

# Giving a facelift to the Turkish tax system

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Almost all tax reforms aim at a single goal: to increase revenue. But Turkey’s 2007 reform was different—simplifying and modernizing the tax system were the key goals. Ali Babacan, Turkey’s State Minister for the Economy, emphasized in October 2005 that “What is important for us is that the system is modernized and aligned with world standards.” Income tax was the big problem, both personal and corporate.

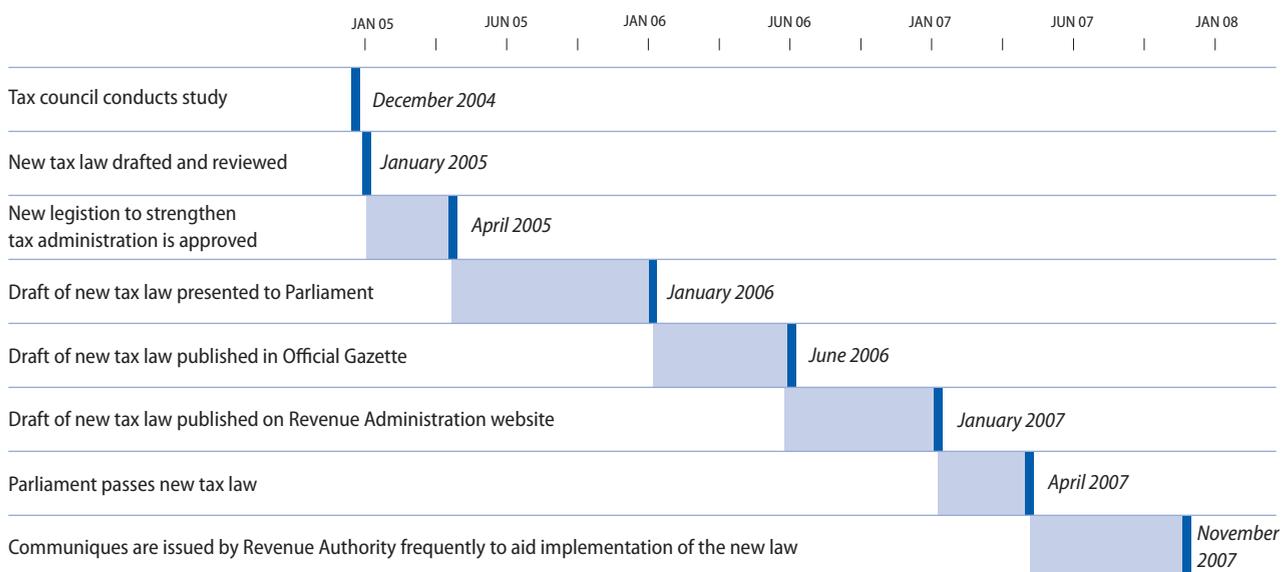
Corporate Income Tax Law 5422 was antiquated and uncoordinated, lacking provisions for such modern tax concepts as transfer pricing, thin capitalization, and foreign participation. It was a barrier to pragmatic business planning. The law also contained scores of temporary provisions, almost equal in number to its permanent ones. And some of the temporary provisions overruled the permanent provisions, leading to uncertainty and inefficiency. Add the law’s numerous exemptions, clothed as investment incentives, and the result was a clumsy maze for potential investors. “In short,” a Revenue Administration Official remarks, “the old corporate tax law was not satisfying the need of foreign investors.”

The government was concerned that the corporate tax law was hindering foreign direct investment. Over 2 years foreign investment had jumped from \$3 million

FIGURE 1

## Timeline of tax reform in Turkey

Source: Doing Business database.



to \$20 million, despite the problems with the law. What could be achieved if the problems were solved?

The government thus decided to reform. While it remains too soon to see the effects, the first signs are promising

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### **Weeding out corporate tax bottlenecks**

The Tax Council—composed of tax consulting firms, the Revenue Administration, academics from local universities, members of the Association of Turkish Manufacturers and Businessmen (TUSAID), the Chamber of Commerce, and nongovernmental organizations—was fundamental to the reform. The Council conducted a study on the corporate tax law and system. In late 2004 it began drafting a new law, which took about 9 months.

The International Monetary Fund was also involved, mainly by providing technical support to the Turkish government under a 3-year stand-by arrangement. The International Monetary Fund focused on budgetary prospects and policies, tax reforms, measures to strengthen tax administration, plans for implementing the newly approved reforms, and progress in further strengthening and reforming bank supervision.

Once the first draft was complete, it underwent a high-level review under the guidance of the Finance Minister. After that, the draft law was published on the Internet for public comments. The Tax Council then undertook a further review of the draft law, followed by a Revenue Administration appraisal, before its presentation to Parliament for debate in early 2006. The draft was published in the Official Gazette on 21 June 2006 and on the website of the Revenue Administration for public comments on 12 January 2007. It passed into law on 3 April 2007 as the Corporate Income Tax Law 5520. Most of its provisions took effect retroactively, as of 1 January 2006.

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### **Introducing novel concepts for corporate taxation**

The reform introduced new corporate taxation concepts and dealt more clearly with areas hardly regulated in the country before. The most novel changes were in transfer pricing, thin capitalization, anti-avoidance measures, foreign participation exemptions, and provisions specific to controlled foreign companies.

The new transfer pricing provisions got the attention of multinationals based in Turkey. Turkey's law now formally adopted the arm's length principle established by the Organisation for Economic Co-operation and Development regime under its Transfer Pricing Guidelines for Multinational Enterprises and Tax Adminis-

trations. Applicable to all transactions between related parties, the provisions introduced new documentation requirements for multinationals operating in the country—in keeping with worldwide trends.

Also remarkable is that for the first time, anti-abuse legislation became part of Turkey's tax law. The goal was to enhance the efficiency of the tax collection system and to seal loopholes, particularly for remittances to tax havens. But to ensure flexibility, the law exempted payments to specific financial institutions from the rigorous demands of the anti-abuse provisions. The Council of Ministers also retained powers to adjust tax rates for certain foreign payments where there was potential for revenue diversion.

The Act widened the income subject to tax for controlled foreign corporations. Under some circumstances the profits of controlled foreign corporations are now taxed as part of the income of its locally resident controlling entity. At the same time the tax paid on the offshore income of the controlled foreign corporation is eligible for a tax credit.

Local holding companies benefited from the new foreign participation exemption. Under certain conditions, dividends and capital gains from offshore subsidiaries are now exempt from income tax in Turkey.

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### **Educating the public—but not soon enough**

Once the new law came into effect a key challenge to implementation came from eliminating tax exemptions and allowances, particularly for investment. It was no surprise that eliminating exemptions faced stiff opposition—especially from those who had previously benefited.

Eliminating these exemptions was meant to simplify the tax code by doing away with special treatment. But opponents argued that the elimination removed necessary tax incentives for corporations.

To arrive at a win-win solution, the government offered affected taxpayers a choice. A revenue official explains, “We introduced a 3-year ‘grandfathering’ system, under which a taxpayer could opt either for a higher tax rate and use investment allowances or for a lower rate without investment allowances.”

The new tax concepts also raised challenges. The government official notes, “Despite our intention to modernize our law by introducing modern ideas, there were problems in the practical application of some new concepts, particularly transfer pricing and thin capitalization.” Why? There were no clear guidelines on the exact compliance procedures.

The Ministry of Finance attempted to solve the problem with communiqués that further explained and clarified. But the communiqués were late in coming. “We began using the communiqués extensively in late 2007, but we should have started earlier,” says a government official.

The delayed communiqués created tax compliance problems because the law was vague on some of the new concepts. Even so, the communiqués, now available to the public through the Internet, have helped. But they can be bulky—some as long as 360 pages.

### Effects on revenue—not yet clear

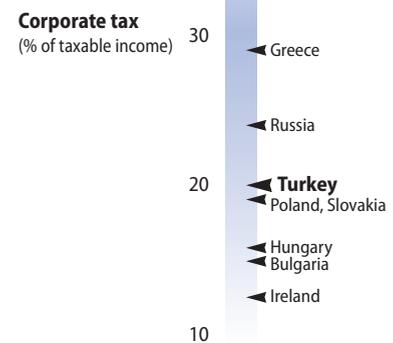
One of the most visible changes introduced by the new law was a 10% reduction in corporate tax rates, from 30% to 20%. On the other hand, the withholding tax rate on profit distribution increased from 10% to 15%.

The new law had an initial negative impact on revenue collection. “Generally,” comments an official, “the Revenue Administration reported a reduction in the amount of revenue collected in 2007, given the lowered tax rates.” The tax revenue from declared corporate income decreased by YTL 211,401,000 (approximately USD 168,196,393).

More positively, the amount of declared taxable income increased even as the number of taxpayers remained constant. The reason was that lower tax rates applied: fewer taxpayers understated taxable income, because they expected to pay less tax on the whole.

As a baseline, an expected long-term outcome of tax reform is to increase revenue by broadening the tax base, improving compliance fundamentals and sealing gaps for revenue leakage. A lesson to be learnt from this case study is that while tax rate reductions may generate increased revenues in the medium term, tax revenues do not always increase in the short term since it takes time for revenue base to increase. Turkey expects to collect higher tax returns in the medium term, particularly if the higher gross domestic product growth of 5.3% for 2007 persists. Tax reform has been cited as a driver of the impressive macroeconomic performance.

FIGURE 2  
Turkey's post reform corporate tax rate compared to selected countries, 2006



Source: Doing Business database.