MAZARS

MAZARS DENGE

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Subject:

AMENDMENTS TO TRANSFER PRICING LEGISLATION THROUGH LAW NO. 6728

Law No. 6728 "Amending Certain Laws to Improve the Investment Climate" was published in the Official Gazette dated 9 August 2016 and numbered 29796 ("the Law"). As explained in the Law's preamble, amendments were made to the tax laws in order to reduce the transaction costs related to investments, to encourage international investments, and to direct savings to productive areas, with taxation arrangements aligned with the action plans designed to improve the applicability and effectiveness of the Tenth Development Plan. In this context, amendments were also made to the transfer pricing legislation. Please find these amendments below, along with our comments on the subject.

1. AMENDMENTS TO DEFINITION AND SCOPE OF RELATED PARTIES

1.1. What is new?

The below provision was added to the second paragraph of Article 13 of the Corporate Tax Law:

"In cases where the relationship is formed by way of direct or indirect shareholding, profit shifting will only be deemed to exist if there is at least 10% shareholding or possession of voting or dividend rights. Parties are considered related when there is direct or indirect possession of at least 10% voting or dividend rights without a shareholding relationship. These ratios shall be considered collectively for the related parties."

(2) Related party means a company's own shareholders and corporations and natural persons that are related to those shareholders; and corporations and natural persons who are directly or indirectly affiliated with or controlled by it in terms of a management, supervision or capital. Spouses of shareholders, siblings and ancestors of shareholders up to the third decree (inclusive) natural and in-law relatives of the shareholders are also considered as related parties. All transactions with individuals in countries or regions declared by the Council of Ministers shall be considered to have been carried out with related parties, and when determining such countries or regions, the Council of Ministers takes into account whether the country, where the earning is gained, has a taxation system which provides the same level of taxation with the Turkish taxation system as well as the ability to exchange information with such country.	(2) Related party means a company's own shareholders and corporations and natural persons that are related to those shareholders; and corporations and natural persons who are directly or indirectly affiliated with or controlled by it in terms of a management, supervision or capital.. Spouses of shareholders, siblings and ancestors of shareholders up to the third decree (inclusive) natural and in-law relatives of the shareholders are also considered as related parties. All transactions with individuals in countries or regions declared by the Council of Ministers shall be considered to have been carried out with related parties, and when determining such countries or regions, the Council of Ministers takes into account whether the country, where the earning is gained, has a taxation system which provides the same level of taxation with the Turkish taxation system as well as the ability to exchange information with such country. **In cases where the relation is created through direct or indirect shareholding, profit shifting occurs only when there is at least 10% shareholding or possession of voting or dividend rights. Parties are considered as related parties when there is direct or indirect possession of at least 10% voting**

	or dividend rights without a shareholding relationship. These ratios shall be considered collectively for related parties.

1.2. Our comments:

Within the framework of this addition, a 10% threshold will be applied when the relationship occurs directly or indirectly through shareholding. It should be noted that this 10% threshold does not apply to the below concepts included in the definition of a related party: "management", "supervision" and "controlled by".

Although similar definitions and examples are also given in the "related party" definition in terms of thin capitalization, we believe that secondary legislation is needed to clarify this legal amendment.

2. AMENDMENTS TO THE HIERARCHY OF TRANSFER PRICING METHODS

2.1. What is new?

Item (ç) of the fourth paragraph (b) of Article 13 of the Corporate Tax Law is amended as follows, and item (d) is added after item (ç):

ç) Transactional profit methods: refers to the methods based on the profit arising from transactions between related parties when determining the arm's length price. These methods include the transactional net margin method and profit split method. In the transactional net margin method, the net profit margin arising from the controlled transaction is measured against the appropriate base determined by the taxpayer, such as costs, sales or assets. The profit split method refers to the arm's length split of total operating margin or loss from one or more related party transactions between related parties pro rata the functions they have performed or the risks they have assumed.

d) In the event it is not possible to adopt any of the above methods to determine the arm's length price, the taxpayer may use another method that it will determine according to the nature of the transaction.

2.2. Our comments:

In the preamble of the Law, it is explained that OECD Transfer Pricing Guidelines were taken into account while determining the methods for applying the arm's length principle in transfer pricing, and it is also noted that in the Guidelines revised by the OECD in 2010, the hierarchy between transactional profit methods and traditional methods has been removed.

This amendment is important both for the transfer pricing plans of taxpayers and for annual transfer pricing reporting. In transfer pricing reports issued before this amendment, it was mandatory to first apply traditional transactional methods (Comparable Price Method, Cash Plus Method, Resale Price Method) before resorting to the "Transactional Net Profit Margin" or "Profit Split" method and to explain why traditional methods could not be applied. However, with the current amendment, taxpayers can choose the method that they consider best suited to the related party transactions, provided that they carry out the analyses set forth in the legislation.

OECD Transfer Pricing Guidelines underline that when "Comparable Price Method" and any other method are equally reliable, the Comparable Price Method should be selected.[1] According to the Guidelines, this method is preferred because it is the most direct method in determining whether the relevant transaction was performed at an arm's length basis.

The legal amendment by the Ministry of Finance to ensure full harmony with OECD Transfer Pricing Guidelines is a welcome development.

3. AMENDMENTS RELATED TO ADVANCE PRICING AGREEMENTS

3.1. What is new?

The below provision was added to the fifth paragraph of Article 13 of the Corporate Tax Law: "*The taxpayer and the Ministry of Finance may apply the designated method for previous tax periods where the statute of limitations has not expired by including the method in the agreement, provided that it is possible to implement applicable repentance and correction*

[1] OECD Transfer Pricing Guidelines, Paragraphs 2.2 and 2.3.

provisions of the Tax Procedural Law, and the agreement conditions are valid for the relevant period. In such case, the executed agreement will substitute the notification described in the relevant provisions, and the declaration and payment will be made accordingly. Taxes that were previously paid will not be refunded due to application of the agreement to the previous tax period."

3.2.Our comments:

As is known, the term of advance pricing agreements (APAs) is three years, and these agreements come into force on the date of signing. With the recent amendment, it becomes possible to apply the transfer pricing method designated in advance pricing agreements retroactively to those tax periods *where the statue of limitation has not yet expired*. We believe that the details will follow in the secondary legislation. We believe it is particularly necessary to clarify whether this applies only to unilateral APAs and whether a retrospective transfer pricing report should be prepared.

4. PENALTY RATE CUT

4.1. What is new?

The below provision was added to Article 13 of the Corporate Tax Law:
"(8) Provided that the obligations regarding the documentation of transfer pricing are fulfilled completely and timely, the tax loss penalty due to taxes which were not paid timely or fully due to profit shifting shall be imposed with a 50% discount, except for the acts listed in Article 359 of Tax Procedural Law."

4.2. Our comments:

The obligations of taxpayers regarding the documentation of transfer pricing are described in the General Communiqué regarding Profit Shifting through Transfer Pricing, Serial No. 1. Pursuant to this Communiqué, the obligations are to fill out the Transfer Pricing Form, Annual Transfer Pricing Form and any information and documents to be requested from taxpayers—who are not required to prepare this Report—for submission to the Administration

or to the tax inspectors. Having said that, the obligations will differ once the draft General Communiqué on Profit Shifting through Transfer Pricing, Serial No. 3, is announced in the Official Gazette and thus comes into force.

This amendment is designed to broaden understanding of how seriously taxpayers approach transfer pricing legislation and to what extent they fulfill the obligations for legal reporting and documentation. For instance, a transfer pricing report drafted by the taxpayer should not be merely a carelessly drafted report but should meet the requirements of the legislation and contain analysis of relevant functions, risks, and assets, as well as information and documentation on why the adopted transfer pricing method was chosen (internal and/or external factors, comparability analysis). In other words, it should be a report demonstrating the level of seriousness of the taxpayer with regard to transfer pricing. Also, all supplementary information and documents on the related party transactions should be complete. We welcome this penalty rate cut granted to the taxpayers who have fulfilled their reporting and documentation obligations timely and fully.

5. VALUE ADDED TAX

5.1. What is new?

The below provision was added to item (d) of the first paragraph of Article 30 of the VAT Law:

"(excluding the VAT paid on earnings distributed in a disguised manner through transfer pricing under Article 13 of Law No. 5520 and paid on the price differences arising in disfavor of the enterprise during the importation under item (5) of the first paragraph of Article 41 of the Income Tax Law or by way of reverse charge)".

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5.2. Our comments:

VAT adjustments are a controversial issue in transfer pricing audits, and this amendment offers clarification. It is now clear that it is possible to deduct the VAT paid on the *earnings distributed in a disguised manner through transfer pricing and paid on the price differences arising in disfavor of the enterprise during the importation or by way of reverse charge*

Yours sincerely,

DENGE İSTANBUL YEMİNLİ MALİ MÜŞAVİRLİK A.Ş.

Gökçe GÜCÜYENER
Head of Transfer Pricing
Mazars/Denge Transfer Pricing Department
ggucuyener@mazarsdenge.com.tr