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(Tentative title) Reinventing the Withholding Tax? – In the World of BEPS, Digital Economy and [to be added later]

General Reporters

Prof. LEE, Chang Hee (Seoul National University School of Law)
changlee@snu.ac.kr

Prof. (Associate) YOON, Ji-Hyun (Seoul National University School of Law)
dellacase@snu.ac.kr

1. Introduction

Our focus is on the present and future of withholding tax in taxing non-residents. The two mechanisms of collecting taxes are, firstly, tax return and payment by the taxpayer, and secondly, tax withholding by the payor of the income or the withholding agent in technical terms. Under the existing norm, the former is used for active income or business profit whereas the latter is generally used for passive or investment income. For active income or business profits, the existing norm resorts to PE as a threshold under a tax treaty if not under the domestic law; absent a PE, business profits derived by a non-resident is not taxable. For passive or investment income, withholding tax typically applies under domestic law, but a treaty often exempts or significantly reduces withholding tax on many categories of income.

The advent of digital economy and the BEPS challenges this common sense of international taxation. Facing rampant tax avoidance, or at least the possibility thereof by multinational enterprises, the BEPS is perhaps in the direction of assigning more revenue to the source countries than under the current norm, at least where the residence or the capital exporting countries do not currently and fully tax the income of their residents and perhaps their overseas subsidiaries. In taxing business profits, in particular, if the BEPS momentum continues, the source countries would likely find a PE where they cannot under the current norm, by reference to a virtual PE etc.

This prospect raises an important issue. Is it the right course of action to lower the PE threshold? The *raison d'être* of the PE concept is that a non-resident has a presence in the source country that is significant enough for the source country to enforce the collection of taxes. From the taxpayer's perspective, the PE rule protects a taxpayer from an unduly harsh

administrative burden of tax compliance of paying taxes on net income despite it only having a negligible presence in the source country. The idea of virtual PE and other suggested ideas of lowering the PE threshold runs exactly counter to this insight. If the issue is re-allocating revenue between the resident and the source countries, a plausible idea is to redefine the scope of passive investment income or re-characterize some forms of taxable income from business profits to passive investment income, with the result of collecting the source country tax by withholding.

The issue, however, is much more complex. Tax withholding is not peculiar to international tax. Looking back into history, it was the backbone of income taxation *per se*, and is still widely in use in domestic settings as well, although its role has been ever diminishing in many developed countries thanks to the improvement of taxpayer morale and improvement of monitoring by revenue authorities. Withholding tax was invented to better collect taxes from the payor or source of income who are far less in number than the payee or the taxpayers proper. In the case of income earned by domestic or more accurately, resident taxpayers, withholding tax typically applies to employment income, interest income, dividend income, etc. It typically does not apply to income paid to corporations or businesses. In tax systems based on the comprehensive concept of income, withholding tax may apply to investment income only as a back-up option, in case a payor and in turn the revenue authorities cannot ascertain the payee's identity.

Contrasting the international versus the domestic implications of the withholding tax warrants an in-depth analysis of the issue. A cornerstone of the norms of international taxation is the principle of non-discrimination between resident and nonresident taxpayers. Even more importantly, as the development in EU law demonstrates, the sharp distinction between resident and non-resident taxpayers may be untenable if the world economy keeps or is to keep globalizing. It may be an unrealistic and an anachronist idea to reinstate and expand tax withholding in the international setting while it is withering out in the domestic setting.

Withholding tax also has a fundamental flaw as a means of collecting source country taxes in that it is usually levied on gross rather than net income. At rates higher than those that have been currently adopted in existing tax treaties, the withholding tax will easily exceed the resident country tax on net income and end up in double taxation. The existing wisdom is that a source country may not ask a non-resident taxpayer to pay taxes on business profits without first finding a PE and then may tax only the profits on the net income. Likewise, the existing wisdom is that a source country taxing passive or investment income is permitted only at a relatively low rate which will not exceed the resident country taxes on net income.

Nevertheless, given the ever-increasing tendencies for sophisticated taxpayers to avoid gaining a permanent establishment status, withholding tax now attracts more attention as a means of protecting the tax base of source countries. Numerous proposals have already been made to generally utilize withholding mechanisms for income earned by non-residents that do

not have a sufficient physical presence. Although it should be noted in this regard that any of these proposals connected with a wider use of withholding tax have yet to be seriously considered and effectively implemented by tax authorities or the legislature of any jurisdiction, it is timely and meaningful to examine various features of withholding mechanisms in general from both a theoretical and comparative-law perspective.

(WE MAY OR MAY NOT COVER THIS: Finally, an analysis of the withholding tax necessarily involves an additional issue of who the taxable income is attributable, in particular in regard to investment funds, partnerships and trusts and other investment vehicles. In theory, this issue of beneficial ownership or substance over form may be deemed a different issue, but in reality, it may often be the most important issue for the withholding agents especially in connection with treaty applicability.)

Our intention and goal in this Main Subject is to compare the framework for withholding taxes in different jurisdictions, identify common features and diverging points, and possibly, suggest some minimum standards and even best practices. We will also cover a number of specific areas where withholding tax might be particularly considered as an attractive alternative to the current system of revenue collection and enforcement, possibly with some real-world cases.

2. Basic structure of the Directives

A. Part I: withholding tax on income earned by resident taxpayers

The directives will consist of three main parts. As a starting point, the first part will address basic, domestic-law aspects of withholding tax. After asking some basic questions on each national reporter's overall income tax system which can serve as a necessary background, the directives will then proceed to ask questions on standard features of withholding tax as implemented in each jurisdiction. The issues will include the following:

- (1) types of income subject to withholding (when attributed to resident taxpayers),
- (2) withholding tax rates for each type of income,
- (3) whether the relevant tax base is gross or net income,
- (4) penalty for not withholding,
- (5) whether there is any legal doctrine that exempts or mitigates withholding obligations when the withholding agent has difficulty in identifying his withholding obligation,
- (6) the mechanism used to ensure that any over-withheld tax is refunded at the end of each taxable period,
- (7) basic framework of litigation procedures on tax withheld or to be withheld, and others.

B. Part II: withholding tax on income earned by non-resident taxpayers

The second part will deal with international aspects of withholding tax. The topics to be covered in this Part will be as follows:

- (1) types of income subject to withholding when earned by non-residents, under both domestic and treaty laws,
- (2) the relevant tax rates and tax base (i.e. gross or net income),
- (3) source rules that apply to those types of income that are subject to withholding,
- (4) whether there is any legal doctrine that exempts or mitigates withholding obligations when the withholding agent has certain difficulties in identifying her withholding obligation including cases where the direct recipient of income is not the beneficial owner thereof or, where the income is received by a hybrid entity, etc.
- (5) whether the withholding agent may exercise his or her own judgment as to whether or not to withhold when the withholding obligation is removed or mitigated by a treaty provision, or if the withholding agent at first has to withhold according to his domestic law and then, either the withholding agent or the non-resident income recipient has to apply for a refund,
- (6) whether the national reporter's jurisdiction imposes withholding obligations even on non-resident payors; if so, whether there is any special mechanism to ensure that this obligation is effectively enforced.

Part III, the basic structure is yet to be conceived and designed. Perhaps we will cover the proposals to overhaul the withholding tax for non-residents in connection with the e-commerce or "digital economy," provision of service (in particular, in "intra-group" context), and financial transactions.