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**A SURVEY OF TWO TYPICAL FORMS OF  
ABUSIVE TAX AVOIDANCE TRANSACTIONS  
AND CONTRACTS: THE THIN  
CAPITALIZATION AND HIDDEN  
DISTRIBUTION OF PROFITS IN TURKISH  
TAX SYSTEM\***

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\* The title of the article can be translated to Turkish as "Peçeleme Yolu ile Vergiden Kaçınma İşlem ve Sözleşmelerinin İki Tipik Biçimine Genel Bir Bakış: Türk Vergi Sisteminde Örtülü Sermaye ve Örtülü Kazanç Dağıtımı".

## Özet

Bu makalenin konusunu, kurumlar vergisinde kullanılan peçeleme yolu ile vergiden kaçınma işlem ve sözleşmelerinin iki özel türü oluşturmaktadır. Söz konusu işlem ve sözleşmeler bazı koşullar altında, yakın şirket veya kişilerden ödünç alınmasını ifade eden “örtülü sermaye” ile kâr dağıtımının gider veya maliyet unsuru gibi gösterildiği “örtülü kazanç dağıtımı”dır.

**Anahtar Kelimeler:** Kurumlar vergisi, örtülü kazanç dağıtımı, örtülü sermaye, peçeleme işlemleri, peçeleme sözleşmeleri, transfer fiyatlandırması, transfer fiyatları, Türk vergi sistemi, vergi, vergi kaçakçılığı, vergiden kaçınma.

## Abstract

This article deals with two particular forms of abusive tax avoidance transactions and contracts used in the corporations tax. Those transactions and contracts are “the thin capitalization”, which implies borrowed from close companies or persons under some circumstances and “hidden distribution of profits”, which expresses showing the distribution of profits as if they were expense or cost items while they were not so.

**Keywords:** Abusive transactions, abusive contracts, corporations tax, covered transactions, disguised capital, hidden distribution of profits, tax, tax avoidance, tax evasion, taxation, thin capitalization, transfer prices, transfer pricing, Turkish tax system.

## 1. Introduction

Companies do not pay income tax; the tax, which they pay, is corporations tax<sup>1</sup>. This tax is charged on the profits of companies. While the individual income tax is a general tax, the corporations tax applies to capital income only. All companies resident in Turkey are liable to corporations tax on trading profits arising after the end of period of account. A company which is not resident but trades in Turkey through a branch or agency is liable to corporations tax on chargeable profits from the branch or agency. Companies resident in Turkey, which are subject to the status of “full liability”, are liable to corporations tax on all its profits wherever arising.

The real basis method of income taxation in real persons and corporations needs the deduction of expenses for earning and maintaining income. The two of non-acceptable expenses for deduction are interests calculated on concealed capital and hidden profits distributed by capital companies. These two concepts have been meaningful not only as non-deductible items, but also independent concepts by their selves. Due to the importance of these subjects in the worldwide literature of taxation, some debates have been occurred on those. In this article, the concepts of the thin capitalization and hidden distribution of profits as kinds of abusive tax avoidance transactions in the Turkish tax system will be examined.

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<sup>1</sup> Except for unlimited partnerships and limited partnerships (partnership in commendams).

## 2. Basic Framework of Related Concepts

It is widely accepted that if taxpayers feel their selves as “victims” of unfair tax burdens, they may tend to pay less taxes. In this case, they have two choices: legally avoiding or illegally evading taxes. Stiglitz offers three basic principles of tax avoidance within an income tax in his prominent article<sup>2</sup>: (1) Postponement of taxes, (2) Tax arbitrage across individuals facing different tax brackets and (3) Tax arbitrage across income streams facing different tax treatment. He states that many tax avoidance devices involve a combination of these three principles. The abusive transactions and contracts are within the extent of abusive tax avoidance strategies.

The abusive transactions and contracts whose typical forms are “covered transactions” and/or “covered contracts” have been ruled as non-deductible expenses in Turkish Corporations Tax Act. Those kind of transactions (and/or contracts) can be resembled fraud against law<sup>3</sup>. In private law, fraud expresses an intentional attitude by which someone obtains an unfair advantage over another one<sup>4</sup>. Although covered transactions and contracts are valid in law of obligations, they don’t have validity in tax law.

Those abusive transactions can be used as illegal tax shelters<sup>5</sup>, which are means of evading taxes, by taxpayers. This kind of abusive tax shelter uses the form and trappings of legal transactions to lessen tax burden in a way neither consistent with the intent of legislature nor sanctioned by law<sup>6</sup>. The concept “tax evasion” is defined as knowingly and willfully failing to declare taxable income<sup>7</sup>. Abusive transactions may be consistent with this definition of tax evasion, but not always with the regulation of “evasion” of the Turkish Law of Tax Procedure unless they do not have its specific features. Two special kind of covered transactions (and/or contracts) are ruled in Turkish Corporations Tax Act as thin capitalization and hidden distribution of profits<sup>8</sup>. If their conditions, which are imposed via the code, have been emerged, the burden of proof of the opposite will belong taxpayer<sup>9</sup>.

According to article 15/2 of Corporations Tax Act, interest paid or calculated on disguised capital is not allowed to be deducted. The concept of “disguised capital”, in other words “the thin capitalization” has been defined in the article 16. According to

<sup>2</sup> See Joseph E. STIGLITZ, “The General Theory of Tax Avoidance”, **National Tax Journal**, September 1985, No. 3, Vol. XXXVIII, p. 325.

<sup>3</sup> See Selim KANETİ, **Vergi Hukuku**, İstanbul Üniversitesi Hukuk Fakültesi yayını, Özdem Kardeşler Matbaası, İstanbul, 1987/1988, p. 45.

<sup>4</sup> See Tuğrul ANSAY, Don WALLACE, Jr., **Introduction to Turkish Law**, Kluwer Law International, Ankara, 1996, p. 153.

<sup>5</sup> All tax tax shelters are not illegal tax avoidance devices. Some of them, such as the pure tax shelters, are entirely legal.

<sup>6</sup> See Joseph J. CORDES, Harvey GALPER, “Tax Shelter Activity: Lessons from Twenty Years of Evidence”, **National Tax Journal**, September 1985, No. 3, Vol. XXXVIII, p. 308.

<sup>7</sup> See Sharmila King, Steven M. Sheffrin, “Tax Evasion and Equity Theory: An Investigative Approach”, **International Tax and Public Finance**, Vol. 9, No. 4, August 2002, p. 505.

<sup>8</sup> See **Corporations Tax Act**, No.: 5422, Article 15/2,3; 16, 17.

<sup>9</sup> See Muallâ ÖNCEL, Ahmet KUMRULU, Nami ÇAĞAN, **Vergi Hukuku**, 11. Baskı, Turhan Kitabevi, Ankara, 2003, p. 342.

article 16, whether loans from real persons and legal entities with which have a direct or indirect partnership relation or constant and close economic relationship with the corporation are continuously used in the enterprise and the ratio of these loans to the equity of corporation is obviously high as compared with similar corporations', those debts are considered as "disguised capital".

According to article 15/3 of Corporations Tax Act, disguised gains distributed by capital companies are not allowed to be deducted either. The concept of "disguised gain" has been defined in the article 17. In the article, some expenses and costs, which are paid by capital companies, have been considered not as expenses or costs, but distributed profits of them indeed.

### 3. Disguised Capital or Thin Capitalization

Since the corporations tax is a tax levied on net corporate gain, all allowable expenses of doing business must be deducted in arriving at taxable corporation income<sup>10</sup>. Income Tax Act and Corporations Tax Act do not accept interests calculated on the capital, which is invested in the enterprise by its owners or partners as a deductible expense item. As mentioned above, the concept has been defined in the article 16 of Corporations Tax Act. Three conditions are counted on in the article 16. Firstly, the existence of loans borrowed from real persons and legal entities with which have a direct or indirect partnership relation or constant and close economic relationship with the corporation; secondly, permanently using in the enterprise; thirdly, obviously higher level of the ratio of these loans to the equity of corporation as compared with similar corporations'.

We see here that the legislature has aimed to prevent taxable gain of corporation from diminishing by fraud against law. If the corporation deduct above mentioned interests as expenses, under existing rules of law that will mean tax loss in the sense of article 341 of Tax Procedure Law, No. 213<sup>11</sup>.

A crucial question should be asked at this point. When company does not calculate interest and does not deduct it from earnings, can those three conditions be adequate to make disguised capital arose? There is a debate on whether a fourth condition, which bases on the article 15/2 exists or not. According to an approach, the fourth condition is not a *sine qua non* of disguised capital. Former conditions are sufficient for it. This viewpoint has especially been adopting by higher officials of administration, maybe as a consequence of fiscals tradition. Another perspective, which has mostly approved by the party of taxpayers, is that calculating and deducting interests are absolutely obligatory to be mentioned of disguised capital.

<sup>10</sup> See. Richard A. Musgrave, Peggy B. Musgrave, **Public Finance in Theory and Practice**, Fifth Edition, Mc- Graw- Hill, New York, 1989, p. 381.

<sup>11</sup> See. Şerafettin AKSOY, **Vergi Hukuku ve Türk Vergi Sistemi**, 5. Baskı, Filiz Kitabevi, İstanbul, 1999, p. 298.

Due to the fact that article 16 refers to article 15/2, considering of the fourth condition is necessary. In other words, disguised capital does not have any meaning by itself. It is significant only as a non-deductible expense. Consequently, the second opinion seems to be much more reasonable than the first one.

Another debate is on that whether gains of exchange rates can be considered like interests, which cause disguised capital or not. Some writers who use historical interpretation method say that gains of exchange rates must be taken into account just like interests. According to their argument, when the Corporations Tax Act was codified in 1949, public opinion did not know the gains of exchange rates. If the legislature had been familiar with this concept at that time, it would take into consideration the gains of exchange rates during codification as a source of disguised capital too. They therefore suggest that gains of exchange rates must automatically be considered.

Because of the legality principle of taxation, taxes and Para taxes (quasi taxes) can only be set, amended and abolished by acts. As a consequence of this principle, ignoring the specific word “interest” and take it as the same with “gain of fluctuations of exchange rates” will not be in accord with the legality principle of taxation. Such an approach, which does not implement the correct way of literal interpretation, violates article 73 of the Constitution.

#### **4. Hidden Distribution of Profits**

Some expenses, which are not accepted for deduction in the Income Tax Act, seem to be deductible in Corporations Tax Act. While funds withdrawn from the enterprise by owner or owners, by spouse or by children of the owner are not accepted for deduction in the Income Tax Act, funds withdrawn from the capital company by partners or by their spouse, children or some relatives are accepted in Corporations Tax Act. Comparing those two acts is not meaningful indeed since partners have not been owners in capital companies such as anonymous corporations, limited liability companies and similar foreign companies. Although shareholders can establish business relationships with capital companies of which they are partners, that relationship must remain within the limits of Article 17. Otherwise, some expenses and costs will be taken into account as distribution of profits through a covered way.

Conditions of distribution of disguised gain are as follows<sup>12</sup>:

- ✓ If the company purchases, sells and services at distinctly higher or lower prices as compared with similar companies in relations with its own partners, real persons and legal entities to whom directly or indirectly attached or under its influence with respect to management, control or capital;
- ✓ If the company carries out of renting or leasing transactions with the above mentioned persons and entities at amounts, which are distinctly higher or lower than the precedents.

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<sup>12</sup> See **Corporations Tax Act**, No.: 5422, Article 17.

- ✓ If the company borrows or lends money above mentioned persons and entities at rates of interest or amounts of commissions which are distinctly higher or lower than the precedents;
- ✓ If the company pays monthly salaries, bonuses, wages or such payments, which are distinctly higher than precedents on behalf of its partners, their spouses, relatives by ancestry or descent up to third degree relation by blood or marriage are employed as the chairman or member of its board of directors, director, manager or other higher officer.

As it is seen, various items of expenses and costs paid treated as distribution under some conditions. According to Article 17, the close relationship between the parties and noticeably higher or lower payments have been main features of the hidden distribution of profits.

The concept of “distribution” is not defined in Turkish Corporations Tax Act. Its meaning can be derived from the theory and comparative tax law. On the other hand, this concept has been explicitly defined in the law of some other countries, for instance the United Kingdom. In the United Kingdom, some payments out made by a company such as dividends are considered as distributions and some others such as interests on loan stock are not<sup>13</sup>.

There are some debates on hidden profits as well. First one is that whether the other corporations besides capital companies can distribute disguised gain or not. If a loss of treasury is necessary for emerging of it or not is the second debate<sup>14</sup>. Some writers propose that not only capital companies but also all the others are able to distribute disguised gain. Those writers base on the idea that the article 17 mentions the word “company” instead of “capital company”. Due to the fact that this approach does not consider the expression of article 15/3, it does not seem to be correct. In other words, as a result of being ignored of the word “capital” in article 17 to avoid unnecessarily repetition by the legislature, the phrase “capital companies” which place in article 15/3 directly refers to article 17. This viewpoint is, therefore, not acceptable at all. Another topic of those debates is whether the existence of disguised gain depends on a loss of treasury or not. Some writers say that disguised gain can be emerged without a loss of treasury as well. Approving this way of thinking is not possible due to deducting those payments definitely causes a loss of tax revenue. If there are not any deducted payments, there will not be any disguised gain.

Transfer pricing seems to be close to hidden distribution of profits. Whereas the first one is a tax advantage, the latter means an abusive tax avoidance transaction. Separating them from each other has crucial importance. The term “tax advantage”

<sup>13</sup> See David W. WILLIAMS, Geoffrey MORSE, **Principles of Tax Law**, Fourth Edition, Sweet&Maxwell, London, 2000, p. 197.

<sup>14</sup> For detailed information about those debate see Şükrü KIZILOĞLU, **Türk Vergi Hukukunda Örtülü Kazanç ve Örtülü Sermaye**, Yaklaşım Yayınları, Ankara, 2002, **passim**; Muallâ ÖNCEL, **Kurumlar Vergisi Açısından Sermaye Şirketlerinde Örtülü Kazanç ve Örtülü Sermaye**, Banka ve Ticaret Hukuku Araştırma Enstitüsü, Türkiye İş Bankası Tesisi, Hukuk Fakültesi, Cebeci Ankara, 1978, **passim**.

expresses the avoidance of a possible assessment to tax<sup>15</sup>. One of the most widespread tax avoidance strategies of the age is to create companies incorporated in one country but also resident in another country, enabling tax deductions to be obtained for the same interest payment in both countries. In addition, the existence of the relationship between a company and its totally owned subsidiary company which is entirely under the control of the main company itself is one of today's realities. Distinguishing these two entities from each other has a great significance for taxation purposes. The tax authorities try to make distinction by imposing "arm's length" transfer prices on transactions between associated companies in order to prevent profits being transferred to the jurisdiction with the lower tax rates<sup>16</sup>.

As a consequence of above mentioned facts, capital companies should be careful with their relations with the close persons and companies to avoid causing hidden distribution of profits and penalties of it. Finally, it can be said that such a transaction is harmful not only for the treasury but also the minority group of shareholders<sup>17</sup>.

## 5. Concluding Remarks

Borrowing transactions and transfer pricing are on the borderline between tax advantages and abusive transactions indeed. These means of tax planning for taxpayers are transformed to covered transactions under certain conditions. In other words, when some events occur, awards of tax advantages turn into penalties. For they may not be clear enough, distinguishing those two is not so easy. In order to avoid committing crimes, corporations must strictly take into account related rules of Corporations Tax Act. As a consequence of the expanding of relations between companies on intra-national and international levels, the significance of borrowings and transfer pricing have been increasing. This tendency forces companies to be much more careful of their behaviors. Otherwise, encountering some tax penalties will be inevitable. It should be notified that both the thin capitalization and the hidden distribution of profits are meaningful from the viewpoint of taxation only as non-deductible expenses. Another meaning cannot be attributed to them further than an expense.

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<sup>15</sup> See Barry PINSON, **Revenue Law**, Sixth Edition, Sweet&Maxwell, London, 1972, p. 658.

<sup>16</sup> See. J. A. KAY, M. A. KING, **The British Tax System**, Fifth Edition, Oxford University Press, New York, 1991, p. 205.

<sup>17</sup> See. Kenan BULUTOĞLU, **Türk Vergi Sistemi**, 8. Baskı, Batı Türkeli Yayıncılık, İstanbul, 2004, p. 163.

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**II- Codes**

CORPORATIONS TAX ACT, No.: 5422.

TAX PROCEDURE ACT, No.: 213.