

Report

[Client]

22.08.2017

I. Facts

Since 2015, [Client] has been rendering services for a company of the group B... Enerji in Turkey (drilling, planning, supervision etc.). [Client] is working with a German sub-contractor, G GmbH from N. This combination corresponds to the express wish of the principal.

Within the framework of a general agreement, the client has rendered services related to a test drilling in 2016. On the invoice for the services, B Enerji had to pay **withholding tax**.

A second general agreement provides that for the next drilling [Client] should establish a company or subsidiary in Turkey. [Client] had made preparations for this purpose before the putsch in July 2016. Following that incident some projects were stopped, the programme of B Enerji became delayed to an important extent.

Now, B Enerji wants to continue in its program, therefore [CLIENT] feels a need to recover the subject „subsidiary/withholding tax“.

[CLIENT] has obtained some information about the subject „withholding tax“. The client has got the impression that the problem „withholding tax“ would only be shifted from B Enerji to the new company/subsidiary of [CLIENT] in Turkey and that at the end [CLIENT] and its sub-contractor GTN would lose an amount covered by the withholding tax with is 20%. This result is not acceptable.

II. The Problem

The question to be resolved relates to means and possibilities to avoid the withholding tax or to ensure that it is refunded, if the German-Turkish Double-Taxation Agreement provides a solution, if it makes sense to establish a company in Turkey.

III. Turkish Tax Law

1. Overview

The Turkish tax system resembles to tax systems like the German or French system. Income is subject to taxation as „income tax“. The „corporate tax“ is imposed on the profit of capital stock companies such as the joint stock company (anonim şirket) or the limited liability company (limited şirket). A speciality of the Turkish tax system is the “withholding tax” which has to be paid by the debtor who pays on an invoice of a service provider.

2. Corporate Tax

For tax purposes, companies are grouped as limited liability companies (corporations and limited companies) and personal companies (limited and ordinary partnerships). State economic enterprises and business entities owned by societies, foundations and local authorities are also subject to corporate taxation.

Whether a company is subject to full or limited tax liability depends on its status of residence. A company whose statutory domicile or place of management are established in Turkey (resident company) will be subject to full tax liability for its worldwide income. If a non-resident company conducts business through a branch or a joint venture, it will have limited liability for tax on profits earned in Turkey on an annual basis. If there is no presence in Turkey, withholding tax will generally be charged on income earned for services provided in Turkey. However, if there is an Avoidance of Double Taxation Treaty, reduced rates or the refund of withholding tax may apply, if the service provider has full and worldwide tax liability in its home country.

The basic corporate income tax rate charged on business profits amounts to 20%. Dividend withholding tax is also applied in the event of profit being distributed to

shareholders. For resident corporations, tax is charged on worldwide income, but credit is granted for foreign tax payable in respect of income from foreign sources (up to the amount of Turkish corporate income tax, i.e. 20%).

Corporations are required to pay Advance Corporate Income Tax based on their quarterly profits at the rate of 20%. Advance Corporate Income Taxes paid during the tax year are offset against the ultimate Corporate Income Tax liability of the company, which is determined in the related year's Corporate Income Tax return.

Corporations with their statutory domicile and place of management outside Turkey but established in Turkey in the form of a branch are subject to tax on an annual return based on income received from the permanent establishment in Turkey. If an entity has no subsidiary in Turkey, it is not subject to Turkish taxation.

From the non-resident's point of view, many payments abroad including those for professional services and technical assistance, royalties and rentals are subject to withholding tax at rates varying up to 20%. In this regard, countries having avoidance of double taxation treaties with Turkey have considerable advantages. Turkey has signed such treaties with 60 countries, including Germany.

3. Withholding Tax

Under the Turkish tax system, certain taxes are collected through withholding by the payers in order to secure the collection of taxes. These include income tax on salaries of employees, lease payments to individual landlords (not to legal entities as landlords), independent professional service fee payments to resident individuals, and royalty, license and service fee payments to non-residents. Companies in Turkey are responsible to withhold such taxes on their payments and declare them through their withholding tax returns.

At the end, the collection of the withholding tax does not lead to a kind of double taxation, if the proceedings for recoverage are observed. These proceedings to recover the payment of such tax by the payer of an invoice are of a bureaucratic nature, which seems to be more difficult in the transnational context. It must be confessed that this system constitutes a disadvantage in the daily business with Turkey.

IV. Double Taxation

1. Introduction

As there is no principle under international law and no multilateral treaty to avoid double taxation, the issue is completely left to the national tax policy, unless there is a bilateral treaty between the countries involved. As both in Turkey and in Germany the principle of taxation of the world income of an individual or legal entity is applicable, double taxation can only be avoided by such a bilateral treaty.

On 1st of August 2012, the Agreement in force today, between the Federal Republic of Germany and the Republic of Turkey for the Avoidance of Double Taxation and of Tax Evasion with respect to taxes on Income (the "Treaty") came into force with retroactive effect as of 1st of January 2011.

Several scenarios are conceivable where a person's income might be taxed twice, i.e. by Germany and Turkey. For example, a person receiving dividends from a Turkish corporation which maintains a fixed place of residence in Germany and Turkey (dual unlimited taxation) or, as the case may be, is only resident in Germany (the present case: unlimited taxation in Germany, limited taxation in Turkey [limited taxation means: only income in Turkey is subject to taxation, from the point of view of Turkey]).

In our case, we have a company seated in Germany making earnings from a Turkish company seated in Turkey. [Client] is subject to *unlimited taxation in Germany* and, according to Turkish tax law, to *limited taxation in Turkey*, where the Turkish company (the addressee of the invoices of [Client]) is hold responsible for the payment of the corporate income tax of the German service provider in Turkey.

We have now to consider how under the German-Turkish double taxation treaty such double taxation can be avoided and how the responsibility of B Enerji can be removed.

2. Relevant Texts of the German-Turkish Double Taxation Treaty

Article 14

INDEPENDENT PERSONAL SERVICES

1. Income derived by an individual who is a resident of a Contracting State in respect of professional services or other activities of an independent character shall be taxable only in that State. However, such income may also be taxed in the other Contracting State if such services or activities are performed in that other State and if:

a) he has a fixed base regularly available to him in that other State for the purpose of performing those services or activities; or

b) he is present in that other State for the purpose of performing those services or activities for a period or periods amounting in the aggregate to 183 days or more in any continuous period of 12 months.

In such circumstances, only so much of the income as is attributable to that fixed base or is derived from the services or activities performed during his presence in that other State, as the case may be, may be taxed in that other State.

2. The term "professional services" includes especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.

Article 22

ELIMINATION OF DOUBLE TAXATION

1. Double taxation for the residents of Turkey shall be eliminated as follows:

a) Subject to the provisions of the laws of Turkey regarding the allowance as a credit against Turkish tax of tax payable in a territory outside Turkey (as they may be amended from time to time without changing the general principles hereof), German tax payable under the laws of Germany and in accordance with this Agreement in respect of income (including profits and chargeable gains) derived by a resident of Turkey from sources within Germany shall be allowed as a deduction from the Turkish tax on such income. Such deduction, however, shall not exceed the amount of Turkish tax, as computed before the deduction is made, attributable to such income.

b) Where in accordance with any provision of the Agreement income derived by a resident of Turkey is exempt from tax in Turkey, Turkey may nevertheless, in calculating the amount of tax on the remaining income of such resident, take into account the exempted income.

2. Double taxation for the residents of Germany shall be eliminated as follows:

a) Unless foreign tax credit is to be allowed under sub-paragraph b), there shall be exempted from the assessment basis of the German tax any item of income arising in Turkey which, according to this Agreement, may be taxed in Turkey.

In the case of items of income from dividends the preceding provision shall apply only to such dividends as are paid to a company (not including partnerships) being a resident of Germany by a company being a resident of Turkey at least 25 per cent of the capital of which is owned directly by the German company and which were not deducted when determining the profits of the company distributing these dividends.

- b) Subject to the provisions of German tax law regarding credit for foreign tax, there shall be allowed as a credit against German tax on income payable in respect of the following items of income the Turkish tax paid under the laws of Turkey and in accordance with this Agreement:
 - aa) dividends not dealt with in sub-paragraph a);
 - bb) interest;
 - cc) royalties;
 - dd) items of income that may be taxed in Turkey according to paragraphs 2 and 5 of Article 13;
 - ee) items of income that may be taxed in Turkey according to Protocol item 6 with reference to Article 15;
 - ff) directors' fees;
 - gg) items of income that may be taxed according to Article 17.
- c) The provisions of sub-paragraph b) shall apply instead of the provisions of sub-paragraph a) to items of income as defined in Articles 7 and 10 and to the assets from which such income is derived if the resident of Germany does not prove that the gross income of the permanent establishment in the business year in which the profit has been realised or of the company resident in Turkey in the business year for which the dividends were paid was derived exclusively or almost exclusively from activities within the meaning of nos. 1 to 6 of paragraph 1 of section 8 of the German Law on External Tax Relations (Aussensteuergesetz); the same shall apply to immovable property used by a permanent establishment and to income from this immovable property of the permanent establishment (paragraph 4 of Article 6) and to profits from the alienation of such immovable property (paragraph 1 of Article 13) and of the movable property forming part of the business property of the permanent establishment (paragraph 3 of Article 13).
- d) The Federal Republic of Germany, however, retains the right to take into account in the determination of its rate of tax the items of income, which are under the provisions of this Agreement exempted from German tax.
- e) Notwithstanding the provisions of sub-paragraph a) double taxation shall be avoided by allowing a tax credit as laid down in sub-paragraph b)
 - aa) if in the Contracting States items of income are placed under differing provisions of this Agreement or attributed to different persons (except pursuant to Article 9) and this conflict cannot be settled by a procedure in accordance with paragraph 3 of Article 24 and if as a result of this difference in placement or attribution the relevant income would remain untaxed or be taxed lower than without this conflict or
 - bb) if after due consultation with the competent authority of the Republic of Turkey, the Federal Republic of Germany notifies the Republic of Turkey through diplomatic channels of other items of income to which it intends to apply the provisions of sub-paragraph b). Double Taxation is then avoided for the notified income by allowing a tax credit from the first day of the calendar year, next following that in which the notification was made.

Article 27**PROCEDURAL RULES FOR TAXATION AT SOURCE**

1. If in one of the Contracting States the taxes on dividends, interest, royalties or other items of income derived by a person who is a resident of the other Contracting State are levied by withholding at source, the right of the first-mentioned State to apply the withholding of tax at the rate provided under its domestic law shall not be affected by the provisions of this Agreement. The tax withheld at source shall be refunded on application by the taxpayer if and to the extent that it is reduced by this Agreement or ceases to apply.

2. Refund applications must be submitted by the end of the fourth year following the calendar year in which the withholding tax was applied to the dividends, interest, royalties or other items of income.

3. Notwithstanding paragraph 1, each Contracting State shall provide for procedures to the effect that payments of income subject under this Agreement to no tax or only to reduced tax in the state of source may be made without deduction of tax or with deduction of tax only at the rate provided in the relevant Article.

4. The competent authorities may by mutual agreement implement the provisions of this Article and if necessary establish other procedures for the implementation of tax reductions or exemptions provided for under this Agreement.

From the above provisions we learn the following:

If [Client] renders services by its engineers in Turkey, such services are taxable in Germany. However, they may be subject to Turkish tax if the engineers spend at least 183 days per calendar year in Turkey for that purpose.

Without respect to the previous, Turkey is entitled to collect a withholding tax. In that case, the payer of that tax must apply for refund, if the conditions are given.

3. How the Double Taxation Treaty Works

In the transnational relationship between Turkey and Germany, the avoidance of double taxation agreement between Germany and Turkey is helpful as to the handling of the withholding tax.

As a general rule, Germany applies the exemption method, i.e. any income item which may be taxed in Turkey is disregarded for purposes of determining the German tax base, Article 22/2 a of the Treaty. However, Germany retains the right to take into account the exempted items for purposes of determining the tax rate of an individual (so-called progression clause), Article 22/2 d of the Treaty.

As a preliminary result we state:

- (1) As the withholding tax is a kind of corporate income tax, [Client] must declare the respective income and submit a document of the Turkish tax authorities that such tax has been paid. In that case, the tax should be reduced by the amount paid in Germany for such services, which have been exclusively rendered in Turkey. [Client] must prove that it is doing business with Turkey and – by means of a certificate of residence (Sitzbescheinigung) – subject to full taxation in Germany.
- (2) [Client] may also apply to the German tax office to get the tax paid in Turkey refunded by its tax office, if it has fully paid its corporate income tax in Germany, and return the payment to B Enerji. In this case, [Client] must submit a certificate of residence (Sitzbescheinigung), showing that it is seated in Germany and fully taxable in Germany.

However, B Enerji doesn't wish to be involved at all. Therefore, we need to find a solution for [Client] to either avoid such withholding tax or to find a system where such tax is easily refunded. In this context it may be considered that avoiding tax-paying in Germany may be both legal and economically favourable.

V. Establishing An Alternative System

In the present situation it is impossible to avoid that B Enerji is liable to pay the withholding tax. Therefore, we have to consider the following alternatives:

- (1) [Client] provides a document that it is paying corporate income tax in Germany, by its local tax authority (payment under Article 14 *in Germany*). If B Enerji submits this sheet, it should be freed from the withholding tax.
- (2) [Client] establishes a subsidiary in Turkey. This makes sense especially when there are long term business opportunities in Turkey.
 - a. If the subsidiary consists in a branch (*dependent subsidiary*), this branch is subject both to the German and the Turkish taxation. The costs of establishment and management are more or less the same as the costs of establishment and management of an independent affiliate, an

incorporated company under Turkish law. The only advantage is that in case of liquidation of the subsidiary, there are no formal liquidation proceedings to be observed that last at least six months, as all debts and credits are attributed to the mother company in Germany.

- b. If a subsidiary is needed, we generally advise to establish a Turkish Limited as *independent subsidiary*, if the foreign company holds more than 75% of the shares. In other cases the decision on the form of incorporation may differ according to the interests and plans of the founding partners. [...] The minimum capital to be paid in is 10.000 TL. [...]

The subsidiary may issue invoices to B Enerji. No withholding tax will have to be paid. Income generated by the subsidiary should not be transferred through invoicing but as profit, taxable as such (Art. 10/4 of the Double Taxation Treaty). If [Client] wishes to issue invoices to the subsidiary (which is only possible in case that the subsidiary is independent), withholding tax can be avoided according to the explanations above.

If not [Client], but the individual shareholders of [Client] wish to establish the Turkish subsidiary, taxation will not be on the profit, but on capital income. In other words: “[Client] Turkey” would be liable to Turkish corporate taxation (20%¹ plus some minor levys [Germany: 15% plus Business Tax = Gewerbesteuer >> ca. 33%), the shareholders to 5% capital income taxation.

If the period of service in Turkey is limited, a *dependent subsidiary* (branch) may be advisable. It can issue invoices on its own, the profit will be attributed to the total income, by communication with the Turkish and German authorities double taxation and withholding tax can be avoided.

Either subsidiary shall issue the invoice to B Enerji with VAT (if B Enerji has a “VAT privilege”, the invoice may be issued without VAT).

¹ Today – 2019 – the tax is 22%.

VI. Summary

The best way to avoid charging B Enerji with the liability for withholding tax and the related bureaucracy to get such tax refunded, is to provide Borusan with a declaration of the German tax authority which proves that [Client] is paying taxes on all turnovers related with Turkey to the full amount in Germany. To do this the Turkish tax authority may need a declaration from [Client] as to its seat being in Germany (Sitzbescheinigung), if not already made. This should be directly be clarified with the respective tax authorities.

If this does not work, the second possibility will be the establishment of a subsidiary in Turkey. If middle or long term business opportunities are given, the establishment of an independent subsidiary (Limited or similar) is advisable. If the business opportunities are restricted, one may – instead of liquidation – contemplate the sale of the company after having achieved its purpose or to establish a dependent branch.

Rumpf