ERNST & YOUNG

English translation

Independent personal services in double tax treaties

With globalization gaining pace, prevention of double taxation is significant both for foreigners investing in Turkey and Turkish investors active abroad. Turkey has been continuing its works for this purpose, signing double tax treaties with new countries, while revising old tax treaties to ensure that they are more effective economically and commercially.

Both new treaties and the revised ones indicate certain changes in the treaty provisions. These changes are evident particularly in the provisions regarding dividend taxation, exchange of information, permanent establishment and independent personal services. The treaties enables more favorable dividend withholding taxation to make investment in Turkey more attractive, while introducing changes in the provisions on exchange of information for the purpose of preventing tax loss and evasion and fighting against such crimes. In addition, there have also been certain changes regarding the treatment of income derived by those engaged in independent personal services.

The double tax treaties signed that Turkey has signed with other countries includes different clauses on the taxation of income derived from independent personal services. In certain treaties, the taxation right is given to Turkey only if the service is performed through a permanent establishment in Turkey, whereas certain treaties prescribe either providing services through a permanent establishment or the 183-day rule. In certain treaties on the other hand the independent personal services performed by non-resident entities are mentioned in the permanent establishment article and evaluated as commercial income.

On the other hand, Turkish tax legislation allows taxation of income derived by non-resident entities from independent personal service through withholding by the Turkish entities receiving the service. Therefore non-resident entities might consider 20% withholding as final taxation.

However, in taxation through withholding, the tax would be applied over the gross income of the non-resident entity; therefore the tax amount payable in the name of the non-resident entity in Turkey could be higher when compared to taxation through net-income basis. On the other hand, in taxation through net-income basis the expenses related with the independent personal services performed in Turkey could be deducted from the income, which may result in a lower tax amount to be declared and paid in Turkey. However, in net income basis taxation, the non-resident entity would have to be registered in Turkey for tax purposes. This may not be a preferable method for non-resident entities, as the tax registration would also bring along certain additional liabilities such as registry at trade register, bookkeeping, filing tax returns and so on.

Although certain tax treaties signed by Turkey prescribe that independent personal services would constitute permanent establishment in Turkey if performed in Turkey for a certain period of time (for instance it is 6 months within any 12 month period in the Turkey- Switzerland Double Tax Treaty[1]), the income derived through permanent establishment should be treated as commercial income and taxed in accordance with these provisions, it would not be wrong to say that regulations of the Turkish tax legislation regarding the taxation of income derived from independent personal service through withholding would also be applicable and allow taxation without establishing a permanent establishment. Of course, in order to be able to consider withholding taxation as final taxation, the total income derived by the non-resident entity from independent personal service should be taxed through withholding. If the total income derived by the non-resident entity is not taxed through withholding taxation, it might not be accepted as the final taxation, which might trigger tax registration and filing obligation for the non-resident entity.

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[1] The Turkey Switzerland Tax Treaty is signed on 18 June 2010 but not entered into force yet. In Article 5 of this treaty with respect to independent personal services it is stated that *"the furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than six months within any twelve-month period".*

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Taxation of share certificates given to employees in the framework of share acquisition plans

1. Initial acquisition of share certificates in the scope of stock options

The article 61 of the Income Tax Code describes remunerations as the benefits paid in cash and in kind and other things that may be represented by money for services rendered, to persons employed by an employer and working at a certain work place. Payments of the remuneration as allowance, compensation, cash indemnity, fund, increase, advance, due, attendance fee, premium, bonus, reimbursement or under any other names; or deciding on payment in form of a certain percentage of the earning provided that it is not of partnership nature, shall not change its nature.

The article does not include any information on the taxation of share certificates given from abroad to the personnel free of charge; however, in a tax ruling given by the Tax Authority regarding the matter, it is stated that share certificates given to the personnel free of charge in case of fulfillment of the conditions determined by the headquarters abroad should be deemed essentially as a benefit provided to the personnel by the company in Turkey. Therefore, the free of charge delivery of share certificates to the personnel should be treated as remuneration income in the period when the benefit entered the employee’s legal and economic disposal, since the employee provides services to the company. Furthermore, the benefit in question should be subjected to withholding tax in the scope of the article 94 of the Income Tax Code and declared by the Turkish resident company with withholding tax return.

With respect to the personnel costs to be charged from abroad to Turkey, the non-resident company should not issue invoice and book such costs as expense based on the payroll. However, to justify the payment of the amount, which is indebted to the personnel as a result of the payroll accrual, to the other company instead of the personnel, it would be sufficient to obtain a debit note that would indebt the company in Turkey to the other company.

2. Dividends received due to the share certificates

Although the term “dividend” is not defined under the Income Tax Code, the dividends of all kinds of share certificates are specified as income from marketable securities and are associated with income elements under the article 75/1 of the Code.

Under the article 86/1-d of the Code on the other hand, annual tax return shall not be filed for income from marketable securities and income from immovable property, which are derived in one calendar year by Turkish residents, whose total amount does not exceed TL 1.170 for 2011 and which are not subject to withholding tax and exemption application, in case of filing tax return for other incomes. Therefore, without prejudice to double tax treaties, tax return shall not be filed in case the dividend received from a non-resident company is below TL 1.170 in 2011 and the dividend amount shall not be included in the tax return, even if the tax return is filed. However, if a dividend exceeding this amount is received, the whole dividend must be declared with the annual income tax return and income tax must be calculated based on the tariff including tax rates determined under the article 103 of the Code.

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3. Share certificates acquired free of charge due to capital increase

Under the Income Tax Code General Communiqué series no. 191, the Tax Authority has stated that addition of the reserves set aside from the profit of the period to the capital in any year is equivalent to participation in the company's capital increase and dividends actually distributed to shareholders; therefore, profit distribution of share certificates or participation shares acquired free of charge from the company's aspect is equal to dividend from the shareholders' aspect. On the other hand, the article 94 of the Income Tax Code states that addition of the profit to the capital shall not be deemed as profit distribution and withholding tax shall not be applied to profits added to the capital.

On the other hand, under the Income Tax General Communiqué series no. 231, the article of the Law in question is applicable only in terms of the withholding tax liability of entities distributing profits, therefore, dividends received by real person shareholders through addition of profit reserves to the capital must be declared in the scope of the articles 85 and 86 of the Code as income from marketable securities. The regulation in question has been cancelled as per the decision dated 08.06.2001 no. "Esas No: 2001/180 Karar No: 2001/224" of the State Council General Assembly of Tax Courts, on the grounds that real person shareholders do not actually receive income from marketable security, since no resources exit the company and there is no change in the shareholders' payment capability in case of addition of the profit to the capital. The decision taken by the State Council is regarding whether the free of charge acquisition of share certificates pertaining to Turkish resident entities is subject to income tax and does not cover the share certificates received free of charge from non-resident entities.

Therefore, the income to be calculated on the basis of the nominal value of share certificates acquired free of charge due to addition of profit reserves to capital by non-resident entities should be declared with annual income tax return as income from marketable security under the Income Tax Code. However, the income shall not be declared if it is below the declaration limit of TL 1.170 determined for 2011.

4. Disposal of share certificates

Under the repeated article 80 of the Income Tax Code titled "Capital Gains", gains derived from the disposal of marketable securities or other capital market instruments, except those which are acquired gratuitously and share certificates which belong to full resident entities and which are retained for more than two years, as well as the gains derived from disposal of shareholding rights or shares are described as capital gains.

On the other hand, the temporary article 67 of paragraph 1, states that gains derived from disposal of share certificates that are listed on Istanbul Stock Exchange and retained for more than 1 year shall not be subjected to withholding tax in the scope of this article.

In the following part of the repeated article 80 of the Income Tax Code, it is stated that TL 8.000 (for 2011) of capital gains derived in a calendar year (except those derived from the disposal of marketable securities and other capital market instruments) is exempt from income tax. In other words, the whole amount of gains to be derived from marketable security sales shall be taxed as capital gains regardless of whether they belong to a Turkish resident or non-resident entity. Therefore, the whole amount of gains to result from the disposal of non-resident entities' share certificates by Turkish resident real persons must be declared with the annual income tax return and subjected to income tax, using the tariff on tax rates determined under the article 103 of the Income Tax Code.

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