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APPROACHES TO IDENTIFYING THIN CAPITALIZATION AND THE CASE OF TURKEY*

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ÖZET

Kurumların vergiden kaçınma gayretleri ile devletlerin vergi gelirlerinin aşınmasını önleme çabalarının bir ürünü olan örtülü sermaye, ortakların kuruma sermaye olarak koymaları gereken değerleri, vergisel çıkarlar amacıyla, kuruma borç olarak vermeleri halinde gerçekleşmektedir. Çok uluslu şirketlerin örtülü sermaye uygulaması ile yurt dışına kaynak transfer edilerek yabancı sermaye özelliği kazanan ulusal sermaye, yabancı sermaye ve dar mükellef yatırımcılara sağlanan vergisel avantajlardan faydalanmakta böylece, çok uluslu şirketlerle ulusal firmalar arasında ve ulusal firmaların kendi aralarında, vergi yükünün azaltılmasından kaynaklanan bir rekabet eşitsizliği oluşmaktadır. Vergi matrahının aşınmasının önlenmesi ve eşitsizliğin giderilmesi amacıyla, örtülü sermaye müessesesi vergi güvenlik tedbirleri kapsamında ele alınmaktadır. Bu çalışmada, örtülü sermayenin tanımı, şirketlerin başvurma nedenleri, ülkelerin mevzuatlarında yaptırım düzenleme nedenleri ve örtülü sermayenin tespitine yönelik başlıca yaklaşımlar incelenmiştir. 5520 sayılı Kurumlar Vergisi Kanunu ile örtülü sermayenin tespitinde, 46 yıl boyunca temel alınan serbest oran yaklaşımı terk edilmiş ve sabit oran yaklaşımı benimsenerek, mükellefler nezdinde oluşan belirsizlikler giderilmiş, vergi idarelerine örtülü sermayenin tespiti konusunda uygulama kolaylığı sağlanmıştır.

Anahtar Kelimeler: Örtülü Sermaye, Kurumlar Vergisi, Borç – Sermaye Oranı

Jel Sınıflandırması: K34, E62

ABSTRACT

Thin capitalization is a consequence of efforts made by companies for the avoidance of taxation and efforts by the state to prevent the erosion of tax revenues. The laws of various countries accept thin capitalization as a loan substituted for capital; however, Turkish tax law recognizes thin capitalization as an act of tax avoidance. This study used various methods to examine the definition of the concept of thin capitalization and the disclosure of thin capitalization. The evolution of thin capitalization within the Turkish tax system, the defined components of thin capitalization in the Corporate

Tax Code No: 5520, its taxation outcomes and revision procedures are discussed, examples in the official communications are explained, and the concept of time limit is presented. The debt / equity fixed rate approach was adopted in the Corporate Tax Code No. 5520, which came into force in 2006. This resolved uncertainty for taxpayers and brought the tax authorities an ease of application for the determination of thin capitalization.

Keywords: Thin Capitalization, Corporate Tax, Debt - Equity Ratio

Jel Classification: K34, E62

INTRODUCTION

Equity is not the only source of financing used by companies to initiate and maintain their activities to meet their financing needs, companies can make use of external sources through borrowing, in addition to the capital paid up by shareholders.[1]

Companies can borrow from independent third parties, or from their own shareholders. Shareholders can finance a company either through equity, or by lending to the company, to obtain various tax, legal or economic benefits. If a company is mainly capitalized through loans by its shareholders, these loans are considered to be concealed or thin capital (*örtülü sermaye*) by Turkish law.

"*Thin capitalization,*" as it is known in international tax literature, refers to cases where "*a company's shareholders or related companies finance the company by giving loans rather than providing equity capital, and the loans in question are in fact a form of concealed equity and not debt*".[2] Thin capitalization occurs when loans received from a company's own shareholders, other group companies, or entities or persons of which

[1] Hasan Hüseyin Savaş, "Örtülü Sermayede Borcun Devamlı Kullanılma Koşulu ve Öz Sermayeye Oranı" [Debt-Equity Ratio and Continuous Use of Debt in Thin Capitalization], **Başar Mevzuat Dergisi**, Year:2, Issue:6, June 1999.

[2] Namık Kemal Uyanık, **Örtülü Sermaye Kontrol Edilen Yabancı Kurum Kazancı Çifte Vergilendirmenin Önlenmesi Düzenlemeleri [Regulations on Thin Capitalization, Earnings of Controlled Foreign Corporations, and the Prevention of Double Taxation]**, Ankara, TÜRMOB Yayınları, 2008, p.10.

the company is a part or with which the company is associated make up a significant proportion of the total capital of the company, and the loans in question meet certain criteria.[3]

Rules to prevent borrowing that is considered to constitute thin capitalization limit interest payments and borrowing from the related parties. As a result, a definition of thin capitalization can also be on the basis of rules limiting lending to a company by related persons or entities.[4]

Most countries with developed economies have legislation and sanctions regarding thin capitalization in their legal systems. Such legislation is not fixed, but changes in response to new conditions arising from economic and social developments.[5]

The most important goals of anti-thin capitalization legislation include protecting the tax base, preventing negative effects on the financial system, and protecting competition.[6]

The Turkish tax law defines thin capitalization in paragraph 1, article 12 of the Corporate Tax Code no. 5520, as follows: "*If the ratio of direct or indirect borrowings from shareholders or from persons related to the shareholders exceeds three times the shareholders' equity of the borrower company at any time within the fiscal year, the exceeding portion of the borrowing will be considered 'thin capital' for that accounting period.*"

As the text of the law makes clear, loans received from shareholders are considered to substitute equity capital and called thin capital if they meet certain criteria.[7]

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[3] Hüseyin Işık, **Çok Uluslu Şirketlerde Örtülü Kazanç ve Örtülü Sermaye [Thin Capitalization and Concealed Earnings in Multinational Corporations]**, Ankara, 2005, T.C. Maliye Bakanlığı Araştırma, Planlama ve Koordinasyon Kurulu Başkanlığı (Research, Planning and Coordination Committee of the Ministry of Finance of the Republic of Turkey) Publication No: 2005/370, s.39; Uyanık, ***op. cit.***, p10; Şükrü Kızılot, **Türk Vergi Hukukunda Örtülü Kazanç ve Örtülü Sermaye [Thin Capitalization and Concealed Earnings in Turkish Law]**, Ankara, Yaklaşım, 2002, p. 48.

[4] Uyanık, ***op. cit.***, p10

[5] Uyanık, ***op. cit.***, p.19; OECD: "Thin Capitalisation," April 2010, (Online) http://www.oecd.org/dataoecd/42/20/42649592.pdf.

[6] Kızılot, ***op. cit.***, p.58 – 59; Uyanık, ***op. cit.***, p.19.

[7] Veysi Seviğ, Örtülü Sermaye Nedir? [What is Thin Capitalization?],**Yaklaşım Dergisi**, Year:10, Issue:118, October 2002, p.33-34.

The criteria required for classifying borrowed loans as thin capital vary according to each country's different legislation and in general they concern borrowing from related persons above a certain limit.[8]

The first condition required for classifying loans as thin capital is that the company borrows from a shareholder or a real or legal person related to the company. The related person in question can be a real or legal person who shares in the capital, control, vote or management of a company above a certain limit defined in legislation.[9] The second condition is that the amounts borrowed from related persons exceed limits defined in terms of ratios, absolute amounts or comparisons with peers.[10]

For tax law purposes, identification of thin capitalization is usually based on the arm's length principle. The arm's length principle is mentioned in paragraph 1, article 9 of the OECD Model Convention. The OECD's Thin Capitalization Report, published in 2000, which is a revised version of the OECD report published on 26 November 1986, also mentions the arm's length principle to identify practices of thin capitalization. The US, as well as other countries, have also adopted the arm's length principle. Article 16 of the now defunct Corporate Tax Code no. 5422 also featured the arm's length principle to identify thin capitalization: "*Loans borrowed by companies from real or legal persons with which the borrower company has a direct or indirect company association or a continuous and close economic relationship are considered to constitute thin capital if these loans are used in the company on a continuous basis and the ratio of these loans to shareholder equity exceeds that which is found in peer companies.*"[11]

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[8] Uyanık, ***op. cit.***, s.11; Emrullah Aslan, **Kurumlar Vergisinde Örtülü Sermaye ve Transfer Fiyatlandırması Yoluyla Örtülü Kazanç Dağıtımı [Concealed Profit Allocation in Corporate Tax via Thin Capitalization and Transfer Pricing]**, Master's Thesis, Afyonkarahisar, Afyon Kocatepe University, Graduate School of Social Sciences, 2006, p. 5.

[9] Uyanık, ***op. cit.***, p.11. For example, in Turkey, in accordance with article 12 of Law no. 5520, related persons for purposes of identifying thin capitalization are defined as persons with a capital, vote or profit share of 10%.

[10] Aslan, ***op. cit.***, p.5. Article 12 of Law no. 5520 defines this ratio as three times the shareholder equity in the beginning of the fiscal period.

[11] OECD, **Model Tax Convention on Income and on Capital Condensed Version**, July 2010, p.181; Işık, ***op. cit.***, p.9; OECD, April 2010, ***op. cit.***; Kızılot, ***op. cit.***, p.63 64.

As the arm's length principle used to identify thin capitalization has subjective elements, new regulations by the OECD and the US aim to develop new methods with criteria that are more objective than the arm's length principle. The development of the new methods aims to avoid inconveniencing tax administrations and taxpayers, and to prevent potential conflicts between the parties. Methods examined in this study use mathematical approaches and accounting techniques designed to calculate debt to equity ratios (between the related parties) for purposes of identifying thin capitalization in the fairest manner possible.[12]

Measures taken by countries to prevent companies from using thin capitalization as a concealed method of profit allocation are usually based on one of two main approaches.[13]

In the first approach, there is no specific legislation concerning thin capitalization; instead, rules to prevent concealed forms of profit allocation or general rules and regulations to prevent tax evasion are used.

In the second approach, apart from the general rules there is specific legislation. Nevertheless, specific legislation on thin capitalization can be made using different approaches.

1. IDENTIFYING THIN CAPITALIZATION IN THE ABSENCE OF SPECIFIC LEGISLATION

In this approach, there is no specific legislation to identify thin capitalization, and instead, general rules that prohibit concealed forms of profit allocation or tax law principles that prevent tax evasion are used. These general rules include rules against tax evasion, rules against exploiting loopholes in the laws, and rules on monitoring irregular behavior, attitudes, or management practices.[14]

When identifying thin capitalization without specific legislation, the economic approach in tax law, or the principle of substance over form, is the starting point, and allows taking economic considerations into account

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[12] OECD, April 2010, ***op. cit.***; Işık, ***op. cit.***, p.9

[13] Uyanık, ***op. cit.***, p.59; OECD, April 2010, ***op. cit.***

[14] Kızılot, ***op. cit.***, p.109; OECD, April 2010, ***op. cit.***

in addition to purely legal ones.[15] As a consequence of the economic approach and the principle of substance over form, concepts and forms of tax law are interpreted on the basis of their economic characteristics, and the economic characteristics of events are taxed.[16]

Thin capitalization occurs when shareholders, to obtain tax benefits, capitalize a company by lending assets in the form of loans instead of providing equity capital. Shareholders' equity is thus concealed in the form of loans and, as a result, thin capitalization can be described as an act of concealment. The company's or shareholders' motivation for concealing shareholders' equity in the form of loans is to erode the tax base by hiding the event that creates tax liabilities.[17] From the perspective of the economic approach and the principle of substance over form, the economic consequences that are concealed need to be taxed. Therefore, when companies substitute loans for shareholder equity, the loans in question are considered to be equity capital on the basis of their economic characteristics, and taxed accordingly.[18] Hence, using the economic approach and the principle of substance over form, it is possible to apply general sanctions to deter thin capitalization, without creating specific provisions in the tax law.

1.1. Advantages of Identifying Thin Capitalization Without Specific Legislation

The advantage of identifying thin capitalization without specific legislation is that unique conditions surrounding each event and company can be examined, and decisions can be made to reflect the *de facto* situation. In other approaches, two companies with similar debt to equity ratios but

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[15] Mustafa Akkaya, **Vergi Hukukunda Ekonomik Yaklaşım [The Economic Approach to Tax Law]**, Ankara, Turhan Kitabevi, 2002, p.33; Yasemin Taşkın, Vergi Hukukunda Ekonomik Yaklaşım İlkesine Genel Bakış [An Overview of the Economic Approach to Tax Law], **Mali Çözüm**, January – February 2012, p.70.

[16] Selim Kaneti, Vergi Hukukunda Ekonomik Yaklaşım İlkesi [The Principle of Economic Approach in Tax Law], **Vergi Dünyası**, Issue.131, July 1992, p.47 – 51; Işık, ***op. cit.***, p.224; Taşkın, ***op. cit.***, p.71.

[17] Işık, ***op. cit.***, p.262 – 263.

[18] Selim Kaneti, Vergi Hukukunda Yorum ve Nitelendirme [Interpretation and Characterization in Tax Law], **İktisat ve Maliye**, XXII, 12, 1986, Source: **Selim Kaneti: Makaleler [Articles]** Istanbul, On İki Levha Yayıncılık, 2011, p.263.

otherwise vastly different capital structures may both face thin capitalization sanctions, without regard for their objective conditions. When thin capitalization, on the other hand, is to be identified without specific legislation, the tax administration bases its decisions on market conditions and comparisons with peer companies, and makes healthier decisions.[19]

1.2. Disadvantages of Identifying Thin Capitalization Without Specific Legislation

When identifying thin capitalization in the absence of specific legislation, the tax administration needs to establish that the practice of thin capitalization constitutes a concealed form of profit allocation. The burden of proof is on the tax administration to prove that thin capitalization exists. Therefore, according to the economic approach and the principle of substance over form, the tax administration has to prove that the loans received from shareholders or related persons are in fact equity capital.[20]

Another disadvantage of not having specific legislation is that it is riskier for taxpayers. From the perspective of companies, the amount of borrowing that could be considered thin capitalization is not clear from the outset, and this uncertainty can create financial bottlenecks for companies.[21]

One other disadvantage of not having specific legislation is that the administration may act in an arbitrary and partial manner.[22]

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[19] Kızılot, ***op. cit.***, p.116- 117; Uyanık, ***op. cit.***, p.60; OECD, April 2010, ***op. cit.***

[20] To rule that thin capitalization exists, the tax administration needs to establish that the loans received from shareholders or related persons could not be borrowed from independent parties under market conditions, that these loans differ from established commercial practices or the practice of peer companies, and that the practice was a means of concealed profit allocation. Uyanık, ***op. cit.,*** p.60; OECD, April 2010, ***op. cit.***

[21] Uyanık, ***op. cit.***, p.60; OECD, April 2010, ***op. cit.***

[22] Uyanık, ***op. cit.***, p.60; OECD, April 2010, ***op. cit.***

2. IDENTIFYING THIN CAPITALIZATION VIA SPECIFIC LEGISLATION

The second main approach used to identify thin capitalization is to make specific legislation concerning how to identify thin capitalization. Such legislation is usually based on a fixed ratio approach, floating ratio approach, or earnings stripping approach.

2.1. The Fixed-Ratio Approach

Also known as the safe haven rule, the fixed-ratio approach considers all, or a portion of the interest payments on loans received from shareholders or related persons, non-deductible -i.e. a form of profit allocation-, if the ratio of such loans to equity exceeds a certain limit.[23]

The debt to equity ratio to be used in identifying thin capitalization is set by law, and loans received by companies from shareholders or related parties are not considered to be thin capital if they do not exceed this ratio. Interest payments on such loans are deductible from the corporate tax base. However, interest paid on loans exceeding the debt to equity ratio set in the law are considered to be a form of profit allocation, and are not deductible from the taxable base.[24]

The fixed-ratio approach can be applied in two different ways:

First, the debt to equity ratio set in the law can be considered the only criterion in identifying thin capitalization. If this ratio is exceeded, the loans in question are automatically classified as thin capital. This method is also called the inflexible ratio method.[25]

In the second method, the debt to equity ratio is not the only criterion; the taxpayer is given an opportunity to explain their practices. In this method, the classification of loans that exceed the debt to equity ratio in the law as thin capital is not automatic. If the taxpayer can show that the loans in question do not violate the principle of arm's length, the loans are

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[23] Kızılot, ***op. cit.***, p.110; Uyanık, ***op. cit.***, s.60; Aslan, ***op. cit.***, p.9; OECD, April 2010, ***op. cit.***

[24] Uyanık, ***op. cit.***, p.60; OECD, April 2010, ***op. cit.***

[25] Kızılot, ***op. cit.***, p.110; Uyanık, ***op. cit.***, p.60; OECD, April 2010, ***op. cit.***

not considered to be thin capital for tax law purposes, even if they exceed the ratio set in the law. To show that thin capitalization does not exist, the taxpayer can provide an analysis of unrelated peer companies' borrowing, loan proposals received from independent lending organizations, or the borrowing capacity of the company.[26]

To identify thin capitalization, the law can set a single ratio that applies to all companies, or different ratios can be set for companies operating in different sectors. This way, tax incentives can be provided to selected sectors, or by setting different ratios for different sectors, competition can be strengthened. For example, in a number of countries that adopt the fixed-ratio approach, the debt to equity ratios for companies in the financial sector are higher compared with companies operating in other sectors.[27]

2.1.A. Advantages of the Fixed-Ratio Approach

One of the advantages of the fixed-ratio approach is that it is easy to implement for the tax administration. The tax administration does not have to collect data on peer companies or conduct other examinations to establish that thin capitalization exists. This is because the rules with which the taxpayer has to comply are already established by law. Any loans in excess of the debt to equity ratio set in law are considered to be thin capital.[28]

A second advantage is that it eliminates uncertainty on the part of taxpayers. Taxpayers have control over their borrowing from shareholders or real persons within pre-set limits, and are able to plan their borrowing activities within these limits.[29]

A general fixed ratio can be set for all corporate taxpayers. Thus, the fixed-ratio approach would not distort competition between peers or result in discrimination.[30]

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[26] Koyuncu, ***op. cit.***, p.413; Uyanık, ***op. cit.*, p**.60; OECD, April 2010, ***op. cit.***

[27] Koyuncu, ***op. cit.***, p.413; Uyanık, ***op. cit.*, p**.60; OECD, April 2010, ***op. cit.***

[28] Aslan, ***op. cit.***, p.9; Uyanık, ***op. cit.***, p. 60; OECD, April 2010, ***op. cit.***

[29] Kızılot, ***op. cit.***, p.109; Uyanık, ***op. cit.***, s. 60; OECD, April 2010, ***op. cit.***

[30] OECD, April 2010, ***op. cit.***;Uyanık, ***op. cit.***, p. 60.

Also, in the fixed-ratio method, taxpayers are not obliged to prove that the loans in question do not constitute thin capitalization.[31]

2.1.B. Disadvantages of the Fixed-Ratio Approach

The fixed-ratio approach has disadvantages for both taxpayers and the tax administration, but taxpayers face further disadvantages.

The first disadvantage for taxpayers emerges if the debt to equity ratio is low. If the debt to equity ratio to be used for purposes of identifying thin capitalization is low, companies with a weak capital structure, which are in need of high levels of borrowing, would face legal sanctions if they borrowed from shareholders or related persons in order to continue their operations. If the fixed ratio in question is low, companies would have to increase their capital or borrow from third parties rather than borrow from shareholders or related persons, even if they genuinely need the loans and have no intention of tax avoidance.[32]

The second disadvantage for taxpayers is that it is difficult to find the ideal ratio, and ratios that do not reflect the needs of companies can create negative consequences for the national economy. Due to the diverse and complex nature of financial transactions, setting a fixed debt to equity ratio could create more problems than it solves.[33] The need for companies to borrow from shareholders or related persons may be greater than the fixed ratio set by the law. If a fixed ratio that fails to meet the needs of companies is set, it may affect the bottom line of businesses, and hamper commercial activities country-wide, eventually resulting in lower business volume overall. The slowdown in the economy would then lower businesses' and individuals' incomes, which would mean lower tax revenues for the state. However, these disadvantages of the fixed-ratio approach can be easily overcome by setting an appropriate debt to equity ratio. In addition, when calculating tax revenues lost by the state, taxes lost due to

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[31] OECD, April 2010, ***op. cit.***;Uyanık, ***op. cit.***, p. 60.

[32] İrfan Çetin, OECD Model Anlaşması Kapsamında Örtülü Sermaye [Thin Capitalization in the OECD Model Convention], **Vergi Dünyası**, Year:24, Issue 284, April 2005, p. 24; Uyanık, ***op. cit.***, p.60; OECD, April 2010, ***op. cit.***

[33] Çetin, ***op. cit.***, p.80; OECD, April 2010, ***op. cit.***

interest payments as a result of thin capitalization should also be taken into account.[34]

Another disadvantage of the fixed-ratio approach is that it reduces the competitiveness of the economy, and creates negative consequences for the country's financial system. Multinational corporations find it easier, compared to local companies, to show loans borrowed from their subsidiaries as loans received from independent third parties. This is because identifying the source of loans originating overseas and establishing that these loans were provided by shareholders or related persons is more difficult compared with loans originating from inside the country. Therefore, compared to local firms, multinational corporations find it easier to borrow from shareholders and related persons. This greater ability to borrow, enjoyed by multinational corporations, puts local companies at a competitive disadvantage. To deal with this distortion in competition, local companies need to improve their borrowing capacity. To this end, they may choose to move assets overseas, or borrow against collateral. As a result, national assets would first be transferred to foreign jurisdictions and then return to the country in the form of loans, with negative repercussions for the financial system.[35]

The fixed-ratio approach also has disadvantages for the tax administration. One disadvantage is that because a fixed debt to equity ratio is established in the law, loans up to this limit cannot be classified as thin capital by the tax administration. In this case, even companies that do not need to borrow from shareholders or related persons may choose to borrow, up to the limit specified in the law, from shareholders or related persons, in order to lower their corporate tax base. Having a legally defined mandate, tax administrations in these cases have to accept the deduction of interest payments on such loans.[36]

2.2. The Floating-Ratio Approach

The floating ratio approach is based on adopting certain principles or criteria rather than relying on a fixed debt to equity ratio to identify thin capitalization. Countries usually adopt one of two floating ratio methods.

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[34] Uyanık, ***op. cit.***, p.60; OECD, April 2010, ***op. cit.***; Çetin, ***op. cit.***, p.24 – 25.
[35] Uyanık, ***op. cit.***, p.61; OECD, April 2010, ***op. cit.***
[36] Koyuncu, ***op. cit***., p.414; Uyanık, ***op. cit.***, p.61; OECD, April 2010, ***op. cit.***

The first method, called the pure floating ratio approach, is based on the arm's length principle. Also known as the principle of no collusion, the principle of arm's length requires comparing loans received by the company from shareholders or related persons with loans received by peer companies operating in the same sector[37]. If the debt to equity ratios or loan amounts of companies that borrow from shareholders or related persons are found to be different from peer companies' practices, loans borrowed from shareholders or related persons are classified as thin capital.

The principle of arm's length is mentioned in article 9 of the OECD Model Convention. Article 9 of the OECD Model Convention compares activities of dependent businesses with those of independent businesses, and allows adjusting prices and profits of dependent businesses by correcting for the effects of conditions that differ from free market conditions.[38]

Differences with peer companies are identified using a range of arm's length reference values. The range of reference values forms the basis of the decision regarding how much of the loans received by a company is comparable to its peers. If the loans received from shareholders or related persons are within the range of reference values, they are not classified as thin capital. When applying the arm's length principle to transfer pricing, the average of reference prices is used. Therefore, the range of reference values for purposes of identifying thin capitalization should also be based on a calculation of averages. Peer companies are defined on the basis of operating in the same sector or under similar conditions, or having similar capital structures, and reference loans can be defined on the basis of the amount borrowed, the interest rate, and maturity.[39]

Another floating-rate method uses indicator ratios to identify thin capitalization. In this method, debt to equity ratios exceeding a fixed ratio set by the law are classified as thin capital, but if the loans received by the taxpayer are shown to be similar to reference loans, these loans are not classified as thin capital.[40]

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[37] Kızılot, ***op. cit.***, p.109; OECD, April 2010, ***op. cit.***

[38] OECD, 2010, ***op. cit.***, p. 181; OECD, April 2010, ***op. cit.*****;** Yasemin Taşkın, **Transfer Fiyatlandırmasında Emsallere Uygunluk İlkesi [The Principle of Arm's Length in Transfer Pricing]**, Istanbul, Türkmen Kitabevi, 2012, p.101.

[39] Koyuncu, ***op. cit.***, p.413; OECD, April 2010, ***op. cit.***

[40] Kızılot, *op. cit.*, p.180; Koyuncu, ***op. cit.***, p.413; OECD, April 2010, ***op. cit.***

In the floating ratio approach, each company is treated as a unique case. The tax administration examines the nature of debt service, the source of the loans, and the motivation for commercial activity in question.[41]

2.2.A. Advantages of the Floating-Ratio Approach

One advantage of the floating-ratio approach for taxpayers is that the debt to equity ratio is adjusted depending on current economic conditions.[42]

Another advantage of the floating ratio approach is that it allows the unique conditions of each company to be taken into consideration. Thus, differences between companies are taken into account when setting the criteria for thin capitalization, and accurate assessments can be made on the basis of objective criteria.[43]

An advantage of the floating-ratio approach for the tax administration is that if the debt to equity ratio needs to be adjusted, there is no need to amend the laws.[44]

One consequence of the floating-ratio approach is that companies would try to limit borrowing from shareholders or related persons to what they actually need.[45]

2.2.B. Disadvantages of the Floating-Ratio Approach

The most important disadvantage of the floating-ratio approach for taxpayers is the difficulty involved in deciding whether the company's level of borrowing exceeds those of peer companies. This is because peer companies' levels of borrowing may change over time, or can be calculated differently by tax administrators, and this uncertainty creates additional risks for companies.[46]

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[41] Kızılot, *op. cit.*, p.180; Koyuncu, ***op. cit.***, p.413; OECD, April 2010, ***op. cit.***
[42] Uyanık, ***op. cit.,*** p.62; OECD, April 2010, ***op. cit.***
[43] Uyanık, ***op. cit.,*** p.62; OECD, April 2010, ***op. cit.***
[44] Uyanık, ***op. cit.,*** p.62; OECD, April 2010, ***op. cit.***
[45] Uyanık, ***op. cit.,*** p.62; OECD, April 2010, ***op. cit.***
[46] Uyanık, ***op. cit.,*** p.62; OECD, April 2010, ***op. cit.***

One disadvantage of the floating-ratio approach for tax administrations is that a separate ratio would have to be calculated for each company. Due to each company being treated as a unique case, the floating ratio is different for each company and the tax office needs to calculate reference levels of borrowing for each company. To calculate these levels, in turn, qualified personnel would need to be trained, company assessments conducted using similar methods, and detailed information collected by the tax administration on borrowing practices in individual sectors.[47]

2.3. Earnings Stripping Approach

The earnings stripping approach places a fixed upper limit on the interest expenses of the taxpayer. Therefore, it is considered to be a form of fixed-ratio approach. Earnings stripping rules were first introduced in the US, and gained widespread acceptance by other countries in recent years. For example, since 2007 France has begun to implement an earnings stripping approach.[48]

In the fixed-ratio and floating-ratio approaches, interest payments that are not allowed as expenses are calculated on the basis of the relationship between debt and equity. In the earnings stripping approach, on the other hand, interest payments that are not allowed as expenses are calculated on the basis of the relationship between the net interest payments and profits of the company. The debt to equity ratio is set at a lower level compared with other approaches and because the debt to equity ratio is lower, more companies face thin capitalization sanctions.[49]

The OECD Model Convention does not contain any provisions directly on thin capitalization, but article 9 recognizes that excessive interest payments can be used as an instrument for profit transfer. Therefore, the OECD Model Convention allows tax administrations to re-adjust company profits.[50]

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[47] Uyanık, ***op. cit.,*** p.62; OECD, April 2010, ***op. cit.***
[48] Işık, ***op. cit.***, p.55.
[49] Kızılot, ***op. cit.***, p.125; Işık, ***op. cit.***, p.55.
[50] OECD, 2010, ***op. cit.***, p. 182.

2.3.A. Advantages of the Earnings Stripping Approach

The earnings stripping approach is easy to implement both for taxpayers and tax administrations. For the taxpayer, there are no extra risks as the debt to equity ratio is fixed, and for the tax administration, identifying thin capitalization is a simple process.[51]

It can be argued that this a more objective method compared to others, because the relationship between net interest payments and profits of the company is also taken into account in addition to the debt to equity ratio.[52]

2.3.B. Disadvantages of the Earnings Stripping Approach

The earnings stripping approach has certain disadvantages because the unique economic conditions each company faces are not taken into account. As a result, whether loans borrowed from shareholders or related persons are similar to the practices of peer companies is not examined.

2.4. Other Approaches

In addition to the three main approaches -based on fixed ratios, floating ratios and earnings stripping-, countries use other methods to identify thin capitalization. These include the quasi-thin capitalization approach, the consolidated group approach, and limiting borrowing.[53]

2.4.A. The Quasi-Thin Capitalization Approach

The quasi-thin capitalization approach is based on the principle of calculating debt to equity ratios for each sector based on objective market criteria, and classifying excessive interest payments as non-deductible expenses. The objective market criteria to be used vary according to industry and sector. Tax administrations can avoid criticism if these standards are set by independent regulatory agencies. Market criteria are preferred because they would reflect de-facto conditions in each market more accu-

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[51] Uyanık, ***op. cit.,*** p.63.
[52] Işık, *op. cit.*, p. 71 - 72. Uyanık, ***op. cit.***, p.63.
[53] Uyanık, ***op. cit.,*** p.64.

rately. However, because market conditions are dynamic, objective market criteria need to be reviewed on a regular basis. In addition, it might be easier to identify market criteria in some sectors, whereas identifying objective criteria in others would be more difficult. In markets where borrowing plays a dominant role, such as the financial and banking sectors, identifying these market criteria is a relatively straightforward task; however, in markets where borrowing plays a relatively minor role, identifying market criteria is difficult. [54]

When implementing the quasi-thin capitalization approach, tax administrations face criticism. The main criticism is that when market criteria are being identified, calculations are not based on the OECD principle of arm's length.[55]

2.4.B. Consolidated Capital Structure Approach

In the consolidated capital structure approach, the debt to equity ratio of a subsidiary company is calculated on the basis of the worldwide consolidated debt to equity ratio of the parent company. Debt to equity ratio of the subsidiary company is compared with the worldwide debt to equity ratio of the parent company, and if the former is larger, interest payments on the excess amount are classified as disallowable expenses. The consolidated capital structure approach is based on the assumption that worldwide debt to equity ratio of the parent company is an indicator of the amount of risk that shareholders or related persons would be willing to take.[56]

As the worldwide debt to equity ratio of the parent company is an objective measure, the consolidated capital structure approach arguably provides a more realistic assessment of the *de-facto* situation compared to the fixed ratio approach. In addition, calculating the debt to equity ratios of multinational corporations is a straightforward task using their financial statements.[57]

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[54] Stuart Webber, **Thin Capitalization and Interest Deduction Regulations**, Copenhagen Research Group on International Taxation – Corit Discussion Paper No. 8, 2010, p. 319. Uyanık, ***op. cit.***, p.64.

[55] Webber, ***op. cit.***, p.3 – 19; Uyanık, ***op. cit.*,** p.64.

[56] Webber, ***op. cit.***, p. 57; Uyanık, ***op. cit.***, p.64-65.

[57] Webber, ***op. cit.***, p. 57; Uyanık, ***op. cit.***, p.65.

The consolidated capital structure approach has been criticized on various grounds. One criticism is that the arm's length principle is not used when calculating debt to equity ratios. The arm's length principle used to identify thin capitalization in the OECD model is based on the idea of comparing peer companies that operate under similar conditions, and requiring them to comply with similar rules. In the consolidated capital structure approach, on the other hand, companies or transactions are not compared with their likes, and thin capitalization is identified on the basis of the worldwide debt to equity ratio of the parent company. A second criticism is that subsidiary companies are not treated as independent legal persons, separate from their parent companies. The subsidiary and the parent companies may be operating under very different market conditions. However, the consolidated capital structure approach does not take these differences into account.[58]

2.4.C. Total Debt Limit Approach

Thin capitalization exists when loans received from shareholders or related persons meet certain criteria, as defined by the law. In the total debt limit approach, the source of a company's loans is not taken into consideration, and a limit is placed on the total debt of the company. Limiting the total debt of related companies, regardless of the source of the loans, does not conflict with article 9 of the OECD model convention on taxes.[59]

The practice of limiting the total debt of companies is not confined to the field of thin capitalization. Within the framework of Basel 2 regulations, total debt is one of the factors taken into account when ratings are assigned to companies operating in the banking and finance sector. Therefore, setting an upper limit for total debt for tax purposes does not conflict with economic rules.[60]

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[58] Webber, ***op. cit.***, p. 57; Uyanık, ***op. cit.***, p.65.
[59] OECD, April 2010, ***op. cit.***; Uyanık, ***op. cit.***, p.66
[60] OECD, April 2010, ***op. cit.***; Uyanık, ***op. cit.***, p.66

3. APPROACHES TO IDENTIFYING RELATED PERSONS IN THIN CAPITALIZATION

Fixed-ratio, floating-ratio, earnings stripping and the other approaches examined above, concern the debt to equity ratios used to identify thin capitalization. However, for borrowing by companies to constitute thin capitalization, there are additional rules besides the loans in question exceeding a certain amount or ratio.

These rules explain which real or legal persons will be considered as related parties for the purposes of identifying loans that constitute thin capitalization. These rules will be explained in the two sections below on minimum shareholding and grouping.

3.1. The Minimum Shareholding Approach

The minimum shareholding rule regulates the source of the loans borrowed by a company and taken into account when identifying thin capitalization. For the loans in question to constitute thin capitalization, they must be received from shareholders or related persons or entities. Loans from other real or legal persons are considered regular loans, and not taken into account when identifying thin capitalization. Thus, the minimum shareholding approach provides definitions of shareholders and related persons or entities for the purposes of identifying thin capitalization.[61]

Regulations on thin capitalization also include definitions of dependent companies and related persons. Some countries define dependent companies and related persons on the basis of holding at least 10%[62] of the shares of the company. This minimum shareholding ratio can be as high as 25%[63] in some countries.[64]

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[61] Uyanık, ***op. cit.***, p.67; Ernst&Young LLP: Thin Capitalization Regimes in Selected Countries, May 2008, p.2.

[62] In Turkey, shareholders and related persons are defined on the basis of holding at least 10% of the shares of the company.

[63] In Germany, prior to the 2008 amendments, loans received from shareholders who held at least 25% of the shares were taken into account to identify thin capitalization.

[64] Uyanık, ***op. cit.***, p.67; Ernst&Young LLP, ***op. cit.***,, p.2.

3.2. Grouping Approach

The grouping approach aims to prevent the so-called "*waterfall effect.*" The waterfall effect refers to the ability of a corporation to avoid taxes via thin capitalization by increasing its debt to equity ratio exponentially using the large number of companies it owns, all the while remaining within statutory limits. In other words, the waterfall effect is a form of collusion that results in the corporation paying lower taxes thanks to its many dependent companies. To prevent this form of collusion, many countries have grouping rules that apply when identifying thin capitalization.[65]

There are three different grouping methods to prevent collusion through the waterfall effect.[66]

In the first grouping method, equities of subsidiary companies are subtracted from the equity of the parent company.[67]

In the second method, loans provided by foreign shareholders to the parent company are subtracted from the equities of subsidiary companies.[68]

In the third method, group companies are treated as a single company, and the debts and equities of all group companies are aggregated as if there is a single taxpayer. If the debt to equity ratios thus calculated exceed the statutory limits, sanctions to deter thin capitalization are applied to the businesses that exceed the limit.[69]

4. THE TURKISH CASE

Thin capitalization legislation in Turkey is best examined in two periods: before 2006 and after 2006.

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[65] Uyanık, ***op. cit.***, p.67; Webber, *op. cit.*, p. 57, 32; Ernst&Young LLP, ***op. cit.***, p.2, 14, 39.
[66] Uyanık, ***op. cit.***, p. 68.
[67] **Ibid.**
[68] Ernst&Young LLP, ***op. cit.***, p.2 Uyanık, ***op. cit.***, p.69.
[69] Ernst&Young LLP, ***op. cit.***, p.2; Uyanık, ***op. cit.***, p.70.

4.1. The Pre-2006 Period

Between 1949 and 2006, thin capitalization was regulated by article 16 of the Corporate Tax Code no. 5422. This article stated that thin capitalization existed if companies used loans received from related persons on a continuous basis in the business, and the ratio of these loans to equity differed significantly from the ratio in peer companies.

The law therefore adopted a floating ratio approach to identify thin capitalization, based on the principle of arm's length; however, the law did not define peer companies. Therefore, filling this gap was left to court decisions.[70] With the Corporate Tax Code no. 5520, which went into effect in 2006, the floating ratio approach was abandoned in favor of the fixed ratio approach.

4.2. The Post-2006 Period

In Turkey, thin capitalization was first regulated by article 16 of the Corporate Tax Code no. 5422, which went into effect in 1949. Article 12 of the Corporate Tax Code no. 5520, which went into effect in 2006, updated

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[70] Some of the relevant court decisions were as follows:
The 4th Chamber of the Council of State, in its decision dated 9 December 1980 with docket no. 80/1223 and decision no. 80/3575, ruled that interest payments made by the defendant company to the corporation that owned 84% of the shares of the company but failed to carry out its obligation to provide three quarters of the capital, at a rate that exceeded normal bank interest rates, constituted thin capitalization.
The 3rd Chamber of the Council of State, in its decision dated 7 May 1998 with docket no. 97/293 and decision no 98/1650, ruled that to identify thin capitalization, the debt to equity ratio of the company should be examined to see whether it complies with the principle of arm's length, and this examination should be carried out by taking the particular circumstances of the company in question into account.
The 4th Chamber of the Council of State, in its decision dated 21 January 1998 with docket no. 97/4874 and decision no. 98/186, ruled that an accusation of thin capitalization, merely on the basis of a comparison with another company operating in the same sector and without firmly establishing that the debt to equity ratio is excessive, would be groundless.
The 3rd Chamber of the Council of State, in its decision dated 12 January 1976 with the docket no. 75/1851 and decision no. 76/39, ruled that interest payments on loans received by Company X from Lender Y, which holds 83% of the shares of the company, via capital increase and issuing bonds and at a rate exceeding 100% of the equity of the company, constitute thin capitalization and these payments cannot be deducted as expenses.

thin capitalization legislation in light of international developments and widely accepted accounting principles.

Paragraph 1, article 12 of Law no. 5520 states that "*If the ratio of direct or indirect borrowings from shareholders or from persons related to the shareholders exceeds three times the shareholders' equity of the borrower company at any time within the fiscal year, the exceeding portion of the borrowing will be considered thin capital for that accounting period.*"

Paragraph 1, article 12 of Law 5520 thus states that thin capitalization exists if loans received from related persons and used by the company exceed three times the equity of the company in the beginning of the accounting period. By establishing the debt to equity ratio -for purposes of identifying thin capitalization- as 3 to 1, the law adopts the fixed ratio approach.

CONCLUSION

The concept of thin capitalization was incorporated into the Turkish Tax System via article 16 of the Corporate Tax Code no. 5422, which went into effect in 1949. Later, the concept of thin capitalization underwent changes as a result of economic developments, and Law 193 enacted in 1960 amended the definition of thin capitalization provided in article 12 of the Law no. 5422. For 46 years, the concept of thin capitalization remained the same, as article 12 of Law no. 5422 remained in effect until the Corporate Tax Code no. 5520 was enacted. The Corporate Tax Code no. 5520, which went into effect in 2006, updated the concept of thin capitalization in light of international developments and widely accepted accounting principles.

With Law no. 5520, the floating-ratio approach was abandoned in favor of the fixed-ratio approach. With the adoption of the fixed-ratio approach, uncertainties faced by taxpayers regarding the debt to equity ratio were removed, and the tax administration was relieved of the obligation to calculate reference values for each company and collect comprehensive borrowing information for each sector. As the law has established a fixed debt to equity ratio of 3 to 1 with which all taxpayers must comply, the adoption of the fixed-ratio approach has made it easier for tax offices to identify thin capitalization.

Another advantage of the fixed-ratio approach is that it removes uncertainties that taxpayers face when a floating ratio approach is in place. Taxpayers are now able to control and plan their borrowing from shareholders or related persons, within the limits set by the law. The fixed ratio of 3 to 1, as established by the law, prevents discrimination between peer companies and protects competition because it applies to all corporate taxpayers.

The fixed-ratio approach adopted by Law no. 5520 also has certain disadvantages. First, it is not clear, reading the preamble to the act or discussions in the literature, which methods were used to arrive at the debt to equity ratio of 3 to 1. Therefore, whether the debt to equity ratio of 3 to 1 is the ideal ratio for companies operating in Turkey is open to debate.

Second, a single debt to equity ratio creates problems because companies operating in different sectors have different borrowing needs. It is normal for the borrowing requirements of companies in different sectors to increase over time. If a fixed ratio that fails to meet the requirements of companies is set, it may affect the bottom line of businesses, and hamper commercial activities country-wide. This, in turn, may result in lower business volume overall and lower incomes for businesses and individuals, thus decreasing tax revenues of the state as well. When companies need to increase their borrowing for economic reasons, their debts would still be evaluated on the basis of the fixed debt to equity ratio of 3 to 1, and these companies would be penalized, even if they had no intention to avoid taxes. Therefore, different debt to equity ratios should be set for the main sectors.

A third disadvantage is that companies that do not need to borrow from shareholders or related persons may choose to borrow, up to the limit specified in the law, from shareholders or related persons, in order to lower their corporate tax base. Having a legally defined mandate, tax administrations in such cases have to accept the deduction of interest payments on such loans as expenses.

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