



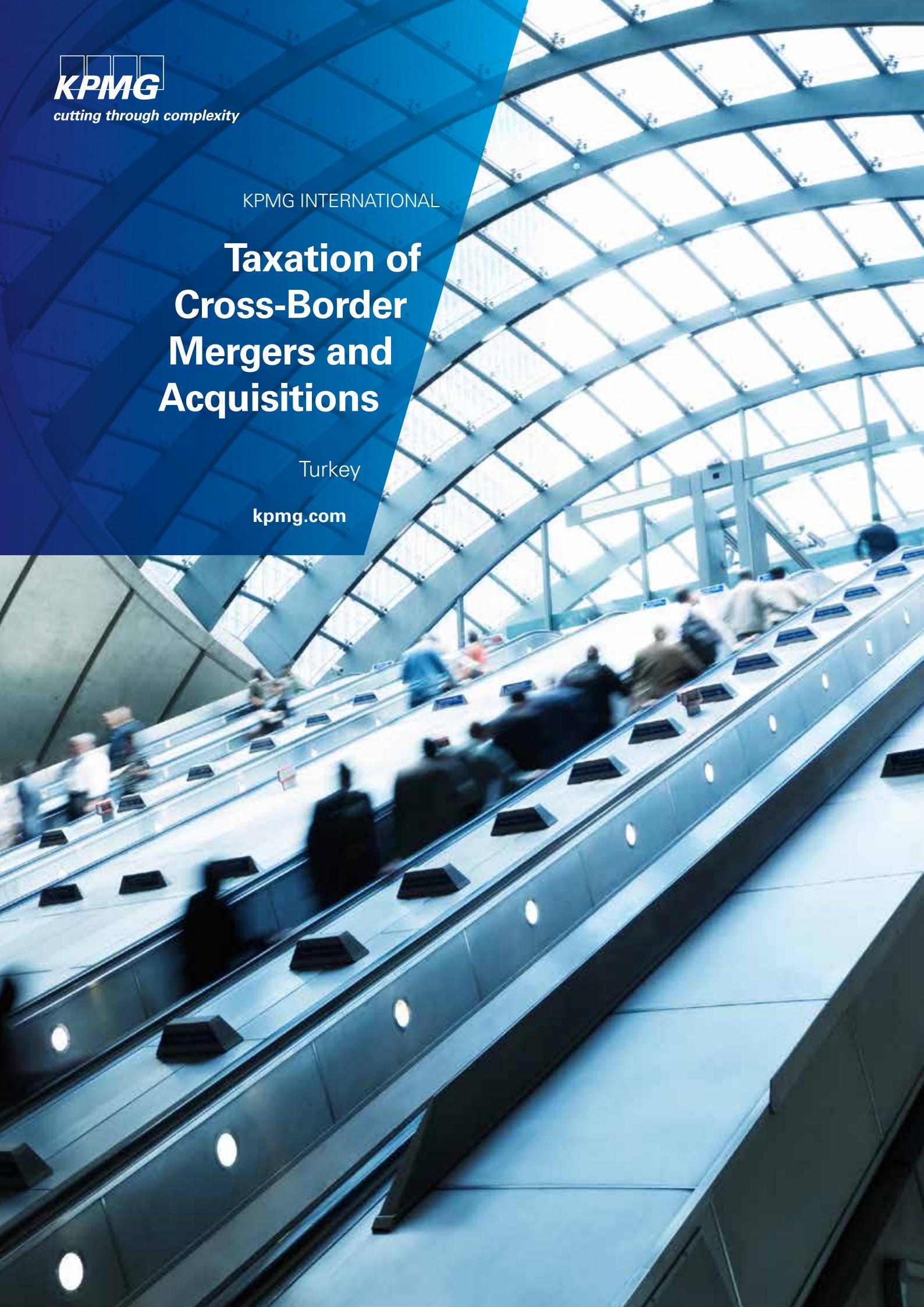
cutting through complexity

KPMG INTERNATIONAL

Taxation of Cross-Border Mergers and Acquisitions

Turkey

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Turkey

Introduction

The Turkish tax environment for mergers and acquisitions (M&A) has been affected by a number of uncertain tax issues that have yet to be resolved. The Turkish government has introduced numerous measures, including tax amnesty programs and investment incentives, which also affect cross-border M&A investors.

The chapter begins by explaining recent tax and legal developments that could potentially be important when planning a cross-border merger or acquisition. The chapter then discusses the key issues when developing a tax-efficient transaction structure.

Two types of capital company are typically used in Turkey for cross-border M&A transactions; a joint stock company (Anonim Sirket – AS) and a limited liability company (Limited Sirket – Ltd.). The following discussions relate to these types of companies unless otherwise stated.

Recent developments

Limitation on financing expense deduction

A new Law (no: 6322) entered into force on 15 June 2012 that amends certain provision in the Corporate Tax Law.

Among other changes, up to 10 percent of the sum of financing expenses (e.g. interest, commission, foreign exchange losses and similar costs and expenses) related to the borrowings that exceed the shareholder's equity of the companies are not tax-deductible. There are exclusions from this rule that must be analyzed on case-by-case basis.

The Law gives the authority to the Council of Ministers to determine a rate (i.e. up to 10 percent) for the restriction of financing expense deduction. The Council of Ministers have not used this authority yet, so the limitations have not been in force for fiscal year (FY) 2013. The new law may become applicable for FY2014 and after, following the government's announcement of the related Decree.

Turkey already has a thin capitalization regime in its Corporate Tax Law that restricts the deductibility of financing expenses incurred on borrowings from shareholders/related parties that exceed three times of the shareholders' equity. No such restriction applied for financing expenses incurred on

borrowings from external parties. Now, under the new Law, a certain percentage of financing expenses on external debt that exceeds the shareholders' equity in the companies can be also rejected as non-deductible expense, which is intended to discourage use of excessive debt by companies that do not have a strong equity.

In view of these developments, investors interested in Turkey should consider the tax implications of financing in more detail when determining the investment models.

Tax relief for 'angel investors'

Turkey introduced new provisions in 2012 (through Law No: 6327) regarding the tax incentives for individual investors to encourage investments in start-up companies.

The individual investors (referred to as 'angel investors') can benefit from a tax deduction (limited to 1 million Turkish lira (TRY) per year) with respect to a certain percentage of equity contributions made to start-up companies in certain encouraged sectors. Under regulations issued in 2013, investors who want to benefit from this regime should apply to the Ministry of Economy to obtain a license for qualification as 'individual investor'.

Incentive for contributions to venture capital funds

Turkey also introduced new provisions in 2012 (through Law No: 6322) regarding tax incentives provided to corporate investors with respect to their contribution to venture capital funds.

The corporate investors can set up reserves from their current-year profit to invest into 'venture capital investment funds' or 'venture capital investment partnerships' established under Turkish Capital Market Board regulations.

The amount reserved for the venture capital fund can be deducted from the corporate tax base of the relevant year, which helps reduce the corporate tax amount.

However, the following conditions should be met in order to benefit from the tax advantage:

- The fund amount should be limited to up to 10 percent of declared profits and up to 20 percent of shareholders' combined equity.

- The fund should be invested until the end of the year in which such fund is reserved.
- Such venture capital funds are reserved under a temporary account under liabilities section of the Balance Sheet. If this fund is withdrawn, taxes accrued before must be paid with late payment interest.
- Investors should re-invest this fund within 6 months following the disposal date of shares/interests in the venture capital trust or investment fund.

On the other hand, dividends to be received by Turkish companies from a venture capital trust or investment fund are entitled to benefit from participation exemption for corporate tax purposes under the new Law.

The new rules regarding the incentives for individual and corporate investors aim to create an alternative channel to meet the financing requirements of start-up companies. It is expected that such companies will be ready for a more structured investment or an M&A transaction in the future.

Transfer pricing regime and impact on M&A market

Following the global trends, Turkish Revenue Administration relies on indirect taxes and implements new compliance rules and tax audits in accordance with the transfer pricing provisions.

Since the implementation of Turkey's transfer pricing regime in 2007, tax authorities are increasing their focus on transfer pricing to protect and widen the domestic tax base. Key developments are as follows:

- In August 2009, the Turkish Revenue Administration issued guidance relating to Mutual Agreement Procedure in the Treaties for Avoidance of Double Taxation.
- Guidelines regarding disguised profit distribution through transfer pricing were published by the Turkish Revenue Administration in November 2010.
- The Turkish Revenue Administration finalized the negotiation and signed the first unilateral advance pricing agreement (APA) in 2011. KPMG in Turkey expects this will lead to more unilateral APA applications, paving the way for bilateral and multilateral APAs in the future.

In view of these developments, cross-border investors considering an M&A investment in Turkey should consider the transfer pricing rules applicable to the operations in the past and how they might change after the investment of a foreign company. In particular, if the investor has intentions to change the operating model (e.g. from an independent sales agent to a limited risk distributor), the likely impact on the financial and tax status of the Turkish company should be analyzed in detail to avoid potential disputes with the Turkish tax authorities.

Turkish Commercial Code: a new legal and financial landscape

The new Turkish Commercial Code (TCC) took effect as of 1 July 2012. Starting from 1 January 2013, it is mandatory for Turkish companies to prepare their standard financial statements in Turkish Financial Reporting Standards (similar to International Financial Reporting Standards – IFRS). They also became subject to an independent audit similar to the regime applied in many western economies.

Needless to say, the new TCC is changing the legal and financial landscape in which Turkish companies will continue to operate. The law aims for more transparency of the companies and more accountability for shareholders and directors who manage those companies.

These developments are also likely to bring important benefits to M&A players in the market. Historically, the accounts of Turkish companies (except for listed and/or regulated entities) were usually maintained for tax purposes and were not required to be audited or disclosed in any manner. Under the new rules, there is more reliable and standard financial data in relation to Turkish entities. External audit reports can be expected to increase the level of confidence of a foreign investor in evaluating a Turkish target and reduce the time and effort required for due diligence or partnership negotiations.

The new TCC also brings new concepts into the Company Law that may be of special interest for M&A investors:

- The new TCC covers the legal framework of company reorganizations like merger and demerger (previously covered mostly by tax laws), and new guidelines will be issued that should smooth the legal implementation of such reorganizations.

Re-domiciliation of companies will be possible under the new TCC. Re-domiciliation of an existing company is an alternative to liquidation and allows the transfer of assets and liabilities to an entity incorporated in another jurisdiction. The related guidelines and corresponding amendments in the Turkish tax legislation are not yet available; they are expected to be adopted by Turkish authorities in future during the phase of application of the new TCC.

- The status and rights of minority shareholders are defined clearly in the new TCC, and there are specific provisions regarding 'minority squeeze-outs', which is a major consideration in an M&A of a target company involving minority shareholders.
- With the new TCC, it will be possible for a company to acquire its own shares (limited to 10 percent of the capital), which was not possible before.
- The new TCC restricts shareholders from being indebted to their companies (except for advance dividend distributions), which creates a major obstacle to repatriation. This restriction also limits the possibility of leveraged buy-outs in Turkey since it is no longer possible to use the assets of a target company to receive a loan for a potential share acquisition of that company.

OECD action plan on base erosion and profit shifting

As a G-20 member, Turkey was one of the first countries to support the Base Erosion and Profit Shifting (BEPS) Action Plan announced by Organisation for Economic Co-operation and Development (OECD). The OECD plan aims to develop internationally agreed means to deter harmful tax actions and improve tax transparency.

In this context, Turkey is now evaluating and implementing the BEPS Action Plan. Among other things, Turkey is working to conclude exchange of information treaties with certain countries and to revise current tax treaties to cover the new exchange of information rules. This is particularly important for the Turkish tax environment where a material amount of funds is known to escape the tax net due to tax avoidance.

The Turkish government has tried to overcome this problem through some local initiatives, like implementation of 'Asset Peace Acts' and 'Tax Amnesty Acts' in previous years. However, a permanent solution has not been obtained,

so Turkey has put strong emphasis on the BEPS Action Plan to encourage Turkish businesses, for example, to discontinue the practice of having unrecorded accounts offshore.

A significant amount of cross-border M&A and investment to Turkey have been structured through favorable tax jurisdictions or tax treaty countries. The impact of BEPS on those structures should be analyzed. This review should extend to potential changes adopted by the other countries.

Further, Turkish and foreign investors and Turkish taxpayers who hold foreign properties should analyze the impact of the changes under the BEPS Action Plan for their current investments and future investment plans.

Asset purchase or share purchase

A foreign company can acquire a Turkish company by acquiring either its assets or its shares.

An asset acquisition can be effected either through a branch of the foreign entity, which is taxable in Turkey as a non-resident, or through a Turkish subsidiary of the foreign company.

Purchase of assets

Goodwill (i.e. a positive difference between the purchase price and the fair market value of assets acquired, if any) can be recognized and depreciated over 5 years.

Tangible and intangible assets can be amortized, based on the rates determined in accordance with the useful life of the assets as announced by the Ministry of Finance.

Transfers between the related parties have to be at fair market value.

Purchase price

In principle, the transfer of assets under an asset transaction should be conducted at fair value, which should be the market value. Transfers between related parties must be documented to comply with transfer pricing requirements.

For the buyer to book the individual assets at their transfer value and determine the goodwill amount (if any), the purchase price must be allocated to individual assets being transferred. It is generally advisable for the purchase agreement to specify the allocation, which is normally acceptable for tax purposes provided it is commercially justifiable.

The allocation of purchase price is more important if there are any assets in the deal that may be exempt from corporate tax and/or valued added tax (VAT) on transfer, such as real estate property or shares/participation rights in another entity.

Goodwill

In the case of an asset deal, an excess of the purchase price over the fair value of the assets being transferred represents goodwill, which can be capitalized by the buyer and depreciated for tax purposes over a period of 5 years.

Turkish tax law does not require recognition of internally developed goodwill and rights in the tax basis balance sheet, so there is usually no tax basis cost for the goodwill in the seller's books and it represents pure taxable income.

Depreciation

The depreciation period of an asset is refreshed in an asset deal. The selling entity may deduct all remaining net book value of assets as the tax basis cost against the transfer value; and the buyer has to book the assets at their transfer value and start depreciating a new term of useful life for each asset (as prescribed by the Communiqués of the Ministry of Finance).

Tax attributes

The tax attributes, such as tax losses and incentives, are not transferred to a buyer in an asset deal. The selling entity has the right to use its existing tax losses and VAT credits against the taxable profits (such as capital gains) and VAT obligations arising from the asset transfer.

Where the target has used an Investment Incentive Certificate (common in energy investments), the transfer of assets for the first 5 years is subject to the permission of the Turkish Treasury. The transfer also may cause a denial of potential tax exemptions to which the seller is already entitled under the certificate.

On the other hand, the potential tax liabilities of the seller should not transfer to the buyer in an asset deal. An exception is identified in the Law Regarding Collection of Public Receivables. Under this provision, the tax office may put aside

a transaction and pursue the assets if the deal is structured to avoid payment of the seller's tax liabilities (which may only be possible in the case of related-party transactions).

Value added tax

Tax-free mergers (including tax-free mergers of small and medium-sized enterprises) and tax-free divisions that meet certain conditions in the Corporate Tax Law are exempt from VAT.

Taxable mergers and asset transactions (including transfers of goodwill) are generally subject to VAT at 18 percent. There is an exemption for real estate property or shares/participation rights held by a company for at least 2 years and transferred through an asset deal.

The purchaser is entitled to recover the VAT so incurred against its output VAT generated from its operations. As a result, the recovery of input VAT may impose a financial burden (time value of money) if the capacity to generate output VAT is limited after the acquisition.

Sales of shares in an AS company are exempt from VAT. A sale of shares in a Ltd. company by another company is exempt from VAT, provided the participation is held for at least 2 years. A sale of shares by an individual is not subject to VAT.

Transfer taxes

Certain documents prepared in Turkey (e.g. share-purchase agreements, loan contracts, mortgage instruments) are subject to stamp duty, usually at 0.948 percent. Loan contracts (and security documents, such as mortgages) for loans from local and foreign banks are exempt from the stamp duty.

Merger agreements are also subject to stamp duty. A stamp duty exemption is available for documents related to tax-free mergers or tax-free divisions (that meet the conditions in the Corporate Tax Law) and documents related to the sale of real estate property or shares/participation rights held by a company at least 2 years.

In an asset deal involving a transfer of title to real estate, the seller and buyer are each subject to a title deed registration fee of 2 percent.

Purchase of shares

An acquisition of shares by a foreign entity has no immediate Turkish income tax consequences.

If the acquisition is made through a Turkish branch or subsidiary, goodwill implicit in the share price cannot be recognized for tax amortization purposes. Further, it is not possible to achieve a tax basis step-up for the target company assets.

A change in the shareholders does not affect the tax attributes of the target company.

Tax indemnities and warranties

In a share deal transaction, the historical tax liabilities of the target (known or unknown) remain in the company and are acquired by the new shareholder(s). The buyer usually asks for tax indemnities and warranties in a share acquisition.

In Turkey, the accounts of a company are open for tax audit for 5 years. There is no procedure to agree the tax status of a company with the tax authorities. In view of this, and due to insufficient coverage of tax audits in Turkey (i.e. tax authorities can only review a limited number of taxpayers and tax litigation cases usually take a long time to resolve), indemnities and warranties are even more stringently applied in share acquisitions in Turkey.

Tax losses

Tax losses can be carried forward for 5 years. No carry back is possible.

After the acquisition of shares, the target company can continue to carry forward its tax losses without any further requirements.

Tax losses of the merged entity can be used by the merging entity if tax-free merger conditions are met.

Crystallization of tax charges

Since the transfer of shares in a company has no effect on the tax status of the assets, this issue is not applicable for Turkey.

Pre-sale dividend

If the target entity has retained profits available for distribution as dividends, the potential tax implications of a pre-sale

dividend versus a capital gain should be considered in light of the circumstances of the buyer and seller.

Transfer taxes

Agreements relating to purchases and sales of shares are normally subject to stamp duty at 0.825 percent.

Agreements relating to transfers of shares of Turkish companies by other companies after a holding period of 2 years are exempt from stamp duty by virtue of a specific exemption provided by the Corporate Tax Law.

Tax clearances

It is not possible to ask for tax clearances from the Turkish tax authorities regarding the tax status of a company.

It is only possible to ask for an official statement from the tax office outlining the reported but unpaid tax liabilities of the company or confirming that there are no overdue and unpaid tax obligations. Such statements do not provide assurance against contingent tax liabilities that may be identified in the course of a tax audit.

It is possible to ask for advance tax rulings for specific structural tax uncertainties in a merger or acquisition.

Choice of acquisition vehicle

This section discusses the acquisition vehicles that may be used in structuring a merger or acquisition in Turkey.

In all cases, there is no capital duty or stamp duty on injecting equity into a Turkish company or branch. The equity contribution is subject to a fund (i.e. contribution to the Competition Board) of 0.04 percent (four per 10,000).

Local holding company

A Turkish holding company usually is structured as an AS or Ltd. company, or as a specific holding company, which the TCC defines as a special type of an AS formed with the primary purpose of investing in other companies. There is no material taxation difference between these forms. However, the special holding company is advantageous because it has a higher dividend capacity than other forms.

Turkish corporate tax law also specifies a special holding company regime and related tax incentives for the purpose of holding the shares or foreign investments through a holding company in Turkey.

A Turkish holding company is not usually seen as efficient. The absence of a tax grouping regime in Turkey means that the acquisition costs and interest expenses at the level of holding company cannot be offset against the target's profits. In theory, it is possible to achieve a deductibility of acquisition costs and interest expenses through a post-acquisition merger of the holding company into the target. However, such structures are under scrutiny by the Turkish tax authorities and have been challenged through the substance-over-form principle. Such structures should be analyzed carefully, and professional advice should be sought on a case-by-case basis.

A Turkish holding company may be a tax-efficient option if the acquisition in Turkey is financed with equity rather than debt, and the foreign investor intends to re-invest in Turkey. In this case, the Turkish holding company can receive dividends from the target entity without any tax leakage (i.e. due to participation exemption rules) and use such dividends for re-investment in other Turkish businesses.

Foreign parent company

The foreign purchaser may choose to make the acquisition itself, perhaps to shelter its own taxable profits with the financing costs, without causing any direct taxation problems in Turkey. However, because Turkey charges withholding tax (WHT) on interest and dividend payments to a foreign party, an intermediate company resident in a more favorable treaty territory may be preferable.

Non-resident intermediate holding company

To ensure a more tax-efficient flow of payments from the Turkish entity to its foreign parent and eliminate potential capital gains tax on a subsequent exit, an intermediate holding company resident in another territory could be used. When determining the applicability of treaty benefits, Turkish tax authorities usually rely on a tax-residency certificate issued by the tax authorities of the territory in which the intermediary

holding is located. As a result, any substance tests should be considered from the perspective of the tax laws of the territory in which the intermediary holding is to be located.

Local branch

A foreign company may hold the shares of a Turkish target through a branch established in Turkey. Although the branch is regarded as a non-resident for tax purposes, it is subject to tax rules similar to those applying to other company forms in terms of its Turkish income and transactions.

In practice, a branch is not seen as a favorable option for several reasons:

- Dividends paid from a Turkish target to the branch are not entitled to participation exemption.
- The remittance of profits and dividends from the branch to its foreign parent is subject to WHT.
- It is an inflexible structure because the branch cannot be legally transferred to a third party later on exit.

Joint venture

A joint venture can be established between a Turkish company and one or more local or foreign entities. If such a joint venture company is incorporated, it takes an ordinary legal form of either an AS or Ltd. and is subject to the same tax implications. An incorporated joint venture may be registered for tax purposes, but it can only be used for specific contractual works and is not available as a holding company structure.

Choice of acquisition funding

A purchaser structuring an acquisition in Turkey needs to consider whether to fund the vehicle with debt or equity. Hybrid financing instruments are not recognized for tax purposes in Turkey, so it is usually necessary to follow the legal definition when classifying a financing structure as debt or equity and assessing the tax implications.

The principles underlying these approaches are discussed below.

Debt

There is no limit on the amount of debt that can be put into a Turkish company and no general restriction on the deductibility of interest. Interest expenses incurred for business purposes are deductible on an accrual basis.

Interest expenses incurred for financing an asset acquisition need to be capitalized as the depreciated cost of the asset until the end of the year in which the asset is acquired.

Interest expenses incurred thereafter can either be recognized as period expenses or capitalized.

The deductibility of interest may be restricted by thin capitalization or transfer pricing rules (discussed later in this chapter).

Debt financing from a foreign source may attract a surcharge (0 to 3 percent) if it is in the form of a foreign loan and based on the average maturity of the loan. This can be avoided by structuring the loan in a foreign currency and with an average maturity of 3 years or more.

Debt financing from a local source in Turkey (such as a bank) does not attract such surcharge. However, the interest payments may be subject to a banking transaction tax, generally at 5 percent.

Deductibility of interest

As noted earlier in this chapter, Turkish tax laws do not impose a general restriction on deductibility of interest. Some specific restrictions are explained below.

Thin capitalization rules

Where the amount of debt (measured at any time during the year) provided to a Turkish entity by its shareholders (or related parties) exceeds three times the equity (i.e. shareholders' equity measured as per the statutory accounts opening balance sheet of the period concerned), the excess of debt above the 3:1 ratio is re-characterized as disguised equity. As a consequence of this thin capitalization status:

- Financing expenses incurred on the disguised equity (related-party debt exceeding three times shareholders' equity) cannot be deducted for corporate tax purposes.

- Interest actually paid on the disguised equity is re-characterized as disguised dividends and subject to dividend WHT at 15 percent (unless reduced by treaty).

Injecting equity or reserves into the company within a period does not help to overcome the thin capitalization status for the current period, because the shareholders' equity is measured as at the opening balance sheet, but it may help for subsequent periods.

When debt is obtained from an external bank against cash guarantees provided by the shareholders, the thin capitalization rules still apply.

Transfer pricing rules

When a Turkish entity receives funding from its shareholders (or related parties), the interest and other expenses charged on the loan should be at arm's length. Any excess paid by the Turkish entity above an arm's length rate cannot be deducted for corporate tax purposes. The excess amount is re-characterized as disguised dividends and subject to dividend WHT at 15 percent (unless reduced by treaty).

Turkey's transfer pricing regulations are similar to the OECD guidelines; normally any report or documentation prepared in a foreign country employing the same rules should be suitable as supporting documents in Turkey.

Interest incurred on share acquisition

Generally, expenses incurred for the purpose of tax-exempt activities are not deductible against income from other taxable activities of a company. Previously, this general rule posed problems for a holding company with interest expenses incurred for the purpose of acquiring shares in another Turkish entity, which potentially led to tax-exempt dividend and capital gains income.

The new Corporate Tax Law stipulates that a holding company in a similar position has the right to deduct such interest expenses against taxable income derived from other activities. In practice, however, a pure holding company does not generate other taxable income. Thus, interest expenses carried forward as tax losses may expire after the carry forward period of 5 years. Further post-acquisition structuring may be required.

Withholding tax on debt and methods to reduce or eliminate it

Interest payments to non-resident corporations are subject to WHT at varying rates of 0 percent, 1 percent, 5 percent and 10 percent. The WHT rate is reduced to 0 percent where the interest is paid to a lender who qualifies as a foreign bank or financial institution.

Interest payments to foreign parties other than banks may attract 18 percent VAT on a reverse-charge basis if the foreign party receiving the interest does not qualify as a bank or financial institution. A stamp tax of 0.948 percent applies on the loan contract unless the loan is received from a bank or financial institution.

Therefore, it is usually less efficient to borrow directly from the Turkish entity and its foreign parent/group entity. These tax inefficiencies may be eliminated through some additional structures.

The new Corporate Tax Law introduced anti-avoidance rules for transactions with entities in low-tax jurisdictions (tax havens). A 30 percent WHT applies to various types of payments to residents of those jurisdictions, which will be named on a list to be published by the Ministry of Finance. The impact of these rules on the ultimate WHT application should be considered.

Checklist for debt funding

- The use of external bank debt may avoid thin capitalization and transfer pricing problems, but debt obtained from an external bank against cash guarantee provided by the shareholders is still subject to thin capitalization rules.
- The use of external bank debt (even with a guarantee by shareholders) should eliminate the WHT and VAT implications on interest payments unless the structure is open to challenge on substance grounds.
- In addition to thin capitalization rules that apply to borrowings from related parties, up to 10 percent of the financing expenses incurred on all borrowings that exceed the shareholders' equity of the company can be classified as non-deductible expense (this rule will enter into force when the Council of Ministers issues a Decree to determine the rate of restriction, up to 10 percent).
- The absence of tax grouping means interest expenses incurred by a holding company in Turkey cannot be offset

against taxable profits of the target. Such an expense can be carried forward as a tax loss to be offset against any other taxable gains that may arise in future.

- Contributions to the equity and reserves of the Turkish entity in one year are included in the debt-to-equity calculation for the following year. When considering the required related-party debt capacity of the following year, any required injection to equity or reserves by the shareholders should be completed before the current period ends.
- Tax deductions may be available at higher rates in other territories.
- A debt from a foreign source may attract a surcharge (0 to 3 percent), if it is in the form of a foreign loan and based on the average maturity of the loan. This can be avoided by structuring the loan in a foreign currency and with an average maturity of 3 or more years.
- A debt from a local source (such as a bank) in Turkey does not attract such a surcharge. Interest payments may be subject to a banking transaction tax, generally at 5 percent.

Equity

Equity injections are subject to a competition board fee of 0.04 percent, with no limit and including additional capital injections to the corporation. The fee is also payable on capital in kind contributions. No other taxes or duties are levied on equity funding.

The level of equity funding in a Turkish entity may need to be considered for other reasons, such as:

- More equity may lead to an increased legal reserve requirement in the entity (as a percentage of the equity), and so reduce the dividend capacity.
- Equity is less flexible should the parent subsequently wish to recover the funds because the reduction of equity in a Turkish company is subject to a regulated process that requires, among other things, the approval of a Trade Court.
- In view of Turkey's thin capitalization rules (3:1 debt-to-equity ratio), a tax-efficient related-party financing structure may require a review of the equity level in the entity.

- There may be other non-tax grounds for preferring equity. For example, in certain circumstances, it may be desirable for a company to have a pre-determined debt-to-equity ratio. This may apply to companies that are subject to industrial regulations (e.g. Turkish holding company of a bank or insurance company) or that expect to submit public bids (e.g. privatization projects or license applications).

Tax-free reorganizations

Turkish Corporate Tax Law allows for tax-free mergers, divisions and share swaps, provided that certain procedural obligations are complied with. Such tax-neutral reorganizations are performed on the basis of book values (i.e. no step-up for the value of the assets), and the historical tax liabilities, if any, are assumed by the surviving entities.

Hybrids

Hybrid financing instruments are not recognized for tax purposes in Turkey. It is usually necessary to follow legal definitions to classify a financing structure as debt or equity and determine the tax implications.

The thin capitalization rules also need to be considered where the lender is a related party.

Discounted securities

The tax treatment of securities issued at a discount differs from the accounting treatment in that the issuer cannot immediately deduct the difference between nominal and discounted values unless the limits are allowed by the law and the authority granted by the law. In Turkey, the main borrower is the government. Few private debt securities are issued by the private sector.

Deferred settlement

An acquisition often involves an element of deferred consideration, the amount of which can only be determined at a later date on the basis of the business's post-acquisition performance. The right to receive an unknown future amount is not regarded as an asset that must be valued for Turkish tax purposes. Such amounts should represent a part of the

transaction (as a tax-triggering event) at the date when the due amounts can be calculated and claimed by the parties according to the terms and conditions of the contract.

For example, in a normal share acquisition structure, the deferred settlement amounts should be included in the final purchase price as a price adjustment and may be taxed or exempted, depending on the tax status of the original transaction.

Other considerations

Turkey normally does not tax the gains of non-residents except where the non-resident has a permanent establishment or a permanent representative in Turkey and the income can be attributed. A specific tax regime applies to capital gains derived from disposal of shares by a non-resident. The gain on sale of shares/participation rights of a company in Turkey may become taxable in Turkey:

- if the transaction occurs in Turkey
- if the transaction is valued in Turkey.

Such transactions have to be evaluated for Turkish tax purposes, depending on the status of the buyer and the seller, the type of the entity whose shares are being transferred, and the method used to effect the share transfer.

Concerns of the seller

The seller is liable to tax on gains realized on the sale of the assets of a business. Losses arising from the sale of assets can be immediately deducted or carried forward.

The seller is liable to tax on gains arising from the sale of shares. Losses are available to offset income from other activities of the corporation.

Seventy-five percent of the gains derived from sale of real estate property or sale of shares of a Turkish company by another Turkish company may be exempted from corporate taxation, provided such property was held for at least 2 years and the exempt gains are retained in a special reserve account for 5 years. This requirement not to repatriate funds for 5 years may be impossible to satisfy, of course, if the seller plans to leave the business entirely.

Since gains derived by a Turkish individual from the sale of shares of a Turkish AS after 2 years are tax-exempt, the seller would strongly oppose structuring the transaction as an asset deal or expect the purchaser to bear the resulting tax by way of a corresponding increase in purchase price.

Moreover, apart from taxation reasons, a seller in need of cash would be reluctant to agree to an asset deal because the repatriation of cash from the selling entity to its shareholders would also pose problems.

Company law and accounting

A foreign company may do business in Turkey by operating as a contractor, establishing a branch, or forming a subsidiary. All became subject to the TCC as of 1 July 2012.

The uniform chart of accounts (as defined by the Turkish Tax Procedural Code) is compulsory for all companies except those subject to regulatory and/or supervisory agencies, which should use Turkish Financial Reporting Standards (TFRS) for their sectors, including banks, brokers, and insurance, leasing and factoring companies. TFRS is aligned with International Financial Reporting Standards (IFRS). The annual accounts for all companies must include an income statement, balance sheet and notes to each. Accounts must be drafted and approved by the general shareholders meeting within 3 months of the end of the financial period.

With the implementation of the TCC, all companies have continued keeping their legal books in accordance with Turkish Tax Procedural Code and applying the uniform chart of accounts. Companies that meet criteria set out in the Law also are required to present their financial statements in line with TFRS (which is identical to IFRS), as of 1 January 2013, and it is mandatory for those companies to issue financial statements subject an external audit requirement.

Group relief/consolidation

Consolidation for tax purposes is not allowed. Each entity is subject to tax on a standalone basis.

Transfer pricing

Turkey's transfer pricing regulations took effect in 2007. They generally align with the OECD model. The regulations

are applicable to domestic and cross-border transactions between related parties. However, a transfer pricing adjustment is not required for domestic transactions between Turkish tax-registered entities as long as there is no ultimate fiscal loss for the government.

The regulations require prices, fees and charges for intercompany transactions (including interest on intragroup financing) to be determined on an arm's length basis, as determined by an acceptable methodology.

Dual residency

Dual residency status is not mentioned in Turkish tax laws, so it is not relevant from a Turkish tax perspective when structuring an M&A transaction in Turkey.

Foreign investments of a local target company

Turkey has introduced a controlled foreign company (CFC) regime in the new Corporate Tax Law. CFC status is determined by a number of criteria. Normally, an operating company with an active business should not be classified as a CFC. On the other hand, an intermediary holding company owned by a Turkish company is likely to be deemed a CFC where the intermediary holding benefits from a participation exemption regime and effectively pays no taxes in its territory. The acquisition of shares in a Turkish target should not lead to a change in the CFC status of its foreign investments.

Turkey also introduced a holding regime in the new Corporate Tax Law to encourage holding foreign investments through a company established in Turkey. The form of the company can be the usual AS or Ltd.

There are no particular requirements from a Company Law perspective to qualify as a holding company.

If the holding company meets the conditions stipulated in the Corporate Tax Law, the dividends and potential capital gains on investments by the Turkish target can be fully exempt from corporate taxes. Further, the dividend WHT to be applied during the ultimate repatriation of profit from the Turkish target to its shareholders is reduced to 7.5 percent (instead of 15 percent).

Comparison of asset and share purchases

Advantages of asset purchases

- Purchase price can be depreciated or amortized for tax purposes.
- Step-up in tax basis (through revaluation) is obtained.
- Previous liabilities of the seller are not inherited.
- Possible to acquire part of the business.
- More flexibility in funding.
- Possible to absorb a profitable business into a loss-making company.

Disadvantages of asset purchases

- Potential need to renegotiate existing agreements and renew licenses, among others.
- More transaction costs (e.g. stamp taxes, title deed registration fees).
- Exemptions on sale of shares are not applicable.
- Tax losses remain with the seller.
- Not favorable for the seller in terms of cash flow.

Advantages of share purchases

- Purchase on net asset basis, so lower capital outlay.
- Likely more attractive to the seller due to available tax exemptions and cash flow.
- Buyer acquires tax attributes of the target, including tax losses.
- Buyer continues to enjoy existing contracts and licenses, among others.

Disadvantages of share purchases

- Acquisition of potential tax liability (difference between market value and tax basis of assets in the target company, which would be crystallized in future on disposal of such assets).
- Inability to recognize goodwill for tax depreciation.
- Acquisition of contingent (unknown) tax liabilities of the target.

Turkey – Withholding tax rates

This table sets out reduced withholding tax rates that may be available for various types of payments to non-residents under Turkey's tax treaties. This table is based on information available up to 1 November 2013.

Source: *International Bureau of Fiscal Documentation, 2014*

	Dividends		Interest ¹ (%)	Royalties (%)
	Individuals, companies (%)	Qualifying companies ² (%)		
Domestic rates				
<i>Companies:</i>	15	15	0/1/3/5/7/10/12/13/15/18	20
<i>Individuals:</i>	15	N/A	0/3/7/10/12/13/15/18	20
Treaty rates				
<i>Treaty with:</i>				
Albania	15	5	10	10
Algeria	12	12	10	10
Australia ³	15	5	10	10
Austria	15	5 ⁴	10/15 ⁵	10
Azerbaijan	12	12	10	10
Bahrain	15	10	10	10
Bangladesh	10	10	10	10
Belarus	15	10	10	10
Belgium	10/20 ⁶	10/15	15	10
Bosnia and Herzegovina	15	5	10	10
Brazil	15	10	15	10/15 ⁷
Bulgaria	15	10	10	10
Canada	20	15 ⁸	15	10
China (People's Rep.)	10	10	10	10
Croatia	10	10	10	10
Czech Rep.	10	10	10	10
Denmark	20	15	15	10
Egypt	15	5	10	10
Estonia	10	10	10	5/10 ⁹

	Dividends		Interest ¹ (%)	Royalties (%)
	Individuals, companies (%)	Qualifying companies ² (%)		
Ethiopia	10	10	10	10
Finland	15	5	5/10/15 ¹⁰	10
France	20	15	15	10
Georgia	10	10	10	10
Germany	15	5	10	10
Greece	15	15	12	10
Hungary	15	10	10	10
India	15	15	10/15	15
Indonesia	15	10	10	10
Iran	20	15	10	10
Ireland	10	5/10 ¹¹	10/15 ¹²	10
Israel	10	10	10	10
Italy	15	15	15	10
Japan	15	10 ¹³	10/15	10
Jordan	15	10	10	12
Kazakhstan	10	10	10	10
Korea (Rep.)	20	15	10/15 ¹⁴	10
Kuwait	10	10	10	10
Kyrgyzstan	10	10	10	10
Latvia	10	10	10	5/10
Lebanon	15	10 ¹⁵	10	10
Lithuania	10	10	10	5/10
Luxembourg	20	10	10/15	10
Macedonia (FYR)	10	5	10	10
Malaysia	15	10	15	10
Malta	15	10	10	10

	Dividends		Interest ¹ (%)	Royalties (%)
	Individuals, companies (%)	Qualifying companies ² (%)		
Moldova	15	10	10	10
Mongolia	10	10	10	10
Montenegro	15	5	10	10
Morocco	10	7	10	10
Netherlands ²⁶	20	15	10/15	10
New Zealand	15	5	10/15	10
Norway	15	5 ¹⁶	5/10/15 ¹⁷	10
Oman	15	10	10	10
Pakistan	15	10 ¹⁸	10	10
Poland	15	10	10	10
Portugal	15	5 ¹⁹	10/15	10
Qatar	15	10	10	10
Romania	15	15	10	10
Russia	10	10	10	10
Saudi Arabia	10	5 ²⁰	10	10
Serbia	15	5	10	10
Singapore	15	10	7.5/10	10
Slovak Rep.	10	5	10	10
Slovenia	10	10	10	10
South Africa	15	10	10	10
Spain	15	5	10/15 ²¹	10
Sudan	10	10	10	10
Sweden	20	15	15	10
Switzerland	15	5 ²²	5/10 ²³	10
Syria	10	10	10	10/15 ²⁴
Tajikistan	10	10	10	10

	Dividends		Interest ¹ (%)	Royalties (%)
	Individuals, companies (%)	Qualifying companies ² (%)		
Thailand	15	10	10/15	15
Tunisia	15	12	10	10
Turkmenistan	10	10	10	10
Ukraine	15	10	10	10
United Arab Emirates	12	10	10	10
United Kingdom	20	15	15	10
United States	20	15 ²⁵	10/15	5/10
Uzbekistan	10	10	10	10
Yemen	10	10	10	10

Notes:

1. Many treaties provide for an exemption for certain types of interest, e.g. interest paid to the state, local authorities, the central bank, export credit institutions or in relation to sales on credit. Such exemptions are not considered in this column.
2. Unless stated otherwise, the reduced treaty rates given in this column generally apply if the recipient company holds directly or indirectly at least 25 percent of the capital or the voting power, as the case may be, of the company distributing dividends.
3. Effective from 1 January 2014.
4. This rate applies if the Austrian company owns at least 25 percent of the capital in the Turkish company, provided that such dividends are exempt from tax in Austria.
5. The lower rate applies to interest paid to a bank or other financial institution (as the case may be).
6. If under the provisions of the Belgian laws, a company resident of Belgium is not charged to corporate income tax with respect to dividends received from a company resident of Turkey, the 10 percent rate applies.
7. The higher rate applies to trademarks.
8. This rate applies if the non-resident company owns at least 10 percent of the capital in the Turkish company.
9. The lower rate applies to equipment leasing.
10. The rate is 5 percent in respect of a loan or credit made, guaranteed or insured for the purposes of promoting export by the Finnish Export Credit or the FINNVERA or similar Turkish public entities whose objective is to promote exports; 10 percent if the recipient is a bank; and 15 percent in other cases.
11. The 5 percent rate applies if the Irish company has held directly at least 25 percent of the voting power of the Turkish company and dividends have been paid out of profits that have been subject to tax in Turkey.
12. The lower rate applies to interest paid in respect of a loan or other debt claim for a period exceeding 2 years or if the interest is received by a financial institution.
13. This rate applies if the Japanese company has owned at least 25 percent of the voting shares in the Turkish company for 6 months immediately before the end of the accounting period for which the dividends are paid.
14. The lower rate applies to interest paid on a loan made for a period of more than 2 years.
15. This rate applies if the non-resident company owns at least 15 percent of the capital in the Turkish company.
16. This rate applies if (i) the dividends are derived by the Government Pension Fund (Statens Pensjonsfond) and provided that such dividends are exempt from tax in Norway, or (ii) the beneficial owner is a company (other than a partnership) which holds directly at least 20 percent of the capital of the Turkish company paying the dividends, provided that such dividends are exempt from tax in Norway.
17. The 5 percent rate applies if the interest is paid to the Government Pension Fund (Statens Pensjonsfond), the Norwegian Guarantee Institute for Export Credits (Garantiinstituttet for Eksportkredit) or Eksportfinans ASA. The 10 percent rate applies if the interest is paid to a bank.
18. This rate applies if the Pakistani company holds at least 25 percent of the capital in the Turkish company and the Turkish company is engaged in an industrial undertaking.
19. This rate applies if the Portuguese company has owned directly at least 25 percent of the capital in the Turkish company for at least 2 years.
20. This rate applies if the Saudi company owns directly at least 20 percent of the capital in the Turkish company.
21. The lower rate applies to interest on loans from credit institutions and interest in relation to sales on credit.
22. This rate applies if the beneficial owner is a company (other than a partnership) which holds directly at least 20 percent of the capital of the company (under conditions).
23. The 5 percent rate applies if the interest is paid in respect of a loan or credit made, guaranteed or insured for the purposes of promoting export by an Eximbank or similar institution, the objective of which is to promote the export.
24. The lower rate applies to copyright royalties.
25. This rate applies if the US company owns at least 10 percent of the voting shares in the Turkish company.
26. Dividend WHT tax may reduce to 10 percent for dividends paid by Turkey to Dutch parent under treaty protocol and reduces to 5 percent for Dutch sourced dividend payments to Turkey under the same article in the treaty protocol.

KPMG in Turkey

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