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Beginning of a New Era in M&A Transactions

Taxation of Capital Gains under the Draft Income Tax Law

The capital gain taxation has always been an issue of concern for those who wish to transfer their shares in a company with the benefit of tax exemptions under the current Income Tax Law and Corporate Tax Law. The Draft Income Tax Law (the "**Draft Law**"), which is still pending before the Turkish Parliament, intends to merge the Income Tax Law and the Corporate Tax Law into one single text and capital gain taxation is one of the hot topics on which material changes are expected. Indeed, it should not be regarded as an overstatement to argue that time is running out for the potential sellers who try to avoid higher tax implications.

A. Current Position

1. Corporate Tax Law

In case a legal entity intends to transfer the shares that it owns in another company, the capital gains derived by such legal entity as a result of the said share transfer transaction will be subject to corporate taxation at a rate of 20%. However, according to the Corporate Tax Law, if such shares are being held for at least two years by the legal entity shareholder, 75% of the capital gains derived as a result of disposal of such shares are exempt from corporate tax; provided that the said capital gains are reserved in a special fund for a period of five years following the share transfer. From the perspective of corporate taxation, there is no difference as to the transfer of shares of a joint stock company (*anonim şirket*) or a limited liability partnership (*limited şirket*) and the said exemption applies in both instances on the condition that the above mentioned conditions are met.

2. Income Tax Law

If a natural person aims to transfer the shares that he/she holds in a company, the income that is generated as a result of such disposal of shares is subject to income taxation under the Income Tax Law (currently, individual income and gains are subject to income tax at progressive tax rates which vary between 15% and 35% and are calculated on a cumulative basis). That being said, the capital gains derived by a natural person as a result of disposal of shares in a joint stock company are exempt from income taxation, if the shares are printed in share certificates / temporary share certificates and if they are held by such natural person for more than two years (this exemption does not apply during the transfer of shares of a limited liability partnership).

B. What the Draft Law Says

The Draft Law brings material changes regarding the tax exemptions on the capital gains generated from the transfer of shares of companies. According to the Draft Law, the exemption rates gradually increase depending on length of the period during which the transferor holds the shares:

- 40%, if the shares are held for more than 2 years;
- 50%, if the shares are held for more than 3 years;
- 60%, if the shares are held for more than 4 years; and
- 75%, if the shares are held for more than 5 years.

The legal entities or natural persons which aim to benefit from such exemption must reserve the said capital gains in a special fund for a period of five years following the share transfer. However, in terms of the application of the said exemption under the Draft Law, it does not matter whether a joint stock company or limited liability company is concerned, whether the shares are printed in share certificates / temporary share certificates or whether the transferor is a natural person or a legal entity.

C. Conclusion

The Draft Law aims to limit the scope of the tax exemptions in connection with the capital gains for both legal and natural persons/taxpayers. If the Draft Law is accepted in the Parliament and enters into force as is, the natural persons and legal entities will no longer benefit from the current tax exemptions in respect of their capital gains and they will only be able to make advantage of the above mentioned exemption rates that increase gradually for each year. In addition to this, limited liability companies will also be included within the scope of this exemption as opposed to the current regime, which we think would result in joint stock companies' losing their privilege in that sense. Therefore, it would be wise to say that new transaction opportunities and/or exits should be scheduled by taking the Draft Law into account.

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