Litigation - Turkey

Council of State to decide on tax courts' decisions on capital replenishment funds

Contributed by **Cerrahoğlu Law Firm**

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The Tax Authority recently conducted audits of the Turkish subsidiaries of a number of multinational pharmaceutical companies in order to review the previous five years' accounts. In the tax audit reports the tax inspectors claimed that the subsidiaries were acting as marketing companies and were providing continuous sales and marketing services to their parent companies abroad free of charge. Thus, they had incurred continuous losses for years and covered such losses through their capital replenishment funds. According to the tax inspectors, the capital replenishment funds provided to these companies from abroad by their shareholders should be deemed as service fees. Had the companies recorded such moneys as service fees in their books, they would not have incurred losses.

Consequently, the Tax Authority levied corporate income tax, value-added tax, a tax loss penalty and default interest on these companies for the capital replenishment fund amounts provided to them from abroad by their shareholders.

Article 324 of the Commercial Code states that:

"*If from the last annual balance sheet it is understood that half of the company's capital has been lost, the board of directors shall immediately meet and notify the general assembly of the situation.*

If there are indications to the effect that the company is in a state of insolvency, the board of directors shall prepare an interim balance sheet based on the sale values of the assets. The company is deemed to be terminated if two thirds of the company's capital has been lost and the general assembly of shareholders has not decided to make up for this capital or to be content with the remaining one third. If the assets of the company become insufficient to meet the receivables of the company's creditors, the board of directors shall promptly notify the court of such situation. In such case, the court shall rule for the bankruptcy of the company. However, if it seems possible that the company's situation can be improved, the court may postpone the bankruptcy ruling upon the request of either the board of directors or one of the creditors. In such case, the court shall take the necessary measures for the safekeeping of the company's assets such as drawing up an inventory or appointing a trustee."

Thus, the Commercial Code provides shareholders with two options. First, without changing the amount of the capital, the shareholders may decide to pay for the loss. Alternatively, if one-third of the capital still exists, the shareholders may 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 to avoid the application of Article 324 of the Commercial Code when a company has lost two-thirds of its capital or more is a cash injection from the shareholders through the creation of a reserve fund to cover losses. In this solution a special fund is created in the company's books, to which the shareholders contribute cash. Even though this solution is not regulated by law, it is accepted by the doctrine and written opinions of the Department of Revenues. In practice, this fund is called the 'cash replenishment fund'.

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

- 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; and

- a tax which is not regulated by law cannot be levied based on abstract opinions and assumptions.

Furthermore, the company claimed that:

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

The Tax Court agreed with the company's arguments, stating in its decision that the tax audit report was based on an incomplete investigation and abstract determinations.

However, in similar cases filed by other pharmaceutical companies, the tax courts rendered adverse decisions and dismissed one of the cases 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 receipt of payments from the parent company abroad under the title of 'cash replenishment funds'.

In this specific case the Tax Authority has appealed the decision before the Council of State, which is yet to render its decision.

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