

Litigation - Turkey

Council of State rules on transfer pricing in pharmaceutical industry

Contributed by **Cerrahoglu Law Firm**

December 13 2011

Background

Facts

Decision

Comment

The Council of State has ruled that during a tax audit on transfer pricing, the factors which may cause price differences between pharmaceutical ingredients should be taken into account.

Background

A few years ago, tax authorities conducted audits on pharmaceutical companies regarding transfer pricing. The auditors questioned various pharmaceutical companies about the prices of the active ingredients that they purchased. The auditors deemed the lowest price as a 'precedent' and considered the difference between such precedent and the price paid by pharmaceutical companies which purchased ingredients from their group companies abroad as disguised profit distribution. Based on this consideration, the tax authorities levied taxes on the Turkish subsidiary of an international pharmaceutical company.

Facts

The subsidiary filed suit before the Tax Court for the cancellation of a tax audit report. The Tax Court rejected the lawsuit based on the following reasoning.

Pursuant to Article 17/1 of the Corporate Tax Law, where a company enters into sale, purchase, production, construction or service transactions with its own shareholders, individuals, legal entities to which its shareholders are related or to which it is directly or indirectly connected regarding its control or capital, or which are kept under its control, for prices that are significantly higher or lower than market prices or free of charge, such company will be deemed to distribute its profit in full or partial disguise. Article 15/3 of the law stipulates that profit which is distributed in disguise cannot be considered as an expense when determining the company's revenue.

According to the report, the active ingredients purchased from the plaintiff's group companies could actually be purchased for a much lower price elsewhere. The report suggested that the subsidiary distributed disguised profit by purchasing ingredients with the same chemical abstracts service (CAS) numbers, bioequivalence and bioavailability properties, but no therapeutic difference compared to others in the market, at inflated prices within its own group.

Therefore, the court believed the report to be fair and in accordance with the law.

The subsidiary applied to the Council of State.

Decision

The appeal was first examined by the Council of State's reporter judge, who was of the opinion that the tax audit lacked proper research on 'precedents', and that the transaction subject to the lawsuit was unfair and thus the decision of the Tax Court should be overruled. The appeal was also examined by the Council of State's prosecutor, who argued that the reasons for appeal did not exist in the present case; therefore, the Tax Court's decision should be upheld.

Finally, the Fourth Chamber of the Council of State decided on the merits of the case unanimously, with the majority in favour of overruling the Tax Court's decision based on the following grounds.

On examination of the scientific reports and essays submitted to the lawsuit file, which were prepared by various universities and the Scientific and Technological Research Council, it was understood that the prices of ingredients with the same CAS number and the same name varied depending on many factors such as production techniques, quality, country of origin, royalty, licence agreement, right of preference in the supply of the ingredients and whether such ingredients were used in the production of original or generic drugs. Even if they had similar bioequivalence and bioavailability properties, there was a price and quality difference between the active ingredients of original and generic drugs.

The existing price difference between active ingredients which were produced by different companies but had the same CAS number was not taken into account in the tax audit report and, therefore, the transaction based on the report was unfair.

In the minority report attached to the decision, a member of the chamber stated that since ingredients with the same name may be priced differently depending on various factors, the Tax Court should re-examine the case in order to determine whether the plaintiff had purchased the same ingredients at significantly higher prices.

Comment

The Tax Court's decision - which was based only on CAS numbers and failed to take into account scientific reports and objections about the production and quality differences between active ingredients - was unfair and could have produced erroneous conclusions regarding transfer pricing issues. The Fourth Chamber's decision acknowledged the factors which should have been taken into consideration in the determination of a precedent. As mentioned, although a member of the chamber opined that the Tax Court should re-examine the case in order to determine whether the subsidiary had purchased the same ingredient at significantly higher prices, such opinion did not affect the outcome of the decision, and the Fourth Chamber did not decide in favour of a re-examination by the Tax Court.

For further information on this topic please contact [Ayşegül Gürsoy](mailto:aysegul.gursoy@cerrahoglu.av.tr) at Cerrahoğlu Law Firm by telephone (+90 212 355 3000), fax (+90 212 266 3900) or email (aysegul.gursoy@cerrahoglu.av.tr).