

Injection of capital advance as a recovery method for technical bankruptcy under the Turkish commercial code

GÜN + PARTNERS
AVUKATLIK BÜROSU

29 March 2017 | by Gün + Partners

Tags: Gün + Partners Turkey Financial and corporate

According to the company statistics published by the Turkish Union of Chambers and Commodity Exchanges (TOBB), a total of 63,709 companies were incorporated in Turkey provided that 4,523 of these companies were incorporated with foreign capital only in 2016. However, due to certain reasons such as incorporation of the companies with the minimum capital required by the law, many companies may fall in the technical bankruptcy situation soon after their establishment. Although in practice technical bankruptcy usually does not cause critical issues in terms of dissolution of companies, it may lead up to liability of the company representatives which puts particularly the companies with foreign capital in a difficult position.

1. Technical Bankruptcy

Turkish Commercial Code numbered 6102 (the "TCC") gives particular importance to the protection of capital in joint stock and limited liability companies which are the most preferred equity company types in Turkey. Under Article 633 of the TCC, mandatory requirements regarding joint stock companies also apply to the limited liability companies with respect to the loss of capital. Accordingly, Article 376 of the TCC regulates specific cases of capital inadequacy in these companies and determines mandatory measures to be adopted by these companies' relevant bodies in each case.

As per Article 376/2 of the TCC, if the last annual balance sheet affirms that two-thirds of the sum of the share capital and legal reserves are lost as a result of accumulated losses ("**Technical Bankruptcy**"), the board of directors must immediately call for a general assembly meeting. At the meeting, the general assembly must resolve on either (i) to fully supplement the capital or (ii) to be satisfied with one-third of the capital. If the general assembly fails to adopt any of these resolutions at the meeting or if a meeting is not convened at all, the company would be deemed dissolved. Also, companies' representatives (e.g. board members and managers) may be subject to legal and criminal liability, if they fail to fulfill their obligations under Article 376 of the TCC as well as the Execution and Bankruptcy Law numbered 2004.

Although many Turkish companies are faced with Technical Bankruptcy due to different reasons (e.g. incorporation of the companies with the minimum capital required by the TCC or becoming indebted to the shareholders in foreign currency), it is uncommon in practice to become dissolved just because of the Technical Bankruptcy under the balance sheet. However, it is worth emphasizing that a company would not be able to properly operate and make long term business or financial plans without remedying Technical Insolvency.

2. Injection of Capital Advance and Its Practice

As indicated above, in case of Technical Bankruptcy under Article 376/2 of the TCC general assembly of the company may decide to fully supplement the capital rather than being satisfied with one-third of the capital. In such a case the company in Technical Bankruptcy may proceed with (i) capital injection by the shareholders, (ii) simultaneous capital decrease and increase or (iii) merger as per Article 139 of the TCC.

As a recovery method, capital injection may be realized via injection of cash to the company either as capital advance or loss remedy fund in order to resolve the Technical Bankruptcy problem. In this article we would like to detail the implementation of the capital advance injection since this is an option commonly preferred by the companies.

2.1. Concept of Capital Advance under Turkish Law

Before the TCC became effective in 2012, as per the Circular on Capital Movements numbered 2002/YB-1 of the Central Bank of the Turkish Republic (the "Former Circular") shareholders were allowed to inject money as capital advance so that the companies would use that money for their commercial activities. However, companies were required to capitalize the capital advance within one year following its receipt. Capital advances which were not added to the company's capital within one year were considered as a credit (loan) and not as a part of the capital.

When the TCC came into force in 2012; Central Bank of the Turkish Republic amended the Former Circular by issuing a new circular numbered 2013/YB-7 (the "Circular") and removed the concept of capital advance from the Former Circular. As per the Circular, the payments made by the shareholders to the companies are now required to be recorded either as capital increase payment or capital payment with the implication that the funds transferred by the shareholders shall not be released by the bank until they are actually registered as capital before the competent trade registry

Related articles

- Emergency buttons for business partners
- How to tackle with Data Protection compliance projects in Turkey
- Law on improvement of the investment environment
- 2015 Cross-border Financing Report: Turkey
- 2015 MINT Guide: A broadening framework

GÜN + PARTNERS
AVUKATLIK BÜROSU

directorate. Accordingly, contrary to the implementation set forth by the Former Circular, since at present the money injected as capital advance cannot be used until it is added to the company's capital and capital increase is registered, the concept of capital advance is no longer available as it was before.

Although the Circular does not stipulate a deadline for adding the capital advance to the capital of the company, according to the established practices in Turkey if the capital advance injected for the potential capital increase is not used to increase capital within a reasonable time period (i.e. maximum one year) then it will be considered as a loan given by the foreign shareholders and will be subject to resource utilization support fund (kaynak kullanım destekleme fonu - KKDF) which is collected by the banks over the principal payment and its interest up to the rate of 3% in 2017.

On the other hand, upon the amendment made by the Law numbered 6637 on Article 10 of the Corporate Tax Law numbered 5520 (the "CTL"), 50% of the interest amount (i.e. Central Bank of Turkish Republic's most recent interest rate which applies to commercial loans in Turkish Lira extended by banks for the year in which the deduction is made shall be taken as a basis) calculated over the capital increases in cash made in a company can be deducted from the corporate income tax base. Capital increase in cash through capital advance payment was also subjected to such interest incentive following the General Communiqué numbered 10 on the CTL (the "Communiqué"). According to the Communiqué, the interest incentive will apply to the capital increase in cash via capital advance on condition that (i) the capital advance is recorded under "other capital reserves" item of the balance sheet as of its deposit to the bank account of the company and (ii) the capital advance is added to the capital and capital increase transaction is registered before the competent trade registry directorate until the end of the fiscal year during which the capital advance is deposited to the bank account.

2.2. Capital Increase via Capital Advance Injection by Companies in Technical Bankruptcy

Under normal circumstances, companies are not allowed to increase their share capital before recovering the Technical Bankruptcy position while the company's equity is negative. For registration of the capital increase, apart from other necessary documents, trade registry directorates require a report from a certified public accountant stating that the former capital of the company has been fully paid. The same report must also state that according to the most recent balance sheet, the net assets of the company are preserved pursuant to Article 376 of the TCC. Otherwise, the trade registry directorates do not register and announce the increase of the company capital. Accordingly, increasing the paid-in capital in a way that the equity will be upper than the minimum threshold (1/3 of the total of the paid-in capital and the legal reserves) is needed so that the certified public accountants prepare their reports in line with the requirement of the trade registry.

In practice, while certain public accountants evaluate the capital increase through capital advance injection as "capital increase from internal resources" and prepare their reports in that direction, the others categorize it under "capital increase in cash". Since the trade registry officers are not qualified to evaluate the financial status of the company, in general they neither examine the balance sheet nor question the type of the capital increase determined in the certified public accountant report. Therefore interpretation of the certified public accountants and content of their reports are of vital importance with regards to type and registration of the capital increase.

Article 462 of the TCC which regulates the capital increase from internal resources states that the reserve funds which are reserved as per the articles of association and the board of directors resolution and are not allotted for a certain purpose, as well as disposable portion of the statutory reserves and funds which are allowed to be converted into capital under the applicable legislation to be added into capital, may be converted into capital to create the internal resources required for capital increase. In light of the different interpretations, capital advance may be categorized as a fund which is allowed to be converted into capital as listed in the Article 462 and the capital increase may be contemplated as to be realized from internal resources. However, considering the interest incentive to be applied also to the capital increase through capital advance provided that the conditions set forth by the Communiqué are fulfilled, it would be much more beneficial for a company to contemplate the process as capital increase in cash rather than capital increase from internal resources. Apart from the interest incentive, we also think that the capital advance should not be interpreted as an internal resource since it is cash money transferred by the shareholders directly for the purpose of the future capital increase of the company.

3. Conclusion

In light of the foregoing, financial position of the companies should be closely followed and any injection of loans or equity should be arranged before the company falls in Technical Bankruptcy situation, if possible. If the company faces with the Technical Bankruptcy situation despite the measures taken by it, regardless of the amount of the capital advance or type of the capital increase, it is essential to cooperate with certified public accountants and attorneys at every stage of the capital increase procedure.

It is also worth to remind that the companies should consider their near future financial position based on their profit and loss projections while determining the capital advance amount to be injected. Injection of the minimum amount required for the equity be upper than the minimum threshold (1/3 of the total of the paid-in capital and the legal reserves) stipulated under the TCC may cause the company's falling under the Technical Bankruptcy position once again in the following years.

Lastly, consulting tax advisors in case of transfer of capital advance should not be disregarded in terms of transfer pricing and camouflaged capital implementations.

Pelin Baysal
Partner
Gün+Partners

Cansu Akbıyıklı
Senior Associate
Gün+Partners

© Euromoney Institutional Investor PL
Registered Office: 8 Bouverie Street, London EC4Y 8AX, United Ki