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Subject Matter:

EVIDENCING THAT INTERNATIONAL INTRAGROUP SERVICE (MANAGEMENT FEE) INVOICES ARE ACTUALLY RECEIVED; POTENTIAL TAX RISKS IN THE EVENT THAT THIS CANNOT BE PROVEN

Summary: In the course of recent tax inspections, the taxpayer may be asked to prove and evidence with documentation, with regard to connection intra-group service (management fee) invoices from abroad,

- that the service is actually received;
- that the recipient actually needs the said service;
- whether there are any facilities/means/staff members that would carry out the same service in the recipient's organization in reliance on its/their technique/experience;
- whether there was such a pass-through merely because the recipient is a group member (whether there was a cost pass-through pretending that such service was received by using the intra-group distribution key, even though in reality such service was not received);
- whether the management fee is at arm's length;
- whether the services received bring any commercial or economic value that would reinforce and strengthen the commercial foothold and position of the company in Turkey.

The taxpayer may also need to prove the link between the said expense and the commercial earnings generated in Turkey. Unless this can be proven in an acceptable way and is substantiated by supplementary explanations, legal action will be initiated for the said services, and such management fee will be considered a distributed dividend under the transfer pricing legislation, and, therefore, a fined corporate tax plus a fined tax deduction (withholding) may be charged. Moreover, the deduction of the reverse charge VAT may be rejected for such payments to abroad in cash or on account.

Today, many foreign capital companies prefer to purchase certain services separately from different countries in which group members are respectively located, but from one or a few members of the group. This way, similar services become less costly, and they are supplied to all group companies from one supplier. The said services may be invoiced to relevant group members under the "management fee" or any other similar name. These management services include, inter alia, supply chain management, human resources/staff member relations, legal issues, corporate strategy, research and development, logistics, financial services, information technology, procurement, sales and marketing, risk management/insurance and security management, and repair and maintenance services. Said services are calculated based on the net sales of the purchasing group company or by applying certain keys to expenditures incurred at the head office. Management services supplied from abroad to group members in Turkey have so far been considered if they were subject to withholding tax, and a high number of rulings have been issued and published on this subject. But recently tax inspectors

first and foremost inquire as to whether those management services are actually received, and they proceed with their evaluations on the basis of whether the documents submitted to them are satisfactory and adequate. In the event that said evaluation turns out to be negative, such payments are considered a profit shifting to the related person, and the relevant taxpayer may face fines on corporate taxes and withholding tax applicable to dividends. Also, if the reverse charge VAT is declared and deducted in connection with these expenses, such deduction may also be rejected.

In light of the above reasons, it is critically important whether a company to which a foreign group company supplies management services or similar services is actually in need of the said services, and if the said services are actually given and the answer to the latter question is yes, then whether necessary documentation has been issued and drafted. In the below paragraphs, we will discuss how the documentation should take place in connection with management services supplied from a foreign group company abroad, and we will recommend certain steps to minimize potential tax related risks.

How should the documentation take place in order to substantiate the intra-group services?

According to Article 6 of the Corporate Tax Code No. 5520 (the CTC), corporate tax should be calculated over the net corporate earnings generated in an accounting period and such provisions of the Income Tax Code applicable to trade earnings should also be applied to the determination of the net corporate earnings. Pursuant to subparagraph (1) of the first paragraph in Article 40 of the Income Tax Code (ITC) No. 193, general expenses incurred to generate and maintain trade earnings may be deducted as expenses in order to calculate the net earnings. Similarly, as the paragraphs entitled “11 Intra-group Services” in the General Communiqué on Disguised Profit Distribution through Transfer Pricing (Serial No: 1) stipulate, there are certain explanations describing whether intra-group services are actually purchased and how these services should be documented.

“11. Intra-group Services

11.1- Definition and Scope of Intra-group Services

Intra-group services mean such services that take place between related companies and which are usually supplied by the parent company to its subsidiaries or by a member of the group to another group member. This kind of services cover the performance and provision of the management, coordination and control functions for the entire group, and the cost of the supply of such services may be assumed by the parent company or a group member assigned with such task or another group member (group service centre).

In connection with intra-group services, the following should be evidenced:

- Whether the service is actually supplied;
- Whether the purchaser(s) of the service actually need(s) the supplied services;

- In case the service is actually received, whether the service (management) fee is in line with the arm's length principle.

11.2- Whether Intra-group Services are actually Supplied

Pursuant to the arm's length principle, in order to determine whether an intra-group service is actually supplied, the question of whether the service brings a commercial or economic value to the recipient group member in a manner that would strengthen its commercial foothold and standing should be taken into account.

Where a related company purchases a service from its parent or another group member while it is not actually in need of that service, or if this service is supplied to the group member merely because it is a group member, said company's purchase of an intra-group service cannot be recognized.

In circumstances where a group member supplies an intra-group service in order to meet a need defined by one or several members of that group, it is quite easy to determine whether the service is actually supplied. For instance, if a related person assumes the repair works for such machinery and equipment used in the manufacture operations by another group member, this may be considered an intra-group service, and it is quite possible to verify whether the said service was actually supplied.

On the other hand, the fact that a payment is made to related persons in return for the services supposedly supplied by an intra-group company, and/or the payment is described as a management fee, would not automatically prove the actual supply of the said services.

The ruling issued by the Revenues Administration on 16.11.2011 under No. B.07.1.GİB.0.03.44-010.01-23 brings about the following clarifications as to intra-group services.

*"In this respect, a service procured by a related person from its parent or the member of the same group may be accepted as an "intra-group service" only if the recipient is in actual need of the said service; it actually uses and benefits from it and the management fee should be in line with **the arm's length principle** calculated by using an appropriate distribution key."*

Pursuant to the arm's length principle, in order to determine whether an intra-group service is actually supplied, the issue of whether the service brings a commercial or economic value to the recipient group member in a manner that would strengthen its commercial foothold and standing should be taken into account. Where a related company purchases a service from its parent or another group member while it is not actually in need of that service, or this service is supplied to the group member merely because it is a group member, the said company's purchase of an intra-group service cannot be recognized.

Besides, the fact that a payment is made to related persons in return for the services supposedly supplied by an intra-group company, and/or the payment is described as management fee, would not automatically prove the actual supply of the said services.

In line with the explanations above:

a) On the condition that the services procured under the agreement are actually needed, these services are actually supplied, and the invoice sum is determined in line with the arm's length principle, payments for the expense share to be invoiced by may be taken into account as expense in order to determine and calculate corporate earnings.

b) Payments for the expense share for service purchases to be invoiced by, but which do not meet the above-mentioned conditions, as well as expense shares to be invoiced by for the services of the same nature falling within the scope of the frame agreement and said Service Agreements, may not be deducted as expenses in order to determine corporate earnings.

Similarly, another ruling issued by the Revenues Administration (dated 16.01.2013 under no 64597866-125[30-2013]-3) quoted below underlines the same facts:

“Intra-group service (management) fees should be separately considered to verify whether they are in line with arm's length principle with reference to both the service purchaser and the service supplier. Besides, the said service fee should be determined by applying an appropriate distribution key.

Pursuant to the arm's length principle, in order to determine whether an intra-group service is actually supplied, it should be taken into account if the service brings a commercial or economic value to the recipient group member in a manner that would strengthen its commercial foothold and standing. Where a related company purchases a service from its parent or another group member while it is not actually in need of that service, or this service is supplied to the group member merely because it is a group member, it is not possible to recognize that the said company has purchased an intra-group service

In line with the explanations above, on condition that your company needs the services to be supplied by foreign related companies and those services are actually supplied, the invoiced sums for those services as well as distribution keys used in this respect should be in line with the arm's length principle.”

As one can see from the ruling quoted here, the Ministry of Finance inquires as to whether services procured from foreign members of the group are actually supplied; the recipient is actually in need of that service and in case the service is supplied, the management fee is in line with the arm's length principle. For this reason, a group company purchasing such services should document the said inquiries in line with the approach by the Ministry of Finance. Otherwise, in case of a potential tax inspection, it is possible that the said management fee may be treated as Non-Deductible Expenses in order to determine the corporate tax earnings and that a fine in the form of a tax charge may be demanded. Moreover, there is a risk that the reverse charge VAT that was declared and deducted in

connection with the said non-deductible expenses may be rejected, and that a VAT may be charged as usual. Similarly, based on an argument that profit distribution took place at the end of the relevant period, a withholding tax fine may be charged in connection with the said non-deductible expenses.

A company that purchases services from abroad should strictly comply with the following conditions, and proceed with and complete the necessary documentation in order to make sure that such management fee invoices (or invoices under similar names) issued by the supplier group company are not subject to a fine in the form of a tax charge:

- Whether the service is actually supplied;
- Whether the purchaser would otherwise purchase the said service from a non-related person instead of the related person, i.e., if it actually needs such service;
- Whether such a pass through is made merely because it is a group member;
- In case the service is actually supplied, whether the management fee is in line with the arm's length principle;
- Whether the supplied service brings any commercial or economic value likely to strengthen the commercial foothold and standing of the purchaser;
- Whether the expenses incurred in connection with the service contribute to the generation and maintenance of the commercial earning in Turkey;
- Whether a detailed agreement with the supplier group member in connection with the services to be supplied;
- Whether there is a clear and understandable distribution key in line with the arm's length principle;
- Whether there are photocopies of the passports of those officers who visit Turkey to supply the services;
- Whether there is correspondence with parties located abroad;
- For each invoice and sum, in-house reports should be certified by the company officers, including technical explanations and descriptions as to the reasons underlying the need to purchase the said service as well as service request forms and similar documents that should be certified by the superiors of the relevant departments;
- Names, titles, positions of those persons at the foreign group member who actually supply the said services, the hours spent by them on which projects/jobs and in which month, the details of the supplied job/work/service/project, unit hour cost for such persons underlying the invoice sum and detailed expense list certified by the responsible officers;
- Under the paragraphs in Sections “(10) Intangible Rights” and “(11) Intra-Group Services” of the General Communiqué on Disguised Profit Distribution through Transfer Pricing (Serial No: 1), such documents and annual transfer pricing reports, as well as other similar documents, information and reports, should be delivered.

Truly yours,

**DENGE İSTANBUL YEMİNLİ
MALİ MÜŞAVİRLİK A.Ş.**

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