2008

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Recommended Citation
Avi-Yonah, Reuven S. "A Coordinated Withholding Tax on Deductibility Payments." Tax Notes 119, no. 9 (2008): 993-6.

A Coordinated Withholding Tax On Deductible Payments

By Reuven S. Avi-Yonah

Reuven S. Avi-Yonah is the Irwin I. Cohn Professor of Law and director of the International Tax LLM Program at the University of Michigan. He would like to thank Calvin Johnson, Robert Dilworth, and Mark Farber for their very helpful comments.

Prof. Avi-Yonah proposes a 35 percent withholding tax on deductible payments made to a non-U.S. resident, in coordination with other OECD members. The tax is aimed at U.S. residents posing as foreign investors and would be refundable when the beneficial owner shows that the payments have been reported to tax authorities in the owner's country of residence. Parts of this paper are based on Avi-Yonah's "Memo to Congress: It's Time to Repeal the U.S. Portfolio Interest Exemption," *Tax Notes Int'l*, Dec. 7, 1998, p. 1817, *Doc 98-35627*, or *98 TNI 234-26*. However, that paper was written at a time when conditions in the U.S. economy were favorable enough to envisage a unilateral repeal of the portfolio interest exemption. No such course is advocated under current economic conditions.

The proposal is made as a part of the Shelf Project, a collaboration by tax professionals to develop and perfect proposals to help Congress when it needs to raise revenue. Shelf Project proposals are intended to raise revenue, defend the tax base, follow the money, and improve the rationality and efficiency of the tax system. The tax community can propose, follow, or edit proposals at http://www.taxshelf.org. A longer description of the Shelf Project can be found at "The Shelf Project: Revenue-Raising Projects That Defend the Tax Base," *Tax Notes*, Dec. 10, 2007, p. 1077, *Doc 2007-22632*, or *2007 TNT 238-37*.

The proposal arises as a part of the Foreign Issues segment of the Shelf Project, which is managed by Charles I. Kingson (University of Pennsylvania Law School) and Prof. Avi-Yonah. The Review Committee for the Shelf Project comprises Peter C. Canellos (Wachtell, Lipton, Rosen & Katz, New York), Robert H. Dilworth (McDermott, Will & Emery, Washington), Joseph H. Guttentag (former Treasury deputy assistant secretary for international tax affairs), Stephen E. Shay (Ropes & Gray, Boston), and Eric M. Zolt (UCLA Law School). Review Committee members are not responsible for any proposals approved by the managers with which they disagree.

Shelf Project proposals follow the format of a congressional tax committee report in explaining current law, what is wrong with it, and how to fix it.

This Shelf Project paper proposes the imposition of a 35 percent withholding tax on all deductible payments made by a U.S. person to a nonresident, in coordination with other OECD members. The withholding tax should be refundable when the beneficial owner shows that the income has been reported to the tax authorities in its country of residence. The main purpose of this proposal is to prevent tax evasion by U.S. residents investing from overseas, thus helping to close the "international tax gap."[1]

Current Law

In 1984 the United States unilaterally abolished its withholding tax (of 30 percent) on foreign residents earning "portfolio interest income" from sources within the United States.[2] Portfolio interest included interest on U.S. government bonds, bonds issued by U.S. corporations (unless the bondholder held a 10 percent or more stake in the shares of the corporation), and interest on U.S. bank accounts and certificates of deposit.[3] This portfolio interest exemption is available to any nonresident alien (that is, any person who is not a U.S. resident for tax purposes), without requiring any certification of identity or proof that the interest income was subject to tax in the investor's country of residence.[4]

[1]*See* Guttentag and Avi-Yonah, "Closing the International Tax Gap," in Max B. Sawicky (ed.), *Bridging the Tax Gap: Addressing the Crisis in Federal Tax Administration* 99 (2005).

[2]Section 871(h). Interest on bank deposits was exempted earlier.

[3]Section 871(h)(2), (3).

[4]Section 871(h)(6) authorizes Treasury to suspend the application of the exemption to prevent evasion of U.S. tax by U.S. persons when there is no adequate exchange of information, but that provision has never been implemented.

Problems With Current Law

The result of enacting the portfolio interest exemption has been a classic race to the bottom: One after the other, all the major economies have abolished their withholding tax on interest for fear of losing mobile capital flows to the United States. The table below shows current withholding rates in European Union member countries and in the United States on interest paid on bank accounts and securities (government and corporate bonds) and on dividends paid to foreign residents in the absence of a treaty.

Country	Bank Accounts	Securities	Dividends
Belgium	0	10	15
Denmark	0	0	15
France	0	0	15
Germany	0	0	15
Greece	10	10	0
Ireland	0	0	0
Italy	10	10	15
Luxembourg	0	0	15
Netherlands	0	0	15
Portugal	15	15	15
Spain	0	0	15
United Kingdom	0	0	15
United States	0	0	30

As the table indicates, most developed countries impose no withholding tax on interest paid to nonresidents on bank deposits and government and corporate bonds. Withholding taxes are imposed on dividends, even though dividends (unlike interest) are not deductible and, therefore, the underlying income has already been taxed once.

The standard economic advice to small, open economies is to avoid taxing capital income at source, because the tax will be shifted forward to the borrowers and will result in higher domestic interest rates. However, the countries in the table include large economies (the United States, Germany, and the United Kingdom) in which the tax is not necessarily shifted forward. Rather, the principal reason for the lack of withholding taxes in most of the countries in the table above is the fear that if those taxes were imposed, capital would swiftly move to other locations that do not impose a withholding tax. For example, the Ruding Committee, writing about the European Community, concluded in 1992 that ''recent experience suggests that any attempt by the [EU] to impose withholding taxes on cross-border interest flows could result in a flight of financial capital to non-EC countries.''[5]

The experience of Germany is a case in point: In 1988 Germany introduced a (relatively low) 10 percent withholding tax on interest on bank deposits, but had to abolish it within a few months because of the magnitude of capital flight to Luxembourg. In 1991 the German Federal Constitutional Court held that withholding taxes on wages, but not on interest, violated the constitutional right to equality, and the government therefore was obligated to reintroduce the withholding tax on interest, but made it inapplicable to nonresidents. Nevertheless, nonresidents may be German residents investing through Luxembourg bank accounts and benefiting from the German tradition of bank secrecy vis-à-vis the government.[6]

The current situation is a multiple-player prisoner's dilemma: All developed countries would benefit from reintroducing the withholding tax on interest, because they would then gain revenue without fear that the capital would be shifted to another developed country. However, no country is willing to be the first one to cooperate by imposing a withholding tax unilaterally; thus they all refrain from imposing the tax, to the detriment of all.

In global terms, this outcome would make no difference if residence jurisdictions were able to tax their residents on foreign-source interest (and dividend) income, as required by a global personal income tax on all income ''from whatever source derived.'' However, as Joel Slemrod has written, ''although it is not desirable to tax capital on a source basis, it is not administratively feasible to tax capital on a residence basis.''[7] The problem is that residence-country fiscal authorities in general have no means of knowing about the income that is earned by their residents abroad. Even in the case of sophisticated tax administrations like the IRS, tax compliance depends decisively on the presence of either withholding at source or information reporting. When neither is available, as in the case of foreign-source income, compliance rates drop dramatically.

In the case of foreign-source income, withholding taxes are not imposed for the reasons described above. As for information reporting, even though tax treaties contain an exchange of information procedure, it is vitally flawed in two respects: First, the lack of any uniform worldwide system of tax identification numbers means that most tax administrations are unable to match the information received from their treaty partners with domestic taxpayers. Second, there are no tax treaties with traditional tax havens, and it is sufficient to route the income through a tax haven to block the exchange of information. For example, if a Mexican national invests in a U.S. bank through a Cayman Islands corporation, the exchange of information article in the Mexico-U.S. tax treaty would not avail the Mexican authorities. The IRS has no way of knowing (given bank secrecy) that the

[5]Report of the Committee of Independent Experts on Company Taxation (Commission of the European Communities, 1992), p. 201.

[6]As indicated by recent press reports, because Luxembourg is now subject to exchange of information under the savings directive (discussed below), German capital has shifted to Liechtenstein.

[7]Joel Slemrod, Comment, in Vito Tanzi, *Taxation in an Integrating World* (1995), 144.

portfolio interest that is paid to the Caymans is beneficially owned by a Mexican resident covered by the treaty.[8]

The resulting state of affairs is that much income from portfolio investments overseas escapes income taxation by either source or residence countries. Latin American countries provide a prime example: It is estimated that following the enactment of the portfolio interest exemption, about $300 billion fled from Latin American countries to bank accounts and other forms of portfolio investment in the United States. Most of these funds were channeled through tax haven corporations and therefore were not subject to taxation in the country of residence. For all developing countries, various estimates of the magnitude of capital flight in the 1980s average between $15 billion and $60 billion per year. Nor is the problem limited to developing countries: Much of the German portfolio interest exemption benefits German residents who maintain bank accounts in Luxembourg, and much of the U.S. portfolio interest exemption benefits Japanese investors who hold U.S. treasuries and do not report the income in Japan. Even in the case of the United States, it is questionable how much tax is actually collected on portfolio income earned by U.S. residents abroad other than through mutual funds. One estimate has put capital flight from the United States in 1980-1982 as high as $250 billion. More recently, Joseph Guttentag and I have estimated the international tax gap (the tax owed by U.S. residents on income earned through foreign tax havens) at $50 billion.[9]

Thus, in the absence of withholding taxes or effective information exchange, income from foreign portfolio investments frequently escapes being taxed by any jurisdiction. This is particularly significant because the flows of portfolio capital across international borders have been growing recently much faster than either world gross domestic product or foreign direct investment. It is currently estimated that international capital flows exceed $1 trillion a day; although this figure is much larger than income from capital, it gives a sense of the magnitude at stake.

This situation has led knowledgeable observers like Richard Bird to write that "the weakness of international taxation calls into question the viability of the income tax itself. . . . If something is not done to rectify these problems soon, the future of the income tax is bleak."[10] Other authors have written papers like "Can Capital Income Taxes Survive in Open Economies?" and "Is There a Future for Capital Income Taxation?" Unless something is done about this situation, the answer to those questions is likely to be no.

[8]While the United States has negotiated tax information exchange agreements with several tax havens, not all are covered, and restrictions in the agreements make it unlikely that the United States will obtain the necessary information to solve this type of problem.

[9]Guttentag and Avi-Yonah, *supra* note 1.

[10]Richard Bird, "Shaping a New International Tax Order," 42 *Bulletin for International Fiscal Documentation* 292 (1988), 303.

A Coordinated Solution

Now may present a unique opportunity to remedy this state of affairs because of the EU's 2003 adoption of a "savings directive." Under the directive, the EU adopted a "coexistence model" based on two options, only one of which can be chosen by a member state: Either to cooperate in an exchange of information program or to levy a 20 percent withholding tax on interest payments made by paying agents within its territory to individual residents of another member state. Under the exchange of information system, the member state agrees to provide automatically, at least once a year, information on all interest payments made by paying agents in its territory in the preceding year to individual beneficial owners residing in every other member state. Under the withholding tax system, the member state agrees to impose a 20 percent withholding tax on all interest payments made by paying agents within its territory to individual beneficial owners residing within the EU. However, the withholding tax is not imposed if the beneficial owner provides a certificate drawn up by his country's tax authorities attesting that they have been informed of the interest to be received. The withholding tax must be credited against the tax liability in the beneficial owner's country of residence.

The EU savings directive applies only to payments within the EU. However, its adoption presents a golden opportunity. As explained above, the problem of nontaxation of cross-border interest flows stems to a large extent from the unilateral enactment of the portfolio interest exemption by the United States in 1984. As observed above, the nontaxation of cross-border interest flows is a repeated prisoner's dilemma: Each player (the EU, the United States, and Japan) refrains from taxing for fear of driving investment to the others, even though they would all benefit from imposing the tax. However, it is well-established that these repeat prisoner's dilemmas can be resolved if parties can signal to each other in a credible fashion their willingness to cooperate.

The EU directive represents just such a signal. The EU is telling the United States that it is willing to go forward with taxing cross-border interest flows. Thus, if the United States were to commit itself to taxing cross-border interest by repealing the portfolio interest exemption, the prisoner's dilemma could be resolved and a new, stable equilibrium of taxing — rather than refraining from taxing — would be established.

The prospects for agreement in this area are particularly good because only a limited number of players have to be involved. The world's savings may be parked in tax havens, but the cooperation of tax havens is not needed. To earn decent returns without incurring excessive risk, funds have to be invested in an OECD member country (and more particularly, in the EU, the United States, Japan, or Switzerland). Thus, if the OECD member countries could agree to the principles adopted by the EU in its savings directive, most of the problem of taxing cross-border portfolio interest flows could be solved.

My proposal is therefore as follows: The United States should move within the OECD for a coordinated implementation of the principles in the EU savings directive. From a U.S. perspective, the main reason for doing so would be to prevent tax evasion by U.S. residents, but cooperation with other OECD members is essential to prevent capital from fleeing the United States. However, while in the EU context, exchange of information could play a large role, because there are few traditional tax havens in the EU, in a global context withholding taxes have to be the primary means of enforcement. As noted above, tax havens with strong bank secrecy laws render it very difficult to have effective exchange of information among OECD member countries. If the investment is made through a tax haven intermediary, exchange of information is likely to be useless unless the tax authorities in the payer's country can know the identity of the beneficial owner of the funds that are paid to the tax haven intermediary.

I would therefore propose that instead of the coexistence model of the EU, the United States, and with it the OECD, should adopt a uniform withholding tax on cross-border interest flows, which should also be extended to interest on bank deposits and to royalties and other deductible payments on portfolio investments (for example, all payments on derivatives).[11] To approximate the tax rate that would be levied if the payment were taxed on a residence basis, the uniform withholding tax rate should be high (35 percent). However, unlike the withholding taxes that were imposed before the current race to the bottom started in 1984, the uniform withholding tax should be completely refundable. To obtain the refund, as in the EU directive, a beneficial owner need only show the tax authorities in the host countries a certificate attesting that the deductible payment was reported to the tax authorities in the home country. No actual proof that tax was paid on the interest income is required: From an efficiency, equity, and revenue perspective, it is sufficient that the home country authority has the opportunity to tax the income from overseas investments in the same way as it taxes domestic-source income. Thus, even if the home country has a generally applicable low tax rate on its residents (or even a zero tax rate, as long as it applies to all bona fide residents), the resident could obtain a refund by reporting the income to the tax authorities in his home country.

Both the proposed withholding tax and the refund mechanism would not require a tax treaty. However, it would be possible for countries to reduce or eliminate the withholding tax in the treaty context when payments are made to bona fide residents of the treaty partner. In those cases, the exchange of information in the treaty should suffice to ensure residence-based taxation. Because most OECD members have tax treaties with most other OECD members, the proposed uniform withholding tax would in general apply only to payments made to non-OECD member countries (including the tax havens).

Were this type of uniform withholding tax enacted by OECD members, it would go a long way toward solving the problem of undertaxation of cross-border portfolio investments by individuals. This undertaxation is unacceptable from an efficiency, equity, or administrability perspective. Moreover, unlike the undertaxation of direct investment, this type of undertaxation is illegal (which is why it is so hard to assess its magnitude). By adopting a uniform withholding tax, the OECD could thus strike a major blow at tax evasion, which is a major problem for the United States as well. In fact, from a U.S. perspective the main benefit of the proposal would be to narrow the international tax gap, and that can only be done in cooperation with other OECD members.

[11]Payments on derivatives are generally not sourced in the United States under reg. section 1.863-7. This rule, adopted in 1991 for similar reasons as the portfolio interest exemption, can and should be repealed if the proposed coordinated withholding tax is implemented.