COUNCIL OF STATE TO DECIDE ON TAX COURT'S DECISIONS ON CAPITAL REPLENISHMENT FUNDS

Contributed by Cerrahoglu Law Firm

THE TAX AUTHORITY recently audited of the Turkish subsidiaries of several multinational pharmaceutical companies to review their previous five years' accounts. The inspectors claimed the subsidiaries were acting as marketing companies and were providing continuous sales and marketing services to their parent companies free of charge. Thus, they had incurred continuous losses and covered them through their capital replenishment funds.

According to the inspectors, the capital replenishment funds provided to these foreign companies by their shareholders should be deemed service fees. Had the companies recorded such moneys as service fees, they would not have incurred losses. Consequently, the Tax Authority levied corporate income tax, VAT, a tax loss penalty and default interest on these companies for the capital replenishment fund amounts provided.

Article 324 of the Commercial Code provides shareholders with two options. First, without changing the amount of the capital, the shareholders can pay for the loss. Second, if one third of the capital still exists, the shareholders can reduce the capital to one third, provided that one third is above the minimum capital requirement (TRY50,000 for joint stock companies and TRY5,000 for limited liability companies). If the company has lost two thirds or more of its capital, but the shareholders take no action, the company is deemed to be dissolved and liquidation will follow.

Another solution is if the shareholders contribute cash to a reserve fund to cover the losses. Even though this is not regulated by law, it is accepted by the Department of Revenues. In practice, it is called the 'cash replenishment fund'.

The pharmaceutical companies filed lawsuits against the tax audit reports. One lawsuit claimed:

- the moneys sent by the shareholders from abroad were intended to replenish the capital;
- the capital replenishment fund was provided to save the company from bankruptcy and forced liquidation;
- a tax not regulated by law cannot be levied based on abstract opinions and assumptions.

The company also claimed:

- a company that operates a manufacturing facility and employs hundreds of people should not and cannot be considered solely as a marketing and service company in order to charge fees;
- services and marketing were not within the scope of the company's objectives according to its articles of association;
- the tax inspector had not conducted a thorough review of the causes of the losses incurred.

The tax court agreed with the company, stating that the tax audit report was based on an incomplete investigation and abstract determinations. However, in similar cases the tax courts rendered adverse decisions.

It also dismissed one case on the grounds that the company had acted as the marketing department of the parent company and, although it had incurred losses for many years, had maintained its economic existence through payments from the parent company abroad under the title of 'cash replenishment funds'. The Tax Authority and the companies have appealed the decisions before the Council of State, which is yet to make a ruling.

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