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The New Double Tax Treaty between Turkey and Germany

A. Introduction

On 1 August 2012, a new Agreement between the Federal Republic of Germany and the Republic of Turkey for the Avoidance of Double Taxation and of Tax Evasion with respect to taxes on Income (the "**Treaty**") came into force with retroactive effect as of 1 January 2011. It replaced its predecessor treaty which was terminated by Germany on 21 July 2009 and ceased to apply as of 1 January 2011. From a German perspective, the Treaty is in line with the last years' tendency of the German tax authorities to modify existing tax treaties which culminated, some weeks ago, in the publication of a German Model Tax Treaty – thereby deviating in significant parts from the OECD and UN Model Tax Treaties. In this bulletin, we will provide you with certain highlights and surprises of the Treaty which might be of particular relevance (i) for German private equity investors into Turkey and (ii) for Turkish private equity investors into Germany.

B. Background on double tax treaties

Like most nations, Germany and Turkey apply a taxation system which is based on the concept of residence or another sufficient domestic nexus. In case a person is deemed to be resident in Germany and/or Turkey, the worldwide income of such person will be subject to German and/or Turkish tax (unlimited taxation); this would be the case if a person had – in case of an individual – a fixed place of residence or habitual abode or – in case of a corporate entity – its registered office or business management in Germany and/or Turkey. In case a person is not deemed to be resident in Germany and/or Turkey but realizes specific income out of German or Turkish "sources" (e.g. dividend or interest income; letting and leasing of real estate or the like), only such source income will be subject to tax (limited taxation); in most cases the limited taxation will be satisfied by way of withholding.

Against this background, several scenarios are conceivable where a person's income might be taxed twice, i.e. by Germany and Turkey. For example, a person receiving dividends from a German corporation which maintains a fixed place of residence in Germany and Turkey (dual unlimited taxation) or, as the case may be, is only resident in Turkey (German limited taxation, Turkish unlimited taxation). However, it is generally common consensus that such scenarios – caused by the separate application of domestic tax systems – are economically unreasonable and, thus, are not desirable.

In order to have such tax conflicts solved, most nations have agreed upon bilateral double taxation treaties. Such treaties are generally negotiated on the basis of the OECD or the UN Model Tax Treaty which both reflect a general understanding and give guidance as to how the taxation right with regard to specific income items should be allocated or apportioned between the two countries involved.

The new Double Tax Treaty between Turkey and Germany is based on the OECD Model Tax Treaty. Reason for the termination and renegotiation was, *inter alia*, that under the former double tax treaty between Germany and Turkey pensions should exclusively be taxed by the residence state so that in the standard scenario of a German pension claim of a Turkish resident (formerly employed in Germany) Germany had no taxation right. Under the new Treaty, the state where the pension payment arises (typically Germany) will be allowed to charge a tax which shall, however, not exceed 10% of the pension gross amount.

C. Highlights of the Treaty

I. Dual-resident companies

An individual person or a corporate entity may very well be regarded as being resident in Germany and Turkey, e.g. a corporate entity might have a Turkish registered office but is actually managed from German territory (dual resident company).

According to the Treaty, the residence of such company shall be determined for treaty purposes by way of mutual agreement on a case by case approach, i.e. the competent German and Turkish authorities shall endeavor to settle the status of the dual resident company. Contrary to the former treaty, it is explicitly stated in the Treaty that in case the competent authorities do not reach an agreement, the dual resident company will be regarded as resident of neither Germany nor Turkey. This way, it is made clear that a dual resident company, in case the authorities do not reach a mutual agreement, cannot benefit from the Treaty.

II. Definition of permanent establishment

A permanent establishment is generally defined as a fixed place of business through which the business of an enterprise is carried on. The existence of a permanent establishment is decisive for the question to which contracting state business profits will be allocated. If a company (resident e.g. in Germany) carries on its business in the other contracting state (Turkey) through a permanent establishment, the right to tax the profits allocable to such permanent establishment will generally be attributed to the contracting state where such permanent establishment is situated (here Turkey).

The Treaty's definition of a permanent establishment is generally consistent with the OECD Model approach. However, as regards building sites, construction, assembly and installation projects it goes beyond the OECD Model Treaty since it additionally makes reference to supervisory activities in connection therewith. Such sites, projects or activities shall constitute a permanent establishment if they last more than 6 months; the OCED Model Treaty, however, is based on 12 months approach. Further, the furnishing of services, including consultancy services, through employees or other personnel shall constitute a permanent establishment if such activities continue for a period of more than 6 months within any 12 months period (which is overall not in line with the OECD Model Treaty).

III. Investments by Turkish private equity investor in German companies

1. Interest income

A Turkish resident investor is generally not subject to German tax on fixed or floating (e.g. EURIBOR-related) interest income received from a German company. Therefore, protection under the Treaty is generally not necessary in these constellations. This applies irrespective of whether the interest is paid under a plain vanilla (shareholder) loan or under a bond issued by a German corporation. In case of bonds, a German paying agent would usually be required to withhold taxes in the amount of 26.375% on any interest payment. However, if the Turkish investor submits to the German paying agent a certificate of residence issued by the Turkish tax authority, the paying agent will refrain from deducting any such withholding tax.

As an important exception, in the absence of the Treaty a Turkish investor would have to pay German taxes at the applicable general tax rate (up to 47.475% for individuals, up to 15.825% for corporations) on the interest payments received if a loan is directly or indirectly secured by German-situs real estate. Pursuant to Article 11 (2), (4) of the Treaty, the applicable tax rate is reduced to 10%. This tax is not levied by way of withholding, but the Turkish investor has to file a German tax return.

2. Income from mezzanine instruments

Coupon payments made on mezzanine instruments issued by German companies, such as profit participating loans (*partiarische Darlehen*), jouissance rights (*Genussrechte*) or silent participations (*stille Beteiligungen*), are generally subject to German withholding tax in the amount of 26.375%. The Treaty explicitly allows Germany to impose such tax if the coupon payments could be treated as tax-deductible on the part of the German debtor company (cf. Protocol No. 3 with reference to Articles 10 and 11).

3. Dividend income

Dividends paid by a German corporation to a Turkish investor are generally subject to German withholding tax in the amount of 26.375%.

It is true that the Treaty provides for a reduced withholding tax rate of 5% if the Turkish recipient is a company which directly holds a participation of at least 25% in the German corporation and of 15 % in all other cases. Nevertheless, the German corporation (or, if the shares are publicly traded, a German paying agent) is generally required to impose withholding tax at a rate of 26.375%. The withholding tax reduction is rather granted by the German Federal Central Tax Office (*Bundeszentralamt für Steuern*) upon application in such a manner that the Turkish investor receives a corresponding refund by the German Federal Central Tax Office.

Please note, however, that for Turkish investors who are not individuals, the application of the reduced withholding tax rate (and the corresponding refund) requires that the Turkish investor passes the qualified three-tier substance test as contained in section 50d 3) German Income Tax Act (*Einkommensteuergesetz – EStG*). This provision, which constitutes a treaty override, is intended to avoid a treaty shopping and basically requires the following: (i) there are economic or other significant reasons for interposing a Turkish entity; (ii) the business operations (Geschäftsbetrieb) of the Turkish investor are adequately equipped to perform its business purpose and (iii) the Turkish investor uses such operations to participate in the general economic market (*Teilnahme am allgemeinen wirtschaftlichen* Verkehr).

4. Capital gains derived from disposal of shares in German corporations

A Turkish resident investor is generally not subject to German tax on capital gains derived from the disposal of shares in German corporations (provided that such shares are not attributable to a German permanent establishment of such Turkish investor or are part of business assets for which a permanent representative in Germany has been appointed). Therefore, protection under the Treaty is generally not necessary in these constellations. Nevertheless, a German paying agent would usually be required to withhold taxes in the amount of 26.375% on any such capital gain. However, if the Turkish investor submits to the German paying agent a certificate of residence issued by the Turkish tax authority, the paying agent will refrain from deducting the withholding tax.

As an important exception, in the absence of the Treaty a Turkish investor would have to pay German taxes at the applicable general tax rate (up to 47.475% for individuals, up to 15.825% for corporations) on capital gains derived from the disposal of shares in German corporations if the Turkish investor (or, in certain constellations, one of his legal predecessors) at any point during the five years preceding the disposal directly or indirectly held at least 1% of the share capital of the German corporation (a so-called "**Qualified Holding**"). In such a constellation, the Treaty may provide relief, but only in certain circumstances:

(i) If the German corporation is a real estate company, Germany remains entitled to levy taxes on the resulting capital gain. A real estate company is given, if more than 50% of its assets (*Aktivvermögen*) consist, directly or indirectly, of German-situs real estate[1].

(ii) If the time between the acquisition and the disposal does not exceed one year, Germany also remains entitled to levy taxes on the resulting capital gain from a disposal of a Qualified Holding (Protocol No. 5 with reference to paragraph 5 of Article 13). This right to taxation of "speculative gains" in connection with a Qualified Holding is rather unique in the world of Germany Double Tax Treaties. However, although the wording of the Protocol is not entirely clear there seems to be a counter-exception (i.e. no German taxation right), if the disposal of the Qualified Holding either (i) refers to shares listed on an approved stock exchange in either Germany or Turkey (a mere listing e.g. on the NYSE would not be sufficient) or (ii) occurs in the course of a corporate reorganization.

(iii) In all other cases, capital gains resulting from a Qualified Holding in a German corporation may only be taxed in Turkey.

5. Relief from double taxation

According to Article 22 (1) a) of the Treaty, subject to the provisions of the laws of Turkey regarding the allowance as a credit against Turkish tax payable outside Turkey (i.e. "deduction" – *mahsuplaşma*), the tax paid in Germany by a Turkish resident will be deducted from the tax payable in Turkey on the relevant income. Such deduction, however, cannot exceed the amount of Turkish tax attributable to such income, which is computed before deduction. Furthermore, if income derived by a Turkish resident is exempt from Turkish tax, Turkey may nevertheless take into account the exempted income while calculating the amount of tax on the remaining

1 Please note that the German version of the Treaty refers to the value of the *Aktivvermögen*, i.e. to the assets side of the balance sheet, whereas the equally binding (!) wording of the Turkish and the English version refer to the value of the company. Both figure may deviate (significantly) if a company is mainly financed by debt. It remains to be seen how the German tax authorities will deal with this discrepancy.

income of such resident. According to Turkish Tax authorities' recent rulings, in order to obtain benefits under a tax treaty, a residence certificate must be presented.

For corporations, the "deduction" (*mahsuplaşma*) regime is governed by Article 33 of the Corporate Tax Law No. 5520 ("**Corporate Tax Law**"). According to Article 33 (3) of the Corporate Tax Law, if a foreign corporation pays dividends to a Turkish corporation, where the Turkish corporation holds at least 25% of the capital of such foreign corporation, the taxes paid / withheld on such dividends will be deducted from the Turkish corporate tax to be paid by the Turkish corporation on the income generated from such dividends. According to Article 33 (4) of the Corporate Tax Law, the amount of corporate taxes paid in Germany which may be deducted from the taxes assessed in Turkey cannot exceed the amount of Turkish tax (20% corporate tax rate) attributable to such foreign income.

IV. Investments by German private equity investor in Turkish companies

1. Interest income

Under Article 11 of the Treaty, the income derived from interest will be taxed, without any limitation to the rates, in the contracting state where the beneficial owner of the interest is tax-resident. Such interest may also be taxed in the contracting state where the interest is derived from. However, in such case the relevant tax cannot exceed 10% of the gross amount of the interest. Accordingly, the interest income that a German resident investor derives from a Turkish corporation will be taxed in Germany. However, such interest may also be taxed in Turkey in accordance with Turkish law. In that case, if the beneficial owner of the interest is a German resident, the tax so charged in Turkey cannot exceed 10% of the gross amount of the interest.

Furthermore, according to the Treaty, if the transaction creating interest arises from a commercial action of a business place located in the other contracting state or from independent personal services conducted through a permanent establishment situated in that other state, the Treaty provisions regarding business profits and independent personal services will apply. Therefore, if a German resident beneficial owner of the interest carries on business in Turkey, where the interest arises, through a permanent establishment situated therein or performs in Turkey independent personal services from a fixed base situated therein and the debt claim in respect of which the interest is paid is effectively connected with such permanent establishment or fixed base, the foregoing provisions of Article 11 of the Treaty will not apply. Such interest income will rather be treated as business profit or independent personal services' income and be subject to Article 7 (Business Profits) or Article 14 (Independent Personal Services) of the Treaty.

Under Turkish tax regime, interest on loans payable to foreign states, international institutions, or foreign banks and foreign corporations that qualify as "financial entities" in their country of residence and that provide loans to the public (and not only to group companies) is subject to a 0% withholding tax. Contrary thereto, a 10% withholding tax rate will apply to interest paid on loans from non-resident entities that do not qualify as "financial entities" and/or that provide loans only to group companies.

2. Income from mezzanine instruments

The payments made by participation banks (*katılım bankaları*) on so-called profit participation accounts, the payments made in exchange for profit / loss participation coupons (*kar/zarar ortaklığı belgesi*), as well as remuneration payments on any types of corporate bonds (*tahvil*) and certain securities (listed in Article 15 of the Corporate Tax Law) are subject to Turkish withholding tax at a rate of 15%. Under the Treaty, Turkey may impose such withholding tax provided that the payments could be treated as tax-deductible on the part of the Turkish debtor company.

3. Dividend income

Under the Turkish tax regime, dividends paid to a non-resident corporation are subject to a 15% withholding tax, unless the rate is reduced under a tax treaty. The Treaty provides for a reduced withholding tax rate subject to certain conditions. If the Germany recipient is a corporation which directly holds a participation of at least 25% in the Turkish corporation, a withholding tax rate of 5% will be applied. In all other cases, the general 15% withholding tax will be applied.

4. Capital gains derived from disposal of shares in Turkish corporations

Capital gains derived by non-resident companies from the sale of shares in Turkish corporations which are listed on a stock exchange are subject to a 0% withholding tax. Capital gains derived from the sale of shares in Turkish corporations which are not listed on a stock exchange (with the intermediation of banks or intermediary institutions) are generally not subject to withholding tax; however, such gains are subject to tax (at a rate of either 24% or 32%) and must be declared within 15 days after deriving the gains.

The Treaty's provisions override this rule. Under Article 13 (5) of the Treaty, the capital gains derived from the alienation (e.g. sale) of shares in a Turkish corporation shares may only be taxed in Turkey, if the time period between the acquisition and alienation does not exceed one year. In such a case, the resulting gain would only be taxable in Turkey and would be exempt from German taxes. In all other cases, the capital gains resulting derived from the alienation of shares in a Turkish corporation may only be taxed in Germany.

5. Relief from double taxation

As a general rule, Germany applies the exemption method, i.e. any income item which may be taxed in Turkey is disregarded for purposes of determining the German tax base, Article 22 (2) a) of the Treaty. However, Germany retains the right to take into account the exempted items for purposes of determining the tax rate of an individual (so-called progression clause), Article 22 (2) d) of the Treaty.

However, in case of private equity investments (interest income, dividend income, capital gains), Germany first and foremost applies the tax credit method, Article 22 (2) a) of the Treaty.

A special provision applies to dividends paid by a Turkish corporation to a German corporation, where the German corporation holds at least 25% of the capital of the Turkish corporation (so-called *Schachtelprivileg*). In such a case, the exemption method may apply provided that, *inter alia*, the German corporation is able to prove that gross income of the Turkish corporation in the business year for which the dividends were paid was

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derived (almost) exclusively from "good" activities within the meaning of Section 8 (1) No. 1 through 6 of the German Foreign Tax Act (*Außensteuergesetz – AStG*). Affected German investors will, therefore, request detailed information regarding the activities of and the income items realized by the Turkish target.

D. Conclusion

The new Tax Treaty between the Federal Republic of Germany and the Republic of Turkey, retroactively in force as of 1 January 2011, deviates in certain important aspects from the OECD and the UN Model Tax Treaty. These deviations may be of particular relevance for German or Turkish private equity investors which are recommended to pay close attention to the new rules when structuring in- or outbound investments.

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