



## **PAYMENT OF DIVIDENDS OUT OF COMPANY'S RESERVE ACCOUNTS AND RETAINED EARNINGS**

Joint-stock companies and limited liability companies may pay dividends to their shareholders out of their annual net profits after transferring required amounts to their reserve accounts mentioned in the Turkish Commercial Code numbered 6102 (“TCC”). The dividend payment procedure is explained in Article 509 titled “Dividend” and Article 519-523 for joint-stock companies and in Article 608 titled “Dividend and Reserves” for limited liability companies. On the other hand, some companies may have doubts regarding the payment of dividends out of their retained earnings and free reserve accounts. Therefore, we aim to answer these questions in this newsletter.

### **EXECUTIVE SUMMARY**

- (i) Principles regarding the payment of dividends in joint-stock companies and limited companies are regulated by the Turkish Commercial Code.*
- (ii) Dividends may be paid only out of the annual net profit and reserve accounts maintained for dividend payment purposes.*
- (iii) Dividends may be paid to shareholders out of the annual net profit only after transferring legal reserves and statutory reserves indicated in the company's articles of association to reserve accounts.*
- (iv) There is not any legal restriction against paying dividends out of retained earnings, free reserve funds, which are not devoted for a specific purpose in the articles of association of a company or in general assembly decisions, and legal reserve funds exceeding fifty percent of issued share capital / paid-in capital.*

### **RELATION BETWEEN RESERVE FUNDS AND DIVIDENDS**

Pursuant to Article 509/2 of TCC, dividends may be distributed only out of the annual net profit and free reserve funds. Articles 519-523 explain how to allot reserve funds and the relationship between reserve funds and the dividends to be paid. However, there is not any detailed explanation about how to pay dividends out of free reserve funds indicated under Article 509/2. Hence, it is essential to determine what kind of reserve funds may be considered as free reserve funds and in which conditions free reserve funds may be freely disposed of. In this regard, reserve funds are classified below according to TCC and then it is evaluated whether or not they may be used for dividend payment.

## I. Reserve Funds

Reserve funds are regulated under Articles 519-523 of TCC and may be classified as below:

**Legal Reserve Funds:** Five percent of the annual profit shall be reserved as a legal reserve fund until this sum reaches twenty percent of paid-in capital. Unless legal reserve funds exceed fifty percent of share capital or paid-in capital, it may only be used for recovering losses, maintaining the activities of the company during tough times or preventing unemployment and easing the results of unemployment.

**Statutory Reserve Funds to be maintained according to the articles of association (Discretionary Reserve Funds):** The articles of association may stipulate that more than five percent of the profit shall be reserved as reserve funds, and that reserve funds may exceed twenty percent of the paid-in capital. Additionally, the articles of association may require maintaining other reserve funds and determine the reason why they are reserved and in which conditions they may be spent. Moreover, the articles of associations may regulate that funds may be reserved in order to found and maintain charitable organizations in favor of the directors, employees and workers of the company, or in order to be given to public legal entities which have similar purposes.

**Reserve Funds to be maintained according to General Assembly Decisions:** General Assembly may resolve on maintaining reserve funds other than specified by TCC and the articles of association if it is necessary for buying new assets for the company and if it may be deemed suitable with regards to permanent development and stable profit distribution, taking into account the benefits of all shareholders.

## II. Uses of Reserve Funds

Reserve funds are the residual part of the net annual profit that is not distributed. The function of reserve funds is to be a protection against the company's loss-making in following years, financial difficulties in case of unexpected losses and expenses. In addition, reserve funds may be used for stabilizing the dividend payment during the periods that annual net profits fluctuate over the years.

Legal reserve funds may only be used for the purposes described under Article 519/3 until it exceeds half of the share capital or paid-in capital. In other words, it means that the part of the legal reserve funds which exceeds half of the share capital may be used freely. Therefore, this residual part has the characteristics of free reserve funds and may be used for capital increase and dividend payment as well.

Although statutory reserve funds are named discretionary reserve funds, they must be reserved if the articles of association regulates it to do so. Such funds shall be reserved accordingly, especially in cases where the purpose to reserve and fields to be spent are determined in the articles of association. As a result, statutory reserve funds may not be used for dividend payment,

Reserve funds maintained due to a decision of General Assembly may be used for dividend payment. In this context, they have the characteristics of free reserve funds.

## III. Retained Earnings and Reserve Funds on Balance Sheets

In the balance sheets of the companies, reserve funds are named in a different way than the way they are named in TCC. To match reserve funds terms of TCC to accounting terms is crucial for the dividend payment process. Therefore, it is important to examine share equity capital types. They are indicated below as classified according to the Uniform Chart of Accounts:

- Paid-in Share Capital
- Capital Reserves
- Profit Reserves
- Retained Earnings (Previous Years' Profit)
- Previous Years' Losses
- Current Period Profit (Loss)

**Capital reserves**, including items such as share premium, share cancellation profits and revaluation funds, are the amounts which occurred due to the change in share capital and which have been retained in the company's accounts.

**Profit reserves** are reserves that retained in the company's accounts according to articles of association of the company or the decisions of its competent bodies in order to mitigate potential risks. The items of profit reserves are following:

- (i) **Legal Reserves:** They are the reserves to be allotted pursuant to TCC articles and refer to legal reserve funds in TCC.
- (ii) **Statutory Reserves:** They are the reserves to be allotted pursuant to articles of association and refer to statutory reserve funds (discretionary reserve funds) indicated in TCC.
- (iii) **Extraordinary Reserves:** They are the reserves to be allotted by General Assembly and refer to reserve funds to be maintained according to General Assembly decisions in TCC.

**Retained Earnings** is the remaining amount of net income in the company's accounts after paying dividends to its shareholders and transferring reserves (legal/statutory/extraordinary reserves) to reserve accounts. Retained earnings may be used for the payment of dividends and capital increase.

#### **IV. Distributions of Dividends at Capital Markets Law.**

A detailed explanation for the payment of dividends is provided in Capital Markets Law Dividend Guide ("Dividend Guide"). Dividend Guide is issued based on Article 13 of Communiqué on Dividends numbered II-19.1 which has been prepared and issued according to Articles 19 and 20 of the Capital Markets Law numbered. 6362. The part of the Dividend Guide named "The Other Sources Usable for Distribution of Dividends" states that:

- In addition to the annual net profit, retained earnings, extraordinary reserves and the other reserves eligible for distribution pursuant to TCC and the articles of association may be used in calculations.
- The dividends may be distributed out of the annual net profit and free reserve funds (reserves allotted by the general assembly and legal reserve funds exceeding half of the paid-in capital)
- In this context, the followings may be used in the calculation of dividend: retained earnings, reserve funds allotted for the purpose of stabling the distribution of dividends, reserve funds that are not devoted to a specific purpose and the other reserves eligible for distribution.

As a result, retained earnings, free reserves that are not devoted to a specific purpose (e.g. Extraordinary reserves) and the portion of the legal reserves exceeding half of the issued / paid-in capital may be used for the distribution of dividends.

## V. Limitations on Dividend Distribution

A provisional article 13 was added to the TCC pursuant to Article 12 of the Law Reducing the Effects of the Novel Coronavirus (COVID-19) Pandemic on Economic and Social Life and Amending Certain Laws numbered 7244 ("Law No. 7244"), which was published in the Official Gazette numbered 31102 and dated April 17, 2020.

Pursuant to provisional article 13; joint-stock and limited liability companies shall pay their profits as dividends up to 25% of their net profit for the 2019 financial year and a company shall not distribute retained earnings and free reserve funds. Similarly, a company's general assembly shall not grant its board of directors the authority to pay advance dividends until September 30 2020. The Presidential Decision numbered 2948 extended the application of the restrictions until December 31, 2020. By January 1, 2021, the restrictions were abolished. As a result, companies may pay dividends not only out of annual net profits of the year 2020 and the undistributed portion of net profits of the year 2019 but also out of the retained earnings and free reserve funds of the year 2019 and previous years.

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*This newsletter has been prepared as of April 16, 2021, for informative purposes regarding the payment of dividends out of reserve funds and retained earnings.*

*Our assessments in this newsletter do not constitute legal recommendation of legal opinion and Aksu Çalışkan Beygo Attorney Partnership may not be hold responsible depending on these assessments. It is recommended to obtain legal opinion for your inquiries within the scope of this memorandum.*

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