Withholding Taxes and Tax Treaties

WIRTSCHAFTS UNIVERSITÄT WIEN VIENNA UNIVERSITY OF ECONOMICS AND BUSINESS

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I. The effects of double taxation conventions

- Income tax and corporate tax are levied in different ways:
  - The person or corporation receiving the income must pay (or at least declare) the tax to the tax administration themselves.
  - Company that pays the income must withhold the tax immediately and pay it directly to the tax administration. This may be a final withholding or a prepayment.

- Withholding taxes are often levied at a lower tax rate, but on the gross amount of income.

II.1. The tax base: The link between the distributive rules and domestic law

- The DTCs develop their limiting effect by initially linking each distributive rule to the respective tax base under domestic law.

- The term "profits" used in Art 7 OECD MC does not refer to a net amount. It is exclusively up to the contracting states to decide whether and, if so, which expenses can be deducted from the income.

II. 2. The tax base: The meaning of the gross amount in the OECD-MA

- Gross amount is explicitly mentioned in two provisions of the OECD MC:
  - Art 10 (2) OECD MC
  - Art 11 (2) OECD MC

- No obligation to calculate taxes on gross amount
- Maximum permissible withholding tax.
- Changes OECD MC 2017: 365 day rule

II. 3. The tax base: The special provision of Art 12B para 2 UN MC

- Art 12B (1) and (2) UN MC operate in the traditional manner, however, Art. 12B (3) UN MA opens the possibility of net taxation:
  - The provision is designed as an option.
  - The tax levied in accordance with it is only levied on the basis of a standardized net amount.

III.1. Implementation of the withholding tax restriction: Right to choose between refund and limitation at source?

- Distributive Rules: Limitation of source state taxation (e.g. Art 11 (2), Art 18 OECD MC)
- OECD-Commentary Para 31 on Art 10 OECD MC:"Paragraph 2 does not settle procedural questions. Each State should be able to use the procedure provided in its own law. It can either forthwith limit its tax to the rates given in the Article or tax in full and make a repayment."
- *OECD-Commentary 2003 on Art 1 OECD MC (first Para 26.2, then Para 109): If a refund system is needed, it should be based on observable difficulties in identifying entitlement to treaty benefits. Also, where the second approach is adopted, it is extremely important that the refund be made expeditiously, especially if no interest is paid on the amount of the refund, as any undue delay in making that refund is a direct cost to the taxpayer."*
- *Role of the OECD Commentaries 1963*
- *Role of the OECD Commentaries 2003: Proportionality?*
- *Subsequent practice?*

III. 2. Implementation of the withholding tax restriction: The meaning of mutual agreements under Art 10 (2) and Art 11 (2)

- WP 12 Drafts (A and B, 1958): Focus Refund – Mutual Agreement
- WP 11 Drafts (1959): More neutral: By mutual agreement settle the procedure for achieving such limitation
- WP 12 Drafts (1960): "… shall by mutual agreement settle the mode of application of this limitation."
- Exclusive competence of competent authorities through mutual agreement
- Consequences for other distributive rules?

III. 3. Implementation of the withholding tax restriction: Limitations on the content of mutual agreements pursuant Art 10 (2) and Art 11 (2)

- The relevant procedure for the purposes of the withholding tax limitation of Art 10 (2) and Art 11 (2) OECD MC, may be regulated in more detail by means of a mutual agreement.
- The mutual agreement may stipulate under which conditions and in which constellations direct reduction at source is not permitted.
- The mutual agreement should not create additional condition of application that is not provided for in the OECD MC.

IV. Concluding remarks

- Withholding taxes are levied frequently, particularly if the recipient of the income resides abroad and there is therefore a concern that the tax administration would otherwise not be able to collect the taxes.
- Withholding taxes can only be levied efficiently if they are assessed on the basis of the gross amount.
- Even if a DTC stipulates that the country of residence must give credit for the tax levied in the source country, the situation may arise where the withholding tax is not covered by the maximum tax credit.
- The DTCs often provide for restrictions on the tax of the source state, being, in practice, the recipient of the income often referred to the refund.
- In the case of DTCs that are modeled on the OECD MC, there is only the possibility of switching to the refund method in the case of dividends and interest. This also requires a mutual agreement.

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