THE CURRENT SITUATION IN TURKEY-THE NETHERLANDS DOUBLE TAX TREATY AND TIPS FOR THE FUTURE AGENDA

Introduction

The Netherlands, which has been a holding center of the world for many years, has been often preferred by outbound Turkish investors as well, due to being vested with the advantages of a holding location at one hand(such as geographical location, economic opportunities, investment environment and facilities, financing opportunities, guarantees regarding the protection of investments in third countries to be invested, etc.) and also having very advantageous provisions in its double tax treaty with Turkey. According to statistics, approximately 35% of the outbound investments from Turkey is being made through the Netherlands, and it is anticipated that capital exported to the Netherlands is approximately $ 50-100 billion in the form of authorised capital or premiums on capital stock. As the Netherlands has increased the minimum liabilities it expects from the companies as a result of the increasing pressures in the international tax arena in recent years, Turkish investors bear much more costs in the Netherlands and strengthen their companies. Nowadays, there are no more letterbox companies in the Netherlands as in the past, and even many trusted executives from Turkey have being appointed to perform actual management functions of those companies in the Netherlands.

In addition to having above-mentioned well-settled holding company advantages, the Netherlands has reinforced its advantageous tax position thanks to its easy to apply participation exemption regime and, recently enacted withholding tax exemption on dividend distributions to companies resident in a treaty country, which is -including Turkey.

Advantages of the Double Tax Treaty between Turkey and the Netherlands

What we have explained so far is valid for many countries that position themselves as an international holding center. So, let's remember the tax treaty provision that makes the Netherlands unrivalled for Turkish investors. Although, together with certain other criteria, in order to exempt dividends from foreign shareholdings, Turkey looks for at least 15% effective (local) corporate and withholding tax burden in the foreign jurisdiction on dividends transferred ; thanks to the double tax treaty between Turkey and the Netherlands, dividends from subsidiaries in the Netherlands could be exempted from taxation in Turkey under fulfilment of only one condition; i.e. having minimum 10% shareholding in that Dutch entity.. While majority of tax treaties of Turkey provide prevention of double taxation through offsetting of taxes paid abroad (credit method), the double tax treaty between Turkey and the Netherlands was one of those tax treaties that constituted an exceptional situation. For example, if the effective tax rate is lower than 15% in a foreign subsidiary location, tax burden on dividends distributed from that subsidiary to Turkey may be increased to 22%. On the other hand, with the introduction of a Dutch holding company, total tax burden over foreign dividends could be limited to the taxes paid in the foreign subsidiary location (unless that subsidiary qualies as a Controlled Foreign Company as per Turkish regulations), and there was no extra taxes arisen in Turkey-Netherlands dividend traffic. This situation, of course, was also within the knowledge of the tax administration, and although it has been to the intention to remove the exemption from the Turkey-Netherlands tax agreement for many years, the negotiations did not yield any results.

Today, we are close to achieving this result, and the subject of our article is the fate of the Dutch agreement and the companies that have heavily invested in the Netherlands for many years.

Outcomes of Multilateral Instrument (MLI)

For the last 10 years BEPS (Base Erosion and Profit Shifting) initiative has been the hottest topic in the international tax agenda, which was developed by the OECD and imposed on the member countries to make the necessary regulations in their domestic legislations. This initiative includes many actions, and one of these actions is the Multilateral Instrument (MLI). which was signed in Paris in 2017. It is aimed to replace the double tax treaties that no longer can respond to today's conditions and that became insufficient to prevent tax evasion which is one of the most important purposes of BEPS initiative, and also aimed to fill the legal gaps in these agreements. Even though this was the initial purpose, MLI could not be fully above the double tax treaties and did not have the power to completely change or even replace them. Countries accepted certain articles, but made reservations for certain articles, hence a uniform application could not be achieved. For this reason, MLI has turned into a kind of rag bag, having a different meaning for each signatory country and therefore is not able to fulfil its objectives precisely, and no country can fully conclude on the approach of another country.

Turkey, is one of these countries that signed the MLI in 2017 and made reservations to those provisions other than the minimum standards, . meaning that these articles of the MLI will not be taken into account, and the relevant articles of double tax treaties will continue to apply. Article 5 of the MLI regarding the prevention of double taxation were among Turkey's reservations in the first signature. This meant that the exemption clause of the double tax treaty between Turkey and the Netherlands, which had been attempted to be amended for many years, would remain in force, which was contradicting with the intention of the Turkish tax administration.

Multilateral Instrument is in force for the Netherlands since all the legal procedures have been completed, but not yet in force in Turkey. However, the legislative proposal was submitted to the Grand National Assembly of Turkey Plan and Budget Commission on June 2, 2010, and the approval process was initiated. The big news regarding the double tax treaty between Turkey and the Netherlands came out at this point; when it was revealed that Turkey, which made reservations to Article 5 in 2017, this time opted for option C in the legislative proposal submitted to the Assembly, and chose offset method as the method to prevent double taxation. As we will elaborate below, this means if the proposal is enacted in that way, the exemption provision of the double tax treaty between Turkey and the Netherlands existing for years will be abolished and all tax advantages will be lost.

Why will the Exemption be Abolished?

With regard to Article 5, the Netherlands chose Option A, the exemption method, in line with its legislation. Turkey will choose option C, in other words tax credit method, in line with its legislation, if the legislative proposal is enacted. So far, it is an highly anticipated situation, and it is also stipulated in the MLI that different options can be selected by the countries.

When we look at this issue from the Netherlands perspective, we see a country that is positioned as the holding center of the whole world, and, it would normally be quite unfavourable for other countries to choose the credit method and tax the dividends distributed from the Netherlands instead of exempting, which is contrary to the current tax treaties offering exemption method. Therefore, the Netherlands could prevent the other country from introducing the credit method with the MLI instead of the exemption method in the applicable tax treaties, by putting a reservation in paragraph 9 of Article 5 of the MLI. The Netherlands did not made such a reservation neither in the first signing of the MLI nor during the enforcement process, and as clearly stated in Article 282 of the explanatory notes annexed to the MLI, it can no longer go back and take action to restrain countries that chose the offset method. Therefore, no steps can be taken by the Netherlands, and verbal conversations with Dutch authorities also confirm this. What only matters now is how the proposal will be enacted in Turkey, and both the tax administration and investors will continue to follow this issue very closely.

Let's take a step back and evaluate the result of this situation for the Netherlands. There are 5 countries (Argentina, Romania, Norway, Portugal and India) which are in a similar situation with Turkey and which have not completed the legal process for MLI. Since these countries are not capital exporting countries except Norway, we can say there is not a huge loss for the Netherlands. Nevertheless, this may be an unknown situation for the Netherlands throughout the whole process, rather than being a situation that was accepted from the very beginning.

The Effects for Turkish Investors and Turkish Tax Administration

First of all, let's make an important reminder. The Dutch companies we are talking about here are holding companies established in the Netherlands by Turkish companies for channelling their investments in third countries and the income derived from these countries is exempted in the Netherlands. There will not be a significant difference regarding operational companies in the Netherlands whose income is subject to corporate tax. Dividends derived from these operational companies will still be exempted from taxation in Turkey as long as the conditions in Article 5/1-b of the Corporate Tax Law are satisfied; the change in the tax treaty will not affect this result.

In case that the exemption provision in double tax treaty is no longer valid after MLI, dividends received through the Dutch holding company will face an additional tax burden at 22% (projected to decrease to 20% by 2021) since the minimum tax burden of 15% would not be satisfied in the Netherlands. Taxes paid in the third country will not be deductable from the tax calculated in Turkey; because our legislation only allows deduction of corporate tax and dividend withholding taxes paid directly in the participating country. As a result, there will not only remain a Dutch holding company whose necessity is controversial, what is worse is there will be a Dutch holding company that has lost its function and has led to a 22% increase in the tax burden of its Turkish investor. This will mean that Turkish companies will/can no longer invest to third countries through Dutch holding companies.

As a natural consequence of this situation, we can foresee that there will be dividend distributions from Dutch holding companies until the time the MLI will enter into force. As can be seen in the following sections of our article, it is possible to make tax-free dividend distributions by making use of the provisions of the current tax treaty until the time when the mentioned change is likely to come into force. Asset Amnesty, which is on the Turkish agenda nowadays, will constitute an important tool in this sense. The fact that there is currently no automatic exchange of information between Turkey and the Netherlands will intensify the Asset Amnesty applications. In this sense, an intense cash inflow can be expected in the short term for Turkey, either through dividend distribution or Asset Amnesty.

While, in the long-term, dividends distributed from countries where there is at least 15% tax burden, can be exempted in Turkey , companies established in countries with a tax burden in the range of 10-15% cannot be forced into dividend distribution and subsequent taxation, since they do not qualify as Controlled Foreign Companies ("CFC"). In addition, companies in countries with less than 10% tax burden, which are the main target group, have already left these structures or already becoming subject to taxation in the Netherlands as a result of being subject to Dutch CFC regulations since 2018. Therefore, with this arrangement, our tax revenues may not increase as expected. It is clear this was not the case in the past; with structures having no economic reality, but only one cash box and one desk, Turkey's tax revenues have been eroded. Consequently, it is quite natural that Turkey, as a developing country, is now seeking for its tax revenues. However, today may not be that day anymore, the actions of the BEPS initiative no longer allow such structures to exist internationally, these structures no longer have a chance to survive, and therefore the juice may not worth the squeeze. So, what will be the fate of Dutch holding companies after this arrangement? The first alternative will be the liquidation of Dutch holding companies on top of that countries where the tax burden is 15% and hence whose dividends can still be exempted in Turkey in the absence of a Dutch holding company. There will be no taxation in Turkey and in the Netherlands on distribution of earnings related to liquidation. Likewise, capital repayment will not be taxed in the Netherlands or Turkey. The exchange rate difference (i.e. f/x gains) that will arise in the repayment of the foreign currency denominated capital will create a serious obstacle for liquidation, since it will be a taxable income for Turkish tax purposes. On the other hand, Turkey's one of the most important focus points in recent years, is bringing foreign currency savings back to Turkey, keeping foreign exchange reserves at a reasonable level and controlling currency fluctuations. In this sense, it would be an important choice between taxing exchange rate differences incurred over the returned capital previously injected into Dutch holding companies or making regulation regarding not taxing the revenues born from the liquidation in order for bringing foreign currency savings back to Turkey. In this respect, we can expect the issue of taxation or exemption of foreign exchange differences arising in liquidation of the foreign subsidiaries to be one of the most popular discussion topics in the near future.

If the liquidation is not preferable due to reasons explained above, it is quite possible to use Dutch holding companies for group financing purposes. The interest income will be subject to corporate income tax in the Netherlands at a parallel rate applied in Turkey, and thus holding companies will refrain from CFC status. The fact that interest expenses are subject to deduction, after taking into account thin capitalisation and transfer pricing limitations, will actually not change the total tax burden for Dutch holding companies, hence the only result for the Turkish tax administration will be the loss of foreign exchange savings which cannot come to Turkey although much needed.

In the event that Dutch companies are excluded from the investment structures, Turkish companies will no longer be able to benefit from the Netherlands' very extensive and very advantageous tax treaties with third countries. This will mean an increase in withholding taxes on dividend distribution from relevant countries , which again will not bring any benefit for Turkey.

When the problems related to liquidation and the possible increase in tax burden are considered together, and considering the investments made and habits gained over the years, it is clear that Dutch holding structures will not be easily dispensable, since the issue is not just about a tax advantage, and the undeniable advantages of being an international holding center are obvious. Of course, investors will want to move their holding centres to countries which can offer similar advantages with the Netherlands through their local legislation and tax treaties with Turkey. Especially companies that have invested in many countries and have a very solid business structure in the Netherlands will still want to maintain Dutch holding companies within the structure. Considering the increasing measures and minimum substance requirements in the international tax arena, this would mean bearing the high costs of a second holding company on top of the Dutch holding company. For tax administrations, the discussion will develop around the "Principal Purpose Test" (“PPT”), which is another sensitive point of the MLI. Even though none of these happen, first experiences regarding the PPT, which will be one of the most discussed issues in the world as well as in Turkey in the following years, will perhaps evolve on this topic. Moreover, the tax administration was discussing this issue within the framework of Article 3 of the Tax Procedure Law, even before the MLI was out of sight.

For companies that cannot tolerate the increase in costs due to their dual holding structure, but still want to keep holding companies abroad, a solution may be the dissolving of the Dutch companies without liquidation by way of cross-border mergers.

How Will the Timing Be?

For MLI to enter into force, first of all the legislative and executive process in domestic legislation in Turkey will need to be completed. After Turkey notifies OECD regarding the completion of such process, the MLI will enter into force the first day of the month following the end of the 3-month period after this notification. On the other hand, the implementation of the provisions in the MLI is a different subject from the entry into force of the MLI.

Date of implementation regarding the regulation that will override the exemption provision in the Dutch tax treaty is the taxation period following the end of 6-month period after the entry into force of the MLI in Turkey. Considering the current situation, the situation that constitutes the subject of our article will make sense as of January 1, 2022 at the earliest. Of course, it is not easy to estimate the timing of the approval process of the MLI. However, even the regulation makes sense as of January 1, 2022, it is clear that how close the risks we have mentioned are.

Conclusion

Regardless of where we stand, the arrangement intended to be made means breaking a 30-years mould. From the perspective of investors, there will be increasing costs, maybe increasing tax burdens, an international investment structure that needs to be reconsidered, and many decisions and actions to be taken, and it bears risks in all aspects. For Turkish tax administration, although it seems that the desired result that has been sought for many years can be achieved through that change via MLI, the results may not make a big difference as expected. It is also possible that there can be conflicts between tax revenues and returning back foreign currency savings to Turkey. The way the proposal will be enacted will of course depend on the balance of power between the parties.

We recommend companies that have directed their investments through the Netherland holding structures following the developments closely, taking into account the timing mentioned above, and at least making the necessary preparations regarding the alternatives and the steps to be taken before waiting for MLI to enter into force.

We strongly recommend that companies that will invest abroad in the future should consider all priorities of the BEPS initiative and assume higher costs for investments for the purpose of their business plans, in order to fulfil the minimum requirements in that foreign jurisdiction.

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