

ORIGINS, SCOPE, AND OPERATION OF WITHHOLDING TAXATION

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PRELIMINARY REMARKS

- Withholding taxation vs. formal tax assessment procedure
 - Withholding mechanism vs. filing tax returns (and receiving tax assessments)
 - Prepayment character vs. stand-alone character
- Terminology
 - Withholding taxation vs. source taxation
 - Withholding taxation vs. withholding tax vs. tax withholding
- Territoriality
 - WHT historically do NOT specifically aim at cross-border situations
 - However: advantages of WHT are even stronger in an international context
- Open technical questions mainly in...
 - Tax treaty law
 - EU tax law

ORIGINS OF WITHHOLDING TAXATION

- Withholding taxes in a national context (in the beginning mainly driven by the Church or war times)
 - First evidence of taxes in general goes back to 3000-2800 B.C. in the Old Kingdom of Egypt
 - Roman Emperor Augustus introduced a first system of direct income taxation which followed a form of tax deduction at source operated by so-called “tax farmers”
 - On 1 December 722 Pope Gregory II wrote to Bishop Boniface with respect to the Christians of Germany: “From the income of the church and the offerings of the faithful he [Boniface] shall make four parts: One of these he shall keep for himself, the second he shall distribute among the clergy according to their zeal in the fulfilment of their duties, the third he shall give to the poor and strangers, but the fourth he shall set aside for the building of the church.”
 - Clear evidence for Germany (1722); UK (1799); US (1862); India (1922)
- Withholding taxes in an international context
 - Before the midst of the 19th century, there were hardly any countries that had implemented a personal income tax in the sense of a modern income taxation with a transterritorial effect
 - Cross-border withholding taxes gained momentum with the so-called “compromise of the 1920s”
 - US Representative Thomas S. Adams “...the source country should have the right to impose ‘impersonal taxes’ (that is, withholding taxes) on the various classes of income while the country of residence should provide a foreign tax credit [...] for the withholding taxes paid to the source country”.

SCOPE OF WITHHOLDING TAXATION

- Mainly in national and cross-border scenarios
 - WHT on employment income
 - WHT on capital income (i.e. interest payments and dividends)
- Mainly only in cross-border scenarios
 - WHT on royalties
 - WHT on payments to foreign athletes and entertainers
 - WHT on technical services
 - WHT on digital services
- Lots of peculiarities
 - Construction WHT in Germany
 - WHT on legal services in Poland
 - Branch profits taxes in Canada and the US
 - Renting of furniture in India
 - WHT on “profit shifting” to related parties in Poland

Three main ways of categorizing withholding taxation...

1. Form of withholding

- Stand-alone character: WHT with a settlement nature (no further tax assessment procedure required)
- WHT as a prepayment on (income/corporate income) tax: WHT is credited against final tax assessment

2. Object of withholding

- Tax subject-related WHT: personal circumstances of taxpayers are taken into account (e.g. wage tax)
- Object-related WHT: personal circumstances of taxpayers are irrelevant

3. Parties to the withholding process

- Bilateral situation: Person that is obliged to deduct the tax becomes the formal taxpayer (exception)
- Triangular situation: Taxpayer is different from person that is obliged to withhold the tax (rule)
 - Often associated with a personal liability of the person that is obliged to withhold
 - Sometimes the taxpayer and this person are technically jointly liable to tax

MODE OF OPERATION (2)

...but also further room for differentiation in terms of...

1. Territoriality

- WHT in purely domestic scenarios
- WHT in cross-border scenarios (with or without the applicability of a tax treaty)

2. Determination of tax base

- Gross tax base (often combined with a settlement nature)
- Net tax base (either through later refund, or at time of withholding through business expenses)

3. Tax rate

- Flat tax rate as the most widely used model (as a percentage of the tax base)
- Graduated or progressive tax rates; lump sum payments; denial of business expense deduction

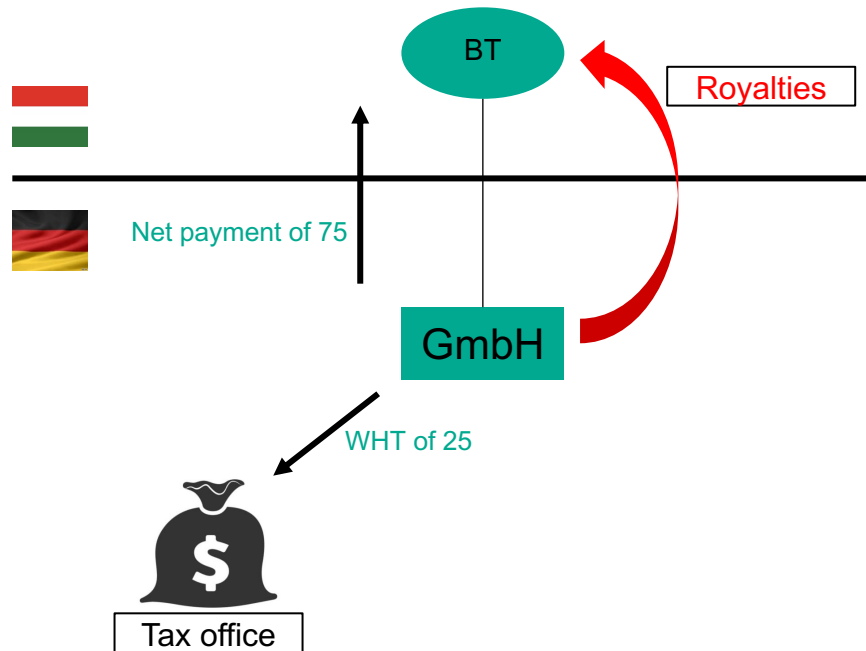
4. Nature of taxpayers

- Individuals
- Corporations

MODE OF OPERATION (3)

General structure of a WHT scenario in an international context

- Agreed gross payment: 100
- WHT rate: 25 %



Central questions...

- Who is the taxpayer?
- Is there a person different from the taxpayer liable to tax?

..which influence the answers to these questions:

- Who is entitled to appeal against the tax assessment?
- Who is entitled to a refund?
- Who is entitled to Directive/treaty benefits?
- From a practical aspect: How to draft a proper tax clause?

Questions also relate to „classics“ of international tax law:

- Who is the beneficial owner?
- Application of anti-abuse rules
- Qualification conflicts
- Genuine link-requirement (e.g. German „register“ cases)

ADVANTAGES OF WITHHOLDING TAXES

- Ethical motives (positive effects on tax justice)
 - Helps reducing tax evasion and non-declaration attempts
 - Equal taxation and ability-to-pay principle
- Fiscal motives
 - Timely, easy and swift collection of taxes
 - Liquidity and maximization of taxes (particularly with gross taxation; irrelevance of personal circumstances)
 - Shift of bureaucracy to taxpayers
- Economic policy motives
 - Simplification of administration (easy control; taxpayer can remain undisclosed)
 - Avoids untaxed capital flight into other countries
 - Development policy goals for developing countries (e.g. tax sparing credit)

DISADVANTAGES OF WITHHOLDING TAXES

- As the case may be: Administrative burden for a third party (i.e. the person that is liable for the tax withholding)
- Costly administrative burden for taxpayers (depending on specific tax, e.g. wage tax and capital income tax)
- Administrative burden for taxpayers subject to the limited tax liability
- Foreign taxpayers: gross taxation and no consideration of personal circumstances
- Further disadvantages
 - Tax evasion still attractive as long as WHT rate is below general tax rate
 - Employment income is shifted into the shadow economy
 - Capital investments are shifted into material assets (e.g. real estate)
 - Often complicated rules in detail (e.g. substance requirements for Directive/treaty benefits)

CLOSING REMARKS

Selected hot topics:

- Beneficial ownership in case of conduit companies (Danish/Luxembourg cases)
(Winther-Sørensen, European Taxation 2023, Vol. 63, No. 7)
- Treaty protection of the person that is obliged to withhold the tax
(Haase, Withholding Taxation in the EU, Edward Elgar, 2023, pp. 157)
- Third-Party Liability for the Payment of Taxes and Their Fundamental Rights
(Baker/Perrou/Pistone, WTJ, Vol. 15, 2023, No. 1)
- Denial of business expenses as “taxation” and treaty protection of the involved parties (Art. 24 Para 4 MC)
(Avi-Yonah, University of Michigan Law School, Law & Economics Working Papers, No. 149)

THANK YOU



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