Turkey

Erdogan Saglam*

Transfer Pricing Legislation

Transfer pricing legislation was introduced in Turkey in June 2006. This article analyses the current state of transfer pricing law and practice, and considers the transfer pricing communiqué which is expected to be released by the tax authorities later in 2007.

1. General

Transfer pricing legislation was introduced in Turkey on 21 June 2006 by Art. 13 of Law 5520 (the Corporation Tax Law). Art. 13, which is subtitled Hidden Distribution of Profits by Transfer Pricing / Payment of Constructive Dividends by Transfer Pricing, entered into force 1 January 2007. The last paragraph of Art. 13 states that the procedures governing transfer pricing will be determined by the Council of Ministers. At the time of writing this article, the Council of Ministers has not yet issued the anticipated decree. In accordance with general practice, the tax authorities are also expected to issue a communiqué on transfer pricing in addition to the decree. However, the absence of such procedures and sub-legislation which could clarify the application of Turkish transfer pricing law could give rise to numerous issues.

Under Art. 13 of the Corporation Tax Law, transfer pricing is defined as follows: If a company sells or purchases goods or services from a related party at a price that is not an arm's length price, the earnings will be deemed to be distributed partially or wholly by means of transfer pricing. Art. 13 further states that rentals, production, construction, lending of monies, remunerations and transactions requiring similar payments will also be evaluated as sales and purchases of goods and services in all cases and conditions. The terms "related party" and "arm's length principle" are also defined in Art. 13.

2. Related Party

The following are classified as related parties under Art. 13.
- shareholders of the company;
- real persons or legal entities related to the company or its shareholders;
- real persons or legal entities which control or which are controlled directly or indirectly by means of administration, supervision or capital; and
- spouses of shareholders, ascendants, descendants up to third degree blood relatives and in-laws of shareholders and their spouses.

Based on a comparison between the taxation capacity of the profits and the Turkish tax system, transactions carried out with persons domiciled in certain countries or regions specified by the Council of Ministers will be deemed to be made with related parties.

3. Arm's Length Principle

Art. 13(3), which adopted the arm's length principle as laid down in the OECD Transfer Pricing Guidelines (OECD Guidelines), mandates that the arm's length principle be complied with when related parties carry out transactions with each other. That is, the prices or considerations for goods and services carried out between related parties should be in compliance with prices and consideration in similar transactions carried out between independent parties.

4. Transfer Pricing Methodology Analysis

Art. 13 sets out three different methods which can be applied to determine an arm's length price or consideration. These methods are classified as traditional transaction methods in the OECD Guidelines. Taxpayers must determine the price or consideration in accordance with the most appropriate transfer pricing method, taking into consideration the nature of the transaction, by applying the comparable uncontrolled price (CUP) method, cost-plus method or resale price method.

If none of these three methods is appropriate and satisfactory for the purpose of determining an arm's length price, the taxpayer may use other methods that are appropriate based on the nature of the transaction. The taxpayer may also apply to the Ministry of Finance in advance for determination of the method to be used. In this case, the method is determined by mutual agreement for a three-year period under the conditions set forth in the agreement.

4.1. Comparable uncontrolled price method

Under this method, the price charged for goods and services in a transaction between related parties is compared with the price that would be agreed between unrelated parties (also referred to as the market price). This definition does not mention the term "uncontrolled price". However, reference is made to the market price. It is not clear whether the legislators meant "uncontrolled price" by the phrase "market price". It is expected that the decree and general communiqué yet to be issued by the Council of Ministers and/or the Ministry of Finance, respectively, will clarify this situation. Until then, the author assumes that market price means the same thing as uncontrolled price, in view of the OECD Guidelines

* Tax Partner, BDO Denet Turkey, Istanbul

and generally accepted principles, and does not consider there to be any difference between the two terms.

Similarly, no preference is made to circumstances in which this method should be applied. However, by its very nature, the CUP method may be applied only if similar uncontrolled transactions can be found with which to make comparisons. It is also expected that the general communiqué will clarify this issue.

4.2. Cost-plus method

Under the law, this method aims at calculating the arm's length price by adding an appropriate gross markup on the cost of the goods or services. Although not indicated in the definition of the cost-plus method (under the law), the following must be assumed: the appropriate markup should take into consideration the functions performed, the assets utilized and the risks assumed by the supplier, and should be calculated on the basis of similar transactions between the related parties or unrelated parties. If the differences between the two transactions materially affect the cost-plus markup, reasonably accurate adjustments must be made to eliminate the material effects of the differences. This method is more commonly used for semi-finished products sold and purchased between related parties, long-term supply agreements and the provision of services between related parties.

4.3. Resale price method

Under the transfer pricing article, this method defines the calculation of the arm's length price by deducting an appropriate gross margin on the resale of goods and services subject to transaction to the unrelated parties. Accordance to OECD norms and principles, this method is more useful when the buyer purchasing from the related party does not add substantially to the value of the product or does not posses valuable marketing intangibles.

The arm's length or appropriate profit margin may also vary in accordance with differences in factors such as accounting policies, marketing, advertisement and distribution costs, as well as the risks assumed.

4.4. Other methods

When arm's length prices cannot be determined by using one of the methods listed above, other methods may be used where appropriate considering the nature of the transactions. At this stage, it is unclear whether these methods will, in fact, be accepted by the tax authorities.

4.5. Transactional net margin method

The transactional net margin method (TNMM) first compares the net profit margin that a taxpayer realizes from a controlled transaction with the net margin the same taxpayer earns in comparable uncontrolled transactions.[1] Where this is not possible, the net profit margin realized by an independent enterprise from comparable transactions may serve as a guide. As a second step, the TNMM examines the net profit margin relative to an appropriate base such as costs, sales or assets. This differs to the cost-plus and resale price methods that compare gross profit margins. The TNMM requires a level of comparability similar to that required for the application of the cost-plus and resale price methods. In the absence of internal uncontrolled transactions, it may be difficult to find external comparables because the net margins for transactions between unrelated parties are rarely available.

4.6. Comparable profits method

The comparable profits method (CPM) evaluates the arm's length character of a controlled transaction based on objective measures of profitability (known as profit level indicators) derived from uncontrolled taxpayers which engage in similar business activities under similar circumstances. The arm's length result is determined based on the operating profit that the tested party would have earned on related party transactions if its profit level indicators were equivalent to those of uncontrolled taxpayers. Profit level indicators are financial ratios that measure the relationships among profits, costs incurred and resources employed. The rate of return on capital employed; return on sales; the ratio of gross profit to operating expenses; and other profit level indicators that which provide reasonable indications of the income that the tested party would have earned had it dealt with controlled taxpayers at arm's length may be used in determining the arm's length result.

Although all of the comparability factors discussed above must be considered, comparability under the CPM is particularly dependent upon resources employed, risks assumed and functions performed. Given adequate data, methods that determine an arm's length price (e.g. the CUP method) or an arm's length gross margin (e.g. the resale price method) provide a higher degree of comparability than the CPM. Accordingly, the CPM generally is considered a method of last resort in circumstances where comparability data relevant to the other methods is not available.

4.7. Profit split methods

A profit split method evaluates whether the allocation (among the related participants to a business activity) of the combined operating profit or loss attributable to a controlled transaction is arm's length based on the relative value of each controlled participant's contribution to that combined operating profit or loss. The relative value of each controlled participant's contribution to that combined operating profit or loss is determined based on the functions performed, risks assumed and resources contributed by each participant to the relevant business activity. The regulations provide for two profit split methods, namely the comparable profit split method and the residual profit split method.

1. Art. 3.26 OECD Guidelines.

A comparable profit split is derived from the combined operating profit of uncontrolled taxpayers the transactions and activities of which are similar to those of uncontrolled taxpayers. The amount allocated to each controlled participant to the relevant business activity is based on each uncontrolled taxpayer's percentage of the combined operating profit or loss. Although all of the comparability factors discussed above must be considered, comparability under the comparable profit split method is particularly dependent upon resources employed, risks assumed and functions performed. The reliability of the results derived from this method is particularly affected by the quality of the data and assumptions relating to the cost and income allocation to the relevant business activity and accounting consistency.

Under the residual profit split method, the combined operating profit or loss from the relevant business activity is allocated between the controlled taxpayers in two steps. First, a functional analysis is performed to allocate operating income to each party to the controlled transaction. This allocation provides a market return for each party's contributions (contributions of tangible property, services and intangibles which are similar to those made by uncontrolled taxpayers involved in similar business activities for which it is possible to identify market returns). Second, any residual profit attributable to the controlled group's valuable intangible property (where similar property is not owned by uncontrolled taxpayers from which the market returns are derived) is divided among the controlled taxpayers based on the relative value of their non-routine contributions of intangible property.

5. Recent Situation

A draft of the Council of Ministers decree was issued in early June in order to solicit feedback from professionals and their organizations. The finalized decree is expected to be issued within a few months. Subsequently, the tax authorities are expected to issue their communiqué, which is anticipated to address the pending matter in more detail. Further to the draft decree, the Revenue Administration issued a draft communiqué in early July for the same purpose.