

Guideline on Turkish Advance Pricing Agreements

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GUIDELINE ON TURKISH ADVANCE PRICING AGREEMENTS

1. General

Advance pricing agreements (APAs) are defined by the OECD transfer pricing guidelines for multinational enterprises and tax administrations as an appropriate set of criteria (for example transfer pricing method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed

period of time in advance of controlled transactions. Generally, an APA means a process which is started by the application of taxpayers and carried on with the negotiations between taxpayer and/or its related party (or parties) and tax authority (or authorities) to resolve transfer pricing issues arising with related party transactions.

The enforcement of APAs in Turkey became effective with the new Turkish corporate income tax law (CITL), number 5520. The CITL was published in the official gazette, number 26205 on June 21 2006.

However, according to article 37 of aforesaid code, article 13, entitled distribution of hidden profit by means of transfer pricing, came into force on January 1 2007. Article 13 of new law contains a provision explaining that transfer pricing applied for purchase or sale of goods or services among related parties as well as the methods to be used for computation of such prices could be determined upon agreement with the Ministry of Finance; the method determined by this mean will be valid for duration of three years given that the terms and conditions fixed by such an agreement do not change. Consequently, APAs have been a part of Turkish tax legislation with this provision.

As indicated in the preamble of new Turkish corporate tax code, the taxpayers are given the chance of negotiating APAs for transactions that occur between related parties by applying to the Ministry of Finance for the method(s) to be used. Thus, taxpayers with any hesitation for the method(s) to be used for inter-company transactions could request the determination of transfer pricing method for a certain period not exceeding more than three years.

It is necessary for the taxpayers to apply with the documents required by Revenue Administration in Ministry of Finance of Turkey (hereafter called as tax administration or tax authorities) for these agreements taking place in many countries' legislation and recommended in the OECD guidelines. It is definite under the conditions and circumstances set by the parties of agreements, if a settlement is arranged on a transfer pricing method. Under the conditions and

circumstances, the method determined in that way will not be criticised by tax authorities subsequently.

The most important side of this system for the taxpayers in Turkey is to have certainty, to use tax planning without any punishment or challenges from tax authorities and to foresee the future more openly. First and foremost, by making an agreement, the most important side for tax authorities is to save the workload and time which may rise from starting point of an auditing until the end of litigation period.

2. The aims of APAs

The aim of APAs for Turkish tax legislation is generally, especially in the short term, to solve the matters faced by mostly the taxpayer because of transfer pricing implications, as these agreements give advantage to both of taxpayers and tax administration. Consequently, the taxpayers could anticipate their legal obligations with the agreement which is made together with tax administration after clarifying transfer pricing methods to be used for the future transactions. This gives a possibility for taxpayers to make use tax planning and especially creates an important effect on the investments.

APAs in Turkish tax legislation largely follow aims such as decreasing the debates between tax authorities and taxpayers and preventing the tax audits that last for a long time and become costly for tax administrations.

Also, it is feasible to avoid the possibility of double taxation with a bilateral or multilateral APA involving Turkish tax authorities and competent tax authorities of Turkey's partner state(s). In transfer pricing practices, such conclusions are seen as important items which encourage the taxpayers to apply for APAs. Mainly, the reason of applying an APA from the point of Turkish tax regulations is to reduce the conflicts arising due to transfer pricing and to diminish the burden on both the taxpayer and tax administration.

3. The scope of APAs

An APA, as indicated in OECD guidelines, states an agreement concluded between taxpayer and tax authority on the controlled transactions to determine the method to be used over a certain period. As understood from this explanation, the scope of APAs in Turkey covers controlled transactions among the related parties. Furthermore in APAs basically the method to be used is determined; however the main facts, such as comparability items, comparables and appropriate adjustments, critical assumptions, are even accepted in the scope of agreement.

At the moment in Turkey, only corporate taxpayers fall under the scope of APAs. From January 1 2008, VIP tax office taxpayers (which are the biggest 500 corporate taxpayers determined according to their revenue, gross profit, extent of asset and the number of employees) and beginning from January 1 2009, all corporate taxpayers without any exceptions or limits will be able to request an APA from the Turkish tax authority, named as revenue administration, for only the cross-border transactions with their non-resident entities or related parties to determine the method to be used. As mentioned above sentence, domestic transactions of corporate tax payers are not encompassed in the scope of APAs.

Also beginning from January 1 2009, it will be possible to request an APA in the subject of transfer pricing for transactions that occurred among the corporate taxpayers operating in the free trade zones in Turkey and other corporate taxpayers in the scope of related parties.

Naturally, it can be said that the taxpayers registered at VIP tax office in Istanbul and operating in the free trade zones could have an APA from the beginning day of 2008. However, although personal income taxpayers are in the scope of transfer pricing regulations, they could request an APA for neither internal nor cross-border transactions.

4. Agreement process in APAs

The process in Turkish APAs commences with a demand to the tax administration, made in writing by the taxpayer. At the application stage, the taxpayer has to submit the documents and papers containing necessary information required for the request to be deemed an acceptable method by tax administration for related party transactions.

As a first step during the APA process, the tax administration examines the documents and papers containing necessary information after the APA request and submission. It is decided at the pre-examination stage whether an APA for those transactions is legally possible.

After this pre-examination, if the answer is positive, the evaluation stage follows. The taxpayer completes any missing items for the APA if the tax administration requires further information at this stage; also the tax authority starts to investigate the conditions surrounding the APA. The tax administration passes onto the analysis stage after the evaluation.

At the analysis stage, examinations are made on comparable transactions, functions performed, assets used, risks assumed, other adjustments, applicable method(s), critical assumptions and the choice and assessment of other essential elements.

The tax administration can accept the taxpayer's request or accept provided that some changes are made or deny it completely after finishing the analysis stage. If the request is denied, the APA request, documents and necessary information papers submitted by the taxpayer at the applying stage are given back by tax administration.

Subsequently, upon finishing the analysis stage, the last step starts and at this stage, an official APA, which is in used just for the two sides and not declared to the third parties, is signed between tax administration and taxpayer.

As mentioned above, the transfer pricing method to be used is specified before the stage in which an official agreement is signed by parties. After concluded, the APA's text generally contains;

- ◆ Implementation clause of APA,
- ◆ Abbreviations,
- ◆ The scope of related party transactions,
- ◆ Application period of the method accepted,
- ◆ Comparables and appropriate adjustments,
- ◆ Critical assumptions,
- ◆ Annual report for APA and documentation
- ◆ Auditing terms of APA,
- ◆ Record retention and submission,
- ◆ Settlement of disputes,
- ◆ Disclosure terms of information and documents shared with tax authorities,
- ◆ Renewal of APA, Revising APA, Cancelling APA
- ◆ Legal amendments,
- ◆ Adjustment and penalties,
- ◆ Statements addresses related with APA
- ◆ Other important subjects

After completing the process and finalising an APA, the tax administration will not be able to challenge the method used by taxpayer provided that taxpayer doesn't violate the clauses of agreement.

However, the APA process may last for years because of reasons such as the complexity of business life and the difficulty to establish adequate information promptly. For this reason, to prevent these kinds of problems it is very helpful for taxpayers if they submit adequate documents and information as requested by tax administration.

If the Turkish tax authorities conclude, having assessed the taxpayer's request for an APA, that related-party transactions have links with other jurisdictions, it

can decide to negotiate a bilateral or multilateral APA with the competent authority (or authorities), and if a tax treaty exists between Turkey and its partner state.

5. Documentation for APAs

The basic information and documents that taxpayers who request an APA should present to the tax administration are:

- ◆ Written application (the requested period of arrangement; names, Republic of Turkey ID numbers, addresses and telephone numbers of taxpayers or their representatives who will be involve in the arrangement process, taxpayers' line of business, structure of organisation (headquarter and branches), shareholders, capital structure, sector, summaries of economic and legal background, definitions of related parties and ownership relations of related parties should be stated in written application);
- ◆ All information related to the functions, risks of corporation and assets that are used;
- ◆ Documents and reasons related to critical assumptions (suggested transfer pricing method and explanations, analysis and other works based on the choice and application of this method);
- ◆ The information related to intangible property ownership and payments of royalty or intangible rights;
- ◆ If the related parties use different accounting standards and methods, the information related to these standards and methods;
- ◆ The price list at the fiscal period of the application date;
- ◆ The cost of production at the fiscal period of the application date;
- ◆ The intercompany pricing policy applied to transactions between related parties;
- ◆ The information about the volumes of controlled and uncontrolled transactions at the fiscal period which involves transaction date and invoices, bank slips and similar documents;

- ◆ Related parties' financial statements from the previous three years, copies of income or corporate tax returns and copies of agreements about foreign transactions;
- ◆ The financial data and documents of the previous three years supporting the suggested transfer pricing method;
- ◆ If there are two or more comparable transactions, the arm's-length range and the method used in the determination of that range; and
- ◆ Other documents required to determine the arm's length price.

The tax administration will ask for additional document containing necessary information from the taxpayer if necessary. If documents and information concerned are written in other languages, they have to be submitted together with original copies after being translated into Turkish.

At the same time, the taxpayers who signed an APA with tax administration have to prepare and submit an annual APA report (The general terms of annual APA report can be seen at the end of article.) covering the transactions within agreement. However, documents and papers containing necessary information for the related party transactions that are not covered by the APA must be kept separately in accordance with the documentation rules in transfer pricing legislation.

6. Renewal of an APA

According to Turkish transfer pricing legislation, taxpayers can request the renewal of an APA. The taxpayer, in such a case, has to fill in a form to renew an APA, no later than nine months before the current APA expires. The taxpayer should also submit appropriate updated supporting documentation, similar to that required for the initial APA request and submission, with the renewal request. Revenue administration may renew an APA under similar terms and conditions when both the taxpayer and administration are satisfied that:

- ◆ The transfer pricing method in the previous APA continues to be appropriate,

- ◆ There have been no material changes in the facts and circumstances underlying the APA and the critical assumptions remain valid and relevant and
- ◆ The taxpayer has complied with the terms and conditions of the previous APA.

7. Revising an APA

An APA which was signed officially between the revenue administration and the taxpayer may be revised if it is established that:

- ◆ There has been a failure to meet any of critical assumptions,
- ◆ There has been a change in the law, including a tax treaty provision, that modifies the tax treatment of any matter covered by the APA,
- ◆ There has been a material change in circumstances,
- ◆ The APA approved by the participating foreign tax administration(s) is not consistent with the Turkish APA or has been revised, cancelled, or revoked in case of bilateral or multilateral APAs.

8. Cancelling an APA

In the form set forth here, the tax authority can cancel an APA unilaterally from the opening day of first APA year and it may proceed as if the agreement were never made by starting a tax audit on taxpayer if:

- ◆ The taxpayer or his non-resident entities or related party (or parties) failed to comply with any material terms or conditions of concerned APA and
- ◆ The information submitted by the taxpayer was misleading, deficient or wrong, both in the APA request or the following stages (including the annual APA report).

9. Certain key points for Turkish APAs

The taxpayers don't have to add all of their related parties into the scope of agreement while applying for an APA. They may even request an APA covering just certain transactions to determine any transfer pricing method(s). In other words, determination of agreement's scope is left completely to the taxpayers in respect of legal arrangements. As stated above, it is possible for taxpayer to renew a current APA which has been made between the sides if he considers the same conditions are still valid. However, the tax administration will examine the conditions and composition of the transactions taking place under the current agreement before accepting the request made by taxpayer for the renewal of the APA.

If the tax administration reaches the decision that the conditions and composition of the transactions have not changed, it can decide to renew the current APA. If however, the tax administration concludes that the conditions and composition of the transactions have changed, the taxpayer must request a new APA by paying a new user charge.

Turkish revenue administration will levy a non-refundable user charge for each accepted APA of TL25,000 (\$21,000) or TL15,000 (\$12,000) for the renewal of an APA. After examination, the tax administration decides whether the critical assumptions have an effect on the survival of the agreement. If it opts that the critical assumptions do not preclude survival of agreement effect, it can let the agreement go on but previous critical assumptions could be revised. If the tax administration decides that the critical assumptions preclude survival of agreement, the previous APA is not renewed and the taxpayer must request a new APA for the related party transaction(s).

10. Evaluations

In practice, the taxpayer and the tax administration should work together to establish mutually acceptable terms and conditions for an APA. The tax

administration will accept the application where all requirements have been met.

A withdrawal of an APA application doesn't not automatically trigger an audit. An APA, signed between tax administration and taxpayer, is only related to that taxpayer and this agreement can't be taken as a comparable to or as an example for other taxpayers when they request an APA. Every APA has unique qualifications and so, just the taxpayer that made the agreement can use it.

The applicant must ensure that related parties that requested an APA make ready the data of their uncontrolled comparable transactions as well as the data about sector, market and other subjects to determine a transfer pricing method. The tax administration could also make some changes within the APA or cancel it all in case of the changes affecting transfer prices in business activities. The taxpayer who requested an APA, could also either withdraw his application or not accept the agreement after APA negotiations with tax administration.

The number of APA request in Turkey is low at the moment, however the importance of APAs as well as transfer pricing will increase for taxpayers through the fast developments in global markets and direct investment flowing into the country.

The amount of direct investment in 2007 is more than \$23 billion a year. If we consider those direct investments and the increasing numbers after beginning of EU negotiations, Turkey will continue to see growing direct investments.

To this end, APAs are going to be a considerable issue for corporate taxpayers, especially for multinational enterprises and their subsidiaries operating globally. There are, at the same time, two APA requests of multinational enterprises waiting to be concluded by the Turkish tax administration in coming months.

1. APPENDIX: FORMAT OF ANNUAL REPORT FOR ADVANCE PRICING AGREEMENT

1. GENERAL INFORMATION

- ◆ Name and business title of Taxpayer
- ◆ Tax Office Registered and Tax Identification Number
- ◆ Address
- ◆ Field of Activity
- ◆ Organizational Structure
- ◆ Information on Related Parties (Tax Identification Numbers, addresses, phone numbers and etc.)

2. INFORMATION ON TRANSFER PRICING ANALYSIS

- ◆ Changes for ownership relations and organizational structure among the related parties in the accounting periods in which APA is in use.
- ◆ Information on whether the conditions and assumptions taken as main indicators in determining the arm's length price in APA are still valid or not.
- ◆ Conditions/critical assumptions anticipated in APA which is not met within concerning accounting period and reasons why conditions/critical assumptions were not met.
- ◆ Important material changes on functions performed, the assets used and the risks assumed, economic conditions, rules of contract and services given by related parties.
- ◆ Required information on the ownership of intangibles and the price of intangibles gained or paid.
- ◆ Summary of financial structures of related parties becoming party to agreement, and changes having capacity to affect on the financial structures of taxpayer.
- ◆ Required information if the related parties started to use different accounting standards and/or methods.

- ◆ Realization dates and amounts of transactions assumed in APA and payer and taker of concerned transaction.
- ◆ The price computed by the method stated in APA and way of computation for the price, information on implementation of method stated in APA in concerned year.
- ◆ Other points determined previously in APA