

TRANSFER PRICING AND EXAMPLE OF TURKEY

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ABSTRACT

“Distribution of Hidden Profits through Transfer Pricing”, provided in the article 13 of Law No.5520 on Corporate Law Tax (CLT) and enacted on 01.01.2007 in Turkey, is set out to compensate or minimize tax losses that may arise out of transfer pricing. One of the most investigated issues in tax audits is distribution of hidden profits through transfer pricing. Transfer pricing issues are discussed in this article especially considering regulations in Turkey.

Keywords: Transfer pricing, relevant person, arm’s length principle, corporate tax.

I. INTRODUCTION

International trade and capital movements are one of three interacting factors in increase in population and income over the last millennium.¹ Individual enterprises have given way to companies due to economic developments. Financial and legal facilities allowed for companies have accelerated this process. The government needs sound source of incomes to render public services it has undertaken, and income from taxes is the primary of such sources. Multinational enterprises with large budget in particular regard transfer pricing as a way of not paying taxes or paying less taxes, and they try to increase their profit in that way. Likewise, as multinational grow and improve their activity, governments start to experience severe problems in their relationship with public administrations. This has become a global war between tax offices of developed countries and multinational companies.

In Turkey where incorporation has growingly gained importance and generalized, possession of an independent personality-isolated from partners-by stock corporations allow them to establish a financial, legal and economic relationship with their partners. Since the essential objective of stock corporations is to return profit to partners, this legal relationship is

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¹ The other two factors are listed as “discovery of productive free spaces and new biological resources on earth, settlement of people on such spaces, transfer of pets and plant species” and “technological and corporate inventions”, **Maddison**, A., *The World Economy: A Millennial Perspective*, OECD Development Center Studies, 2000, Paris, p. 18.

aimed to provide partners with saving on taxes they must pay by means of indirect ways without visible violation of laws. This aim is further reinforced when shareholders pay for the income tax based on the distribution of profit after corporation tax is paid especially in stock corporations.

While regulations on corporate tax remain at national level, transfer pricing has become one of the most challenging and current fields of tax legislation because of growingly increased cross-border transactions of multinational enterprises as a result of globalization, in return, needs of government for stricter rules against multinational enterprises that reduce their tax burden by means of transfer pricing.²

Transfer pricing is a method used to overcome difficulties in money transfer between countries due to strict foreign exchange regimes. Transfer pricing is directly related to tax legislations because of different tax applications between states. It is natural that any state requires to pay taxes of earnings achieved within their political borders to their own treasury. Currently, distribution of hidden profits by means of transfer pricing is not only limited to transfer of international profits but also becomes a current issue in relation with businesses and transactions with relevant local persons. Through transfer pricing, it is possible for companies to minimize the tax that they must pay as a result of businesses and transactions executed with relevant local persons. Therefore, the legislation bans using such transactions and methods that would compromise tax claims.

“Distribution of Hidden Profits through Transfer Pricing”, provided in the article 13 of Law No.5520 on Corporate Law Tax (CLT) and enacted on 01.01.2007 in Turkey, is set out to compensate or minimize tax losses that may arise out of transfer pricing. One of the most investigated issues in tax audits is distribution of hidden profits through transfer pricing. The Law No.5520 sets out that profit that is distributed by transfer pricing by companies should be considered to determine company profit, that is, the profit distributed by transfer pricing shall not be deducted from annual income in determination of basis.

Because retention of dividends by shareholders distributed after deducting corporate tax from profit of companies (also depending on exceeding a certain limit) by means of income tax increases the weight of overall tax load on such profit, companies and shareholders tend to use a number of fraudulent methods as a compensation.

Earnings that should stay within the company in distribution of hidden profit through transfer pricing is transferred by various ways to real persons or companies “related” to the

² **Eden, L., Tina, D., William, P. W.**, Standards Across Borders: Diffusion of the Arm’s Length Standard in North America, Accounting, Organizations and Society, Vol. 26, Issue 1, January, 2001, p. 1.

company or its shareholders. With distribution of hidden profit through transfer pricing, the untaxed income of a company is shifted to other related persons not by means of normal profit distribution or repayment of capital. It is not easy to notice that the profit is distributed implicitly as this transfer of interest is performed behind a curtain of legal transaction. This is hidden behind a legal transaction between the company and the related person such as trading, renting, manufacturing and construction, borrowing money, and loan. Distribution of hidden profit through transfer pricing is that the company transfers profit to real persons or companies “related” to such company.

The nature and limits of distribution of hidden profit through transfer pricing are determined in detail in positive law in Turkish tax system. In order to prevent company’s earnings from transferring outside the company without subject to law within the company, the article 13 of CLT No.5520 states that the profit shall be deemed distributed as hidden profit and the article 11/1-c “Not acceptable deductions” of the same law sets out that such distributed profit shall not be deducted from the company’s earnings.

II. DEFINITION OF “TRANSFER PRICING”

Initially “transfer pricing” was used as a concept of business economics, but then with globalization it has been mainly mentioned together with tax legislation. Transfer pricing is a price that is implemented by a commercial establishment among its own departments or arms for sales of goods and service.

The “home country” is defined as the location of centers of multinational enterprises and the “source country” is defined as other countries where they operate. An “affiliated enterprise/affiliate” or “branch” is opened in the source country.³ The affiliated enterprise/affiliate is an independent enterprise that legally exists in the source country. In a multinational company structure, partnership controlling the management is defined as the “parent” in case of holding or similar participation and the other one is defined as “child partnership”.

In general, parent owns the shares of affiliated enterprise/affiliate in full or variable rates, and the affiliated enterprise pays dividend to its partners. The branch mostly operates in direct connection with the parent and transfers its profit without declaring as dividend.

³ **Jenkins, G., P., Shukla, G. P.,** Public Finance in Open Economies, Harvard Law School International Tax Program Harvard Institute for International Development, June, 1998, p. 109.

In business life, creating payments as result of various activities, companies reduce a number of earnings from taxable base as expense by shifting them to related real persons or companies.⁴ So, transfer pricing is transfer of an earning that should be kept within the company to real persons or companies related to company as a result of unrealistically affected financial balance sheet items by various businesses and transactions performed to reduce earnings of companies.

In transfer pricing, purchase of goods and services between affiliated enterprises is performed over artificial prices, but not over a market price. Prevention of transfer pricing precludes reducing company's assets in favor of personal assets of partners or related persons and transferring some portion of earnings within the company to outside the company without taxing.

Transfer price is a sales price of goods, intangible right or service of a business to an affiliated enterprise.⁵ In other definition, transfer pricing is an internal value on raw materials, goods or services delivered by an affiliated company to other company of a group of companies. Transfer price is implemented when an intermediate goods produced by any profit center is transferred to the other profit center that will use this intermediate goods as input.

"Transfer pricing" is a price applied by a enterprise for sales of goods and services to its affiliated company or parent or branch. Transfer pricing, also referred to as "intercompany pricing" or "internal pricing" is a price applied on internalized transactions between interrelated units of the same enterprise. Transfer pricing becomes a problem not only for multinational company but also for states when enterprises engage in cross-border production business.

A stock corporation is established with the intent of achieving profit and distributing it to its partners. However, this profit must be distributed to in compliance with procedures approved by laws. Companies, whose intention is to derive profit and distribute it to their partners, transfer their earnings that need to be included in corporate tax base to real persons or companies they are in a relationship to achieve taxational advantages by overstating financial items or understating proceeds on the balance sheet. So reduced company earning is defined as "*distribution of hidden profit through transfer pricing*" in the tax legislation.

German Federal Supreme Court of Tax (Bundesfinanzhof) defines distribution of hidden profit through transfer pricing as follows: "*A company is deemed to perform hidden*

⁴ Oates, M. A., O'Brien, J. M., Transfer Pricing, ITJ, January, February, 2008, p. 58.

⁵ OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Paris, 2001, p. 3.

payment through transfer pricing when it provides interests - other than dividends and similar normal payments that would not be provided to non-partner third parties when it acts as a prudent manager - to its partners, or a real person related to this company or its partners, or real persons or companies or partner's relatives that are directly or indirectly related to, or in possession of, this company regarding administration, controlling or capital, with reduction in the company's profit.”⁶

Companies must first subject their earning to corporate tax in accordance with financial balance sheet. The purpose of issuing a financial balance sheet is different from that of commercial balance sheet. A commercial balance sheet shows the economic power of enterprises whereas a financial balance sheet is issued in compliance with tax legislations.

Since the objective of companies is to derive profit and distribute it to their partners, profit should be fully identified, shown (displayed) on the balance sheet, and distributed in compliance with law. If a company distributes its profit implicitly through transfer pricing to related real persons or companies and affords advantage, this must be added in financial profit and commercial profit.

Normal profit distribution occurs when a company derives profit in the current period after fulfillment of corporate tax and similar liabilities or in case of presence of accumulated profit from previous periods. “Normal profit distribution” is to distribute profit derived by the company to partners after it is subjected to corporate tax and other legal liabilities are fulfilled. However, in some cases company's profit is not distributed to partners by normal distribution but distributed by indirect ways and without subjecting to corporate tax. Such distributed profit distribution is defined as “hidden profit distribution” in the tax legislation.

Earning of a company is the positive difference in total of profit and loss account statement. This difference can be affected by changes to either of these statements. For example, hidden profit distribution is possible through transfer pricing by understating company values from items that affect either side of profit-loss account such as wage, interest and rent or by overstating values paid by the company.

Valuation of capital items within the company with very high amounts increase the depreciation allowance and reduces profit of sales in fixed assets. So, it affects the profit-loss account and allows to transfer some portion of earnings to partners through transfer pricing.

⁶ BFH, 10/01/1973, I 119/70.

III. TRANSFER PRICING AND OBJECTIVES AT GLOBALIZATION SCALE

International economic integration, defined as “globalization” and growingly experienced by the world’s economy since 1950s, describes organization of economic activities and extension of transactions beyond political boundaries of nation-states. In this respect, “globalization” is growingly increasing economic integration and dependence process between countries.⁷

Globalization, a multidimensional concept, increases the economic integration and provides real persons and companies with advantage over low-tax rates. With elimination of economic boundaries, globalization has results against countries that apply high tax rates and results in economic losses. With globalization, labor and capital shift to economically more advantageous countries, escaping beyond country borders. So, tax competition is gradually increases across countries.⁸

Subject to globalization of economic activities, international commercial volume of goods and services has been extended by increased activities of multinational company activities. As a result, prices have gained importance which would be applied during transfer of tangible and intangible values such as goods, service and industrial property rights among parent-affiliated foreign companies. While the price used for transfer of goods and services have a nature of income for parties, it is a profit to states that needs to be taxed. Accurately identified transfer prices distribute the profit derived from such transfers among parties, and tax offices of relevant countries make effort for obtaining a fair share from taxing such profit.⁹

Diversification of financial markets and instruments and emergence of new technologies with globalization have paved the way for illegal operations and transactions and created new opportunities for taxpayers to evade tax.¹⁰

While this implementation should fairly tax companies in transfer pricing, it should create adequate tax income for all relevant countries. Thus, it is necessary to implement legal

⁷ **Nayyar, D., Court, J.**, Governing Globalization: Issues and Institutions, UNU, World Institute for Development Economics Research, Tokyo, 2002, p. 4.

⁸ **Edwards, C.**, Tax competition spurs globalization – Worldview – countries develop low-tax strategies to lure business, USA Today (Society for the Advancement of Education), March, 2003, http://findarticles.com/p/articles/mi_m1272/is_2694_131/ai_98829800/, 11/04/2014.

⁹ **Elliott, J., Emmanuel, C.**, International Transfer Pricing: Searching for Patterns, European Management Journal, Vol. 18, No. 2, 2000, p. 216.

¹⁰ Nayyar, Court, p. 3; **UN**, Recommendations of the High-Level on Financing for Development, New York, 22 June 2001, p. 2.

regulations and international agreements in order to minimize double taxation, avoidance of tax, and evasion of taxes.¹¹

Globalization requires strong players that are financially and economically competent to stand up against cruel conditions of the system. The most important one of these players is multinational enterprises. Multinational enterprises are establishments whose ownership, in part or in whole, belong to them in two or more countries and which carry out production and marketing activities, have their own corporate strategies, and implement these strategies on all affiliated organizations or branches. With globalization, the share of multinational enterprises in commercial trade has been increased and in-group transactions has exceed 60% of global commercial volume.¹² In line with this change, states attempt to increase their income and companies attempt to reduce the amount of tax they will pay.

Because multinational enterprises operate in more than one country, they derive tax advantages by transferring goods and services between them through transfer pricing policies, increase their profit and reduce their cost. Multinational enterprises realize the half of current commercial value between them, that is, as a trade between related companies and turn this into an advantage by means of a number of mechanisms such as transfer pricing.

With globalization, tax advantages provided by different countries may be helpful to multinational companies' intent to evade tax or avoid tax. For example, tax exemption (tax holiday) that is applied on investments by developing countries allows multinational companies to enter into collaboration with local establishments and transfer their profit to such establishments through transfer pricing, reducing their tax burden.¹³

Transfer is performed at global scale and pricing is considered under international transfer pricing in case of sales of goods and services among affiliated companies and subsidiaries of multinational companies in various countries. Although transactions executed between in-group companies in the same country only concern tax income of that country, pricing of goods and service transfers that incorporate international elements affects tax income of multiple countries.

Purpose of international transfer pricing can be listed as:¹⁴

- ✓ Performance assessment system,

¹¹ **Emmanuel**, C. R., National Government Incentives: The Crux of The International Transfer Pricing Conundrum, Transfer Pricing Symposium, Leuven University, 09-10 December 1996.

¹² **UN**, Transfer Pricing History, State of the Art, Perspectives, ST/SG/AC.8/2001/CRP 6, 26 June 2001, p. 2.

¹³ **Tanzi**, V., **Zee**, H. H., Tax Policy for Emerging Markets: Developing Countries, National Tax Journal, Vol. 53, No. 2, June, 2000, p. 316.

¹⁴ **Cheng**, H. C., Case Study Application of VSM to Transfer Pricing, Systemic Practice and Action Research, Vol. 18, No. 4, August, 2005, p. 381.

- ✓ Motivation of directors of affiliated companies/departments,
- ✓ Purpose compatibility,
- ✓ Reduced income tax,
- ✓ Reduced tariffs in export/import,
- ✓ Minimized risk for exchange rate,
- ✓ Minimum conflict with host country,
- ✓ Cash flow management,
- ✓ Competition in international markets.

The desire of states to further benefit from mobile capital that emerges with globalization and the presence of countries defined as “tax heavens”¹⁵ make important the concept of transfer pricing to both developed and developing countries. The loss of tax occurs when profit is distributed implicitly through transfer pricing. Transfer pricing reduces taxable profits of multinational companies and increases after-tax profits.

Multinational enterprises especially establish their affiliated companies in countries where corporate tax is never applied or applied with a low rate. If such countries are to be classified, the first group would include countries such as Bermuda, the Bahamas and Cayman Islands where no income element is taxed; the second group would include countries such as Virgin islands where the rate of income tax is very low; the third group would include countries such as Panama and Hong Kong where only domestic income is taxed; and the fourth group would include countries such as Turkey where financial advantages are offered to those who make investment in certain areas by allowing tax exemption in such areas. Given this quad classification, the reason why a multination enterprise desires to establish an affiliated company in a country that applies no or little tax is that such multination enterprise actually wants to maintain normal operation in that country where affiliated company is located and low tax rate is applied, thus to pay less portion of derived profit as tax, or only to pay less tax, in other words, transit to more profitable position.

There are many reasons that encourage companies to carry out hidden profit distribution through transfer pricing. For example, when the parent company sells to the branch located in a foreign country, the rate of corporate tax or customs tax of that country lead the parent company to carry out hidden profit distribution through deficient (low) pricing. Again, the parent company that sells to support newly established/baby foreign

¹⁵ Tax heavens are due to international tax competition. Countries are defines as “tax heaven” that invite entities and organizations of other countries to make investments in their country with proposal of paying less tax.

branch can perform hidden profit distribution through deficient (low) pricing. As is seen, multinational companies carry out hidden profit distribution by issuing low invoice for import and export through goods and service transfer to related organizations in order to reduce corporate tax and customs duty. It is unlikely that payment balance of relevant country is not affected by this pricing level between companies.¹⁶

Factors that influence transfer pricing of companies do not only include taxes. Also, economic and commercial factors such as profit transfer, exchange risk, price control, anti-monopoly, and anti-dumping investigations lead companies to perform transfer pricing.

Transactions executed among group companies do not only involve goods and service flow but also involve material and nonmaterial transactions such as interest rates for sources used or a license payment for a patent used. It is difficult to resolve such transactions under transfer pricing.

It is essential for companies to execute transactions in the market where they operate on an arm's length basis. Likewise, companies are expected to fulfill their tax duty and support public financing of the country where they do business. Incomes and taxes need to be accurately allocated for fair and continuous execution of international trade and investments. It is a fact that companies, as required by market conditions, tend to differentiate prices for transfer in various countries based on the market price with an attempt of reducing their tax burden.

There are various reasons to adopt regulations on transfer pricing in globalizing world. The basic motivation that leads companies to transfer pricing is tax.¹⁷ The major purpose of transfer pricing is to achieve tax advantages. Other reasons for using transfer pricing as a strategy pertain to internal control and international objectives.

The major three reasons for transfer pricing are to manage tax burden and relevant objectives, to maintain competitive status, and to make progress on fair performance assessment.¹⁸ Objectives of transfer pricing regarding tax can be listed as follows:

- Purchase with high price and sell with low price from/to affiliated companies in countries with high tax rate, and vice versa in countries with low tax rate,

¹⁶ **Dunning, J. H., Sauvant, K. P.**, "Preface" Transnational Corporations: Transfer Pricing and Taxation, The UNCTAD, Vol. 14, 1994, p. 1; **Plasschaert, P.**, United Nations Library on Transnational Corporations: Transfer Pricing and Taxation, London, 1994, p. 2.

¹⁷ **Brem, M., Tucha, T.**, Aus dem Controlling heraus zu angemessenen Verrechnungspreisen: Reporting, Analyse und Monitoring, DStR, 08/48, November, 2008, p. 2334.

¹⁸ **Cravens, K.**, Examining The Role Of Transfer Pricing As A Strategy For Multinational Firms, International Business Review, 1996, N. 6, p. 127.

- Paying less withholding tax by shifting payments for withholding tax for profit share, patent, know-how and trademark right to be paid outside into externally purchased goods,
- Understatement or no-statement of prices for service, nonmaterial rights, etc., which needs to be applied by the company in country with high tax rate on other companies within affiliated group companies so that tax load can be reduced by assuming costs of other companies,
- Paying less for customs duty and VAT by understating the transfer price for imported goods,
- Paying less tax by changing transfer prices to be protected from limitations on profit transfers, foreign currency and rate of exchange,
- Deriving less profit, thus paying less tax by increasing the share of affiliated companies in the country with high tax rate when allocating prices of service to affiliated companies, which is rendered in the head office of multinational company and used by affiliated companies, and by reducing the share of affiliated companies in the country with low tax rate and increasing costs of company in the country with high tax rate.

Followings are examples of transfer pricing:

- ✓ Company partner has a duty in the board of directors and is paid higher than their peer,
- ✓ Company makes special payments over turnover to its partner in addition to precedent compensation,
- ✓ Partner borrows from the company with no or very low interest,
- ✓ Partner borrows money from the company that should be known it cannot be refunded at the time of giving
- ✓ One of the partners lends money to the company with a very high interest,
- ✓ Partner sells the company goods for an extraordinary price, or purchase from the company goods or economic values under same conditions, or benefits from reduction in a special way,
- ✓ Partner sells the company shares for a price higher than stock exchange price or sells the company's partner shares for a price lower than stock exchange price,

- ✓ The company assumes liabilities in favor of one of the partners, such as debt or warranty,
- ✓ Company waives its rights to partners,
- ✓ Establishment pays to a third party that does not only work for the company but also for one of the partners for both tasks and this payment is reflected on company's accounts.

IV. TRANSFER PRICING AND EXAMPLE OF TURKEY

The first legal regulation on distribution of hidden profit was made in 1949 when Corporate Tax Law (CTL) No. 5422 (former) was enacted in Turkish tax system. Only one paragraph of the article regarding distribution of hidden profit was amended by the law No.2362 on 24.12.1980 until 2006 when the CTL No.5520 (new) was issued. Although there have been many changes to Turkish and global taxation system, economic conditions, technologies and many issues in 57 years of its enactment, making no amendments to the law has brought with a large number of problems. Until the new law was enacted, it should be noted that nothing was included in the applicable legislation on distribution of hidden profit other than a provision of law; even no relevant general communique existed, and it has been managed by the Council of State's decisions for over 50 years. Therefore, the Council of State's decisions must be considered when discussing distribution of hidden profit which is particularly important for taxing corporate taxpayers in Turkey.

When Turkish tax legislation is compared with foreign tax legislations regarding distribution of hidden profit through transfer pricing, it appears that it is aimed to prevent lowering basis that should be declared in some indirect methods. However, despite this common purpose Turkish tax legislation has been far behind the foreign tax systems for long years. There are highly comprehensive regulations on distribution of hidden profit through transfer pricing in modern tax legislations, and OECD has issued many reports in this regard. In Turkey, regulations on distribution of hidden profit entered into force by Corporate Tax Law No.5422 (former) in 1950. Finally, CTL No.5520 (new) entered into force on 21.06.2006 brought substantial amendments to distribution of hidden profit through transfer pricing. These amendments have approximated Turkish tax legislation to international regulations. Thus, the importance of distribution of hidden profit through transfer pricing is apparent for Turkish tax legislation, which is considered as a safety measure for tax and has a particular importance for taxing corporate taxpayers in Turkey.

The nature and limits of hidden profit distribution through transfer pricing in Turkish tax system are set out in detail in positive law. To prevent company's earnings from being transferred outside the company without taxing within the company, in cases listed in the article 13 of CTL No.5520 the profit is deemed to have been implicitly distributed through transfer pricing, and the article 11/1-c "Not acceptable deductions" of the same law sets out that such distributed earnings shall not be deducted from the basis. Distribution of hidden profit through transfer pricing is one of the safety measures for tax included in the "not legally acceptable deductions" in the CTL No.5520. In general, the new regulations comply with principles of transfer pricing issued as a guideline for multinational companies and tax offices in 1995 by OECD of which Turkey is a member. However, this compliance does not mean that we do not have problems with implementation of transfer pricing. Yet, new regulations appear to create further suspicion, cause hesitation and problems in practice as compared to previous regulations.

The article 3 of CTL No.5520 is as follows:

"Distribution of hidden profit through transfer pricing"

ARTICLE 13- (1) If corporations sell or purchase goods or service to/from related parties for a price or amount determined in violation of arm's length principle, the profit shall be deemed distribution of hidden profit through transfer pricing in part or in whole. Purchase, sales, manufacturing and construction transactions, renting and leasing transactions, borrowing and lending money, transactions requiring bonus, compensation and similar payments shall be considered as purchase or sales of goods or service under any circumstances and conditions.

(2) The related party means shareholders of the corporation; the real persons or corporations that the corporations or their shareholders are associated with, or the real persons or corporations the administration, supervision or the capital of which depend directly or indirectly on them or which are under their influence. Spouses of the shareholders, ancestors and descendants of the shareholders or their spouses, as well as their other relatives by consanguinity or affinity of third degree or less, are considered related parties. Any transactions performed with the persons in the countries or regions that are announced by the Council of Ministers are deemed to have been performed with the related parties considering whether tax system of the country where profit is derived provides same level of taxation capacity as taxation capacity created by Turkish tax system as well as in consideration of information exchange.

(3) Arm's length principle means the compliance of the prices and value which will be applied to the purchase or sale of goods and services from and to the related parties, with the prices and value that would have been formed in the absence of such relation between them. The records, schedule or documents of the prices or value that are determined in accordance with the arm's length principle must be maintained as documentation of proof.

(4) Corporations shall determine the prices and the value that they would apply to the transactions with their related parties using the most appropriate of the following methods:

a) Comparable price method: This method means to determine a sales price that is in compliance with comparable prices the taxpayer would apply by comparing it to the market price, which real persons or legal entities would apply that have no relationship between them and which enter into purchase and sale transactions of goods and services of comparable nature.

b) Cost plus method: This method means to calculate a price that is in compliance with comparable prices, by increasing the cost of the corresponding goods or services based on a reasonable gross profit rate.

c) Resale price method: This method means to calculate a price that is in compliance with comparable prices, by subtracting a reasonable gross sale profit, from the price that would apply in case of resale of the good or the services of transaction to the natural or legal persons that has no relation among them.

ç) Where it is not possible to achieve an arm's length price using any of the above methods, the taxpayer may use other methods determined by such taxpayer in accordance with the nature of transactions.

(5) The methods to be used for the prices or value of the goods or services that would be purchased from or sold to the related party may be determined in agreement with the Ministry of Finance upon the taxpayer's request. Such determined method is final under conditions and duration set out in the agreement with no longer than three years.

(6) Profit that is distributed in part or in whole as a hidden profit through transfer pricing shall be deemed as profit that has been distributed as of the last day of the fiscal period, during which the conditions of this Article are realized for the purposes of the implementation of the Income and Corporate Tax laws. Previous taxation transactions shall be corrected accordingly by the taxpayers that are parties thereto. However, the taxes that have been levied shall be finalized and paid in the name of the corporation engaging in hidden profit distribution in order to make such correction.

(7) The profit is deemed to have been distributed as hidden profit due to domestic transactions executed under related parties and between the offices or permanent representatives in Turkey of fully obliged corporations and foreign corporations only when the Treasury makes a loss. A loss of treasury means that any collection of taxes, which must be accrued on behalf of the corporation and related parties due to prices and amounts determined against arm's length principle, is accrued deficiently or late.

(8) Procedures for transfer pricing are determined by the Cabinet."

To treat a profit as a profit that has been distributed implicitly through transfer pricing, it is necessary for legal reason determined as purchase/sale of goods or service to provide interest to certain real persons or companies and the interest achieved by such persons or companies be based on their title of "related party". To mention the presence of distribution of hidden profit through transfer pricing under the article 13 of CTL No.5520, it is necessary to have these three elements together: the title of "related party", providing interest to the related party and arm's length principle.

The article sets out that purchase, sales, manufacturing and construction transactions, renting and leasing transactions, borrowing and lending money, transactions requiring bonus, compensation and similar payments shall be considered as purchase or sales of goods or service "under any circumstances and conditions", and the profit may be distributed through transfer pricing using listed legal forms; however this does not mean that the profit may only be distributed by listed forms on the basis of hidden profit distribution. The legal forms mentioned in the article 13/1 of CTL No.5520 are example of "purchase/sales of goods or services" and, in a sense, a guide to tax office. In case of a transaction executed between the related party and the company against arm's length principle using any of the legal forms mentioned in the article text, such transaction shall be deemed, under any circumstances and conditions, as distribution of hidden profit through transfer pricing. So, it saves the lawmaker tax office to assess and appraise whether the legal form used for the transaction is convenient for distribution of hidden profit through transfer pricing. Yet, convenience of mentioned legal forms for distribution of hidden profit through transfer pricing is actually determined by the lawmaker itself.

The known most typical examples of hidden profit distribution through transfer pricing are mentioned in the article of CTL No.5520. The article 13 of CTL No.5520 sets out the "subject of an agreement" not the "type of agreements". In other words, when an agreement is made between related parties on issues mentioned in the article against arm's

length principle, such agreement shall, “under any circumstances and conditions”, be considered under hidden profit distribution through transfer pricing.

It is possible to distribute the profit through transfer pricing on the basis of hidden profit distribution by disguising behind a legal transaction of any form and number encountered in commercial and economic. Limitation or determination of these legal forms one-by-one is both against the operation of establishment and the purpose expected by lawmaker of this regulation. In this respect, it is also possible to distribute the profit on the basis of hidden profit distribution through transfer pricing using legal forms not mentioned in the law provided that it is under “purchase/sale of goods or service”.

The tax administration has further extended the scope, which was already extensive, by “interpreting” the definition of related party determined by the law in the administrative disposition¹⁹ in regard to hidden profit distribution through transfer pricing. Such extensive interpretation in the administrative disposition in regard to hidden profit distribution through transfer pricing would be against the legality principle of tax as well as cause severe problems in practice. The tax administration tends to extend the scope of related party by developing a variety of criteria not mentioned in the law. For example, a real person who has an economic and social relationship with company partners is considered as a “related party”. Limit and intensity of such relationship is not certain. “Creation” of an element, which is not mentioned by the lawmaker, by the tax administration is one of the most concrete examples of usurpation of functions.

The article 13/2 of CTL No.5520 defines the related party as “the real persons or corporations the administration, supervision or the capital of which depend directly or indirectly on them or which are under their influence”, thus it is accepted to distribute hidden profit through transfer pricing not only to company’s own shareholders, or to persons associated with companies or shareholders but also to persons close the company. It is difficult to identify objective criteria. It is obvious that certain issues that would be subject of tax audits would cause penalized assessment and the taxpayer would be mistreated due to forced interpretation as in the period when CTL No.5422 (former) was in force.

In Turkey, while (real/legal) persons that have a dealership relationship are not considered related party in terms of goods and service for dealership, inclusion of companies located in a foreign country by administrative disposition of tax administration in the scope of related party is against the principle of equality in taxation as well as an explicit violation of no-discrimination principal of OECD Model Tax Convention.

¹⁹ General Communiqué on Hidden Profit Distribution through Transfer Pricing with Serial Number 1.

Any transactions executed with persons in the country or region declared by the Cabinet as tax heaven in consideration of whether tax system of the country where profit is derived provides same level of taxation capacity as taxation capacity created by Turkish tax system as well as information exchange are deemed hidden profit distribution through transfer pricing “just because they are executed with persons in that country or region”, and in such case other elements are not investigated that are sought by CTL No.5520 for the presence of hidden profit distribution through transfer pricing.

The article 13/5 of CTL No.5520 sets forth the methods to be used for the prices or value of the goods or services that would be purchased from or sold to the related party may be determined by making a cash-price agreement with the Ministry of Finance upon the taxpayer’s request. Since the tax administration has an easy access to information on the taxpayer through cash-price agreement, it would be true to say that the likelihood of auditing taxpayers, who make a cash-price agreement with the tax administration in line with chronic mentality of Turkish tax administration is higher than those who have no such agreement. The cash-price agreement is only specific to relevant taxpayer and concerns that taxpayer, and cannot be used by other taxpayers as a precedent or submitted as a proof for transactions executed.

It is often encountered that transactions of private law between related parties and corporations are used for tax collusion in practice. One of the common examples of such transactions of private law, referred to as “veiling” in the doctrine, in the tax legislation is hidden profit distribution through transfer pricing. As stated by the article 13 of CTL No.5520, the veiling occurs when parties execute transactions in compliance with their true will but with a value lower than precedent value or price in distribution of hidden profit through transfer pricing. Agreements between the corporation and related parties are valid as they reflect the truth according to private law, but somewhat invalid as they are veiling according to tax legislations.

Distribution of hidden profit through transfer pricing is fraud against law. In fact, regulation of fraud against law in the legislation is against the *raison d'être* of this establishment. Yet, fraud against law is not set forth by the lawmaker but serves as a legal insurance for prevention of occurrence of an undesired consequence. And this is not expected to set out in the law. However, since it is particularly set out in the article 13 of CTL No.5520, distribution of hidden profit through transfer pricing is not actually fraud against law as it is; but against a provision that bans fraud against law, in other words, against the law. But,

because the lawmaker explicitly sets out and regulates this issue, this does not change the legal nature of hidden profit distribution through transfer pricing that is defined as fraud against law. Not the entire veiling agreement is considered invalid, only the portion that exceeds normal limits is considered invalid in hidden profit distribution through transfer pricing.

The article 13 of CTL No.5520 includes a presumption of intention specific only to corporate tax in regard to transactions deemed as “purchase/sales of goods or service”. In this article, the tax administration is not required to prove that the taxpayer has performed an intentional action in order to appraise the difference between the declared and weighted and the actual tax-basis for transactions deemed as “purchase/sales of goods or service”. In other words, if a transaction that is mentioned in the article is executed between related parties, it is adequate to identify that inconsistency between considerations constitutes contradiction to arm’s length principle. On the other hand, to impose the article 13 of CTL No.5520 for transactions not mentioned in the article, such transactions need to be included in the purchase/sales of goods or service”. In this case, the tax administration needs to prove that such transaction is included in the purchase/sales of goods or service” in order for transaction to cause hidden profit distribution through transfer pricing. In other saying, presumption of intention does not apply to such transactions in regard to subjective element of hidden profit distribution through transfer pricing; burden of proof passes from the taxpayer to the tax administration.

Profit that is distributed implicitly through transfer pricing is deemed the distributed profit share as of the last day of fiscal period, or the amount transferred to head office for limited taxpayers, and needs to be withheld depending on the legal nature of related party. In practice however it is difficult to detect as of the last day of fiscal period whether distribution of hidden profit has been performed through transfer pricing.

Basically, the corporation to which hidden profit is distributed through transfer pricing not need to make any correction in its records. The legal regulation of hidden profit distribution through transfer pricing is a safety measure for tax. In this respect, company transactions that depreciate the profit of the company by distributing hidden profit only through transfer pricing should be criticized; no criticism should be directed to the company which hidden profit is distributed through transfer pricing. It is not appropriate to make correction or return for such company. In fact, the transaction executed by this company is real but not invalid by a taxation error.

Despite not included in the law, the tax administration states based on the explanation in the ground that the profit that is deemed hidden profit distribution through transfer pricing shall be considered “net amount” and completed to gross amount. It is not right to adopt such mentality by an administrative disposition, which is not set forth by the lawmaker and causes change in the transaction price used as a base.

V. CONCLUSION AND EVALUATION

The major objective of hidden profit distribution through transfer pricing is to achieve tax advantages. Although regulations on corporate tax do not go beyond the country borders, growingly increased cross-border transactions of multinational enterprises with globalization have made hidden profit distribution through transfer pricing to be one of the most difficult and current fields of tax legislation. Therefore “transfer pricing”, which was initially used as a concept of business economics, is now mentioned with tax legislation in today’s world economy.

The fact is the globalization that provides economic opportunities to taxpayers for avoidance of tax or tax evasion. Diversification of financial markets and instruments and emergence of new technologies with globalization have paved the way for illegal transactions of tax to be executed. In this sense, hidden profit distribution through transfer pricing reduces the taxable profit of multinational companies in particular and increases the after-tax profitability. So, analysis and interpretation of transfer pricing also requires to consider other rules that regulate the economic life.

The importance of hidden profit distribution through transfer pricing at global level has brought with international studies. The basic values on transfer pricing are included in the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration issued by OECD in 1995, which is reviewed on yearly basis. This Guidelines is based on the article 9/1 of OECD Model Tax Convention. The OECD Guidelines consider the arm’s length principle” as the key determinant in transfer pricing. The precedent value is defined in the article 9/1 of OECD Model Tax Convention. The OECD Guidelines is a detailed and systematic list of recommendations for transfer pricing.

The main goal of companies is to derive economic benefits. In other words, the company serves as a tool for shareholders to gain profit. This usually leads to nesting of relations between tax legislation and private law as well as causes tax problems resulting in hidden profit distribution through transfer pricing. As a rule, the tax legislation recognizes

transactions of private law between related parties and companies; thus such relationship is considered valid in regard to tax legislation. However, because links to private law create convenient opportunities to hide transfer of benefits between related parties and companies, it is necessary to evaluate such transactions from the perspective of principles and rules of tax legislation as well.

In Turkey, hidden profit practice was generally executed by adjudication in the period when CTL No.5422 (former) was in force. In fact, this practice of which details were not set forth and which fell behind developments caused problems. However, the detailed version of CTL No.5520 (new) entered into force on 01.01.2007 and this has revealed that tax administration, through administrative disposition, maintains its old mentality that does not consider constitutional tax principles. In this respect, a judicial opinion and doctrinal sources to feed this judicial opinion are needed in Turkey more than ever in order to shape and guide the practice today.

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