Editorial

Deduction of tax at source

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The efficiency from a government standpoint of collecting tax by deduction at source is obvious. Even if it is only the standard rate liability which is collected, leaving any further liability at higher rates to be recovered by direct assessment on the taxpayer, the amount of revenue collected is likely to be greater than would otherwise be the case. Moreover the administration of the withholding and the accounting to the tax authorities will usually be concentrated in the hands of concerns which arguably should be well-equipped to deal with such compliance matters. Even in less well-organised businesses compliance can be further encouraged where the person required to make the withholding is not just a paying agent but is himself entitled to a tax deduction for the payment made. The entitlement to deduction for, say, a payment of interest can be made conditional on the withholding of the appropriate tax and the accounting for that tax to the Revenue authorities. No withholding, no deduction. In this way the Revenue authorities can use the conflict between taxpayers, between deduction and withholding, to secure their objective.

Generally speaking where payments are being made by a person who is required to withhold tax he will be in possession of most of the information required to enable him to determine whether tax should be deducted and, if so, at what appropriate rate. The character of the transaction will be clear whether it is, say, a dividend, a payment of interest, or a wage or salary. In some cases where the payment is made to a foreign recipient resident in a treaty country a reduced rate or nil rate may apply but there will usually be guidance and certification procedures to follow. The general principle will be – if in doubt about the applicability of any reduced rate, deduct the full amount.

The advantages of withholding at source are extended in some jurisdictions to cover collection at 'source'. Source is used here to describe not the foreign source but the moment of collection of the funds by an intermediary on behalf of the taxpayer. Thus a taxpayer resident in a country receiving a foreign currency dividend from a foreign company will give the dividend cheque to his bank to collect. The bank may then be obliged to deduct a local withholding tax from the proceeds of the cheque, account for it to the Revenue and credit only the net proceeds to the taxpayers' account. Again, for the Revenue, this provides a way of economically collecting the standard rate of tax.

The position of the collecting agent is clear, provided that he is aware of the nature of the payment which he has to collect. However it may not be obvious on the face of it what is the nature of the payment. In some jurisdictions it may require some tax analysis in order to establish whether the receipt has, for example, the nature of income and is subject to withholding tax or whether it has a capital nature and is not subject to a withholding tax. Given the availability of sophisticated tax advice this would be any easy matter to resolve. However the amounts involved may be small in each individual case and the volume of transactions may be very large. Moreover because the processing of such transactions has to be delegated to people relatively unsophisticated in tax terms they may not even spot that there could be a problem. Trying to build a sufficiently elaborate verification system to cover every eventuality is extremely expensive. Failing to do so may mean that the collecting agent fails to discharge his obligation to withhold tax whereupon he is accountable to the tax authorities for the tax which should have been withheld. And thus a contingent liability accumulates until such time as the size of liability exceeds the cost of installing expensive systems to cope with it.

Another area where similar problems can arise is where tax relief is given at source. Here the payer is allowed to deduct and retain an amount of tax from the payment which he is making. This represents the relief to which he is entitled while the recipient is then able to recover an equivalent amount of tax from the tax authorities. If the payer is not actually entitled to a deduction for the amount of, say, interest which he is paying then repayment may be withheld from the recipient. In this case the burden of proof thus shifts onto the

recipient to show that he has taken reasonable care to ensure that the payer is entitled to the relief. Again this will involve the effective operation of some reasonably sophisticated system of questions and declarations so that the recipient can ensure that he will be entitled to recover the tax which has been withheld at source on account of the relief.

In both the collecting agent role and the relief at source role the intermediary is being charged with the burden of collecting tax or ensuring that tax relief is being given on a reasonably correct basis. Substantial costs are involved apart from the contingent liability already mentioned if the transactions are not correctly processed.

Increasing international flows of income mean that, for example, the number of transactions handled by collecting agents have increased significantly. Whether the whole burden of accounting for such transactions should properly fall upon such agents is something which needs to be debated. Who ultimately bears the costs, and the contingent liability when it materialises? The shareholders (through reduced profits), the customers (through a higher general level of charges) or the particular customers involved (through a specific transaction charge)? (The beneficiaries are the general body of taxpayers to the extent that total revenue is increased through deduction at source. In a sense what is happening is a version of tax farming, i.e. the collection of tax revenue is contracted out to tax agents. In the days when this was a prevalent means of collecting tax the agent usually paid a fixed sum for the right to collect the tax and could retain any tax collected in excess of that amount: there was always the opportunity for the agent to make a profit. Thus he was able to cover his collection costs. Of course the system was open to abuse and for that reason died out. But what we now have is, in some cases, almost the reverse. The agent is required to collect the tax. He must account for all tax collected. He may also be required to account for tax which he *should* have collected. And he receives little or no recompense for his costs. Collection at source is a highly effective method of collecting tax but it may, where the volume of transactions is significant and some analysis is required to determine whether there is any liability, impose substantial compliance costs.