherlands, Poland, Portugal, Spain, Sweden and the United Kingdom perform that periodic assessment.[46] In Turkey, TRA publishes tax expenditures in its yearbook; however, no assessment is provided on those data. Thus, whether TRA perform a periodic assessment of tax expenditures is not known publicly.

A base broadening policy does not require that all tax reliefs should be repealed. International practice suggests that, under a clear and principle-based approach, reliefs and incentives which encourage innovation, R&D etc. are still effective tools for tax policy design.[47]

On the other hand, base broadening measures have sometimes been criticized by European business community. It is argued that non-profit taxes have become a more

[44] Spengel and Zinn (n 42) 494-495.

[45] Garnier and others (n 30) 15.

[46] ibid 17.

[47] FCWG (n 17) para 5.102.

crucial factor in the overall tax burden on companies such that they restrict the liquidity and deepen the unfavourable effects of the crisis on the financial situation of corporations.[48]

Spengel and Zinn, based on the well-known methodology of European Tax Analyzer, evaluated the "tax cut-base broadening" policies. Their results revealed asymmetric effects over the last decades such that profitable and low-leveraged firms benefited from that policy, while less profitable and highly debt-financed companies are heavily exposed higher tax burdens.[49]

Base broadening was also among the main objectives of Turkish corporate tax reform of 2006. Base broadening was thought to compensate the negative effects of CITR cut. As seen in the table below, the share of corporation tax in state's budget and total economy for Turkey increased in the period following 2006 corporate tax reform. In the year in which tax cut was enacted, 2006, the share of corporation tax in total tax revenue and GDP declined compared to its pre-tax cut level. However, it recovered soon and the trend has been generally upward in 2006-2012 period. Base broadening policy, together with other affirmative factors such as economic growth and increasing firm profitability, contributed to this trend significantly.

Table 2: The Share of Corporate Income Tax in State's Budget and GDP - Turkey (in %)

	1965	**1975**	**1985**	**1995**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
CIT as % of Total Tax Revenue	4.80	5.10	9.50	6.70	7.10	6.00	6.80	7.30	7.70	7.30	7.50	7.40
CIT as % of GDP	0.51	0.61	1.09	1.13	1.76	1.70	1.63	1.78	1.89	1.90	2.08	2.10
Source : OECD Statistics												

[48] Spengel and Zinn (n 42) 495.

[49] ibid 510-11.

5.3. Share of Corporate Income Tax in States' Budgets

Taxes are traditionally classified as direct (e.g. personal income taxes, corporate income taxes) or indirect (e.g. VAT, excise duties). The former group allows greater redistribution as it is impractical to introduce progressivity in latter group of taxes. Thus, the recourse to direct taxes is greater in the countries where public opinion is more sensitive tax redistribution objectives of a tax policy.[50]

Revenue structure by type of tax shows diverse characteristic across the world. For example, in EU countries, EU-15 Member States raise roughly equal shares of revenues from direct taxes, indirect taxes, and social contributions; however, the NMS-12 countries, except Malta, typically have a lower share of direct taxes in the total. There are noteworthy differences between EU-15 Member States as well. The Nordic countries and the United Kingdom have relatively high shares of direct taxes in total tax revenues. On the other hand, in France and Germany, the share of direct taxes is relatively low due to the high rates of social contributions.[51]

Differences in tax structure seem to reflect certain basic differences between low and high-income countries. In general, the higher the level of per capita income, the more a country derives revenue from direct taxes, especially those on personal income. Low-income countries tend to rely on excise taxes on tobacco, alcohol etc. due mainly to the low administrative costs in relation to collection of taxes. In contrast, collection of direct taxes (and plus VAT) requires a more developed and effective tax administration. It also brings higher administrative and compliance costs.[52] Below table figures the variety in the revenue structure by type of tax across OECD countries.

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[50] Eurostat Statistical Books, *Taxation Trends in European Union: Data for EU Member States, Iceland and Norway* (European Commission 2013) 27-28 < http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-DU-13-001/EN/KS-DU-13-001-EN.PDF> accessed 22 July 2014

[51] ibid 28.

[52] Bird and Zolt (n 16) 8.

Table 3: Tax Revenue by Sector as Percentage of Total Taxation - 2012 (in %)

	Taxes on Income and Profit	Social Security	Payroll	Property	Indirect Taxes	Other
Austria	29.1	34.4	6.9	1.3	27.5	0.5
Belgium	34.7	32.0	0.0	7.5	24.9	0.0
Canada	47.2	15.5	2.1	10.7	24.4	0.1
Denmark	61.7	1.9	0.6	3.8	31.6	0.0
France	23.6	37.4	3.2	8.6	24.4	2.6
Germany	30.4	38.2	0.0	2.4	28.4	0.0
Greece	24.7	31.8	0.0	5.9	37.3	0.0
Hungary	17.0	32.6	2.4	2.3	45.0	0.5
Ireland	42.8	14.7	0.6	6.5	34.9	0.0
Italy	32.8	30.5	0.0	6.2	25.5	4.8
Norway	48.0	22.7	0.0	2.9	26.4	0.0
Portugal	26.9	27.9	0.0	3.9	40.5	0.6
Spain	30.1	35.8	0.0	6.2	26.6	1.0
Sweden	34.9	23.3	10.1	2.4	28.8	0.1
Turkey	**21.8**	**27.2**	**0.0**	**4.2**	**45.0**	**1.7**
UK	35.7	19.2	0.0	11.8	32.8	0.0
USA	47.7	22.3	0.0	12.2	17.9	0.0

Source : OECD Revenue Statistics 2013

Across the OECD, the share of corporate income tax have followed an almost horizontal trend, averaging between 7.5% and 10.5% of total receipts since 1965. This is significantly less when compared to receipts from personal income taxes, social security contributions, and taxes on goods and services.[53]

The importance of social security contributions and general consumption taxes in states' budgets is increasing across the OECD member states. Personal income taxes and social security contributions form over half of all government tax revenues. Corporate income and property taxes are relatively less important, constituting smaller composition of total tax receipts.[54]

[53] FCWG (n 17) para 4.11

[54] ibid para 4.13.

Corporate income tax revenues are a larger portion of tax revenues for developing countries compared to developed countries. However, we should note that globalization and increasing share of services and intangibles in value-creation process recently make it harder to locate the source of corporate income; it gets harder for those countries to tax corporate income.[55]

Below table summarizes trend in the share of corporation tax across OECD and in Turkey for the period 1965-2013. The share of corporate income tax in total tax revenues for Turkey remained within 5.0% - 7.5% band, which was below OECD Average, in 1965-2012 period.

Table 4: The Share of Corporate Income Tax in Total Tax Revenues (in %)

	1965	**1975**	**1985**	**1995**	**2000**	**2005**	**2010**	**2011**	**2012**
Austria	5.4	4.4	3.5	3.3	4.6	5.2	4.6	5.2	5.3
Belgium	6.2	6.9	4.9	5.4	7.2	7.4	6.0	6.6	6.9
Canada	14.9	13.6	8.2	8.2	12.2	10.4	10.6	10.3	9.5
Denmark	4.5	3.2	4.8	4.8	6.6	7.7	5.8	5.8	6.3
Germany	7.8	4.4	6.1	2.8	4.8	5.1	4.3	4.7	4.8
Hungary	n/a	n/a	n/a	4.5	5.7	5.7	3.3	3.3	3.3
Greece	1.8	3.4	2.7	6.3	12.2	5.1	7.7	6.5	n/a
Norway	3.8	2.9	17.2	9.2	20.9	27.0	23.5	25.2	24.6
Spain	9.2	6.9	5.1	5.4	8.9	10.7	5.5	5.7	6.6
France	5.3	5.2	4.5	4.9	6.9	5.5	5.0	5.7	5.6
Italy	6.9	6.3	9.3	8.7	6.9	6.9	6.6	6.3	6.4
Netherlands	8.1	7.7	7.0	7.5	10.1	9.8	5.6	5.4	n/a
Portugal	n/a	n/a	n/a	7.8	12.1	8.6	9.1	9.8	8.6
Sweden	6.1	4.3	3.5	5.8	7.6	7.5	7.6	7.3	6.8
United Kingdom	4.4	6.2	12.6	8.1	9.7	9.3	8.8	8.6	8.1
US	16.4	11.4	7.5	10.3	8.7	11.6	9.8	9.4	10.6
Japan	22.2	20.6	21.0	15.9	13.8	15.5	11.6	11.8	n/a
Turkey	**4.8**	**5.1**	**9.5**	**6.7**	**7.3**	**7.1**	**7.3**	**7.5**	**7.4**
OECD Average (Weighted)	**8.8**	**7.6**	**7.9**	**8.0**	**9.6**	**10.1**	**8.5**	**8.7**	**n/a**

Source: OECD Revenue Statistics 2013

[55] Bird and Zolt (n 16) 37.

5.4. Share of Corporate Income Tax in Total Economy

In order to understand the impact of a certain form of taxation on an economy, it is required first to understand the size of the relevant tax amount.[56]

In Europe, the decline in CITRs has not been observed in the tax-to-GDP ratios. According to European Commission's data for 1995-2006, despite the decline in headline statutory CITRs, the role of corporate income tax revenue grew considerably across member states, corporate tax-to-GDP ratio rising from 2.7% in 1995 to 3.3% in 2006.[57]

Piotrowska and Vanborren searched for the driving factor for the trend observed in corporate tax revenues. They looked at the trend in corporate tax revenues to corporate income and found a downward one in general. This led them to the conclusion that base broadening efforts might have not fully compensated for the decrease in statutory CITRs. They pronounced "corporatization" as the main factor behind the increasing corporate tax to GDP ratio.[58]

Below table depicts the trend in corporate tax revenue as percentage of GDP across OECD countries in 1965-2012 period.

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[56] Merks (n 15) 326.

[57] Joannae Piotrowska and Werner Vanborren, 'The Corporate Income Tax Rate – Revenue Paradox: Evidence in the EU' (2007) European Union Taxation Papers Working Paper No 12, 2 <http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_papers/taxation_paper_12_en.pdf> accessed 22 July 2014

[58] ibid 24.

Table 5: The Share of Corporate Income Tax in Total Economy (in %)

	1965	1975	1985	1995	2000	2005	2010	2011	2012
Austria	1.8	1.6	1.4	1.4	2.0	2.2	1.9	2.2	2.3
Belgium	1.9	2.7	2.2	2.3	3.2	3.3	2.6	2.9	3.1
Canada	3.7	4.3	2.6	2.8	4.3	3.3	3.2	3.1	2.9
Denmark	1.4	1.2	2.2	2.3	3.3	3.9	2.8	2.8	3.0
Germany	2.5	1.5	2.2	1.0	1.8	1.8	1.6	1.7	1.8
Hungary	n/a	n/a	n/a	1.9	2.2	2.1	1.2	1.2	1.3
Greece	0.3	0.7	0.7	1.8	4.2	3.3	2.5	2.1	n/a
Norway	1.1	1.1	7.3	3.8	8.9	11.7	10.0	10.7	10.4
Spain	1.4	1.3	1.4	1.7	3.1	3.9	1.8	1.8	2.2
France	1.8	1.8	1.9	2.1	3.1	2.4	2.1	2.5	2.5
Italy	1.8	1.6	3.1	3.5	2.9	2.8	2.8	2.7	2.9
Netherlands	2.6	3.1	3.0	3.1	4.0	3.8	2.2	2.1	n/a
Sweden	2.0	1.8	1.7	2.8	3.9	3.7	3.5	3.2	3.0
United Kingdom	1.3	2.2	4.7	2.7	3.5	3.3	3.1	3.1	2.9
US	4.0	2.8	1.9	2.8	2.5	2.4	2.3	2.3	2.6
Japan	3.9	4.2	5.7	4.2	3.7	4.2	3.2	3.4	3.4
Turkey	**0.5**	**0.6**	**1.1**	**1.1**	**1.8**	**1.7**	**1.9**	**2.1**	**2.1**
OECD Average (Weighted)	**2.2**	**2.1**	**2.6**	**2.7**	**3.2**	**3.5**	**2.9**	**3.0**	**n/a**

Source: OECD Revenue Statistics 2013

As seen above, on average, weighted by GDP, tax revenues on corporate income have remained within the band of 2.0% - 3.5% since 1965. The trend has been almost same for each country with the notable exception of Norway.

For Turkey, corporate tax to GDP ratio remained between 0.5% - 2.1%. Despite the decline of statutory CITR after 2006 reform, the share of corporate tax in total economy followed an upward trend thanks to base broadening efforts and increasing business profitability.

5.5. Decline of Imputation Systems

Corporate income tax systems can be catalogued according to various criteria. One criterion is the extent of the integration of corporate income taxation into income taxation.

Based on integration preference, corporate tax systems can be divided up into three classes: no integration (classical system), partial integration and full integration.[59]

When initially introduced, most corporate income tax systems were classical, under which the return on corporate investment is taxed at both corporate level and shareholder level.[60] In the classical system, dividends are neither exempt in the company nor is the shareholder entitled to a tax credit or some other income taxation advantages. [61]

As an alternative to classical system, integration systems were favoured by some countries in the past. Integration of corporation tax and personal tax did take various forms depending on the degree of double taxation elimination (double taxation reducing or double taxation avoiding) and the level at which double taxation is relieved (corporate level or shareholder level).[62]

In its simplest form, integration could be established by allowing dividends to be paid without any tax consequence to shareholders - so called dividend exemption.[63] However, countries generally opted for more complex forms in the past, full imputation system at the shareholder level or 100% dividend deduction or split rate system at the corporate level. A group of countries such as Germany, France, Italy and Finland preferred full imputation system under which a corporate level tax with a credit for such tax to be claimed by shareholder upon the ultimate distribution of profit. Another group of countries such as Japan followed a split rate tax system under which distributed earnings are taxed at a lower rate than undistributed earnings.[64]

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[59] Otto H. Jacobs, 'Corporate Income Tax Systems in the European Union - An Analysis of their Effects on Competition and Reform Proposals' (1999) Intertax 265

[60] Merks (n 15) 322.

[61] Jacobs (n 59) 264-68.

[62] Charlotte Crane, 'Corporate Taxation' in Bouewijn Bouckaert and Gerrit De Geest (eds), *Encyclopedia of Law and Economics: The Economics of Public and Tax Law* (Edward Elgar Pub 2000) 187

[63] Greece followed this approach in the past.

[64] Crane (n 62) 187.

As an option between classical system and double tax avoiding systems, some countries followed double taxation reducing systems. A group of countries such as United Kingdom, Ireland, Spain and Portugal followed partial imputation system at the shareholder level under which dividends are incorporated together with tax credit at various levels in the individual income tax base and then are progressively taxed. Another group of countries such as Belgium, Denmark, Luxembourg, Austria and Sweden followed shareholder relief system under which dividends are not included in the personal income tax base but instead are taxed at a reduced tax rate that is final.[65]

Imputation systems, either full or partial, have been problematic in cross-border situations, because when applied in cross-border situation it requires one state to give imputation credit for the underlying corporate tax paid to another state. This led states to limit the application of imputation systems to domestic situations. However, that was precluded by freedom of establishment guaranteed by TFEU in EU context and led many EU states, such as United Kingdom, to leave imputation system.

Turkey used to apply imputation system between 1995 and 2002; however, it was found administratively complicated and burdensome, and thus Turkey shifted back to classical system in 2003. According to Turkish system, income is taxed at the corporate level at first, then it is subjected to withholding tax at the dividend distribution stage. Dividend income is fully exempted if the shareholder is another corporate entity, while it is subjected to half exemption if the shareholder is an individual person. Resident individuals are granted full credit for the withholding taxes on dividends.

5.6. Territorial Taxation vs. Worldwide Taxation

It is common to classify tax systems into two separate groups based on the treatment of cross-border income: worldwide taxation systems and territorial taxation systems. Double taxation is not a problem in territorial tax system under which business income is taxed only if it is derived from sources within the country. However, worldwide taxation

[65] ibid.

under which taxpayers are taxed on all their income including foreign source income brings together double taxation problem.[66]

The trend in the world is towards territorial taxation. The key factors behind this trend could be best explained by the disadvantages inherent in credit system. The credit system is often criticized because of (a) the significant complexity inherent in foreign tax credit limitation rules; (b) the complications of credit provisions looking through complex ownership structures; and (c) the high administrative burden imposed on taxpayers. On the other hand, The exemption system is generally favoured due to its greater simplicity from both an administrative and compliance perspective.[67]

All G-7 countries other than the United States have now adopted territorial taxation (or a partial version) for active business income.[68] In 2009, Japan and UK, which levied a repatriation tax on corporate foreign dividends for long years, switched to a policy of dividend exemption (territoriality) with some modifications. The rationale behind the shift from a worldwide system with deferral and foreign tax credits to territoriality were similar in both the UK and Japan: simplification and encouraging repatriation of large pools of earnings retained off-shore. Several recent proposals for US corporate tax reform suggest this option. It is highly argued in US, as it was in the cases of the UK and Japan, that the US system of worldwide taxation is unduly complex and burdensome, deters repatriation of income, and encourages foreign incorporation.[69]

The countries around the world were grouped into three categories based on their choice of cross-border income taxation in a recent IFA Cahier Report:

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[66] Gauthier Blanluet and Philippe Durand, 'Key Practical Issues to Eliminate Double Taxation of Business Income' (IFA Cahier General Report, IBFD 2011) 20

[67] ibid 26-27.

[68] Thornton Matheson, Victoria Perry and Chandara Veung, 'Territorial vs Worldwide Corporate Taxation: Implications for Developing Countries' (2013) IMF Working Paper WP/13/205, 3 <http://www.imf.org/external/pubs/ft/wp/2013/wp13205.pdf> accessed 22 July 2014

[69] ibid 5.

The first group is composed of 11 countries[70] with a system primarily based on worldwide taxation. These jurisdictions apply the credit system on both active and passive income including dividends from subsidiaries. However, those systems vary in itself. For example, Brazil taxes foreign source income generated by foreign subsidiaries on a current basis; while other countries such as USA, Argentina and China tax foreign source income upon repatriation. The exemption method may be applicable in a DTC context under limited circumstances.[71]

The second group consists of 13 countries[72] that have adopted a hybrid system such that foreign business income is taxable in the state of residence even if earned through a foreign branch, while the income is exempt if it is received in the form of a dividend deriving from a foreign subsidiary. The double taxation on foreign branch income is relieved through credit.[73]

Finally, the third group includes 8 countries[74] which follow territoriality principle. They exempt both profits from foreign branches and dividends from foreign subsidiaries. Credit method is applied to foreign passive income, either in a domestic or treaty context.[75]

Turkey follows a territorial system too. Turkey exempts profits from foreign branches under the condition of repatriation of profits and minimum 15% tax burden in source jurisdiction. Dividends from foreign subsidiaries are also exempted under the same conditions plus the condition that resident taxpayer should hold minimum 10% of share capital of foreign subsidiary for at least 1 year. On the other hand, in most cases, exemption

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[70] United States, China, Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela, Norway and India

[71] Blanluet and Durand (n 66) 24.

[72] Belgium, Germany, Finland, Luxembourg, Malta, Poland, Portugal, Sweden, United Kingdom, Canada, Russia, South Africa and New Zealand

[73] Blanluet and Durand (n 66) 24.

[74] Australia, Austria, Denmark, Estonia, France, the Netherlands, Spain and Switzerland

[75] Blanluet and Durand (n 66) 24.

is not extended to foreign passive income. Double taxation in relation to those income is relieved through credit method either unilaterally or through DTC.

5.7. Increasing Use of Anti-Abuse Rules in the Corporate Taxation Process

Action to combat tax evasion is being given priority in the political agenda of increasing number of member states.[76] Recent G-20 and OECD project, BEPS, is also mainly referring to this problem and proving that how serious concern this topic is on the political agenda of countries.

Turkey has similar concerns such that in 2006 corporate tax reform, specific anti-avoidance provisions, such as controlled foreign entity, thin capitalization and transfer pricing, in CITA were rewritten and brought in line with international standards.

Thin cap legislation in Turkey is very close to German thin cap legislation. Taxpayers adapt themselves to thin cap rule and in particular do not exceed the safe haven limits. Thus, its application in Turkey is very straightforward and leads to relatively few conflicts between tax authorities and taxpayers.

The application of transfer pricing legislation in Turkey, which generally follows OECD TP Guidelines, constitutes some peculiarities. First, it is applicable not only to cross-border transactions but also to domestic transactions, which is mainly due to the fact that Turkish corporate tax regime does not allow group taxation. In addition, though designed in accordance with OECD guidelines, 1999 version, the Turkish TP legislation was not yet updated according to the changes in the 2010 version of OECD TP Guidelines (i.e. nine step approach in comparability analysis, business restructurings). Also, similar to the situation in most developing countries, availability of local data for comparability analysis is too limited in Turkey, because only publicly held companies are obliged to

[76] European Commission, 'Tax Reforms in EU Member States - Tax Policy Challenges for economic growth and fiscal sustainability ' (2012) Taxation Papers Working Paper N 34-2012, 31 <http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_papers/taxation_paper_34_en.pdf>

declare their financial data. Foreign databases such as ORBIS, Amadeus, TP Catalyst etc. are used in practice for comparability purposes; however, there exists a Court decision[77] rejecting the use of Amadeus database for benchmarking studies due to the fact that database does not contain any Turkish comparables. On the other hand, both TRA and Turkish TP legislation lack enough guidance on the use of those databases for comparability analysis.[78]

The Turkish corporate tax regime has special anti-avoidance provisions like CFC and withholding tax on payments to low tax jurisdictions[79] as well; however, the application of those provisions is limited compared to thin cap and TP legislations.

We should also note that not only specific anti-avoidance rules but also general anti-avoidance rules (GAARs) are part of modernization process of taxation systems. Recently, in 2013, United Kingdom introduced a statutory GAAR into its tax legislation. China introduced a statutory GAAR in 2008 and India plans to introduce a GAAR from 2016. Several British Commonwealth countries and some Asian countries, such as Hong Kong and Singapore, have had general anti-avoidance rules for many years.[80] The current political and public climate around tax avoidance promotes the introduction or strengthening of anti-avoidance provisions like GAARs. However, the extensive use of those as a threat could be problematic. For this reason, many jurisdictions with GAARs

[77] 11th Tax Court (Istanbul), E.2009/3169 K.2010/2091

[78] Ozlem Alioglu and Mehmet Devrim Askin , 'Turkey - Transfer Pricing' (Topical Analyses, IBFD 2014) 5-6 < http://online.ibfd.org/document/tp_tr > accessed 22 July 2014

[79] Payments made by resident corporations to corporations resident or PEs carrying out activities in low-tax jurisdictions are subject to a 30% corporate income withholding tax. Low-tax jurisdictions are to be included in a list to be issued by the Council of Ministers. Yet, Council of Ministers has not announced the list since 2006.

[80] Judith Freedman, 'Designing a General Anti-Abuse Rule: Striking a Balance' (2014) Asia-Pacific Tax Bulletin 167

have administrative arrangements, e.g. GAAR panel, which constitutes an approval mechanism for GAAR application.[81]

Turkish tax system includes an old GAAR provision, enacted first in 1980 and based on principally substance-over-form principle. Turkey does not have a specialist group or a GAAR panel regulating the application of GAAR provision. Turkish GAAR is widely applied in tax audits conducted by tax inspectors and it sometimes raises complaints among taxpayers.

5.8. Group Taxation Regimes

Corporate groups are the new trend in the business world. Companies come together to form complex group structures with different strategic aims. From taxation point of view, those groups demands a corporate tax system following an economic rather than legal approach in calculating taxable income. A few countries meet this claim through group taxation (or fiscal consolidation) regimes inserted into their domestic tax law.[82]

In general, group taxation regimes vary across those countries. Broadly, the mechanism of the group taxation regime can be classified into three distinct categories : consolidation system, group contribution system and group relief model.[83]

Under the consolidation system, the income of each member company is combined at a group level. The group operates as a single entity for tax purposes, thus the parent company is liable to pay the tax on behalf of the entire group. On the other hand, group contribution systems permit taxpayers to make tax deductible contributions to group companies that have incurred losses. Each company in the group remains liable for its own tax obligations and files its own returns. Finally, in group relief model, transfer of tax losses

[81] ibid 168.

[82] Srinivasa Rayo, Rajendra Nayak and Lubna Kably, 'Worldwide Tax Trends - Fiscal Consolidation or Group Taxation' < https://www.bcasonline.org/articles/artin.asp?854> accessed 11 July 2014

[83] ibid.

from one group company to another is allowed and at the end each company in the group files its own tax return.[84]

Domestic group consolidation regimes are currently available in Australia, Austria, Denmark, France, Germany, Italy, Mexico, the Netherlands, New Zealand, Spain and the United States. Group or consortium relief systems are applicable in Ireland, New Zealand, and the United Kingdom, while group contribution regimes are available in Norway and Sweden. A particular feature of those regimes is their being optional in all countries, except Denmark. Other requirements such as minimum shareholding, minimum holding period, duration of consolidation election etc. vary considerably across countries.[85]

Though being available in limited number of countries for the time being, group taxation is undoubtedly a crucial element of modernization process of tax systems. In Turkey, draft CITA prepared for 2006 corporation tax reform was including a group taxation provision; however, the provision was excluded during the enactment stage due to revenue loss concerns. DITA currently pending before the Parliament does not also include a group taxation provision. In author's view, the lack of such structure is the most noteworthy issue in the modernization analysis of Turkish corporate tax regime.

5.9. Corporate Tax Neutrality Against Financing Structure

In most corporate income tax systems in Europe, the general accounting principle, which is that interest is deductible while dividend is non-deductible, is valid as the rule of law. In economic terms, the deductibility characteristic of debt finance creates distortions in corporate finance choices, leading corporations to excessive debt finance.[86] Favourable

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[84] ibid.

[85] OECD, *Corporate Loss Utilisation through Aggressive Tax Planning* (OECD Publishing 2011) 31 < http://dx.doi.org/10.1787/9789264119222-en> accessed 23 July 2014

[86] Ruud A. de Mooij and Michael P. Devereux, 'Alternative Systems of Business Tax in Europe: An applied analysis of ACE and CBIT Reforms' (2009) European Commission Taxation Papers Working Paper No.17 2009, 9

treatment of debt is also threat for base erosion through international profit shifting and hybrid instruments.[87]

Alternatives have been proposed in order to make corporate tax systems more neutral against financing decisions. 'Comprehensive business income tax' (CBIT) and 'the allowance for corporate equity' (ACE) are two widely accepted proposals. CBIT basically disallows the deductibility of interest for corporate income tax purposes, while ACE grants equity holders an allowance equal to a notional risk-free return on equity. The core difference between CBIT and ACE is that former allows a wider tax base while the latter features a narrower tax base than current corporate income tax systems. In other words, CBIT allows for a lower statutory CITR to generate the same amount of revenue than ACE does.[88]

Recently, ACE and CBIT have received renewed interest from policy makers. For example, Italy, Croatia and Austria experimented with ACE features in their corporate tax systems. Brazil and since 2006 Belgium have ACE provisions. Many European countries have introduced thin-capitalisation rules that limit interest cost deductibility. The Netherlands has introduced an interest box under which both interest received and interest paid face a reduced rate of 5%, which in principle resembles CBIT.[89] In Denmark, there is a limitation of interest deductibility rule depending on EBIT figure and a ceiling over deductible interest.[90] France and Portugal curbed the deduction of interest payments above the threshold of 3 million EUR. Similarly, Spain, Sweden and Finland restricted the scope of deductibility of interest expenses on intra-group loans. Hungary enacted a cash-flow tax

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<http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_papers/taxation_paper_17_en.pdf> accessed 23 July 2014

[87] Ruud A. de Mooij, 'Tax biases to debt finance: Assessing the problem, finding solutions' (IMF Staff Discussion Note, IMF 2011) 4 < https://www.imf.org/external/pubs/ft/sdn/2011/sdn1111.pdf> accessed 23 July 2014

[88] De Mooij and Devereux (n 86) 9.

[89] ibid 7.

[90] Eurostat Statistical Books (n 50) 71.

for small companies, which in practice allows for immediate expensing of all financing costs.[91]

Turkey introduced an interest expense limitation provision to CITA in 2012. The limitation affects taxpayers with debt to equity ratio above 1 and will be related only to excess amount of debt over equity. The provision authorized Council of Ministers to determine a limitation percentage not exceeding 10%. The Council of Ministers has not determined limitation rate yet, thus the provision is not currently applicable. The same provision is included in pending DITA as well.

6. PECULIARITIES OF TURKISH DTC NETWORK

The treaty with Austria, which was signed on 3 November 1970, became the first double taxation treaty for Turkey. Turkey now has tax treaties with eighty countries.[92] DTCs signed with Gambia, Kosovo, Mexico and protocols concluded with Belgium and South Africa are pending for ratification.[93] The full list of effective Turkish DTCs (as of March 2014) can be reached at TRA's web site.[94]

DTCs are treaties under international public law. It is a constitutional issue to implement DTCs into domestic law. They might either have the same status as domestic provisions or they might be superior (or below) domestic provisions.[95] Under Turkish legal structure, the procedure for incorporating DTCs into Turkish legal order and their status are

[91] Gaëlle Garnier and others (n 30) 18.

[92] Hakan Uzelturk, 'The Impact of the UN and OECD Model Tax Conventions on Turkish Tax Treaties' (2011) Intertax 437

[93] Yalti (n 6) 80.

[94] <http://www.gib.gov.tr/fileadmin/mevzuatek/uluslararasi_mevzuat/VERGIANLASMALIST.htm>

[95] Michael Lang, *Introduction to the Law of Double Taxation Conventions* (Online Book, 2nd edition, IBFD 2013) ch3, 2-3

set out in Arts. 90 and 104 of the Turkish Constitution, and Act 244 on the Enactment of International Treaties.[96]

Article 90(5) of the Turkish Constitution provides that treaties that have been enacted according to the relevant procedure have the force of law, but their unconstitutionality cannot be asserted before the Constitutional Court. The supremacy of international agreements over domestic law was not explicitly stated in Article 90(5).[97] Turkish courts, especially the Constitutional Court and the Supreme Administrative Court, solved this controversy through interpretation and approved the superiority of international agreements in their decisions for long years. However, in 1997, the Constitutional Court changed its jurisprudence and held that international treaties can be overridden by a subsequent domestic law. The Court added that any conflict between the provisions of domestic law and of international treaties can be solved under the principles established as 'lex posterior derogat legi priori' and 'lex specialis derogat legi generali'.[98] This made the issue more controversial.

In 2005, Article 90(5) of Turkish Constitution was amended, the sentence added to Article 90(5) stated that:

"in the case of a conflict between international agreements in the area of fundamental rights and freedoms duly put into effect and the domestic laws due to differences in provisions on the same matter, the provisions of international agreements shall prevail."

The amendment in the Constitution solved the controversy partially, at least for treaties in the area of fundamental rights and freedoms. However, as for DTCs, whether

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[96] Billur Yalti Soydan, 'Taxation and the European Convention on Human Rights in Turkey' (2002) European Taxation 86

[97] Emre Ferhatoglu, 'Tax Rules in Non-tax Agreements: Turkey' in Michael Lang et al. (eds), *Tax Rules in Non-tax Agreements* (IBFD 2012) ch 23, 1-2 < http://online.ibfd.org/document/trnt_head> accessed 23 July 2014

[98] Yalti (n 6) 76.

they are agreements in the area of fundamental rights and freedoms or not has arisen another topic for discussion.[99] Under current legal framework, there exists a large consensus on following the general principles of law when a conflict arises between domestic law and DTC.

Lang, in his book, mentions about above-mentioned problem and argues that whether the treaty prevails as 'lex specialis' or whether a later domestic law prevails as 'lex posterior' cannot be decided by examining the provisions alone. He suggests taking into account all interpretation materials into account. In his view, if the interpretation leads to the result that the domestic law prevails, this constitutes an infringement of international law.[100] The author fully agrees with Lang's argument.

The personal scope of the Turkish DTCs does follow OECD MTC definition. DTC benefits are available to residents of contracting states. Turkey generally follows the OECD Model definition of a person as an individual, company or a body of persons in its DTCs. However, some of Turkish DTCs[101] widen that definition.[102] Turkey has not concluded any inheritance and gift tax treaties.[103]

Turkish tax treaties have generally adopted Article 4 of the OECD MTC as the tie-breaker rule to resolve dual residency problem. The most applicable tie-breaker rules are place of habitual abode for natural persons and place of effective management for legal persons.[104]

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[99] Ferhatoglu (n 97) 2.

[100] Lang (n 95) ch 3, 4.

[101] The DTCs with Tunisia, Romania and the Netherlands.

[102] Uzelturk (n 92) 438.

[103] Yalti (n 6) 84.

[104] Uzelturk (n 92) 438.

Turkish DTCs generally do not contain comprehensive provisions on limitation on benefits. Only a limited number of DTCs[105] contain a provision that can restrict treaty benefits.[106]

As for non-discrimination, Turkey generally follows the OECD MTC. Non-discrimination article is available in all Turkish DTCs. Though not referred much in Turkish tax practice, the non-discrimination article in Turkish DTCs has some practical results. For example, non-residents who are subject to withholding tax on gross basis for their passive income might opt for net basis taxation on their request. Similarly, under current domestic law, some non-residents enjoy the benefit of lower domestic WTR on interest payments rather than the higher rate in their treaties thanks to non-discrimination article in DTCs.[107]

According to an OECD survey, Turkey was considered as a jurisdiction that has substantially implemented the internationally agreed tax standard in relation to mutual assistance, exchange of information and mutual assistance issues.[108]

On 3 November 2011, Turkey signed the OECD Convention on Mutual Administrative Assistance in Tax Matters. Turkey also signed exchange of information agreements relating to tax matters with Bermuda, Gibraltar, Guernsey, the Isle of Man and Jersey which are pending before the ratification procedure. Furthermore, most Turkish DTCs contain an exchange of information clause corresponding to article 26 of the OECD MTC, while only some DTCs also provide for mutual administrative assistance in the collection of taxes.[109]

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[105] DTCs with Brazil, Canada, Denmark, Israel, Kazakhstan, Lebanon, Luxembourg, Malta, Qatar, Saudi Arabia and United States.

[106] Yalti (n 6) 80-81.

[107] Turkey-Italy DTC is an example for this situation.

[108] Uzelturk (n 92) 448.

[109] Yalti (n 6) 84.

Some Turkish DTCs[110] contain a remittance basis clause in order to avoid double non-taxation. According to those clauses, the residence state grants relief under DTC only with regard to the income remitted to or received in that state.[111]

Turkish DTCs do not contain any arbitration clauses or reciprocity rules.[112]

6.1. Permanent Establishment (Article 5)

In line with OECD MTC, Turkish DTCs group permanent establishments (PEs) into three categories: fixed place of business; building sites, construction and installation projects; and dependent agent PEs. Domestic law definition of PE is relatively broader than DTC definition.[113] Thus, a non-treaty situation might yield to significantly different taxation results.

For the definition of a permanent establishment, Turkish tax treaties generally follow the OECD MTC. Nonetheless, Turkey has a reservation on OECD MTC regarding the duration limit for constituting a building site and construction PE. Turkish reservation states that building sites or construction or installation projects must last for more than 6 months in order to constitute a PE; however, it is possible to observe various duration limits[114] (6,9,12 and 24 months) in Turkish DTCs.[115]

In contrast to domestic legislation, warehouses and independent agents are generally not included in the definition of PE under Turkish DTCs. However, under some of Turkish

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[110] DTCs with Ireland (Article 23(5)) and Singapore (Article 22)

[111] Yalti (n 6) 83.

[112] Yalti (n 6) 84.

[113] Zeki Gunduz, Ulas Ceylanli and Yelda Kemaloglu, 'Turkey - Permanent Establishments' (Topical Analysis, IBFD 2014) 14 <http://online.ibfd.org/document/pe_tr> accessed 23 July 2014

[114] For example 24 months (Macedonia, Mongolia, Tajikistan); 12 months (Brazil, China, Saudi Arabia, UAE, Bulgaria, Crotia, Czech Republic); 9 months (Syria, Malaysia, Latvia, Egypt, Portugal); 6 months (France, Italy, UK, US, Netherlands, Spain, Sweden, Switzerland, India, Finland, Japan, Luxembourg, Singapore, Romania).

[115] Yalti (n 6) 66.

DTCs, contrary to OECD MTC approach, a group of independent agents who have no authority to conclude contracts in the name of the enterprise are treated as PE. Those independent agents habitually maintain a stock of goods or merchandise from which they regularly deliver goods or merchandise.[116]

In the 2008 update to the OECD MTC, Turkey inserted a reservation to MTC to treat a person as having a permanent establishment in Turkey if the person performs professional services and other activities of an independent character, including planning, supervisory or consultancy activities, with a certain degree of continuity either directly or through the employees of a separate enterprise.[117]

Turkey also reserved the right to subject income from the leasing of containers to a withholding tax at source in all cases. In the case of the application of Articles 5 and 7 to such income, Turkey would like to apply the permanent establishment rule to the simple depot, depot-agency and operational branches cases.[118]

In line with Article 5(7) of the OECD MTC, Turkish DTCs provide that the existence of a subsidiary company does not, of itself, cause that subsidiary to constitute a PE of its parent company, because such a subsidiary company is an independent legal entity from a tax perspective. The DTC between Turkey and Saudi Arabia deviates from that general rule.[119]

6.2. Attribution of Profit to PEs (Article 7)

Though only 5 countries including Turkey placed a reservation against AOA in 2010 version of OECD MTC, the applicability of authorized OECD approach (AOA) in international tax practice has been too limited up till now. Only 17 DTCs contained new Article 7 since 2010.

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[116] ibid.

[117] OECD, *Commentaries on the Articles of the Model Tax Convention* (OECD 2010) art 5, para 54

[118] ibid art 7, para 90.

[119] Gunduz, Ceylanli and Kemaloglu (n 113) 19.

The UN Model has adopted neither the AOA nor any AOA-related changes of the OECD MTC and its Commentary. Consequently, it may be concluded that the AOA has not yet become a uniformly applied international standard at a treaty level.[120] The requirement of domestic law changes is shown as the biggest impediment for widespread application of AOA.

Originally, AOA aimed to eliminate the diversity in methods used for attributing income to PEs across OECD member countries. Different rules in each OECD member country was creating uncertainty, and due to this uncertainty, taxpayers were refraining from establishing PEs in foreign jurisdictions even if their foreign jurisdiction activities are limited in scope.[121] However, it seems that AOA could not become successful in meeting that aim. Due to its limited application, AOA remained as another method leading to further diversity in practice.

Turkey, together with Chile, Greece Mexico, New Zealand, has reserved its right to use the pre-2010 version of article 7 of the OECD MTC and therefore has not endorsed any changes in relation to AOA in its international tax practice.[122] Thus, one must consider old Article 7 of OECD MTC and its commentary when dealing with the attribution of income to PE under Turkish DTCs.

Generally, Turkish domestic law lacks specific guidance on the attribution of profits to a Turkish PE.[123] In Article 22 of CITA, it is stated that income of PE will be calculated based on the rules valid for resident taxpayers. Jurisprudence on this issue is also rare.

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[120] Sebastian Paulitsch and Martin Eckerstorfer, 'Implementation of the Authorized OECD Approach: Case Study of Permanent Establishment Profit Determination under the Austria-Germany Income Tax Treaty' (2014) International Transfer Pricing Journal 185

[121] Arne Schnitger, 'Comments on the Klaus Vogel Lecture – Problems Arising under Domestic Tax Law Due to the Introduction of the Authorised OECD Approach' (2013) Bulletin for International Taxation 211-212

[122] Paulitsch and Eckerstorfer (n 120) 185.

[123] Gunduz, Ceylanli and Kemaloglu (n 113) 49.

Under this uncertain framework, the OECD commentary seems the only guidance for attributing income to Turkish PEs for the moment.

Turkey's observation in relation to OECD Commentary on Article 7 is also noteworthy. In its observation in para 84 of Commentary on Article 7, Turkey states that it does not share the views expressed in para 28 of Commentary on Article 7. This shows that Turkey adopts a narrower interpretation regarding the Article 5(4) of OECD MTC.

6.3. Taxation of International Transportation Companies (Article 8)

In Article 8 of the OECD MTC, the place of effective management principle has been used for the taxation of profits from the operation of ships or aircraft and from inland waterways transport.

Turkish DTCs include varying scopes of international transportation, such as sea, land and air transportation regarding its geographic situation. Turkey reserved its right not to extend the scope of Article 8 to cover inland transportation.[124]

Turkey also has an observation in para 29 of Commentary on Article 8. Accordingly, Turkey reserves its position regarding the application of Article 8 to income from inland transportation of passengers or cargo and from container services. Also, in para 42 of Commentary on Article 8, Turkey reserves the right in exceptional cases to apply the permanent establishment rule in taxation of profit from international transport. The reservation also covers the right to broaden the scope of the Article to cover transport by road vehicle and to make a corresponding change to the definition of 'international traffic' in Article 3.

6.4. Taxation of Dividend and Interest Income (Article 10&11)

Taxing rights on dividend and interest income received by resident persons in a contracting state belongs to the state in which the shareholder is resident. Nonetheless, the source state is also granted a right of taxation though being limited. OECD MTC foresees

[124] OECD (n 117) art 8, para 32.

the limitation of source state taxing right on dividend income between 5% and 15% and on interest income at 10%. This allocation rule is generally valid for Turkish DTCs as well.[125] However, Turkish DTCs deviate from OECD MTC in two respects.

First, Turkey prefers to limit its source state taxing right through bilateral negotiations. From this respect, Turkish DTC network reflects UN model characteristic. The limit for source state taxing right varies in each DTC.

As for dividends, limitation is defined depending on the amount of shareholding. In most Turkish DTCs, taxpayers benefit from more favourable rates if they hold at least 25% of the shares of distributing company. The most favourable rate, 5%, is available in DTCs with Norway, Finland, Germany, Macedonia, Albania, Egypt, Israel, Portugal, Serbia and Montenegro, Bosnia, Saudi Arabia, Switzerland and Australia.

As for interest income, withholding tax rate (WTR) is generally limited at 10%. In DTCs with UK, Sweden, Belgium, Denmark, Italy, France and Finland, the WTR is capped at 15%. However, because the WTR on interest payments is currently set at 10% domestically, the domestic rate is applicable to the residents of those countries thanks to the non-discrimination clause in relevant DTCs.

Second, Turkey reserves its taxing right in relation to profit repatriation of a PE to its resident jurisdiction.[126] Article 30 of CITA limits the exercise of that taxing right at 7.5% domestically. Turkey reserved that taxing right explicitly in DTCs with Romania, Greece, Hungary, Croatia, India, Netherlands, Belgium and United Kingdom.

On the other hand, Turkish DTCs contain beneficial ownership clauses in articles related to dividend and interest income. However, we should note that the applicability of those clauses in Turkish tax practice is very rare. Some DTCs[127] still explicitly provide that

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[125] Uzelturk (n 92) 441.

[126] OECD (n 117) art 10, para 85.

[127] DTCs with Belgium, France, Italy, Pakistan, Romania and Sweden

the beneficial ownership requirement is to be interpreted as preventing third state residents from obtaining treaty benefits.

The definitions of "dividend" and "interest" in Turkish DTCs mainly follow the definition in OECD MTC. In recent years, legal disputes regarding the context of dividend term in Turkish DTCs have frequently been observed. It is highly surprising that Supreme Administrative Court (SAC) gave contradictory decisions on the same facts and circumstances in relation to those disputes. One recent example is *Carrefoursa v TRA 4th Chamber, SAC, Case E.2011/9815 K.2014/2897*.

In *Carrefoursa v TRA*, Carrefour, the multinational retail giant resident in the Netherlands, was operating its retail business in Turkey through its subsidiary, CarrefoursaTr, which was resident in Turkey. In 2008, CarrefoursaTr benefited from investment allowance, which was subjected to a withholding tax due to provisional article 61 in PITA, in its corporate tax return. Provisional article 62 stated that income benefiting from investment allowance and subjected to 19,8% withholding tax in accordance with provisional Article 61 was exempt from withholding tax upon distribution.

Based on this legal background, CarrefoursaTr claimed for reduced WTR (%10) available in Turkey-Netherlands DTC. CarrefoursaTr simply argued that withholding tax imposed on investment allowance was in lieu of withholding tax on dividend payments. TRA rejected this claim and the issue was brought before the tax court. The first-tier tax court held in favour of TRA. Taxpayer appealed to Supreme Administrative Court (SAC).

SAC, in its reasoning, referred to the definition of dividend in the Article 10 of Turkey-Netherlands DTC and stated that investment allowance at issue cannot be considered within the scope of dividend term defined in the relevant DTC. SAC added that investment allowance could not be treated as dividend just because both payments were subject to withholding tax under the same provision of PITA in the past. Thus, SAC upheld the first-tier tax court's decision.

Actually, SAC had followed the same jurisprudence in previous cases.[128] However, it should be noted that there has been other recent SAC decisions which held in favour of taxpayer on exactly the same facts and circumstances.[129]

6.5. Taxation of Royalty Income (Article 12)

OECD MTC grants taxing right on royalties to the state in which the taxpayer is resident. Turkey, with a few other countries[130], reserves its source state taxing right on royalty income.[131] While the WTR on royalty income is limited to 10% in most Turkish DTCs[132], some DTCs include two different rates depending on the characteristic of payment.[133]

Turkey does not follow the royalty definition of OECD MTC in some of its DTCs. For example, royalty definition covers payments for the leasing of ships and airplanes in Turkey-Japan DTC, and a group of Turkish DTCs[134] treat income from the sale of intellectual property rights as royalty income. DTCs with India and Brazil treats payments for technical services as royalty, whereas the protocols attached to DTCs with France and Belgium explicitly state that income from technical service will not be regarded as royalties.

The legal disputes for royalty taxation usually arise when TRA tends to interpret royalty definition in a wider context, though the relevant DTC has exactly the same MTC definition. Payments for technical services, management fees and cross-border leasing of

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[128] SAC decided , e.g. *Ford Motor Company v TRA* 4th Chamber, SAC, K.2013/2373; *Barcelonesa de Metales v TRA* 3rd Chamber, SAC, E. 2010/6329 K.2012/3957

[129] *Bosch v TRA* 3rd Chamber, SAC, E.2010/3898 K.2013/3423; *Philip Morris v TRA* 3rd Chamber, SAC, E.2010/3289 K.2012/3737

[130] Australia, Chile, Korea, Mexico, New Zealand, Poland, Portugal, the Slovak Republic, Slovenia

[131] OECD (n 117) art 12, para 36.

[132] Exceptions are India and Thailand DTC with %15 and Jordan DTC with %12.

[133] DTCs with USA, Syria, Estonia, Latvia and Lithuania.

[134] DTCs with US, Denmark, South Korea, UK, Spain, Israel, Italy, Luxembourg, Malta, Mongolia, Norway, Uzbekistan, Romania, Russia, Singapore and New Zealand.

airplanes are usual suspects for tax litigations. TRA usually argues that payments for those services are a kind of consideration for the use of information concerning industrial and commercial experience (for technical services and management fees) or industrial equipment (for airplanes) and thus treat those income as royalty for tax purposes. The Court decisions related to technical services and management fees are generally in favour of TRA, while the decisions related to cross-border leasing of airplanes are contradictory.

For example, in *Sun Express v TRA 3rd Chamber, SAC, E.2012/1059 K.2013/4521*, the Court, considering leasing payments as a sum paid for the use of industrial equipment, held that payments for cross-border leasing of airplanes were within the scope of royalty definition according to Turkey-United States DTC, and thus denied the first-tier court decision stating that those payments constituted business income for non-resident lessee. On the contrary, in *Turkish Airlines v TRA 4th Chamber, SAC, E.2012/5211 K.2013/1866* and *Inter Express v TRA 4th Chamber, SAC, E.2010/355 K.2013/2832* , the Court held in favour of the taxpayer on the same facts and circumstances and simply stated that taxing right of business income belongs to residence state unless such income is gained through a PE in source state.

6.6. Capital Gains Taxation (Article 13)

Turkish DTCs generally follow OECD MTC principle in relation to taxation of capital gains. However, it partly deviates, especially for capital gains from the alienation of shares and bonds.

In a group of DTCs[135], capital gains derived from bonds and shares are taxable if the period between acquisition and alienation does not exceed one year or if the bonds are not quoted on a Stock Exchange in Turkey. In another group of DTCs[136], capital gains derived

[135] DTCs with the United States, Belgium, the Netherlands and Italy.

[136] DTCs with Azerbaijan, Germany, UAE., Belarus, Bulgaria, Algeria, Czech Republic, China, Denmark, Indonesia, Finland, France, India, the United Kingdom, Kazakhstan, Kirghiz Republic, South Korea, North Cyprus, Luxemburg, Hungary, Macedonia, Malaysia, Egypt, Mongolia, Moldova, Uzbekistan, Poland, Romania, Russian Federation, Slovakia, Slovenia, Sudan, Tajikistan, Thailand, Tunisia,

from shares and bonds are taxable only if the period between acquisition and alienation does not exceed one year.[137] DTC with Spain gives taxing right to Turkey with an additional condition which is the sale of share or bond must be to a Turkish resident. In some other DTCs, taxing right for the gains derived from the alienation of shares are allocated based on varying criteria.[138] In another group DTCs[139], the taxing right for the gains derived from alienation of shares and bonds is allocated to source state without any condition. In the remaining category of DTCs[140], the resident state is given the sole taxing right in relation to capital gains derived from shares and bonds as the OECD MTC suggests.[141]

6.7. Independent Personal Services (Article 14)

OECD deleted Article 14 from MTC stating that the provisions of that Article were similar to those applicable to business profits. The elimination of Article 14 in 2000 reflected the fact that there were no intended differences between the concepts of permanent establishment, as used in Article 7, and fixed base, as used in Article 14, or between how profits were computed and tax was calculated according to which of Article 7 or 14 applied.[142] However, Article has still survived in DTCs, especially in those of developing countries. That is most probably due to lower threshold for source state taxation in Article 14 when compared to PE threshold in Article 5.

Turkmenistan, Ukraine, Jordan, Greece, Iran, South Africa, Lebanese Republic, Ethiopia, Qatar, Yemen, Georgia, Oman and Canada.

[137] In DTCs with Norway, holding period should not exceed 2 years; while in DTC with Austria, maximum holding period for source state taxing right is kept at 6 months.

[138] DTCs with Sweden and Pakistan uses 'place of issuance' as criterion, while DTC with Singapore considers 'place of alienation'.

[139] In DTCs with Saudi Arabia and Bahrain, taxing right remains solely with source state. In DTC with Japan, taxing right is shared with source state without any condition.

[140] DTCs with Albania, Bangladesh, Estonia, India, Croatia, Israel, Kuwait, Latvia, Lithuania, Syria, the Kingdom of Morocco, Bosnia Herzegovina, Serbia and Montenegro.

[141] Uzelturk (n 92) 443.

[142] OECD (n 117) 156-157.

Treatment of cross-border service income vary across jurisdictions. Following OECD MTC, a group of countries treat it as business income under their DTCs. Another group of jurisdictions deals with the issue under Article 14. A third group treats service income, especially income from technical services, as royalty income and makes some modifications in treaty definition of royalty. In most DTCs, those approaches are applied in a combination.[143]

Retaining Article 14 in its DTCs, Turkey also deviates from OECD MTC. Source state taxing right for independent service income arises upon satisfaction of either 183-day rule or fixed base conditions in Turkish DTCs. In limited number of DTCs[144], income from technical services are covered under royalty definition. However, in practice, tax inspectors tend to interpret royalty definitions broadly and characterize payments for independent personal services as royalty income. That practice has been brought before tax courts by a large number of taxpayers. Surprisingly, Court decisions on this issue are generally in favour of TRA, in other words Turkish courts have also a strong tendency to resort to know-how provision of relevant Turkish DTCs on this issue.

For example, in *Renault 3rd Chamber v TRA, SAC, E.2013/6530 K.2013/5725*, Renault S.A.S resident in France provided an enterprise resource management software to its Turkish subsidiary. Renault SAS also provided technical and advisory services for the software. Turkish subsidiary made monthly payments for both the use of software and related technical and advisory services. The taxpayer claimed that payments in question were not in the scope of royalty payments defined in Article 12 of Turkey-France DTC. TRA rejected that claim and the issue was brought before the court. The first-tier tax court held in favour of TRA, but said that only payments related to the use of software must be treated as royalty. Then, taxpayer appealed to SAC for the part held in favour of TRA. TRA upheld the decision of first-tier court in relation to payments related to the use of software. On the other hand, SAC dismissed the decision of first-tier court in relation to payments related to technical and advisory services. The Court explained that the payment for the use

[143] Ariane Pickering, 'Taxation of Enterprise Services ' (IFA Cahier General Report, IBFD 2012) 19

[144] For example DTCs with Morocco, India, Australia and Brazil.

of software constituted a whole, and thus it was not possible to separate total payment as decided by first-tier court.

Similarly, in *Hilton v TRA 4th Chamber, SAC, E.2010/9475 K.2012/4240*, the Court ruled that management fees paid by Hilton-Turkey to Hilton International SAS and Hilton Munich Park for the consultancy services received must be considered within the scope royalty payments in accordance with Article 12 of relevant DTCs.

6.8. Double Taxation Relief (Article 23)

Turkish DTCs follow a hybrid policy for the relief of double taxation. However, the predominant method for double taxation relief is credit method such that it currently exists as the relief method in around 75% of Turkish DTCs. Exemption for active business income/credit for passive income as a method for relieving double taxation is applied in a limited number of DTCs.[145]

In some of Turkish DTCs[146], there exists a tax sparing mechanism which is available to Turkish residents for certain categories of foreign income. In another group Turkish DTCs[147], tax sparing is granted to the residents of treaty partner for their certain category of income derived from Turkey.[148]

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[145] DTCs with Albania, Azerbeijan, Bangladesh, Belgium, Latvia, Indonesia, Estonia, Morocco, India, the Netherlands, Sweden, Krgyzstan, Cyprus, Letonia, Lithuania, Macedonia, Moldova, Slovakia, Thailand and Turkmenistan.

[146] DTCs with Bosnia (general), Croatia (dividends), Ethiopia (business profits), Italy (dividends, interest, royalty and business profits), Korea (dividends, interest, royalties), Malaysia (interest, royalties) and Pakistan (dividends, interest, royalties, professional services).

[147] DTCs with Austria (interest, royalties), Bosnia (general), Denmark (dividends, interest, royalties), Ethiopia (business profits), Finland (dividends, interest, royalties), France (dividends, interest, royalties), Italy (dividends, interest, royalties, business profits), Korea (dividends, interest, royalties), Malaysia (interest, royalties), Pakistan (dividends, interest, royalties, professional services), Singapore (dividends, interest, royalties, business profits), Spain (dividends, interest, royalties), Switzerland (interest, leasing payments, royalties), United Kingdom (business profits).

[148] Yalti (n 6) 81.

7. BEPS AND TURKISH CORPORATE TAX REGIME

In February 2013, governments in the G20 and OECD have launched an international action plan to combat base erosion and profit shifting (BEPS) through international tax planning structures used by multinationals to pay very little tax globally.[149] The plan defined base erosion as a serious risk to tax revenues, tax sovereignty and tax fairness for OECD member countries and non-members alike.[150] The plan was also seen as a response to public demands that politicians do something about the perceived tax burden inequity between multinationals and domestic enterprises.[151]

The importance of developing countries was specifically addressed in BEPS Action Plan. The plan noted that those countries may face BEPS issues differently due to the special characteristic of their legal and administrative frameworks.[152] But in general, it is proposed that developing countries have much to gain from active participation in BEPS action plan, as many of the actions in the BEPS Action Plan will also help developing countries secure their tax base.[153]

7.1. Is BEPS Relevant for Turkey?

Turkey has a unique characteristic as to the classification of countries based on their development level. Through being classified as a developing country; by the size of its economy and its growth pattern, it largely deviates from a large majority of developing economies. Turkey is mainly a capital-importing country. The trade balance which is mainly financed by portfolio investments rather than foreign direct investment shows large

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[149] Shee Boon Law, 'Base Erosion and Profit Shifting - An Action Plan for Developing Countries' (2014) Bulletin of International Taxation 41

[150] OECD, *Addressing Base Erosion and Profit Shifting* (OECD Publishing 2013) 5 <http://dx.doi.org/10.1787/9789264192744-en> accessed 24 July 2014

[151] Law (n 149) 41.

[152] OECD, *BEPS Action Plan* (OECD Publishing 2013) 25-26

[153] Law (n 149) 46.

deficits in Turkey. Having a large young-age population, Turkey has also been an interesting market for the most large MNCs in recent years.

One might think that BEPS project might not promise much for Turkey, as a developing country. However, as a member of G-20, Turkey is following BEPS-related developments very closely. Turkish delegates regularly attend BEPS project meetings in OECD and discuss the implications of BEPS-related developments in their internal meetings. General consensus is that BEPS output, at its current stage, does not signal an immediate need for reform in Turkish direct tax system. It is also asserted that BEPS effect on Turkey will not be neither positive nor negative in the short term, because Turkey is neither a capital exporting country nor a regional hub for foreign direct investment. The officers state that the developments in other countries should be observed carefully, because some action plans, i.e. digital economy and transfer pricing, might produce beneficial outcomes for Turkish tax system as well.

7.2. How to Address BEPS?

BEPS implementation has several components: OECD recommendations for implementation; legal and administrative changes by individual governments; intergovernmental coordinated action; corporate compliance with new rules and guidelines; and BEPS actions of non-OECD countries.[154]

Many of the action items will require implementation by individual countries. That implementation could include amendments to laws and regulations, changes to bilateral treaties, tax administration modifications, and changes in audit practice.[155]

BEPS implementation is a complex task, because countries have divergent level of interest in the project. Developed countries, such as Germany, UK, France, are more

[154] Mindy Herzfeld, 'Implementing BEPS' (2014) Tax Analysts Worldwide Tax Daily 1 <http://services.taxanalysts.com/taxbase/tni3.nsf/SearchIndex/944A9BC39565AC9485257CFE00097F6C?OpenDocument&highlight=0,mindy > accessed 24 July 2014

[155] ibid.

willing to make changes in their law to address BEPS concerns, whereas the willingness for reform in smaller countries attracting foreign direct investment through their competitive tax system (Netherlands, Belgium, Ireland) is relatively less. Potential conflicts of law, especially with EU law, and general moral hazard problem regarding earlier adoption of recommendations are seen as other obstacles in the implementation process of BEPS. It is also not clear how non-OECD member countries of G20, e.g. China and India, and also United States will react to BEPS-related developments.[156]

Despite the above-mentioned complexities, some countries have already begun implementing BEPS recommendations. Based on anecdotal evidence, individual auditors and agents in various jurisdictions started to adopt audit positions consistent with their own view of BEPS goals, regardless of the enactment of any action item recommendations into law.[157]

The Turkish corporate tax regime already addresses some BEPS-related concerns under its currently effective legislation. For example, in relation to Action 4, Turkish thin cap legislation has been rewritten in 2006 reform; in addition, though not being effective yet, a new interest expense cap provision was added to CITA last year. Interest deductions, especially intra-group borrowings, have been frequently examined in Turkish tax audits. Similarly, inserting a CFC provision into corporate tax regime in 2006 reform, Turkish corporate tax regime already addresses the concerns related to Action 3.

Some BEPS-related concerns did not attract much attention in previous Turkish tax practice. Digital economy (Action 1), hybrid mismatch arrangements (Action 2), treaty abuse (Action 6) and transfer pricing related problems (Action 8, 9, 10) are among those concerns. BEPS developments in those areas could at least potentially affect Turkish tax audit practice in the short term.

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[156] ibid 2-3.

[157] ibid 3.

8. CONCLUSION

Our study showed us that many jurisdictions have taken steps to modernize their corporate tax systems to align better with rapidly shifting business models. The modernization of tax systems is an ongoing project on the political agenda of most countries.

Recent modernization efforts in corporation tax systems have, in general, similar characteristics. Corporate tax reforms across the world have mainly aimed to reduce statutory CITRs while broadening the corporate tax base. It seems that the base broadening efforts have compensated the revenue loss caused by the decline of CITRs, as the share of corporation tax in total tax revenues and also in total economy have followed either horizontal or slightly upward trend in several jurisdictions for the period following the decline of CITRs. The shift from worldwide taxation to territorial taxation has been another noteworthy trend in the corporate tax world. Major credit countries, Japan and UK, recently shifted to the territorial basis of taxation and the same shift is currently debated intensely as a policy proposal in United States. Similarly, countries integrating their corporate and income tax systems through imputation system left this approach due to its drawbacks in relation to cross-border investments. Anti-abuse rules have become more pronounced in corporate tax systems. Their application in corporate tax practice significantly increased. GAARs entered into the fiscal policy agenda of countries without a GAAR regime, e.g. UK, India, China, Indonesia, South Africa. In addition to those, group taxation regimes due to their recognition capacity of economic substance have started to receive considerable support from business community. Provisions aiming corporate tax neutrality against corporate financing structures (CBIT and ACE) have broken through in a limited number of jurisdictions; however, the trend shows that we will see those provisions in a greater number of jurisdictions in the near future.

Turkish corporate tax regime has gone through a modernization process as well in the last decade. The 2006 reform replaced the old CITA. Turkish corporate tax reform addressed the majority of worldwide trends in the modernization of corporate tax systems. CITR was cut from 30% to 20%, while many exemptions were nullified in order to broaden

tax base. The share of corporate tax revenue in total tax revenues and total economy remained almost stable in the period following the 2006 reform.

The Turkish corporate tax regime was originally based on the classical system as to the integration of corporate and personal income tax and it was following a territorial basis of taxation policy. The 2006 reform did not change those two characteristics. The most radical change in 2006 reform has been towards specifically designed anti-avoidance rules. Though having a well-established GAAR regime since 1980, old CITA was lacking modern specifically designed anti-avoidance rules. The 2006 reform inserted CFC provisions and also brought thin cap and TP legislations in line with international standards. The reform originally intended to bring a group taxation regime such that a provision had already been drafted. However, that provision was omitted in Parliament due to the concerns in relation to its potential negative effect on tax revenues. As for tax neutrality against corporate finance decisions, Turkey has opted to follow CBIT approach rather than ACE. Though not being effective yet, a provision for limiting interest expense was introduced into CITA in 2012.

In the analysis of a jurisdiction's corporate tax regime from an international perspective, understanding the peculiarities of related jurisdiction's DTC network has great importance. Turkey, with currently effective 80 DTCs, has a large DTC network. Turkish DTCs follow OECD MTC in general. However they reflect UN MTC characteristics and other specificities in some respects.

Turkey, together with four other countries, reserved its position on the use of AOA for the attribution of profits to Turkish PE. Turkey applies old Article 7 in its international tax practice. Turkey also retains independent personal service income provision (former Article 14 of OECD MTC) in its DTCs, although that provision was removed from OECD MTC in 2000 and independent personal service income has been suggested to be treated as business income since then. Turkey refrains from following OECD recommendation in this respect due to fact that old Article 14 of OECD MTC provides a lower threshold for source state taxation than Article 7 does.

Turkey also reserved its position regarding the limitation of source state taxing right on passive income. Turkey negotiates the limitation of source state taxing right on passive income separately for each DTC. It should also be noted that source state taxing right in relation to capital gains derived from the disposal of bonds and shares, which is usually under the condition that disposal takes place within the specified time limits from the purchase, is another peculiar characteristic of Turkish DTC network.

The most peculiar characteristic of Turkish DTC network is related to royalty taxation. Similar to most developing countries, Turkey deviates from OECD MTC in this respect and demands source state taxing right in its treaty negotiations. Also, some Turkish DTCs contain a wider royalty definition compared to OECD MTC, generally including income from technical services and consultancy services within the scope of royalty definition. The peculiarities of royalty taxation are not limited with those. There exists a strong tendency among tax inspectors to treat management fees and other service fees as royalty income for tax purposes. Turkish courts, surprisingly, hold in favour TRA on this issue. The more surprising finding is that Turkish court decisions favouring TRA on that issue lack sufficient reasoning and legal discussion such that it is not possible to fully understand the reasoning behind that tendency.

Considering our word limitations, we tried to give a very brief outlook of Turkey-BEPS relationship in the final part of this study. We briefly concluded that BEPS project promises future changes in Turkish domestic law, DTC network and especially in tax audit practice at least for certain action plans, i.e. Action 1, Action 4, Action 7, Action 8,9,10. Turkish tax authorities are aware of BEPS-related developments and are following the process as part of their fiscal policy agenda.

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