English translation

Withholding tax base in payments made to individual retirement and insurance companies

This article covers our explanations and opinions about certain judicial decisions relating to the taxation of payments made to participators in the scope of life insurance policies and individual retirement agreements signed particularly after 7 October 2001 by individual retirement and life insurance companies.

I. Income from movable property

Under the clause 15, paragraph 2, article 75 of the Income Tax Code, payments made by retirement funds with legal personality, provident funds, retirement and insurance companies to those who abandon the system are considered as income from movable property.

On the other hand, the repeated article 21 of the Income Tax Code stipulates exemptions at varying rates depending on the period of presence in the system and depending on whether the individuals were entitled for refund. For example, 25% of the payments made to those who become entitled to retirement on the individual retirement system is exempt from income tax.

As per the article 86 of the Income Tax Code which stipulates the circumstances under which tax return will not be filed, individuals who derive the aforementioned income from movable property shall not file tax returns for these incomes.

II. Withholding tax rates

Not filing tax return does not mean that these incomes are entirely excluded from the scope of tax. The article 94, clause 15 of the Income Tax Code stipulates the application of income withholding tax over the aforementioned income from movable property during payment.

Accordingly, withholding tax shall be applied at;

- 15% over the payments made to those who abandon the system without paying premium, fee and contribution for 10 years,
- 10% over the payments made to those who paid contribution for 10 years but abandoned the individual retirement system without being entitled to retirement and to those who pay premium and fee to other funds and insurance for 10 years and those who abandon the system due to force majeure such as death, disablement or liquidation,
- 5% over the payments made to those who become entitled to retirement on the individual retirement system and abandon the system due to force majeure such as death, disablement or liquidation.

III. Determination of the withholding tax base

According to the interpretation of the Tax Authority, the term “payments made” under the article 75, paragraph 2, clause 15 of the Income Tax Code covers all payments made, including principal amounts. According to this view, withholding tax at rates specified under the article 94 of the Income Tax Code must be applied over the total payments made including principal amounts, depending on the time of presence on the system. Insurance and retirement companies have implemented their applications in accordance with this view of the Tax Authority and applied withholding tax over the total amount including principal amounts during exits from the system.

A. Judicial decisions on the issue

The decision dated 30.01.2009 of the 3rd Tax Court of Istanbul states that the revenue derived on the system by the plaintiff should be treated as income from movable property rather than the whole amount (including principal amount) paid to the plaintiff and the tax should be applied to this amount.

Upon an application made to the State Council Office of the Chief Prosecutor against a Tax Court decision which became finalized as the Tax Authority did not appeal to the Regional Administrative Court, the State Council Office of the Chief Prosecutor was requested to annul the decision in favor of the law.

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After evaluating this request, the 4th Chamber of the State Council provided the following explanations in its decision dated 24.01.2011 File No: 2009/8882, Decision No: 2011/269:

"Income from movable property is defined under the aforementioned article 75, paragraph 1 of the Income Tax Code no. 193 and it is explicitly stated that among the values that are represented with cash capital or money, dividends, interests, rent and similar revenues derived due to composed capital are in the nature of income from movable property. Accordingly, since the income derived by the plaintiff due to payments made in cash for three years to the insurance company shall be considered as income from movable propert; the portion of payments made by the insurance company except the principal amount are in the nature of income from movable property rather than the whole amount of payments. Therefore, the withholding tax applied under the clause 15/a of the article 94 of the Income Tax Code no. 193 over the total payments refunded to the plaintiff is not lawful.

In this case, the annulment of the Tax Court decision, which is not contrary to the effective law, is not legally possible in favor of the law."

There are no other means to appeal against the dispute upon the State Council decision which states that the annulment of the Tax Court decision in favor of the law is not legally possible.

B. Method to be applied

In case whole amount of payments made by insurance or individual retirement companies are subjected to withholding tax, administrative means of solution should first be resorted to in case the due date for filing lawsuit has expired. In case no results can be obtained in this way, the issue should be brought to court.

On the other hand, according to our opinion, it would be beneficial if the Tax Authority abandons its interpretation that withholding tax must be applied to the whole amount of payments made by insurance or individual retirement companies, in the framework of the judicial authority's approach towards the issue. A general regulation (communiqué) should be introduced by the Ministry of Finance in order to change the application so that withholding tax is applied only to the revenue part of payments made by insurance or individual retirement companies as per the article 75 of the Income Tax Code rather than the whole amount including principal amount.

Furthermore, we are also of the opinion that the regulation to be introduced should include provisions on the termination of disputes at judicial stage and refund of taxes levied unjustly before.

Deduction of taxes paid abroad

I. Introduction

The terms "residency" and "non-residency" are explained under the article 3 of the Corporate Tax Code. According to the article, resident entities are taxed over the whole amount of gains they derive in and outside of Turkey. In case the gains derived abroad by resident entities are taxed in that country as well, this situation might result in double taxation. In order to prevent double taxation, the legislator introduced certain regulations under which it allowed the deduction of taxes paid abroad from taxes paid in Turkey with certain limitations.

II. Deduction of taxes paid for gains derived abroad

Under the article 33 titled "Deduction of taxes paid abroad" of the Corporate Tax Code, corporate tax and similar taxes paid abroad for the gains which are derived in foreign countries and recorded under general final accounts in Turkey are deductible from the corporate tax assessed on these gains in Turkey.

The rate effective during the transfer of the related gains to the general final accounts shall be applied to taxes paid abroad in foreign currency.

III. Period of deduction

In cases where the partial or whole deduction of taxes paid at source over the gains that are derived in Turkey and included in tax returns in Turkey is not possible due to the absence of taxable corporate profit in Turkey in

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the related year as a result of loss deduction or exemptions, this deduction right may be exercised by the end of the third subsequent fiscal period, under the restrictions specified below.

IV. Taxes paid by controlled foreign entity

In cases where the article 7 of the Corporate Tax Code is applied, the income and corporate tax and similar taxes paid by the controlled foreign entity may be deducted from the corporate tax calculated over the entity's taxable profit in Turkey.

V. Deduction of taxes paid over dividends received from non-resident affiliates

The portion of income and corporate tax and similar taxes paid over gains constituting the source of dividend distribution in countries where the foreign affiliates are resident, which corresponds to the dividend amount, can be deducted from the corporate tax payable in Turkey over the dividends received by resident entities from their foreign affiliates 25% of whose capital or voting right is owned directly or indirectly by them. The dividend added to the gains shall be taken into account by including the income and corporate tax and similar taxes paid abroad over these gains.

It would be beneficial to explain the calculation regarding the issue with an example. Information on the gains derived by the company (X) from the company (Z) resident in the country (Y) is provided below.

Rate of participation of the entity (X)	% 30
Corporate tax rate in the country (Y)	% 10
Withholding tax rate applied to dividends distributed in the country (Y)	% 20
Total corporate profit of the entity (Z)	1.000.000
Corporate tax paid by the entity (Z) in the country (Y) (% 10)	100.000
Participation gains derived by the entity (X) (gross)	300.000
The portion of corporate tax paid in the country (Y), which corresponds o the participation gains derived by the entity (X) (300.000 x %10)	30.000
Distributable profit of the entity (Z)	900.000
After-tax dividend received by the entity (X)	270.000
Tax withheld abroad during distribution over the dividend received by the enti (X) (270.000 x % 20)	54.000
Net dividend amount received by the entity (X)	216.000

**Foreign currency dividends received from abroad and the taxes paid have been calculated in TL.*

The company (X) will add to its corporate profit the gross amount (TL 300.000) of the net dividend amount of (TL 216.000), which is received from the company (X) and which is not exempt from corporate tax in Turkey. The portion up to (300.000 x % 20=) 60.000 TL paid abroad over these gains [(100.000 x % 30) + 54.000=] 84.000 TL may be deducted from the corporate tax calculated in Turkey over these gains. The tax amount paid abroad which exceeds 60.000 TL (i.e. 24.000 TL) is not deductible.

VI. Limitation to the deduction of taxes paid abroad

The amount deductible from taxes to be assessed in Turkey for the foreign gains shall not exceed the amount to be calculated by applying the corporate tax rate specified under the article 32 of the Code to the gains derived abroad.

In cases where it is planned to deduct taxes paid abroad from the corporate tax to be calculated in Turkey, the amount of foreign gains included in the tax base in Turkey must have been grossed up and must include these taxes as well.

For example,

Corporate profit derived by the company (X) in the country (Y)	1.000.000 TL
Rate of tax (corporate tax, etc.) in the foreign country	% 25
Corporate tax rate currently effective in Turkey	% 20
Amount of tax (corporate tax, etc.) paid in the foreign country	250.000 (=1.000.000*%25)
Tax amount calculated in Turkey for these gains	200.000 (=1.000.000*%20)

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Under the conditions specified above, the Company (X) will include 1.000.000 TL in its corporate profit in Turkey but may not deduct the portion of the tax paid abroad for these gains, which exceeds the tax calculated for these gains in Turkey (i.e. 50.000 TL (250.000 – 200.000), from the tax calculated in Turkey. Furthermore, it should also be noted that this tax is deductible neither in the current year, nor in following years.

On the other hand, in cases where the gains derived abroad are exempt from corporate tax, the taxes paid abroad over these gains are not deductible from the corporate tax calculated in Turkey

In addition, whether the portion exceeding the corporate tax rate shall be treated as expense in the deduction of taxes paid abroad is also important. In the tax rulings provided regarding the issue, it is stated that the portion exceeding the corporate tax rate cannot be treated as expense in the deduction of taxes paid abroad from the corporate tax in Turkey.

VII. Deduction of taxes paid abroad from advance tax

The regulation allows taxpayers to deduct taxes paid abroad from advance taxes. In case of income derived from abroad within the advance taxation period, the taxes paid through withholding or by other means over these incomes in the countries where they are derived will be deductible from the advance tax amount calculated for that period. However, the amount to be deducted shall not exceed the amount to be calculated by applying the advance tax rate specified under article 32 of the Corporate Tax Code to the gains derived abroad.

VIII. Documentation of taxes paid abroad

In order to deduct the tax paid abroad, the tax must be substantiated with certain documents. Basically, these documents are tax returns filed abroad or tax returns and declarations relating to withholding taxes applied for other companies, as well as payment documents, accrual vouchers and similar documents.

Taxes paid in foreign countries must be substantiated with documents that are received from competent authorities and certified by the Turkish embassies or consulates in the country in question, or in their absence, by similar representatives that protect Turkish interests in that country. Otherwise, the tax paid in the foreign country would not be deductible from tax assessed in Turkey.

In case documents relating the taxes paid abroad cannot be submitted during corporate tax assessment, the tax paid or payable in the foreign country shall be calculated over the rate known to be effective in that country, but shall not exceed the 20% corporate tax rate. The amount can be subjected to deduction on the corporate tax return. The portion of the assessment corresponding to the amount calculated in this way shall be deferred. If the required documents are submitted to the related tax office in 1 year as of assessment date at the latest, the assessment should be corrected according to the final amount written on these documents.

In cases where the documents are not submitted on time without force majeure or it is understood that the deduction right is lower than the deferred tax amount after submission of the documents, delay surcharge shall be calculated in accordance with the provisions of the Law no. 6183 on the Procedure of Collection of Public Receivables for the deferred taxes.

IX. Order of tax deduction

In some cases, the annual corporate tax returns of Corporate Taxpayers may include advance taxes paid within the year, taxes paid through withholding in Turkey and taxes paid abroad at the same time. In this case, taxes paid abroad shall be deducted first from the corporate tax calculated. If there are remaining amounts, taxes paid through withholding in Turkey and advance taxes shall be deducted.

X. Effect of double tax treaties

Today there are many double tax treaties (DTT) signed by Turkey, based on the rule that one single tax of the same type may be applied to a certain source.

While taxes paid at source over the gains derived in foreign countries and transferred to general final accounts in Turkey are deducted in Turkey, the provisions of the DTT signed between Turkey and the country in question should be taken into account (if any). The sections on “Prevention of Double Taxation” under double tax treaties explain how double taxation can be prevented in Turkey. These sections of certain treaties include provisions stating that certain gains shall be exempted in Turkey. In case the gains derived from abroad are

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exempted as per the Corporate Tax Law, the taxes paid abroad over these gains would not be deductible from the tax calculated in Turkey; and due to this principle the related sections of the treaties are significant in the deduction of taxes paid abroad.

XI. Conclusion

The regulation introduced regarding the deduction of taxes paid abroad essentially aims to prevent double taxation by allowing the deduction of taxes paid abroad by resident entities from the tax paid in Turkey.

While deducting the taxes paid abroad from corporate tax paid in Turkey, taxpayers must,

- ✓ Act in accordance with regulations under the law and communiqué,
- ✓ Take into account the maximum deduction limit applicable in Turkey,
- ✓ Substantiate the taxes paid at source subject to deduction with the certified documents obtained from competent authorities in the related country,
- ✓ Take into account the provisions of the double tax treaty signed with the related country, if any.