

# Self-Employed Evasion and Tax Withholding: A Comparative Study and Analysis of the Issues

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## INTRODUCTION

Self-employed individuals are widely known for evasion of the income tax, and tax administrators throughout the world have searched for ways to induce the self-employed to comply with their tax obligations. Self-employed individuals enjoy greater opportunities for evasion than other taxpayers and seem largely undeterred by the risk of detection and application of penalties. One approach to tax compliance uses structural devices that reduce or eliminate opportunities for evasion. A common structural device is withholding of tax at source, whereby payors of income deduct tax from income before it reaches the taxpayer. Withholding is often used in connection with wages, salaries, and other income, such as interest and dividends. It is, however, not used as frequently in connection with business income derived by self-employed individuals and other taxpayers. Yet withholding has a long history as an effective tool in securing compliance with the income tax, and evidence shows that withholding on business income has reduced tax evasion by self-employed individuals.

This Article examines how certain developed and developing countries have structured systems for withholding on business income and identifies features of their systems that may be useful

to tax policymakers and administrators in designing similar withholding systems. The systems described illustrate a broad range of possibilities for withholding on business income. The analysis of these various withholding provisions indicates the choices that must be made between policy objectives that call, on the one hand, for broad withholding that reaches as many taxpayers as possible and, on the other hand, for limited withholding that is fair to taxpayers and administratively feasible for the government.

Section I considers the problem of noncompliance and reviews the evidence relating to income tax evasion by self-employed individuals. Section II describes the methods used by governments to deal with noncompliance and looks at the role of withholding in tax administration and compliance. Section III examines the provisions or proposals for withholding on business income in nine countries. These countries are presented in three groups: those that withhold on fees for services, those that withhold on payments for goods or supplies as well as on fees for services, and those that limit withholding to payments for services within certain industries. Section IV analyzes the issues in withholding on business income with reference to the withholding provisions discussed in Section III and evaluates them in light of policy considerations. The Article concludes that a carefully structured system for withholding on business income reduces tax evasion by self-employed individuals and promotes other tax policy objectives. The Article also makes suggestions for the design of a system for withholding on business income.

## I. THE PROBLEM OF NONCOMPLIANCE

### *A. In General*

The individual income tax is used throughout the world because of its appeal as a "modern" tax: it is based on ability to pay, can take into account taxpayers' personal circumstances, is adaptable to progressive rates, is more neutral in its economic effects than most indirect taxes, and has a highly elastic yield.<sup>1</sup> Both developed and developing countries depend on the income tax as a major revenue source. The individual income tax is the leading source of revenue in countries belonging to the Organisation for Economic Cooperation and Development (OECD), pro-

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<sup>1</sup> R. GOODE, *GOVERNMENT FINANCE IN DEVELOPING COUNTRIES* 102 (1984).

viding on average about one-third of their government revenues.<sup>2</sup> In 1985-86 the individual income tax accounted for about 64% of total revenue in Canada<sup>3</sup> and New Zealand,<sup>4</sup> over 50% in the United States,<sup>5</sup> and almost 40% in Japan.<sup>6</sup> Among the developing countries, six derived more than 25% of their total tax revenues from the individual income tax in the late 1970s and early 1980s, and twenty-eight derived from 10% to 20% in those years.<sup>7</sup> Moreover, the income tax is likely to play an increasingly important role in these countries as they become industrialized.<sup>8</sup>

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<sup>2</sup> COMMITTEE ON FISCAL AFFAIRS, ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, PERSONAL INCOME TAX SYSTEMS UNDER CHANGING ECONOMIC CONDITIONS 7, 9-11 (1986) [hereafter OECD].

<sup>3</sup> DEPARTMENT OF FINANCE, CANADA, TAX REFORM 1987: ECONOMIC & FISCAL OUTLOOK 48 Table A-2 (1987). The major sources of federal tax revenue in Canada are the personal income tax, corporate income tax, and sales tax. Since 1971-72, 57% to 67% of total revenue from these sources has come from the personal income tax. The corporate income tax made up almost 18% of the total revenue from these sources in 1985-86 and 15% to 26% in each year since 1971-72. *Id.*

<sup>4</sup> *New Zealand: Treasury Briefing Paper*, 6 ASIAN-PACIFIC TAX & INVESTMENT BULL. 62 app. I at 73 (1988). The personal tax continues to be the largest component of total tax revenue, even after introduction of the Goods and Services Tax in 1986. *Id.* at 68. In 1987-88 the Goods and Services Tax was expected to yield 19.3% of total tax revenue, and the personal income tax yield was expected to decrease to 50.4%. *Id.* at 73. One purpose of the Goods and Services Tax was to reduce the overreliance on the personal income tax. Prebble, *Tax Reform in New Zealand*, in TAX REFORM IN THE ASIAN-PACIFIC COUNTRIES, FOURTH ASIAN-PACIFIC TAX CONFERENCE 18, 24 (1986).

<sup>5</sup> OFFICE OF PUBLIC AFFAIRS, INTERNAL REVENUE SERVICE, U.S. DEP'T OF THE TREASURY, INTERNAL REVENUE SERVICE HIGHLIGHTS 1988, at 27 Table 3 (1989). The individual income tax has contributed about 51% to 53% of total tax revenue since 1984. *Id.*

<sup>6</sup> NATIONAL TAX ADMINISTRATION OF JAPAN, AN OUTLINE OF JAPANESE TAX ADMINISTRATION 4 Table 2 (1988) [hereafter JAPANESE TAX ADMINISTRATION].

<sup>7</sup> Tanzi, *Quantitative Characteristics of the Tax Systems of Developing Countries*, in THE THEORY OF TAXATION FOR DEVELOPING COUNTRIES 205, 212-15 Table 8-2, 224-25 (D. Newberry & N. Stein eds. 1987). Table 8-2 provides data for 86 developing countries. *Id.* at 212-15. Individual income taxes accounted for 10.3% of total tax revenue for the 86 countries as a group. *Id.* at 224.

<sup>8</sup> See R. GOODE, *supra* note 1, at 90-91; Goode, *Implementing Tax Reform in Sub-Saharan Africa*, 43 TAX NOTES 605, 609 (1989) [hereafter Goode, *Implementing Tax Reform*]. See also JAPANESE TAX ADMINISTRATION, *supra* note 6, at 6 Table 3. Table 3 provides data for Japan, the Federal Republic of Germany, France, Italy, the United Kingdom, and the United States, and shows a steady increase in the contribution of direct taxes to total tax

The individual income tax, however, can present formidable enforcement problems. One prerequisite for its successful use as a major revenue source is a high degree of voluntary compliance.<sup>9</sup> The difficulties in attaining voluntary compliance were recognized long ago:

It is notorious that the ascertainment of individual income is exceedingly difficult. If the attempt to reach the income of the individual rests upon the declaration of the taxpayer himself, we are putting upon him a strain which, in the present state of the relations of the individual to the government, may be characterized as exceedingly severe. It presumes a condition of integrity, a readiness to support one's share, and a complete absence of any desire to benefit oneself at the expense of one's neighbor, which is unfortunately still too rare at the present time.<sup>10</sup>

Recently, much attention has focused on the problem of non-compliance.<sup>11</sup> Noncompliance with the income tax may be broadly classified into four types: failing to file a tax return or declaration; underreporting income; overstating exemptions, deductions, or credits; and failing to make timely payment of established tax liability.<sup>12</sup> In each case, noncompliance may be

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receipts. For example, direct taxes increased in Japan from 51.4% of total tax revenues in 1955 to 72.8% in 1985, and in the Federal Republic of Germany from 32.6% in 1950 to 52.7% in 1985. *Id.*

<sup>9</sup> R. GOODE, *supra* note 1, at 102-03. The other prerequisites are high degrees of monetization and literacy, the prevalence of honest and reliable accounting, honest and reasonably efficient administration, and a political system not dominated by wealthy groups acting in their own self-interest. *Id.*

<sup>10</sup> E. SELIGMAN, *THE INCOME TAX* 34 (2d ed. 1914).

<sup>11</sup> *See, e.g.*, INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION, PUB. NO. 38, MEASURES FOR IMPROVING THE LEVEL OF VOLUNTARY COMPLIANCE WITH TAX OBLIGATIONS, TECHNICAL PAPERS AND REPORTS OF THE 18TH GENERAL ASSEMBLY OF THE INTER-AMERICAN CENTER OF TAX ADMINISTRATORS (1985); INCOME TAX COMPLIANCE: A REPORT OF THE ABA SECTION OF TAXATION, INVITATIONAL CONFERENCE ON INCOME TAX COMPLIANCE (P. Sawicki ed. 1983) [hereafter *INCOME TAX COMPLIANCE*]; Durst, *Report of the Second Invitational Conference on Income Tax Compliance*, 42 *TAX LAW* 705 (1989).

<sup>12</sup> *See* INTERNAL REVENUE SERVICE, U.S. DEP'T OF THE TREASURY, *INCOME TAX COMPLIANCE RESEARCH: ESTIMATES FOR 1973-1981*, at 19 (1983) [hereafter *COMPLIANCE RESEARCH FOR 1973-1981*]; A.B.A. Comm'n on Taxpayer Compliance, *Report and Recommendations on Taxpayer Compliance*, 41 *TAX LAW* 329, 330, 339-41 (1988) [hereafter *ABA Compliance Report*]; *see also* M. Casanegra de Jantscher, *Types of Tax Noncompliance* (1982) (unpublished paper presented at the 16th General Assembly of the Inter-American Center of Tax Administrators) (copy on file with U.C. DAVIS L. REV.) (discussing noncompliance through concealment of tax base;

intentional or unintentional. Tax evasion is the deliberate and knowing act of noncompliance.

The amount of revenue lost because of noncompliance is not known precisely,<sup>13</sup> but is generally regarded as substantial. For example, the estimated income tax gap in the United States for 1981 was about \$81.5 billion, more than the budget deficit for that year.<sup>14</sup> In Australia the revenue loss due to income tax evasion in 1984-85 was thought to be at least A\$3 billion per year and growing.<sup>15</sup> In the United Kingdom the Chairman of the Board of Inland Revenue estimated that about £10 billion per year in earnings evaded tax, resulting in a tax loss of £3 billion to £4 billion.<sup>16</sup> In Canada the tax loss due to noncompliance in 1980 represented about 10% of reported taxes.<sup>17</sup> In the Philippines the amount lost in 1984 because of noncompliance with the individual income tax was estimated at P9.2 billion.<sup>18</sup>

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overstatement of deductions, exemptions and tax credits; shifting or diversion of tax base; and delinquency in tax payments). Noncompliance may also theoretically involve overcompliance, *i.e.*, the assessment and payment of more tax than legally necessary. The data of the U.S. Internal Revenue Service (IRS) show a fairly constant percentage — about 8% — of returns with errors of overcompliance. K. KINSEY, SURVEY DATA ON TAX COMPLIANCE: A COMPENDIUM AND REVIEW 24 (American Bar Foundation Taxpayer Compliance Project Working Paper No. 84-1, 1984). Survey data indicate that about one-third of taxpayers in the United States do not take deductions to which they think they are entitled. The reasons for not doing so include a concern that the deduction might not be correct, ignorance or forgetfulness, insufficient records, fear of audit, or the perception that the deduction is too trivial or complicated. *ABA Compliance Report, supra*, at 345.

<sup>13</sup> For a review of the various techniques used to measure tax evasion and the difficulties associated with them, see Richupan, *Measuring Tax Evasion: A Brief Description of the Major Techniques*, 21 FIN. & DEV., Dec. 1984, at 38; S. RICHUPAN, INCOME TAX EVASION: A REVIEW OF THE MEASUREMENT TECHNIQUES AND SOME ESTIMATES FOR THE DEVELOPING COUNTRIES (International Monetary Fund Doc. DM/84/46, 1984).

<sup>14</sup> *ABA Compliance Report, supra* note 12, at 334; see COMPLIANCE RESEARCH FOR 1973-1981, *supra* note 12, at 3 Table I-1. The income tax gap is the difference during a given year between the correct income tax liability and the total amount of income tax which is voluntarily paid (*i.e.*, without enforcement action such as collection, examination, or criminal investigation). *Id.* at 5.

<sup>15</sup> REFORM OF THE AUSTRALIAN TAX SYSTEM: DRAFT WHITE PAPER 4, 36-37 (Australian Gov't Pub. Serv. 1985) [hereafter AUSTRALIAN WHITE PAPER].

<sup>16</sup> Ilersic, *Tax Evasion in the United Kingdom*, 27 CAN. TAX J. 693 (1979).

<sup>17</sup> Gourlay, *Tax Abuse—A View from Revenue Canada*, 2 CAN. TAX'N 82, 83 (1980).

<sup>18</sup> Yoingco, *Tax Reform in the Philippines*, in TAX REFORM IN THE ASIAN-

As well as leading to revenue losses, a tax system characterized by widespread noncompliance also places an unfair burden on honest taxpayers. Tax evasion by some may lead to tax evasion by others,<sup>19</sup> causing a further loss of revenue. If the government compensates for the loss by raising rates, tax evasion becomes even more profitable and attractive. The higher rates in effect penalize honest taxpayers, who comply either because they want to or because they have no opportunities for evasion. If the government, however, takes effective steps to prevent or combat noncompliance, it can raise revenue without increasing taxes or reducing spending.

### *B. Tax Evasion by Self-Employed Individuals*

Self-employed individuals engaged in business, the professions, and agriculture are sometimes collectively referred to as the "hard-to-tax." Those concerned with tax evasion have long regarded them with suspicion, leading one observer to remark: "The low incomes to which the self-employed admit defy belief."<sup>20</sup> The difficulty of inducing them to report income correctly and to pay the tax due was described almost four decades ago as a "problem that harasses every tax administrator in every country."<sup>21</sup>

The problem persists. In Japan, for example, the popular belief is that, while tax authorities detect 90% of wage and salary income, they detect only 60% of self-employment income and

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PACIFIC COUNTRIES, FOURTH ASIAN-PACIFIC TAX CONFERENCE 112, 134, 139 Table 1 (1986). This estimate was made by the National Tax Research Center in Manila. For 1985 total collections from the income tax were about P13.9 billion. *Id.* at 139 Table 1.

<sup>19</sup> The considerable publicity beginning in early 1978 about the underground economy in the United States and widespread tax evasion was one of the reasons that led to the first major study of noncompliance with the federal income tax. *See infra* notes 37-39 and accompanying text. The government was concerned that publicity about many taxpayers working "off the books" and "skimming off the top" could have an adverse impact on tax compliance. COMPLIANCE RESEARCH FOR 1973-1981, *supra* note 12, app. A at 41.

<sup>20</sup> O'Higgins, *Tax Evasion and the Self-Employed: An Examination of the Evidence—II*, 1981 BRIT. TAX REV. 367, 369 (quoting the General Secretary of the Inland Revenue Staff Federation).

<sup>21</sup> Shoup, *The Tax Mission to Japan*, in 1951 PROCEEDINGS OF THE NATIONAL TAX ASSOCIATION 229, 231 (R. Welch ed. 1952).

40% of farming income.<sup>22</sup> This perception is so common that the Japanese have coined a special term, *ku-ro-yon* (“nine-six-four”), to reflect these gaps.<sup>23</sup> In addition, only 39.5% of individuals engaged in business and 14.6% of farmers actually paid the national income tax in Japan in 1983, as compared to 87.5% of wage and salary earners.<sup>24</sup> In Australia an estimated one-third (A\$1 billion) of the total revenue lost to income tax evasion in 1984-85 resulted from the understatement of business income by unincorporated enterprises.<sup>25</sup> In the United Kingdom the amount lost to tax evasion by self-employed individuals exceeded an estimated £200 million per year.<sup>26</sup>

The self-employed have continually been the most difficult group for the tax administration in Israel.<sup>27</sup> There, a study of income tax evasion found it “plausible” to ascribe most of the reporting gap to underreporting by self-employed individuals.<sup>28</sup> Colombia has also experienced widespread and blatant tax eva-

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<sup>22</sup> H. ISHI, *THE JAPANESE TAX SYSTEM* 80 (1989); see also Shoup, *The Tax Mission to Japan, 1949-50*, in *TAX REFORM IN DEVELOPING COUNTRIES* 177, 206 (M. Gillis ed. 1989); Kaneko, *Japan: An Overview of Current Taxation Issues*, *INTERTAX*, Feb. 1986, at 32, 34.

<sup>23</sup> H. ISHI, *supra* note 22, at 80. Although the results are far from satisfactory, statistical procedures roughly confirmed these ratios. It is not known to what extent these gaps are due to evasion or to avoidance. *Id.*

<sup>24</sup> Aoki, *The National Taxation System*, in *PUBLIC FINANCE IN JAPAN* 103, 111 (T. Shibata ed. 1986) [hereafter Aoki, *National Taxation System*]. The percentages for 1982 are almost identical. See Aoki, *A Survey of the Japanese Tax System*, 39 *BULL. FOR INT’L FISCAL DOCUMENTATION* 435, 438 (1985) [hereafter Aoki, *Survey*].

<sup>25</sup> AUSTRALIAN WHITE PAPER, *supra* note 15, at 36-37. “Understatement of income” refers to nonreporting of taxable income and overstatement of expenses. *Id.* at 37.

<sup>26</sup> Hasson, *Tax Evasion and Social Security Abuse—Some Tentative Observations*, 2 *CAN. TAX’N* 98, 106 (1980).

<sup>27</sup> H. WILKENFELD, *TAXES AND PEOPLE IN ISRAEL* 143 (1973). Individuals suspected of a high degree of evasion in the 1960s included building contractors, professionals, and dealers and brokers in real property. *Id.* at 243.

<sup>28</sup> Commission on Tax Reform, *Estimate of Tax Evasion in Israel*, in *THE UNDERGROUND ECONOMY IN THE UNITED STATES AND ABROAD* 323, 326 (V. Tanzi ed. 1982). The reporting gap is the difference between what should have been reported and what was actually reported. The high incidence of tax evasion among the self-employed in Israel was also suggested by the results of the income tax amnesty in 1967. H. WILKENFELD, *supra* note 27, at 248. Of the taxpayers who participated in the amnesty, 71.4% were self-employed individuals, who reported 64% of all additional income disclosed during the amnesty. *Id.* at 248 n.77.



sion by the self-employed. According to a 1968 study, the “probable underreporting percentages” for certain independent professionals were 94% for lawyers, 76% for dentists, 32% for engineers, 28% for physicians, and 11% for architects.<sup>29</sup> The study also found that many businesses had not filed tax returns.<sup>30</sup>

A study of the income tax in Jamaica before the 1986 tax reform found that most self-employment income was outside the tax net. Thus, Jamaica’s income tax functioned essentially as a levy, through withholding, on salaries and wages.<sup>31</sup> The major form of tax evasion by self-employed individuals was nonfiling, and evidence suggested that the great majority of the self-employed were not even known to the Jamaican tax authorities.<sup>32</sup> One part of the study focused on the tax compliance of independent professionals: attorneys, accountants, architects, physicians, optometrists, and veterinarians. The study found that only about 20% paid income tax in some year between 1981 and 1983, and that about 60% did not have an income tax reference number.<sup>33</sup> The study estimated the resulting revenue loss to be about half of the total income tax collected in 1983.<sup>34</sup> The study extended its analysis to self-employed individuals in nine other occupations,<sup>35</sup>

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<sup>29</sup> Herschel, *Taxation of Agriculture and Hard-To-Tax Groups*, in FISCAL REFORM FOR COLOMBIA: FINAL REPORT AND STAFF PAPERS OF THE COLOMBIAN COMMISSION ON TAX REFORM 387, 402-05 (M. Gillis ed. 1971). The “probable underreporting percentage” is the amount of unreported net income divided by the net income reported. *Id.* at 405.

<sup>30</sup> *Id.* at 403-05. The nonfiling percentages were 37% for beauty parlors, 34% for restaurants, 30% for shoe stores, 24% for jewelry stores, and 22% for clothing manufacturers. *Id.* at 405. The study determined nonfiling percentages for each type of activity by dividing the number of taxpayers for whom there was no record of a tax return by the total number of taxpayers in the sample. *Id.*

<sup>31</sup> Bahl, *The Political Economy of the Jamaican Tax Reform*, in TAX REFORM IN DEVELOPING COUNTRIES 115, 133, 142 (M. Gillis ed. 1989) [hereafter Bahl, *Jamaican Tax Reform*]; see also R. BAHL & M. MURRAY, *INCOME TAX EVASION IN JAMAICA* (Syracuse University Jamaica Tax Structure Examination Project Staff Paper No. 31, 1986) (estimating revenue cost of income tax evasion by self-employed in Jamaica). See generally Bahl, *Jamaica: Tax Reform—Evaluation and Lessons*, 44 BULL. FOR INT’L FISCAL DOCUMENTATION 37 (1990).

<sup>32</sup> R. BAHL & M. MURRAY, *supra* note 31, at 10.

<sup>33</sup> Bahl, *Jamaican Tax Reform*, *supra* note 31, at 144; R. BAHL & M. MURRAY, *supra* note 31, at xvi-xvii.

<sup>34</sup> Bahl, *Jamaican Tax Reform*, *supra* note 31, at 144.

<sup>35</sup> The nine occupations were: service stations, customs broker, auto repair, auto parts, hair care, real estate, contractor, transport operator, and beverage and spirits. *Id.* at 144-45.

with similar results: less than 20% had filed returns, and the revenue cost of evasion was about 50% of income tax collections.<sup>36</sup>

As in other countries, self-employed individuals in the United States have a tradition of noncompliance, and studies have consistently shown them to be among the worst tax offenders. The Internal Revenue Service (IRS) has conducted three major studies of noncompliance with the federal income tax. The first study, which measured nonreporting of income by individuals in 1976, estimated total unreported income from legal sources at \$75 billion to \$100 billion, resulting in a tax loss of \$13 billion to \$17 billion.<sup>37</sup> The largest component of total unreported income was "self-employment income," which accounted for about \$33 billion to \$40 billion (40% to 44%) of total unreported income.<sup>38</sup> The study also estimated the reporting percentages for eight categories of income; the lowest percentages were for self-employment income (60% to 64%) and rents and royalties (50% to 65%).<sup>39</sup>

The second IRS study provided estimates for 1973, 1976, 1979, and 1981 of the income tax gap due to noncompliance by individuals and corporations.<sup>40</sup> The total legal-sector income tax gap for all taxpayers grew from \$28.8 billion in 1973 to \$81.5 billion in

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<sup>36</sup> *Id.* at 144.

<sup>37</sup> INTERNAL REVENUE SERVICE, U.S. DEP'T OF THE TREASURY, ESTIMATES OF INCOME UNREPORTED ON INDIVIDUAL INCOME TAX RETURNS 6-7, 11 Table 3 (1979) [hereafter ESTIMATES OF UNREPORTED INCOME]. The report also estimated that unreported income from certain illegal activities, such as drug trafficking, illegal gambling, and prostitution, ranged from \$25 billion to \$35 billion in 1976, for a tax loss of \$6 billion to \$9 billion. *Id.* at 17 Table 4.

<sup>38</sup> *Id.* at 6-7 Table 1. "Self-employment income" included net income of nonfarm and farm proprietorships, partnerships, and self-employed individuals working outside the context of regularly established businesses. *Id.* at 7.

<sup>39</sup> *Id.* at 8 Table 2. The reporting percentages for the other types of income were: 97% to 98% for wages and salaries; 84% to 90% for interest; 84% to 92% for dividends; 84% to 88% for pensions, annuities, estates, and trusts; 78% to 83% for capital gains; and 70% to 75% for other income, such as alimony, lottery winnings, prizes, and awards. *Id.* at 7-8.

<sup>40</sup> The study measured noncompliance due to failure to file, understatement of income, overstatement of deductions, and nonpayment of tax. COMPLIANCE RESEARCH FOR 1973-1981, *supra* note 12, at 1, 3. The concepts and estimating methods used in the 1983 study were substantially different from those used in the 1979 study. *Id.* at 1, app. A at 41. Thus, the estimates for 1976 in the 1983 study were not necessarily the same as the estimates in the 1979 study. *See id.* app. A at 45.

1981. Individuals accounted for \$75.3 billion, or about 92%, of the total tax gap for 1981.<sup>41</sup>

The study measured nonreporting of income by filers and nonfilers in terms of “voluntary reporting percentages” (VRPs), which expressed, on a gross income basis, what was reported as a percentage of what should have been reported.<sup>42</sup> From 1973 to 1981, the VRP for all income declined from 91.2% to 89.3%,<sup>43</sup> and the VRP for nonfarm proprietor income declined from 84% to 78.7%.<sup>44</sup> Of twelve categories of income, the VRP for nonfarm proprietor income ranked sixth in 1973 and seventh in 1976, 1979 and 1981.<sup>45</sup> The study also estimated the VRPs for 1981 of twelve categories of income in terms of net income, reflecting both underreported income and overstated expenses. The VRP for nonfarm proprietor net income ranked ninth at 50.3%, followed by partnership and small business corporation income with a VRP of 47%.<sup>46</sup> Rental income ranked eleventh with a VRP of

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<sup>41</sup> *Id.* at 3 Table I-1. The study focused on unreported income in the legal sector, although it also presented estimates of unreported income in the illegal sector (confined to drug trafficking, illegal gambling, and prostitution). The study estimated that the illegal sector income tax gap rose from \$2.1 billion in 1973 to \$9.0 billion in 1981. *Id.* at 2.

<sup>42</sup> *Id.* at 6. The 1983 study also expressed noncompliance in absolute dollar amounts and estimated that unreported income rose from \$93.9 billion in 1973 to \$249.7 billion in 1981, an increase of 166% in eight years. *Id.* at 8. Because current-dollar measures of noncompliance would be expected to increase rapidly in a period of high inflation such as 1973-81, the dollar amounts were recast in terms of “voluntary reporting percentages” (VRPs) to determine the underlying real compliance tendencies. *Id.*

<sup>43</sup> *Id.* at 10, 11.

<sup>44</sup> *Id.* at 10 Table III-2. The VRPs for nonfarm proprietor income were 82.2% in 1976 and 80.7% in 1979. *Id.*

<sup>45</sup> *Id.* In 1981, for example, nonfarm proprietor income ranked after wages and salaries; dividends; interest; farm proprietor income; pensions and annuities; and rents. It ranked ahead of estate and trust income; royalties; capital gains; state income tax refunds, alimony, and other income; and informal supplier income. *Id.* The lowest VRP (20.7%) was for informal supplier income, which was indicated at a constant rate because no data were available with which to support trend estimates. *Id.* at 10, 11. “Informal suppliers” are individuals who sell goods or services “on the side.” *Id.* at 23. Examples of informal suppliers are sidewalk vendors, moonlighting craftsmen or mechanics, and unlicensed providers of child or elderly care services. *Id.* app. D.

<sup>46</sup> *Id.* at 21-22 Table IV-2. The VRP for farm proprietor income could not be calculated because the reported amount was a negative figure. The VRPs for other types of income were: 93.9% for wages and salaries; 86.9%

37.2%, and informal supplier income was last with a VRP of 20.7%.<sup>47</sup>

The third IRS study, published in 1988,<sup>48</sup> estimated the gross income tax gap for 1987 at almost \$85 billion, approximately \$63.5 billion, or 75%, of which was due to noncompliance by individual taxpayers.<sup>49</sup> About \$48.3 billion (56.9%) of the gross tax gap was due to underreporting of income by individual filers.<sup>50</sup> Nonfarm sole proprietors accounted for over \$16.7 billion (34%) of the \$48.3 billion gap; when informal suppliers were included, these two groups accounted for over half (\$24.4 billion or about 51%) of this gap.<sup>51</sup> In contrast, underreporting of wages and salaries by employees who filed returns accounted for less than \$1.4 billion, or 3%, of the \$48.3 billion gap.<sup>52</sup>

Other studies have focused on the tax compliance of independent contractors in the United States. A 1977 study by the U.S. General Accounting Office (GAO) found that independent contractors who had been reclassified as employees by the IRS had paid 89% to 92% of the income tax they owed.<sup>53</sup> The GAO also reviewed the files of eighty-two independent contractors reclassified as employees: 16% had not reported all of their self-employ-

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for pensions and annuities; 86.3% for interest; 83.7% for dividends; 74.2% for estate and trust income; 62% for state income tax refunds, alimony, and other income; 61.2% for royalties; and 59.4% for capital gains. *Id.* at 22.

<sup>47</sup> *Id.*

<sup>48</sup> INTERNAL REVENUE SERVICE, U.S. DEP'T OF THE TREASURY, INCOME TAX COMPLIANCE RESEARCH: GROSS TAX GAP ESTIMATES AND PROJECTIONS FOR 1973-1992 (1988) [hereafter GROSS TAX GAP ESTIMATES]. This study presented the IRS's revised estimates of the gross income tax gap due to individuals and corporations that failed to file returns, underreported income, or overstated deductions, exemptions, or credits. The estimates did not include the tax gap due to nonpayment of admitted tax liability. *Id.* at iv.

<sup>49</sup> *Id.* at 1-3.

<sup>50</sup> *Id.*

<sup>51</sup> *Id.* at 2-3. The tax gap due to underreporting of income by partnerships and small business corporations was estimated separately at about \$3.2 billion. *Id.* The tax gap due to underreporting of income by farm proprietors was estimated at \$1.9 billion. *Id.* at 3.

<sup>52</sup> *Id.* Underreporting by nonfarm proprietors and informal suppliers who filed returns made up almost 29% of the gross tax gap for 1987, while underreporting by wage and salary earners made up about 1.6%. *Id.*

<sup>53</sup> COMPTROLLER GENERAL, U.S. GENERAL ACCOUNTING OFFICE, REPORT TO THE JOINT COMMITTEE ON TAXATION, TAX TREATMENT OF EMPLOYEES AND SELF-EMPLOYED PERSONS BY THE INTERNAL REVENUE SERVICE: PROBLEMS AND SOLUTIONS 24-25 (1977).

ment income, and 13% of self-employment income had not been reported.<sup>54</sup> The IRS conducted its own study in 1977 and found that independent contractors reclassified as employees had reported only about 74% of their compensation.<sup>55</sup> In 1979 the IRS did a more comprehensive study involving payments to over 7,000 individuals. This study concluded that at least 47% of the workers treated as independent contractors had reported none of their self-employment income and that only about 76% of all self-employment income had been reported for income tax purposes.<sup>56</sup>

Finally, a 1982 study examined 359 civil fraud and negligence cases litigated from 1967 to 1977 involving individuals charged with underreporting income on tax returns.<sup>57</sup> More than 40% of the cases involved self-employed individuals (about 25% involved proprietors and 16% involved professionals).<sup>58</sup> More than half of the total unreported income in all cases was income from self-employment.<sup>59</sup>

Various explanations have been given for the relatively high incidence of noncompliance among self-employed individuals. Because these individuals are often large in number but small in terms of operations, they may be neglected by tax administrators, who find it more cost-effective to concentrate on large taxpayers from whom the tax recovered justifies the cost of enforcement.<sup>60</sup>

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<sup>54</sup> *Id.* at 25.

<sup>55</sup> *Id.* app. V at 71. Also in 1977, the U.S. Department of Justice estimated that in many cases self-employed taxpayers reported 50% or less of their self-employment income. The Department of Justice based this estimate on past experience and a survey of its trial attorneys. *Id.* app. VII at 87.

<sup>56</sup> STAFF OF JOINT COMM. ON TAXATION, 96TH CONGRESS, 1ST SESS., DESCRIPTION OF PROPOSALS RELATING TO INDEPENDENT CONTRACTORS SCHEDULED FOR A HEARING, app. at 13, 15 (Comm. Print 1979) [hereafter INDEPENDENT CONTRACTOR PROPOSALS] (discussing 1979 IRS Employee/Independent Contractor Compliance Study). The study also showed that reporting for social security purposes was lower than for income tax purposes. Almost 62% of workers had not paid any social security tax due on their income. *Id.* at 17 Table 1.

<sup>57</sup> Hoff, *Tax Withholding at Source Would Reduce Underreporting of Income on False Returns*, 14 TAX NOTES 443, 444 (1982).

<sup>58</sup> *Id.*

<sup>59</sup> *Id.*

<sup>60</sup> See, e.g., R. MUSGRAVE, FISCAL REFORM IN BOLIVIA: FINAL REPORT OF THE BOLIVIAN MISSION ON TAX REFORM 355 (1981); Herschel, *supra* note 29, at 402.

Administration is also difficult because self-employed individuals often do not keep adequate books and records; even when they do, tax officials have no way to judge their accuracy.<sup>61</sup> Greater tax evasion by the self-employed has also been explained by the “disguised tax burden,” or indirect cost of taxation, which is often higher for the self-employed than for other taxpayers and for which the self-employed may compensate by taking advantage of their tax evasion opportunities.<sup>62</sup>

The reason most often given for noncompliance by the self-employed is that they have better opportunities for tax evasion than other taxpayers. The informal business practices and high mobility of some self-employed individuals often make it difficult for tax administrators to keep track of them, enabling such individuals to escape detection. The self-employed often deal in cash and can underestimate their receipts. They can inflate business costs and commingle business and personal expenses. Self-employment income in many cases is not subject to tax withholding or information reporting, and tax administrators have no independent verification of this income. Thus, for self-employed individuals, compliance is largely a matter of choice.

## II. WITHHOLDING AS A COMPLIANCE TOOL

### A. *Approaches to Noncompliance*

Governments have used three broad interrelated approaches to promote compliance and to discourage noncompliance. The first approach consists of informing, assisting, and educating taxpayers<sup>63</sup> and is directed at those who are inclined to comply with their tax obligations. The second approach focuses on enforcement and sanctions, and its objectives are to detect and punish

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<sup>61</sup> See, e.g., R. MUSGRAVE, *supra* note 60, at 355.

<sup>62</sup> See Strümpel, *The Disguised Tax Burden—Compliance Costs of German Businessmen and Professionals*, 19 NAT'L TAX J. 70, 75-76 (1966). Indirect costs of taxation include the costs of computing taxable income and tax liability, consulting tax accountants, and complying with withholding obligations. *Id.* at 70; see also Baldwin, *Taxation Compliance Costs—Implications for the Small Business*, 1989 BRIT. TAX REV. 319 (examining specific compliance problems of four small construction businesses).

<sup>63</sup> See Delorme, *General Report* in 65a CAHIERS DE DROIT FISCAL INT'L—STUDIES ON INT'L FISCAL LAW 43 (1980). See generally *National Reports* in 65a CAHIERS DE DROIT FISCAL INT'L—STUDIES ON INT'L FISCAL LAW 129 (1980) (describing taxpayer education and assistance programs in numerous countries).

noncompliant taxpayers and to deter others.<sup>64</sup>

The third approach, sometimes referred to as “structural compliance,” is based on the premise that one of the main causes of tax evasion is the existence of evasion opportunities.<sup>65</sup> This approach thus consists of changing the structure of the tax system to eliminate or reduce opportunities for noncompliance. For example, in the United States the Tax Reform Act of 1986 reduced the opportunity for taxpayers to overstate many types of deductions, adjustments, and credits by eliminating or severely limiting them.<sup>66</sup> Information reporting, which requires payors of income to report details about payments and payees to tax authorities, discourages noncompliance by increasing the risk of detection. Cash transactions, which often facilitate tax evasion practices, can be discouraged by making such transactions more visible (*e.g.*, requiring payors to report them),<sup>67</sup> by eliminating large denomination currency,<sup>68</sup> or by limiting the life of large denomination bills.<sup>69</sup>

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<sup>64</sup> There are conflicting views on the role and effectiveness of sanctions, and some studies indicate that enforcement activities and sanctions play only a small part in securing compliance. See Freiberg, *Enforcement Discretion and Taxation Offences*, 3 AUSTL. TAX F. 55, 57-58 (1986) (citing specific studies and authorities). Excessive reliance on enforcement and sanctions may also decrease voluntary compliance if taxpayers develop a strongly negative attitude toward the tax administration. STAFF OF JOINT COMM. ON TAXATION, 98TH CONG., 1ST SESS., BACKGROUND ON FEDERAL INCOME TAX COMPLIANCE 47 (Comm. Print 1983) [hereafter BACKGROUND ON COMPLIANCE], excerpted in *Joint Committee Discusses Routes to Better Tax Compliance*, 19 TAX NOTES 1187, 1190 (1983); see also Freiberg, *supra*, at 58; Strümpel, *The Contribution of Survey Research to Public Finance*, in QUANTITATIVE ANALYSIS IN PUBLIC FINANCE 13, 28-29 (A. Peacock ed. 1969).

<sup>65</sup> See, *e.g.*, Freiberg, *supra* note 64, at 57.

<sup>66</sup> ABA Compliance Report, *supra* note 12, at 355.

<sup>67</sup> See Feffer, Timbie, Weiner & Ernst, *Proposals to Deter and Detect the Underground Cash Economy*, in INCOME TAX COMPLIANCE, *supra* note 11, at 293, 294, 300-01. The authors also suggest the “toll charge approach” as a way of making cash transactions more visible. Under this approach, the availability of tax benefits, such as deductions for business expenses, to payors of cash is conditioned upon their willingness to identify the payee. This approach, however, has no effect on cash payments that are not claimed as deductions. *Id.* at 300-01.

<sup>68</sup> See BACKGROUND ON COMPLIANCE, *supra* note 64, at 47. This method was used in India in 1946 and 1978. C. SRIVASTAVA, TAX ADMINISTRATION IN INDIA 153 (1986).

<sup>69</sup> In Switzerland larger denomination bills expire periodically, and holders of such bills are required to exchange them at a bank. See AMERICAN

One of the most commonly used structural devices to prevent noncompliance is withholding of tax at source. This device requires payors of income to withhold tax from payments, thus depriving the payee of the opportunity not to pay tax. Through withholding "the government enforces payment of the income tax . . . not directly from the person who receives the income and is therefore liable for it, but indirectly, by exacting its payment, before the income reaches his hands, from the person who is to pay it to him."<sup>70</sup>

Withholding has a long history as a compliance tool. It may be a particularly appropriate tool to counter noncompliance by self-employed individuals, since their tax-evading opportunities are thought to be the primary cause of their evasion.

### B. Historical Note on Withholding

From its inception, withholding has been used to secure compliance with the income tax. England introduced the principle of "taxation at source" when it re-enacted the income tax in 1803.<sup>71</sup> The principle was designed to prevent "the gross frauds and evasions" that had characterized the first income tax.<sup>72</sup> The new law abolished the general return of income and replaced it with a schedular system.<sup>73</sup> The law also used taxation at source wher-

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INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, UNDERREPORTED TAXABLE INCOME: THE PROBLEM AND POSSIBLE SOLUTIONS 43 (1983) (suggesting Swiss system of periodic expiration of large denominations as possible solution to underreporting).

<sup>70</sup> H.C. BLACK, A TREATISE ON FEDERAL TAXES 244 (1917).

<sup>71</sup> See B. SABINE, A HISTORY OF INCOME TAX 35-38 (1966). The income tax was first introduced in England in 1799 to raise revenue for the Napoleonic Wars. *Id.* at 25. It was levied on total income at the general rate of 10%. *Id.* at 23. The tax was very unpopular, primarily because it was regarded as inquisitorial, an invasion of privacy, and a potential instrument of tyranny. *Id.* at 27, 29-30, 33. The tax was repealed in 1802 when hostilities with France ceased temporarily. *Id.* at 34-35. See generally A. HOPE-JONES, INCOME TAX IN THE NAPOLEONIC WARS (1939); A. FARNSWORTH, ADDINGTON: AUTHOR OF THE MODERN INCOME TAX (1951).

<sup>72</sup> A. FARNSWORTH, *supra* note 71, at 1, 20. The first income tax had been a failure due to widespread evasion and weak administration. The estimated yield for the first year was £10 million, but the actual yield was under £6 million. B. SABINE, *supra* note 71, at 33; see also A. FARNSWORTH, *supra* note 71, at 18-26. The yields for 1800 and 1801 were also below the estimates for those years. See *id.* at 21-22.

<sup>73</sup> B. SABINE, *supra* note 71, at 35. The 1803 tax was divided into five schedules: Schedule A applied to rental income from land and buildings;



ever possible to collect the tax from the first possessor of income, who had less incentive to evade tax on that income. Taxation at source, also referred to as "deduction of tax at source," "stoppage at source," or "withholding of tax at source," applied to rents, dividends, and annuities payable out of public revenues, and salaries and pensions paid by the government.<sup>74</sup> In these cases, the income tax was assessed directly on payors of income, who were required to deduct the tax and remit it to the government. Taxation at source also applied to interest, but in a different manner: the new income tax abolished the deduction for interest, but authorized borrowers to deduct tax from interest paid to creditors and to retain it in lieu of the deduction.<sup>75</sup> The changes made in 1803 were effective. The tax, levied at 5%, raised almost as much revenue as the first income tax, which had been levied at double that rate.<sup>76</sup> The "great success" of the tax was due primarily to the principle of taxation at source.<sup>77</sup>

Withholding was also an important feature of the Civil War income tax in the United States, introduced in 1862 to raise revenue for the Civil War.<sup>78</sup> The tax was levied on total income at 3% and 5%.<sup>79</sup> Withholding at 3% applied to dividends and bond interest paid by railroad companies, dividends paid by certain financial institutions and insurance companies, and salaries of federal employees.<sup>80</sup> In 1864 Congress increased the withhold-

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Schedule B covered farming profits; Schedule C applied to interest, dividends, and annuities payable out of public revenues; Schedule D applied broadly to business and professional profits and contained a "sweep-up" provision; and Schedule E applied to salaries, wages, and pensions paid from public funds. *Id.*; see also E. SELIGMAN, *supra* note 10, at 90-96 (discussing in detail schedular system of 1803 income tax).

<sup>74</sup> E. SELIGMAN, *supra* note 10, at 89-95.

<sup>75</sup> *Id.* at 95-96. This rule avoided the necessity of disclosing private transactions and prevented the frauds that had been committed under the first income tax. *Id.*

<sup>76</sup> See B. SABINE, *supra* note 71, at 29, 38.

<sup>77</sup> E. SELIGMAN, *supra* note 10, at 216. The framework of tax legislation and administration in the United Kingdom is still based on the design of the 1803 income tax. J. KAY & M. KING, *THE BRITISH TAX SYSTEM* 35 (4th ed. 1986).

<sup>78</sup> Tax Act of 1862, ch. 119, 12 Stat. 432 (1862). See generally E. SELIGMAN, *supra* note 10, at 430-81 (discussing Civil War income tax).

<sup>79</sup> Tax Act of 1862, § 90. The 3% rate applied to annual income over \$600 but not exceeding \$10,000; the 5% rate applied to income over \$600, if total income exceeded \$10,000. *Id.*

<sup>80</sup> Tax Act of 1862, §§ 81, 82, 86. The financial institutions required to

ing rate to 5% and extended withholding to dividends and bond interest paid by canal, turnpike, canal navigation, and slackwater companies.<sup>81</sup>

The advantages of taxing income at its source were well recognized. “[I]t was much easier and simpler to collect [tax] from the corporations than from the individual stockholders and bondholders . . . .”<sup>82</sup> Withholding also reduced evasion: “a large portion of the tax was paid without the income passing through the hands of the eventual payor of the duty, while fraudulent returns were rendered impossible and the necessity of supervision was reduced to a minimum.”<sup>83</sup> In 1865 the federal government collected almost 40% of income tax receipts through withholding.<sup>84</sup>

The Civil War income tax expired by limitation in 1872.<sup>85</sup> Withholding did not play a major role in the collection and enforcement of the income tax in the United States until 1943, when Congress introduced withholding on wages and salaries.<sup>86</sup>

Withholding became widely used to collect the income tax during World War II. Before then, the income tax in England and the United States had affected only a very small part of the population.<sup>87</sup> Because of the need for revenue to finance the war, the individual income tax became a mass levy in the United Kingdom and the United States.<sup>88</sup> For the first time, the income tax

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withhold were banks, trust companies, and savings institutions. *Id.* § 82; see also E. SELIGMAN, *supra* note 10, at 435-40.

<sup>81</sup> Internal Revenue Law, ch. 173, §§ 120, 122, 123, 13 Stat. 223, 283-85 (1864). These changes were part of the more comprehensive system of taxation enacted in 1864. E. SELIGMAN, *supra* note 10, at 440-49.

<sup>82</sup> Hill, *The Civil War Income Tax*, 8 Q.J. ECON. 416, 427 (1894).

<sup>83</sup> Howe, *The Federal Revenues and the Income Tax*, 4 ANNALS AM. ACAD. POL. & SOC. SCI. 557, 568 (1894).

<sup>84</sup> *Id.*

<sup>85</sup> E. SELIGMAN, *supra* note 10, at 467.

<sup>86</sup> Congress re-enacted the income tax in 1913, and the United States has had an income tax since then. From 1913 to 1916 the income tax law contained broad withholding provisions; these were replaced in 1917 by information reporting. Lent, *Collection of the Personal Income Tax at the Source*, 50 J. POL. ECON. 719, 723-24 (1942). Withholding was retained primarily in connection with payments to nonresident aliens and foreign corporations. H.C. BLACK, *supra* note 70, at 245-46.

<sup>87</sup> J. KAY & M. KING, *supra* note 77, at 20 (regarding United Kingdom); S. RATNER, *TAXATION AND DEMOCRACY IN AMERICA* 143 (1967) (regarding United States).

<sup>88</sup> J. KAY & M. KING, *supra* note 77, at 21 (discussing taxation in United

affected a majority of working people, who were unaccustomed to budgeting on a yearly basis and might have difficulty in making one lump sum tax payment at the end of year.<sup>89</sup> Without some arrangement like withholding, the individual income tax could not be extended to lower income groups.<sup>90</sup> Withholding enabled wage earners to meet their tax obligations by spreading tax payments throughout the year, and enabled governments to collect small tax liabilities from many taxpayers without incurring huge administrative costs.

Germany made withholding a permanent feature of its personal income tax after World War I.<sup>91</sup> By the early 1940s, Canada, Australia, and the United Kingdom had instituted withholding of tax on wages. In Germany and Canada the tax withheld was the tax due on current income, but in Australia and the United Kingdom withholding on wages was used to collect the prior year's tax liability.<sup>92</sup> The United Kingdom switched to a current payments system in 1944, when PAYE (pay-as-you-earn) was introduced. Since then, PAYE has been the principal method of collecting the income tax.<sup>93</sup>

In the United States the Current Tax Payment Act of 1943

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Kingdom during World War II); R.E. PAUL, *TAXATION IN THE UNITED STATES* 317-26 (1954) (discussing U.S. Revenue Act of 1942).

<sup>89</sup> See J. KAY & M. KING, *supra* note 77, at 20-21. The United Kingdom experienced considerable problems from 1914 to 1918 collecting income tax from wage earners unaccustomed to saving to meet large semi-annual demands for tax. B. SABINE, *supra* note 71, at 201 n.83.

<sup>90</sup> Lent, *supra* note 86, at 725; see generally P. STRAYER, *THE TAXATION OF SMALL INCOMES* 128-46 (1939) (discussing administrative aspects of direct taxation of small incomes).

<sup>91</sup> Lent, *supra* note 86, at 719. See generally Dobriner, *An Outline of Germany's Experience in Taxing Persons with Small Incomes*, 25 *BULL. NAT'L TAX ADMIN.* 66 (1939).

<sup>92</sup> Lent, *supra* note 86, at 719-21; see also B. SABINE, *supra* note 71, at 196-201 (discussing withholding systems in United Kingdom during World War II); N. BARR, S. JAMES & A. PREST, *SELF-ASSESSMENT FOR INCOME TAX* 23-24 (1977) [hereafter BARR]. In the United Kingdom, the system was criticized for the hardship it caused when tax owed on relatively high incomes was withheld from lower incomes. This hardship typically occurred when wage earners moved to lower paying jobs or when their wages were subject to wide, seasonal fluctuations. BARR, *supra*, at 23, 126; Murray, *Withholding and Pay As You Earn: A Contrast in British and American Methods of Tax Collection*, 1962 *BRIT. TAX REV.* 173, 185. See also B. SABINE, *supra* note 71, at 200-02 (describing political aspect of transition to current payments system in United Kingdom).

<sup>93</sup> BARR, *supra* note 92, at 24; J. KAY & M. KING, *supra* note 77, at 21.

instituted withholding on wages and salaries on a current basis.<sup>94</sup> Withholding was introduced not only to ease compliance with the payment obligation, but also to combat inflation by reducing purchasing power.<sup>95</sup> Withholding on wages and salaries has remained in effect since 1943 and has been the “foremost” contributor to the “very high rate of voluntary compliance” in the United States.<sup>96</sup>

### C. *Withholding in the Modern Context*

Withholding is widely used today to collect the individual income tax. As a taxation device, withholding “has probably done more to increase the tax-collecting power of central governments than any other one tax measure at any time in history.”<sup>97</sup> Withholding on wages and salaries, the most common use of withholding, is “everywhere the backbone of the individual income tax.”<sup>98</sup> Virtually every country that levies an individual income tax has withholding on wages and salaries, notable exceptions being France and Switzerland.<sup>99</sup> Withholding is also used in

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<sup>94</sup> Current Tax Payment Act, Pub. L. No. 68, 57 Stat. 126 (1943); *see also* R.E. PAUL, *supra* note 88, at 347-48 (describing enactment of Current Tax Payment Act). About 70% of the taxpayers became substantially current in their income tax liabilities through withholding. *Id.* at 348-49. Since withholding was to take effect in 1943 while income tax liabilities for 1942 remained unpaid, part of the tax due for one year was cancelled to relieve the burden of having to pay two years' tax liabilities in one year. *Id.* at 349.

<sup>95</sup> *Id.* at 331, 347.

<sup>96</sup> Alexander, *How to Attain Voluntary Compliance*, in INTER-AMERICAN CENTER OF TAX ADMINISTRATORS, PAPERS AND REPORTS OF THE TENTH GENERAL ASSEMBLY 97, 99 (1976).

<sup>97</sup> MacGregor, *Further Thoughts on Tax Levels and Prospective Welfare Expenditures*, 4 CAN. TAX J. 171, 173 (1956).

<sup>98</sup> Goode, *Implementing Tax Reform*, *supra* note 8, at 610. In most countries withholding is on a current basis. Lawmakers in The Gambia recently switched to a current basis with the enactment of the Income Tax (Amendment) Act in 1988. Until then, wage withholding collected the previous year's tax liability. Letter from Samba E. Saye, Deputy Commissioner of Income Tax, The Gambia, to author (Jan. 12, 1990) (copy on file with U.C. DAVIS L. REV.).

<sup>99</sup> *See* OECD, *supra* note 2, at 35. Singapore and Hong Kong are also exceptions; they do not provide for withholding on wages or salaries. *See* PRICE WATERHOUSE, *DOING BUSINESS IN SINGAPORE* 100 (1988) (noting absence of withholding tax on wages, salaries, and dividends in Singapore); INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION, *TAXES AND INVESTMENT IN ASIA AND THE PACIFIC*, ch. Hong Kong 41 (1989) (noting absence of withholding tax on salaries in Hong Kong).

connection with other types of income, such as interest, dividends, and payments to nonresidents, from whom the income tax might otherwise be difficult to collect.

Withholding is favored as a collection device for a variety of reasons. As mentioned earlier, it provides a convenient payment method to taxpayers and enables the government to collect small amounts of tax efficiently.<sup>100</sup> Withholding also speeds up tax collection, insures a steady flow of funds to the treasury, and increases total tax revenue because of earlier receipt of tax payments.<sup>101</sup> In addition, withholding avoids the problem of inability to pay by collecting tax before taxpayers spend their income.

Tax policymakers and administrators favor withholding because of its impact on taxpayer compliance. Withholding is instrumental in securing compliance with the requirements of filing a return, reporting income accurately, and paying tax. First, withholding induces compliance with the filing requirement by identifying taxpayers previously unknown to the tax administration. For example, one of the most important consequences of the Prescribed Payments System, a withholding system for certain industries introduced in Australia in 1983, was the number of taxpayers identified as not having filed income tax returns.<sup>102</sup> By 1986 the number of tax returns filed annually by individuals in the Australian construction industry had increased by over 110%, and returns in the road transport industry had increased by

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<sup>100</sup> See *supra* text accompanying notes 89-90. From the government's perspective, it may be preferable to overwithhold rather than to incur the additional expense of collecting small tax liabilities. Lent, *supra* note 86, at 731. In Australia, the graduated withholding tables applicable to wages and salaries are designed to overwithhold slightly in order to reduce the number of debit assessments. Dixon, *Tax Avoidance and Withholding Tax*, 2 AUSTL. TAX F. 33, 34 (1985).

<sup>101</sup> See generally, COMMITTEE ON FISCAL AFFAIRS, ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, INCOME TAX COLLECTION LAGS (1983) [hereafter INCOME TAX COLLECTION LAGS]. The early receipt of tax payments is particularly important in a country with high inflation. See Hirao & Aguirre, *Maintaining the Level of Income Tax Collections Under Inflationary Conditions*, 17 INT'L MONETARY FUND STAFF PAPERS 277, 310 (1970).

<sup>102</sup> COMMONWEALTH ASS'N OF TAX ADMINISTRATORS, REPORT ON THE SEVENTH TECHNICAL CONFERENCE 57-58 (1986) [hereafter CATA REPORT]. During the first two years of operation, almost 22,300 nonfilers were identified. See *infra* note 402 and accompanying text. For a description of the Prescribed Payments System, see *infra* notes 361-86 and accompanying text.

50%.<sup>103</sup> In Malawi legislation enacted in 1985 required tax withholding from certain payments for goods.<sup>104</sup> The tax administration there subsequently noted an increase in the number of new taxpayers engaged in business — over thirty were identified each month — and a “remarkable improvement” in the filing of returns and settlement of tax debts by taxpayers affected by the new provision.<sup>105</sup> In Colombia withholding on wage and salary income, in effect for six months during 1956-57, increased the number of taxpayers by more than 70% — from about 160,400 in 1956 to over 273,000 in 1957 — without any substantive change in law.<sup>106</sup> Withholding also promotes compliance with the filing requirement by encouraging taxpayers to file returns in order to claim refunds.<sup>107</sup>

Second, withholding results in more accurate income reporting. It increases the risk of detection of underreporting, because withholding agents usually submit information returns to the government in connection with the tax withheld. In Australia about 95% of reportable salaries and wages are voluntarily declared,<sup>108</sup> and the Prescribed Payments System has raised the level of income disclosures by subcontractors in the affected industries.<sup>109</sup> The high proportion of salary income known to the tax authori-

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<sup>103</sup> See *infra* notes 403-04 and accompanying text. The net tax assessed also increased significantly — by about 280% in the construction industry and 145% in the road transport industry. COMMISSIONER OF TAXATION, ANNUAL REPORT 1986-87, at 20 (1987) [hereafter COMM'R REPORT 1986-87].

<sup>104</sup> See CATA REPORT, *supra* note 102, at 62-64.

<sup>105</sup> *Id.* at 64.

<sup>106</sup> White & Quale, *The Colombian Individual Income Tax: Rates, Exemptions, Deductions, and Administrative Aspects* in FISCAL REFORM FOR COLOMBIA: FINAL REPORT AND STAFF PAPERS OF THE COLOMBIAN COMMISSION ON TAX REFORM 301, 330 n.55 (M. Gillis ed. 1971). The withholding tax on wages and salaries was withdrawn for political reasons in 1957. *Id.* In 1966 Colombia established a current payments system, which included graduated withholding on wages and salaries. *Id.* at 324.

<sup>107</sup> Overwithholding from wages may be essential for the successful administration of a self-assessment system because the prospect of a tax refund induces many taxpayers to file returns. See BARR, *supra* note 92, at 131.

<sup>108</sup> AUSTRALIAN WHITE PAPER, *supra* note 15, at 39. The tax withheld on the remaining 5% reduces the effective evasion to about A\$100 million per year. The total revenue loss due to evasion was estimated at A\$3 billion per year. *Id.*

<sup>109</sup> AUDITOR-GENERAL, EFFICIENCY AUDIT REPORT, AUSTRALIAN TAXATION OFFICE: PRESCRIBED PAYMENTS SYSTEM 1 (1986) [hereafter AUDITOR-GENERAL].

ties in Japan — about 90% — is attributed to the elaborate withholding system applicable to such income.<sup>110</sup> Studies in the United States have consistently found that voluntary reporting was the highest for wages and salaries, the major kind of income subject to withholding.<sup>111</sup>

Third, and perhaps most importantly, withholding facilitates compliance with the obligation to pay. Much of the individual income tax in many countries is paid through withholding. In Japan nearly 78% of the total individual income tax revenue for 1987 was paid through withholding.<sup>112</sup> In Canada about two-thirds of the total revenue in 1986 was paid through source deductions.<sup>113</sup> A study of income tax collections in twelve OECD countries showed that in 1978 nine of them had collected from 80% to 95% of gross individual income tax revenues through withholding.<sup>114</sup> Withholding on certain income, such as wages and salaries, may be used to collect not only the tax on that income but also the tax on other income not subject to withholding.<sup>115</sup>

Withholding also assures that taxpayers pay at least some tax, even if they fail to file returns or otherwise disregard their tax obligations. In the United Kingdom the only tax paid by some

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<sup>110</sup> Kaneko, *supra* note 22, at 34.

<sup>111</sup> See Vitez, *Information Reporting and Withholding As Stimulants of Voluntary Compliance*, in *INCOME TAX COMPLIANCE*, *supra* note 11, at 191, 192; *ESTIMATES OF UNREPORTED INCOME*, *supra* note 37, at 8; *COMPLIANCE RESEARCH FOR 1973-1981*, *supra* note 12, at 10; *GROSS TAX GAP ESTIMATES*, *supra* note 48, at 5; Fratanduono, *Trends in Voluntary Compliance of Taxpayers Filing Individual Returns*, in *INTERNAL REVENUE SERVICE, U.S. DEP'T OF THE TREASURY, TREND ANALYSES AND RELATED STATISTICS: 1986 UPDATE* 15, 21 (1986).

<sup>112</sup> *JAPANESE TAX ADMINISTRATION*, *supra* note 6, at 22.

<sup>113</sup> *CATA REPORT*, *supra* note 102, at 99.

<sup>114</sup> *INCOME TAX COLLECTION LAGS*, *supra* note 101, app. I at 11-23. The percentages of the gross individual income tax withheld, before refunds, were 95% in Norway, 91% in Sweden and the United States, 90% in Ireland, 89% in Australia and the United Kingdom, 87% in Denmark, 83% in Finland, and 80% in the Netherlands. The percentages were lower for Greece (60%), Portugal (54%), and France (11%). *Id.*

<sup>115</sup> In the United Kingdom the withholding tax on wages and salaries is used to collect the tax due on small amounts of other income not subject to withholding. The amount of other income is deducted from the taxpayer's tax-free allowance, which is taken into account in determining the rate of withholding. The lower allowance results in higher tax deductions. See *CHANCELLOR OF THE EXCHEQUER, THE REFORM OF PERSONAL TAXATION, 1986*, CMND. No. 9756, at 52; BARR, *supra* note 92, at 27.

subcontractors was tax withheld under the Construction Industry Tax Deduction Scheme.<sup>116</sup> For many years in Australia, large amounts of tax withheld on wages and salaries have not been claimed as credits by taxpayers in the annual assessment process.<sup>117</sup> This has been interpreted as an indication of the significant level of avoidance and evasion with respect to other income not subject to withholding.<sup>118</sup>

Since its origin in England as an anti-evasion device, withholding has played a varied and important role in the administration and enforcement of the income tax in many countries. Given the effectiveness of withholding in improving taxpayer compliance, the issue for most governments is not whether to withhold. Rather, the issues are how to design a withholding system that is fair and administratively feasible and how to extend withholding to areas of known evasion. These issues are considered in the following sections.

### III. WITHHOLDING ON BUSINESS INCOME IN SELECTED COUNTRIES

This section examines the provisions enacted or proposed by nine countries for withholding on business income in the domestic context. "Business income" means income from a trade, business, profession, or occupation, excluding agriculture. "Domestic context" refers to payments by residents of one country to residents of the same country. The focus is on withholding that affects business income derived by self-employed individuals, such as sole proprietors, independent professionals, and other individuals engaged in independent activities. The discussion, however, considers withholding on business income derived by all resident taxpayers, because withholding provisions often apply

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<sup>116</sup> See COMMITTEE ON ENFORCEMENT POWERS OF THE REVENUE DEPARTMENTS, REPORT, 1983, CMND. NO. 8822, at 133 [hereafter COMMITTEE ON ENFORCEMENT POWERS] (describing Construction Industry Tax Deduction Scheme). The committee report noted that about half of the subcontractors subject to the tax deduction scheme failed to claim credits for or repayment of the tax withheld. Thus, the only tax they paid was the tax that had been withheld, which, according to the Inland Revenue, was probably less than the tax owed. *Id.*

<sup>117</sup> Dixon, *supra* note 100, at 34. Approximately A\$519 million of tax withheld from wages and salaries in 1980-81 remained unclaimed as of June 30, 1984. The figures for subsequent income years were much higher. *Id.*

<sup>118</sup> *Id.*



to business income in general and are not limited to payments to self-employed individuals.

Business income may be broadly regarded as consisting of fees for services, profits from the sale of goods or supplies, or a combination of both. Fees for services include payments for a wide variety of services, including:

- Professional services, such as legal, medical, consulting, and architectural engineering;

- Entertainment services, such as acting, singing, directing, and performing in athletic events;

- Academic services, such as teaching and research;

- Office-related services, such as stenographic, typing, and computer services;

- Commercial services, such as selling, delivery, road transport, moving, janitorial, security, and cleaning; and

- Building and construction services.

Fees for services also include payments to models, artists, and other individuals providing services. Business income from the sale of goods or supplies includes profits from manufacturing, wholesale trade (selling to businesses, the government, and institutions), and retail trade (selling to individuals and households).

The countries in this section are presented in three groups. Three of the countries in the first group — the Philippines, Japan, and Ireland — provide for withholding on fees for services. The United States proposal for withholding also falls into this group. The countries in the second group — Indonesia, Pakistan, and Egypt — withhold on payments for goods and supplies as well as on fees for services. These countries also use “reverse withholding” by payees, in addition to the usual method of withholding by payors. The countries in the third group — the United Kingdom, Ireland, and Australia — have relatively narrow provisions which limit withholding to fees for work or services in certain industries with a history of tax evasion.

#### *A. Withholding on Fees for Services*

The most common form of withholding on business income is withholding on fees for services. Fees for services are analogous to wages paid to employees in that both are for the supply of labor. Withholding on such fees is thus consistent with the treatment of wages, which are almost universally subject to withhold-

ing. Unlike most employees, however, self-employed individuals may incur significant expenses in the production of income. Therefore, the fee received may not reflect net earnings subject to tax.

For practical reasons, withholding on fees for services is on gross payment. Countries, however, may compensate for taxpayers' expenses by establishing low rates for withholding or by providing for a reduced tax base. For example, withholding in the Philippines is at rates well below the highest marginal income tax rate for individuals and the rate for corporations. The basic withholding rate in Japan is 10%, the lowest progressive rate applicable to individual income. Japan also provides for a reduced withholding base in some cases.

The discussion below examines withholding on fees for services in four countries.<sup>119</sup> The Philippines' Expanded Withholding Tax System typifies a broad withholding system, applicable to fees for most types of services. Japan is one of the few industrialized countries with broad withholding on fees for services. Its system is narrower than the Philippines' system and applies primarily to fees for professional, entertainment, and office-related services. Withholding in Ireland is narrower still, applying only to fees for specified professional services paid for by government

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<sup>119</sup> Other countries that provide for withholding on fees for services include: Argentina, *see* Massone, *The Argentine Income Tax Reform*, 40 BULL. FOR INT'L FISCAL DOCUMENTATION 237, 248 (1986), People's Republic of China, *see* Li, *People's Republic of China: The New Regulatory Tax on Individual Income*, 41 BULL. FOR INT'L FISCAL DOCUMENTATION 167, 169 (1987), South Korea, *see* MINISTRY OF FINANCE, KOREA, KOREAN TAXATION 79-82 (1987); Choi, *Withholding Tax Systems in Korea*, 5 ASIAN-PACIFIC TAX & INVESTMENT BULL. 506, 507-08 (1987), New Zealand, *see* INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION, TAXES AND INVESTMENT IN ASIA AND THE PACIFIC, ch. New Zealand 116 (1989), Nigeria, *see* Ezejelue, *Nigeria: Recent Amendments to Tax Laws*, 42 BULL. FOR INT'L FISCAL DOCUMENTATION 315, 316-17 (1988), Portugal, *see* de Sousa, *Withholding Tax*, 29 EUR. TAX'N 135, 136 (1989); Cunningham, *Portugal: Withholding Taxes*, 43 BULL. FOR INT'L FISCAL DOCUMENTATION 223, 224 (1989), Spain, *see* Caballero, *Spain: The Reformulated Individual Income Tax and Net Wealth Tax for 1989/1990—A Practical Approach*, 30 EUR. TAX'N 13, 18 (1990), Fiji, India, and Kenya, *see* CATA REPORT, *supra* note 102, at 14, 47, 48, 51, Sierra Leone, St. Lucia, Uganda, and Western Samoa, *see* COMMONWEALTH ASS'N OF TAX ADMINISTRATORS, BACKGROUND PAPERS/SUMMARIES FOR SEVENTH TECHNICAL CONFERENCE 125-26, 137, 149, 153-54 (1986) [hereafter CATA BACKGROUND PAPERS].

agencies.<sup>120</sup> The United States is included in the discussion because of its effort, albeit unsuccessful, to enact legislation for withholding on fees for services. The proposed legislation would have subjected to withholding fees paid to self-employed individuals who, like employees, work primarily for one or two principals.

### 1. The Philippines

The Philippines introduced an income tax on both individual and corporate income in 1913.<sup>121</sup> The individual income tax was levied on global income until 1982, when a schedular system was introduced to broaden the base, reduce avoidance and evasion, and simplify administration.<sup>122</sup> The progressive tax rates, which ranged from 3% to 70%, were repealed. In their place were established separate schedules and rates for wages and salaries, business income, and passive (investment) income.<sup>123</sup> In 1986 the Philippines shifted toward globalization, adopting a uniform rate structure with rates ranging from 0% to 35% for all income derived by individuals, except passive income.<sup>124</sup> Passive income continued to be taxed separately on the gross amount at various rates, with tax collected through a final withholding tax.<sup>125</sup>

In 1978 the Philippines introduced the Expanded Withholding

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<sup>120</sup> Ireland also applies withholding to payments for work in the construction industry. *See infra* notes 345-60 and accompanying text.

<sup>121</sup> Yoingco, *The Individual Income Tax System of the Philippines*, in *INCOME TAXATION IN THE ASEAN COUNTRIES* 44 (S. Rolt & H. Talib eds. 1986); *see generally* INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION, *TAXES AND INVESTMENT IN ASIA AND THE PACIFIC*, ch. Philippines 59-90 (1988) [hereafter Chapter Philippines] (discussing Philippine tax system).

<sup>122</sup> *See* Yoingco, *supra* note 18, at 114-18; Yoingco, *Attempts to Restructure the Philippine Income Tax and Recent Developments*, 35 *BULL. FOR INT'L FISCAL DOCUMENTATION* 487, 488-92 (1981) [hereafter Yoingco, *Attempts to Restructure*].

<sup>123</sup> Yoingco, *supra* note 121, at 47-53; *see also* Chapter Philippines, *supra* note 121, at 83-90.

<sup>124</sup> Yoingco, *supra* note 18, at 118-19. The 1986 measures also introduced a single rate of 35% for the corporate income tax, which had been levied previously at 25% and 35%. *Id.* at 127.

<sup>125</sup> Yoingco, *supra* note 121, at 52. For example, interest on savings deposits was subject to withholding at 17.5%, and dividends and royalties were subject to withholding at 15%. *Id.* The 1986 tax reform increased the withholding rate on interest and royalties to 20% and abolished the tax on dividends. Yoingco, *supra* note 18, at 120.

Tax System.<sup>126</sup> Under this system, withholding applies to various types of income,<sup>127</sup> including business income, derived by resident individuals, domestic corporations, and foreign corporations engaged in business in the Philippines.<sup>128</sup> The types of business income subject to withholding under the Expanded Withholding Tax System may be broadly classified as: professional, talent, or promotional fees; payments to designated contractors; and certain other business payments.<sup>129</sup>

Professional, talent, and promotional fees are subject to withholding at 10% when paid to individuals and at 5% when paid to corporations.<sup>130</sup> Withholding at these rates applies to fees paid to: (1) independent professionals, including actuaries, appraisers, and interior decorators; (2) persons in the entertainment business; (3) professional athletes and other recipients of talent fees;

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<sup>126</sup> The Expanded Withholding Tax System (EWT System) was introduced by Presidential Decree No. 1351 of April 17, 1978. Gison, *The Philippine Expanded Withholding Tax System*, 2 *ASIAN-PACIFIC TAX & INVESTMENT BULL.* 95 (1984) [hereafter Gison, *EWT System*]; see also Gison, *The Philippine Withholding Tax System*, in *INCOME TAXATION IN THE ASEAN COUNTRIES* 247 (S. Rolt & H. Talib eds. 1986). Decree No. 1351 was implemented through various regulations which were later revised and consolidated under Revenue Regulations No. 6-85, known as the Revised and Consolidated Expanded Withholding Tax Regulations. Rev. Reg. 6-85 (May 2, 1985), reprinted in *REVENUE REGULATIONS UPDATED* at 1059 (E. Orduño ed. Supp. 1986) [hereafter Rev. Reg. 6-85]. Revenue Regulations No. 6-85 was amended by Revenue Regulations No. 8-85 (Sept. 12, 1985) (copy on file with U.C. DAVIS L. REV.), and by Revenue Regulations No. 1-89 (Jan. 9, 1989), reprinted in 24 *PHIL. REVENUE J.*, Feb. 1989, at 20 [hereafter Rev. Reg. 1-89]; see also *Philippines: Withholding Tax Extended*, 23 *Tax News Serv. (Int'l Bur. Fisc. Doc.)* 204-05 (Aug. 9, 1989) (discussing Revenue Regulations No. 1-89).

<sup>127</sup> The EWT System also applies to real property rentals; payments to film owners, lessors, and distributors; and income distributions to beneficiaries of trusts and estates. Rev. Reg. 6-85, *supra* note 126, § 1(c), (d), (f), at 1060-62.

<sup>128</sup> See Chapter Philippines, *supra* note 121, at 73-74. Nonresident individuals and foreign corporations not engaged in trade or business in the Philippines are subject to withholding under the rules applicable to nonresidents. See Gison, *The Philippine Withholding Tax System*, *supra* note 126, at 249-56.

<sup>129</sup> See Rev. Reg. 6-85, *supra* note 126, § 1(a)-(e), at 1059-62.

<sup>130</sup> *Id.* § 1(a), (b), at 1059-60. Income subject to withholding under this provision includes per diems, allowances, and amounts paid to professional entertainers, athletes, and recipients of talent fees for public appearances or for the use of their names or pictures for purposes of advertisements or sales promotions. *Id.* § 1(a)(8), at 1060.

and (4) insurance agents and adjusters, management and technical consultants, and business and bookkeeping agents and agencies.<sup>131</sup>

Payments made to designated contractors, whether individual or corporate, are subject to withholding at 1%.<sup>132</sup> This provision covers general engineering contractors,<sup>133</sup> general building contractors,<sup>134</sup> specialty contractors,<sup>135</sup> and other contractors engaged in a wide variety of activities.<sup>136</sup> Withholding at 5% applies to payments to customs, insurance, real estate, and commercial brokers and to agents of professional entertainers.<sup>137</sup> Withholding at 15% applies to payments made to partners by general professional partnerships, and withholding at 10% applies to professional fees paid to medical practitioners by hospitals and clinics or paid by patients to medical practitioners through hospitals or clinics.<sup>138</sup>

The persons<sup>139</sup> required to withhold under the Expanded

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<sup>131</sup> *Id.* § 1(a)(1)-(8), at 1059-60.

<sup>132</sup> *Id.* § 1(e), at 1060.

<sup>133</sup> *Id.* General engineering contractors are those whose principal contracting business requires specialized engineering knowledge and skill relating to fixed works such as railroads, highways, roads, tunnels, airports, bridges, overpasses, and pipelines. *Id.*

<sup>134</sup> *Id.* § 1(e)(1)(b), at 1061. General building contractors are contractors whose principal business relates to the construction of structures and enclosures (*e.g.*, plants, refineries, parks, playgrounds) that require use of more than two unrelated building trades or crafts. *Id.*

<sup>135</sup> *Id.* § 1(e)(1)(c), at 1061. Specialty contractors are those whose principal contracting business consists of construction work requiring specialized building trades or crafts. *Id.*

<sup>136</sup> *Id.* § 1(e)(2), at 1061. "Other contractors" include filling and demolition contractors; mine drilling equipment operators; dockyard operators; installers of water systems, gas or electric light, heat, and power; operators of stevedoring, warehousing, and forwarding establishments; transportation contractors for the carriage of goods; printers, bookbinders, lithographers, and publishers (with some exceptions); messenger, janitorial, private detective and security agencies; credit and collection agencies; advertising agencies; independent producers of television, radio, stage performances or shows, and of "jingles"; labor recruiting agencies; installers of elevators, central air-conditioning, computers, and other equipment, and providers of related maintenance; persons selling computer services; landscapers; and persons engaged in garbage collection and disposal. *Id.*

<sup>137</sup> *Id.* § 1(g), at 1062.

<sup>138</sup> Rev. Reg. 6-85 § 1(h), (i), *added by* Rev. Reg. 1-89, *supra* note 126, at 20.

<sup>139</sup> "Persons" as used in this Article refers not only to individuals, but

Withholding Tax System are individuals making payments in the course of their trade or business, corporations, and government agencies, including government-owned or controlled corporations and provincial, city, and municipal governments.<sup>140</sup> No withholding is required on payments to persons exempt from tax, to exempt organizations, or to the national or local governments.<sup>141</sup> Persons and organizations exempt from tax must present to the payor a certificate of exemption issued by the Commissioner of Internal Revenue.<sup>142</sup> Withholding agents must remit the tax withheld monthly with returns, file returns annually, and provide statements quarterly or annually to the persons from whom they withheld tax.<sup>143</sup> The tax withheld is provisional and creditable against the taxpayer's liability for the year.<sup>144</sup>

Broad as it is, the Expanded Withholding Tax System applies only to persons and payments specifically mentioned in the regulations. For example, withholding does not apply to commissions paid to certain salespersons,<sup>145</sup> payments for photographic services,<sup>146</sup> or payments for the purchase of goods.<sup>147</sup> Nor does withholding apply to payments to general professional

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also to entities and business organizations such as partnerships, companies, and corporations.

<sup>140</sup> Rev. Reg. 6-85, *supra* note 126, § 2, at 1062.

<sup>141</sup> *Id.* § 4, at 1062. Exempt organizations are subject to withholding in connection with income derived from real or personal property or from any activity conducted for profit. *Id.*

<sup>142</sup> *Id.*

<sup>143</sup> *Id.* §§ 5, 6, at 1062-63. Withholding agents that fail to comply with their obligations are subject to penalties. *Id.* § 8, at 1063-64. They may also be denied a deduction for any payment, otherwise deductible from gross income, from which tax should have been withheld but was not. *Id.* § 9, at 1064.

<sup>144</sup> *Id.* § 6, at 1063. Taxpayers are entitled to a credit only if they declare as income the payment from which tax was withheld and establish the fact of withholding. *Id.* § 10, at 1064-65.

<sup>145</sup> See Gison, *EWT System*, *supra* note 126, at 95-96. In a series of rulings, the Philippine Bureau of Internal Revenue (B.I.R.) held that certain types of income were not subject to the EWT System because revenue regulations did not specifically include them. B.I.R. Rul. 314-82 (Dec. 29, 1982) excluded commissions paid to book salespersons; B.I.R. Rul. 5-82 (Jan. 13, 1982) excluded commissions to travel agency sales representatives. *Id.* B.I.R. Rul. 225-87 (Aug. 3, 1987) excluded commissions paid to individual collection agents not associated with a collection agency. See COMPLETE 1987 NUMBERED B.I.R. RULINGS at 251 (Career Development Center, Inc. 1988) [hereafter 1987 B.I.R. RULINGS].

<sup>146</sup> B.I.R. Rul. 106-86 (July 11, 1986), *reprinted in* COMPLETE 1986

partnerships<sup>148</sup> (although they must withhold tax at 15% when making distributions to their partners) or to payments made by individual consumers.

The Expanded Withholding Tax System has been in effect for more than ten years, but it is hard to gauge its impact on tax compliance or on the performance of the income tax.<sup>149</sup> What is known, however, is that tax evasion has long been a problem in the Philippines.<sup>150</sup> Specific compliance problems were noted in connection with interest and dividends,<sup>151</sup> but compliance seemed to improve after introduction of the schedular system in 1982.<sup>152</sup> The taxation of income derived by businesses and

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NUMBERED B.I.R. RULINGS at 106 (Career Development Center, Inc. 1987) [hereafter 1986 B.I.R. RULINGS].

<sup>147</sup> See, e.g., B.I.R. Rul. 121-86 (July 22, 1986), reprinted in 1986 B.I.R. RULINGS, *supra* note 146, at 121 (ruling payments to manufacturer of packaging materials not subject to withholding); B.I.R. Rul. 067-87 (Mar. 4, 1987), reprinted in 1987 B.I.R. RULINGS, *supra* note 145, at 72 (ruling payments to corporation selling and installing glass and mirrors not subject to withholding).

<sup>148</sup> B.I.R. Rul. 411-87 (Dec. 23, 1987), reprinted in 1987 B.I.R. RULINGS, *supra* note 145, at 449 (ruling payments to professional partnership of Certified Public Accountants not subject to withholding because partnership not entity subject to corporate income tax).

<sup>149</sup> Since the mid-1970s, the income tax has generally accounted for about 20% of total tax revenues. See Yoingco, *supra* note 18, at 114, 139 Table 1. In 1979 the share of total tax revenue from the individual tax was 10.6%, and that of the corporate tax 9.5%. See Yoingco, *Attempts to Restructure*, *supra* note 122, at 487. The percentage of total income tax collected under the EWT System was 0.6% in 1979, 5.5% in 1980, 6.5% in 1981, and about 11% in 1982 and 1983. Since 1983 the Bureau of Internal Revenue has not kept separate records for collections under the EWT System. V. Mamalateo, *The Philippine Expanded Withholding Tax System* (student paper submitted in Comparative Tax Administration, Harvard Law School Int'l Tax Program, Oct. 12, 1988) (copy on file with U.C. DAVIS L. REV.).

<sup>150</sup> Yoingco, *supra* note 18, at 134. One study estimated the individual income tax evaded in 1984 at about P9.2 billion. *Id.*

<sup>151</sup> A national survey conducted in 1969 showed that about 40% of the taxpayers surveyed had not reported dividends and about 50% had not reported interest. Guevara, *Taxation of Dividends and Interest in the Philippines*, in *INCOME TAXATION IN THE ASEAN COUNTRIES* 366 (S. Rolt & H. Talib eds. 1986). The percentages dropped slightly in a 1976 survey, but the figures were not convincing enough to confirm that compliance had improved. The lack of an efficient monitoring and recording system in the Philippines made nondisclosure an attractive alternative. *Id.*

<sup>152</sup> Tax collections on passive income increased significantly after 1982, when such income became subject to a final withholding tax on the gross

independent professionals, in particular, has been a “thorny area” in the Philippine tax system.<sup>153</sup> The numerous tax amnesties offered by the government, the most recent in 1986,<sup>154</sup> indicate a continuing problem with compliance and administration. The problem of noncompliance may extend to the obligation to withhold, as suggested by the fact that some of the earlier amnesties applied to withholding tax liabilities.<sup>155</sup>

## 2. Japan

Japan levies an income tax on resident individuals at progressive rates ranging from 10% to 50%<sup>156</sup> and on corporations at a rate of 37.5%.<sup>157</sup> Both taxes are collected in part through withholding. Withholding applies, for example, to employment and retirement income paid to individuals and to interest and dividends paid to individuals and corporations.<sup>158</sup>

Withholding is widely used in connection with business income derived by individuals performing services. Withholding also applies to some fees paid to corporations.<sup>159</sup> Fees subject to withholding include those paid to the following individuals: independent professionals, such as land surveyors, business con-

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amount. The tax collected in 1984 represented a 1,728% increase over the tax collected in 1981. Yoingco, *supra* note 18, at 118.

<sup>153</sup> Yoingco, *Attempts to Restructure*, *supra* note 122, at 490.

<sup>154</sup> Yoingco, *Philippines: Experience with Tax Amnesty Legislation*, 41 BULL. FOR INT'L FISCAL DOCUMENTATION 172, 176 (1987). There were 10 tax amnesties from 1972 to 1981. Six were for previously untaxed income or wealth, and four for untaxed or improperly taxed goods or motor vehicles, nonfilers of income tax, delinquent tax accounts, and disputed assessments. *Id.* at 173-76. Since 1981 there have been three executive orders granting one-time tax amnesties on previously untaxed income, delinquent real property taxes, and disputed assessments. *Id.* at 173, 177.

<sup>155</sup> *Id.* at 173-75.

<sup>156</sup> INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION, TAXES AND INVESTMENT IN ASIA AND THE PACIFIC, ch. Japan 169 (1990) [hereafter Chapter Japan]; *see also* TAX BUREAU, MINISTRY OF FINANCE, AN OUTLINE OF JAPANESE TAXES 1988, at 24 (1988) [hereafter JAPANESE TAXES] (describing 1988 tax rates ranging from 10.5% to 60%). *See generally* H. ISHI, *supra* note 22 (discussing Japanese tax system).

<sup>157</sup> Chapter Japan, *supra* note 156, at 169. A lower rate applies to small corporations — those with capital not exceeding ¥100 million. *Id.*

<sup>158</sup> JAPANESE TAXES, *supra* note 156, at 25, 26.

<sup>159</sup> *Id.* at 26. For example, fees paid to corporate or individual agents of public entertainers are subject to withholding, unless the agent has obtained a certificate from the tax office. *Id.* at 26, 70.



sultants, building agents, and appraisers; professional athletes; models; and public entertainers and related professionals.<sup>160</sup> Withholding also applies to certain other individuals, including lecturers, translators, proofreaders, bookbinders, broadcasters, stenographers, music composers, designers, and preparers of manuscripts and recordings.<sup>161</sup> In all these situations, the rate of withholding is 10% of each payment up to ¥1 million, and 20% on the excess.<sup>162</sup>

In other cases, fees are subject to withholding at 10% only, and the withholding base is reduced by specified amounts. For example, ¥200,000 per month is deducted from payments made to physicians or dentists out of the social welfare fund, ¥120,000 per month from fees paid to salespersons or bill collectors, and ¥50,000 per payment from fees paid to professional boxers.<sup>163</sup> Other payments reduced for withholding purposes include prizes paid to individual or corporate racehorse owners (20% of the prize plus ¥600,000), fees paid to notaries public and land and house inspectors (¥10,000 per payment), and fees paid to bar hostesses (¥5,000 per day).<sup>164</sup>

All persons paying the fees enumerated above must withhold at the prescribed rates. Individuals, however, are included as withholding agents only if they are required to withhold from wages paid to housekeepers (*i.e.*, if an individual employs more than two housekeepers).<sup>165</sup> Withholding agents must remit the tax collected monthly and submit payment records to the tax office annually.<sup>166</sup> The tax withheld is credited against the taxpayer's final liability for the year.<sup>167</sup>

According to the National Tax Administration in Japan, the withholding system is operating smoothly. The many withholding agents understand their withholding obligations and fulfill them properly.<sup>168</sup> In 1983 there were about 5.7 million withholding agents, of which about 3.2 million were employers withhold-

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<sup>160</sup> *Id.* at 69.

<sup>161</sup> *Id.*

<sup>162</sup> *Id.*

<sup>163</sup> *Id.* at 70.

<sup>164</sup> *Id.*

<sup>165</sup> *Id.* at 64, 70.

<sup>166</sup> *Id.* at 64, 73.

<sup>167</sup> *Id.* at 64.

<sup>168</sup> JAPANESE TAX ADMINISTRATION, *supra* note 6, at 22, 27.

ing from wages and salaries.<sup>169</sup> In 1986 withholding on business income accounted for about 5.3% — almost ¥725 billion — of the income tax collected through withholding.<sup>170</sup>

### 3. Ireland

In 1987 Ireland introduced withholding at 35%, exclusive of the value-added tax, on fees paid to individuals and corporations for certain professional services.<sup>171</sup> Fees subject to withholding include fees for medical, dental, optical, pharmaceutical, veterinary, legal, accounting, auditing, consulting (*e.g.*, financial, economic, marketing, advertising), architectural, engineering, surveying, and geological services.<sup>172</sup> Withholding applies to payments made to residents and nonresidents, but not to payments under a construction contract subject to the construction industry tax deduction scheme.<sup>173</sup>

Fees are subject to withholding only when paid by government officials or departments (*e.g.*, Revenue Commissioners, Attorney General, Director of Public Prosecutions), local authorities, and certain other public boards and authorities, but the Minister for Finance may by regulation extend the withholding obligation to other payors.<sup>174</sup> Withholding agents must remit the tax collected monthly; they must also file monthly returns whether or not they make any payments.<sup>175</sup> The tax withheld is creditable against the taxpayer's liability for the year, and overpayments are refunded.<sup>176</sup> In addition, taxpayers may claim interim refunds under certain circumstances.<sup>177</sup>

### 4. The United States

The United States makes relatively limited use of withholding.

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<sup>169</sup> Aoki, *National Taxation System*, *supra* note 24, at 121.

<sup>170</sup> JAPANESE TAX ADMINISTRATION, *supra* note 6, at 22. Withholding on wages and salaries accounted for more than 72% of the income tax collected through withholding. *Id.*

<sup>171</sup> Finance Act, No. 10 § 13(1) (1987), *reprinted in* 1987 ACTS OF THE OIREACHTAS 15-16 (Stationery Office 1987).

<sup>172</sup> *Id.*

<sup>173</sup> *Id.* §§ 13(1), 16(1)(a), (b). *See infra* text accompanying notes 342-60. Payments to employees are governed by Ireland's wage withholding provisions. Finance Act, No. 10 § 13(1).

<sup>174</sup> *Id.* § 14(1), (2).

<sup>175</sup> *Id.* § 17(1)-(3).

<sup>176</sup> *Id.* §§ 15(2)-21.

<sup>177</sup> *Id.* § 19.

Withholding applies essentially to wages, salaries, and related income paid to employees or former employees.<sup>178</sup> Withholding does not apply to other income paid to residents, except in certain cases of noncompliance.<sup>179</sup> The government, however, has attempted without success to extend withholding to business income derived by certain self-employed individuals and to interest and dividends paid to residents.<sup>180</sup>

The proposal to withhold on business income was related to the employment tax controversy that arose in the late 1960s when the Internal Revenue Service (IRS) increased its enforcement of employment tax laws and sought to reclassify some workers as employees.<sup>181</sup> The main issue was the classification of self-employed individuals, commonly referred to as independent contractors.<sup>182</sup> At the heart of the controversy was the difference in

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<sup>178</sup> 26 U.S.C. §§ 3401-3406 (1988). For example, withholding applies to taxable fringe benefits and sick pay paid by employers. *Id.* § 3401(a), (g). Withholding also applies to gambling winnings. *Id.* § 3402(g). Pensions and annuities are subject to withholding only at the taxpayer's election. *Id.* §§ 3402(o), 3405.

<sup>179</sup> 26 U.S.C. § 3406 (1988). "Backup withholding" at 20% applies, for example, to taxpayers who do not provide their correct taxpayer identification numbers to payors. *Id.* § 3406(a)(1). "Backup withholding" applies only to certain types of income, such as interest, dividends, fees, commissions, payments to brokers, rents, and royalties. *Id.* § 3406(b).

<sup>180</sup> The most recent effort to withhold on interest and dividends was the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (1982). See Severt, *The Battle Over Interest and Dividend Withholding: Beyond the Hysteria*, 19 TAX NOTES 683 (1983). The withholding provisions were repealed before they took effect; "backup withholding" was enacted in 1983. See *supra* note 179. For the prior proposals, see Pechman, *Withholding for Interest and Dividends*, in 2 TAX REVISION COMPENDIUM 1479 (1959); STAFF OF JOINT COMM. ON TAXATION, 97TH CONG., 1ST SESS., DESCRIPTION OF PROPOSALS RELATING TO WITHHOLDING ON INTEREST AND DIVIDENDS (Comm. Print 1980).

<sup>181</sup> STAFF OF JOINT COMM. ON TAXATION, 96TH CONG., 1ST SESS., ISSUES IN THE CLASSIFICATION OF INDIVIDUALS AS EMPLOYEES OR INDEPENDENT CONTRACTORS 7 (Comm. Print 1979) [hereafter ISSUES IN CLASSIFICATION]. If the IRS prevailed on the reclassification of workers as employees, the employer became liable for income and social security tax not withheld, the employer's share of social security tax, and unemployment tax. Large tax liabilities were involved, especially if the reclassifications were retroactive. See Stewart & Kramer, *An Empirical Answer to the Problem of Determining "Employee" or "Independent Contractor" Status*, 58 TAXES 747, 748 (1980).

<sup>182</sup> See, e.g., Agricola, *Independent Contractor Status: A Policy Analysis*, 8 TAX NOTES 443 (1979); Marmoll, *Employer-Employee Relations: Independent Contractor vs. Employee Status*, 37 INST. ON FED. TAX'N § 29.01 (1979).

tax treatment between employees and self-employed individuals. In an employer-employee relationship, the employer must withhold income and social security tax from wages paid. Employers are also liable for unemployment tax and for their share of social security tax.<sup>183</sup> If the worker is self-employed, the principal is not required to withhold any tax and is not liable for social security or unemployment tax on the compensation.<sup>184</sup> According to the IRS, these differences encouraged the classification of many workers as self-employed. Withholding on self-employment income was one of many proposals put forward to deal with the issues relating to independent contractors.<sup>185</sup>

Independent contractor status, with its consequent lack of withholding, provides an opportunity for self-employed individuals to evade income and social security tax. A 1979 IRS study confirmed suspicions of widespread evasion by self-employed individuals reclassified as employees by the IRS.<sup>186</sup> The Treasury Department saw withholding on compensation paid to independent contractors as the only effective way to prevent large-scale noncompliance<sup>187</sup> and in 1979 proposed a 10% withholding tax on payments to certain independent contractors.<sup>188</sup> The proposal was directed at independent contractors who were de facto employees in that they worked primarily for one or two principals with whom they had a continuing service relationship.

The proposal required payors to withhold 10% from payments made in the course of business for services provided by certain independent contractors, including salespersons.<sup>189</sup> The tax withheld was credited first to the individual's social security tax

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<sup>183</sup> ISSUES IN CLASSIFICATION, *supra* note 181, at 1-4.

<sup>184</sup> *Id.* at 3-5. Self-employed individuals must pay social security tax on their self-employment income and may also be required to make estimated tax payments during the year. *Id.*

<sup>185</sup> See INDEPENDENT CONTRACTOR PROPOSALS, *supra* note 56, at 8-9.

<sup>186</sup> See *id.* app. at 13-14; see *supra* text accompanying notes 53-56.

<sup>187</sup> *Treasury Says Independent Contractor Status Invites Evasion*, 8 TAX NOTES 824 (1979) [hereafter *Treasury Says*] (discussing testimony of Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy before House Subcommittee on Select Revenue Measures).

<sup>188</sup> See INDEPENDENT CONTRACTOR PROPOSALS, *supra* note 56, at 8.

<sup>189</sup> *Id.* For the purpose of withholding, compensation to salespersons in the form of discounts was measured by the difference between the suggested or estimated selling price to retail customers and the purchase price paid by the salesperson. *Id.*

liability and then to income tax liability.<sup>190</sup> The proposal contained two exceptions to the withholding requirement. The first was designed to prevent overwithholding. Workers who expected to owe less tax than the amount withheld could elect out of withholding.<sup>191</sup> The second exception excluded payments to "real" independent contractors who performed similar services for five or more payors.<sup>192</sup>

The Treasury Department estimated that the withholding proposal would result in an annual revenue gain of \$600 million.<sup>193</sup> Congress, however, failed to enact it. Opposition to the proposal came from industry groups and individuals typically treated as independent contractors, such as commission salespersons, real estate agents, life insurance salespersons, truck drivers, movers, and construction workers.<sup>194</sup> The employment tax controversy has not been resolved, and the IRS views the misclassification of workers as a growing problem.<sup>195</sup> An IRS analysis of about five million businesses indicated that in 1984 about 14% had misclassified employees as independent contractors.<sup>196</sup>

*B. Withholding on Payments for Goods and Services  
and "Reverse Withholding"*

This subsection examines the withholding provisions of Indonesia, Pakistan, and Egypt. In addition to broad withholding on fees for services, each of these countries provides for withholding

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<sup>190</sup> *Treasury Says, supra* note 187.

<sup>191</sup> See INDEPENDENT CONTRACTOR PROPOSALS, *supra* note 56, at 8. To elect out of withholding, the worker submitted to the payor a signed form providing the payor with information (e.g., worker's name, address, social security number) necessary for information reporting purposes. Payors who obtained the required information would not be penalized later for not withholding. *Id.*

<sup>192</sup> *Id.*

<sup>193</sup> *Treasury Says, supra* note 187.

<sup>194</sup> STAFF OF JOINT COMM. ON TAXATION, 96TH CONG., 2D SESS., SUMMARY OF TESTIMONY ON PROPOSALS RELATING TO INDEPENDENT CONTRACTORS 13-18 (Comm. Print 1979).

<sup>195</sup> U.S. GENERAL ACCOUNTING OFFICE, TESTIMONY: INFORMATION RETURN REQUIREMENTS FOR INDEPENDENT CONTRACTORS 9 (1989).

<sup>196</sup> *Id.* These misclassifications resulted in a revenue loss of about \$1.6 billion in 1984, due generally to employment taxes not paid by employers and to deductions claimed by misclassified workers that they could not have claimed had they been classified as employees. *Id.* at 3-4; U.S. GENERAL ACCOUNTING OFFICE, TAX ADMINISTRATION: INFORMATION RETURNS CAN BE USED TO IDENTIFY EMPLOYERS WHO MISCLASSIFY WORKERS 3 (1989).

on certain payments for goods or supplies.<sup>197</sup> In Indonesia withholding on payments for goods is limited to payments by the government. In contrast, withholding in Pakistan and Egypt applies broadly to payments for goods or supplies. Withholding in these two countries is thus likely to affect most manufacturers and wholesalers.

As in other countries, withholding is based on gross payment. Indonesia takes into account taxpayers' costs through a reduced withholding base for both providers of services and sellers of goods. For example, the withholding base for fees paid to independent professionals is 40% to 60% of the gross fee, and the withholding base for payments by the government for goods or services is 6% of the purchase price. The various rates of withholding in Pakistan and Egypt are generally below the lowest rate for individual income, and the rates applicable to payments for goods or supplies are lower than the rates applicable to fees for services.

These countries use both the usual method for withholding, whereby payors deduct tax from payments made to payees, and a second method for the advance collection of tax, referred to here as "reverse withholding." "Reverse withholding" is similar to the method used for collecting a sales tax: payees, such as sellers of goods and government officials, collect income tax by adding it to the amount billed to the payor. For example, customs officials in Indonesia, Pakistan, and Egypt collect income tax from importers by adding the tax to the customs duties payable on imports; suppliers in Egypt add income tax to the price of goods sold to sellers and manufacturers.

Indonesia and Pakistan restrict "reverse withholding" to tax collection by government officials. Egypt, however, makes extensive use of both "reverse withholding" and withholding and

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<sup>197</sup> Other countries providing for withholding on payments for goods and supplies as well as on fees for services include: Colombia, *see* INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION, 1 TAXATION IN LATIN AMERICA, ch. Colombia 81 (1989), Israel, *see* KESSELMAN & KESSELMAN, SUMMARY INFORMATION ON: BUSINESS ORGANIZATION, ACCOUNTING, TAXATION, INVESTMENTS—ISRAEL 110-11 (1984), Sudan, *see* Salama, *Direct Taxation in the Sudan*, 43 BULL. FOR INT'L FISCAL DOCUMENTATION 17, 19-20 (1989), Thailand, *see* Thailand: *New Withholding Taxes*, 39 BULL. FOR INT'L FISCAL DOCUMENTATION 275 (1985), Bangladesh, Ghana, and Malawi, *see* CATA REPORT, *supra* note 102, at 48-49, 62-64, 67; CATA BACKGROUND PAPERS, *supra* note 119, at 7, 49, 71-72.

requires many firms and entities to collect tax using either or both methods. One result is "cross-collection," where one party to a transaction collects tax from the other through withholding, while the other party collects tax from the first through "reverse withholding." Tax is thus collected at each end of the transaction, but the net payment may be the same as if no tax had been withheld or added.

### 1. Indonesia

Before 1984, when the current income tax in Indonesia was introduced, income derived by individuals was taxed under the Income Tax Ordinance of 1944, as amended, and income derived by companies was taxed under the Corporation Tax Ordinance of 1925, as amended.<sup>198</sup> Withholding applied to certain types of income, such as wages and salaries paid to employees,<sup>199</sup> and interest, dividends, and royalties paid to individuals and companies.<sup>200</sup>

In 1967 Indonesia instituted the "MPO system"<sup>201</sup> for withholding on business profits. This system sought to remedy difficulties in assessing and collecting income tax from small enterprises, such as independent businesses, traders, and farmers.<sup>202</sup> District tax offices appointed certain companies and individuals as MPO collectors, who were required to collect tax from the taxpayers with whom they transacted business.<sup>203</sup> The MPO collectors either withheld tax from payments made to suppliers or added tax, as a percentage of the amount due, to invoices submitted to customers ("reverse withholding").<sup>204</sup> Various rates

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<sup>198</sup> Din, *Indonesia: Tax Systems and Laws of ASEAN Countries*, in 8 TAX SYSTEMS & LAWS OF ASEAN COUNTRIES 1, 3, 25 (L. Javellana ed. 1982).

<sup>199</sup> *Id.* at 32.

<sup>200</sup> *Id.* at 22-25. Interest, dividends, and royalties were taxed under the Tax Law on Interest, Dividends and Royalties of 1970, which was a withholding tax generally levied at 20%. *Id.* at 2, 22-25.

<sup>201</sup> "MPO" stands for *Menghitung Pajak Orang Lain*, or to calculate another's personal or corporate income tax. Din, *supra* note 198, at 16. The MPO system was complemented by the "MPS system." "MPS" stands for *Menghitung Pajak Sendiri*, or to calculate one's own tax. The MPS system was a self-assessment scheme under which taxpayers made monthly prepayments of their income, corporate, and net wealth tax. *Id.* at 14.

<sup>202</sup> See Hirao & Aguirre, *supra* note 101, at 317.

<sup>203</sup> Din, *supra* note 198, at 14, 16-17.

<sup>204</sup> *Id.* MPO collectors were required to remit the tax collected to the tax

applied, but the general rate was 2%.<sup>205</sup> The MPO system collected a substantial amount of revenue, but it was cumbersome, difficult to administer, and subject to abuse.<sup>206</sup>

Indonesia enacted a major tax reform at the end of 1983, effective January 1, 1984, and repealed the former income tax laws, including the MPO system of collection.<sup>207</sup> The new income tax covers both individuals and entities,<sup>208</sup> with progressive rates ranging from 15% to 35%.<sup>209</sup> Business income is subject to withholding if it consists of certain commercial income, fees for professional and similar services, or fees for technical or managerial services.

While the withholding provisions applicable to commercial income are similar to the former MPO system of collection, they are much narrower and designed to reduce excessive advance collections.<sup>210</sup> Withholding and "reverse withholding" apply to commercial income only if it consists of income from importing, or income from providing goods or services paid for out of government funds.<sup>211</sup> The law requires that the tax collected approx-

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office every month. *Id.* at 16-17. The tax collected was provisional and creditable against the taxpayer's liability for the year. *Id.* at 31-32.

<sup>205</sup> Hirao & Aguirre, *supra* note 101, at 318 n.57. For example, the rate was 3% on film rentals and 1% on motor oil. *Id.*

<sup>206</sup> Morgan, *Withholding Taxes Under Indonesia's New Income Tax Law*, in *INCOME TAXATION IN THE ASEAN COUNTRIES* 213, 215 (S. Rolt & H. Talib eds. 1986). In 1968 taxes withheld made up 17% of the total tax collected under the individual income tax and 32% of tax collected under the corporate tax. Hirao & Aguirre, *supra* note 101, at 319.

<sup>207</sup> See Law No. 6 Year 1983, reprinted in *NATIONAL TAXES SYSTEM OF THE REPUBLIC OF INDONESIA* 3 (ALDA Pub. Co. 1984) [hereafter *NATIONAL TAXES*]; Wall, *Taxation of Individuals Under Indonesia's Tax Laws*, in *INCOME TAXATION IN THE ASEAN COUNTRIES* 37 (S. Rolt & H. Talib eds. 1986).

<sup>208</sup> See generally Wall, *supra* note 207, at 37 (discussing taxation of individuals); *INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION, TAXES AND INVESTMENT IN ASIA AND THE PACIFIC*, ch. Indonesia 91-108 (1990) [hereafter *Chapter Indonesia*] (discussing taxation of individuals and companies). "Entities" includes companies, government-owned enterprises, corporations, associations, firms, partnerships, cooperatives, foundations, institutions, and permanent establishments of foreign companies. Law No. 7 Year 1983, art. 2(1), reprinted in *NATIONAL TAXES*, *supra* note 207, at 63, 65; *Elucidation on the Law of the Republic of Indonesia Re Income Tax*, reprinted in *NATIONAL TAXES*, *supra* note 207, at 87, 89-90 [hereafter *Elucidation*].

<sup>209</sup> Law No. 7 Year 1983, art. 17(1).

<sup>210</sup> *Elucidation*, *supra* note 208, at 136.

<sup>211</sup> Law No. 7 Year 1983, art. 22; *Elucidation*, *supra* note 208, at 136-37.



imate the tax due on the income.<sup>212</sup> The Minister of Finance, who is authorized to designate tax collectors,<sup>213</sup> has designated only certain government agencies to collect tax. This has eased the administration and supervision problems that stemmed from having numerous persons in the private sector collect income tax for the government.<sup>214</sup>

The customs administration is designated to collect income tax from individuals and entities engaged in importing, and collects tax by adding it to customs duties.<sup>215</sup> The tax base is net income from importing, deemed to be 10% of the value of goods for licensed importers and 30% for unlicensed importers.<sup>216</sup> The rate for "reverse withholding" is 25%, making the effective rate 2.5% for licensed importers and 7.5% for unlicensed importers.<sup>217</sup>

Payments from government funds to individuals and entities providing goods or services are subject to withholding at 25%.<sup>218</sup> The basis for withholding is net income, deemed to be 6% of the purchase price, resulting in an effective rate of 1.5%.<sup>219</sup> Withholding agents for this purpose are certain government agencies and other bodies, such as state banks, making payment out of government funds.<sup>220</sup> No withholding is required if the total payment (not each installment) is less than Rp. 50,000, if the taxpayer submits an exemption certificate issued by the tax authorities, or if the payment is for fuel, electricity, gas, water, postage, telephone, or transportation services.<sup>221</sup>

Broad withholding applies to fees paid to independent profes-

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<sup>212</sup> Law No. 7 Year 1983, art. 22; Elucidation, *supra* note 208, at 136-37.

<sup>213</sup> Law No. 7 Year 1983, art. 22; Elucidation, *supra* note 208, at 136-37.

<sup>214</sup> Morgan, *supra* note 206, at 215.

<sup>215</sup> Decree of Minister of Finance No. 965/KMK.04/1983, arts. 1, 2 (Dec. 31, 1983), reprinted in NATIONAL TAXES, *supra* note 207, at 297 [hereafter Decree No. 965].

<sup>216</sup> Chapter Indonesia, *supra* note 208, at 92.

<sup>217</sup> Decree No. 965, *supra* note 215, art. 4, at 299; Chapter Indonesia, *supra* note 208, at 92.

<sup>218</sup> Decree No. 965, *supra* note 215, art. 4, at 299; Chapter Indonesia, *supra* note 208, at 92.

<sup>219</sup> Chapter Indonesia, *supra* note 208, at 92.

<sup>220</sup> Decree No. 965, *supra* note 215, arts. 1, 2, at 297-98; Chapter Indonesia, *supra* note 208, at 91. The agencies designated are the Directorate General of Budgetary Affairs and Routine and Project Treasurers at the central and regional administration levels. Decree No. 965, *supra* note 215, at 298.

<sup>221</sup> Chapter Indonesia, *supra* note 208, at 93.

sionals or associations of independent professionals for services provided in Indonesia.<sup>222</sup> Such fees are subject to withholding at 15% of net income. Net income is deemed to be a fixed percentage of the gross fee paid: 40% for doctors; 50% for architects and other independent professionals; and 60% for lawyers, accountants, consultants, and notaries public.<sup>223</sup> If fees are paid after deducting costs, the 15% rate applies to the net fee.<sup>224</sup> Taxable and nontaxable entities, including the Government of Indonesia, foreign governments, and international organizations, are required to withhold.<sup>225</sup>

Fees paid to certain individuals — other than independent professionals — who perform personal services in Indonesia on a contract basis are subject to withholding at 15%, with Rp. 8,000 per day exempt from withholding.<sup>226</sup> Individuals to whom these provisions apply include artists, athletes, teachers, lecturers, researchers, writers, authors, salespersons, consultants, and individuals in the entertainment business.<sup>227</sup> Withholding agents for this purpose are individual employers and taxable and nontaxable entities, whether or not employers.<sup>228</sup>

Withholding at 15% is also required on fees for technical or managerial services performed in Indonesia by individuals or

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<sup>222</sup> Law No. 7 Year 1983, art. 21(1)(d); Elucidation, *supra* note 208, at 135.

<sup>223</sup> Decree of Minister of Finance No. 356/KMK.04/1986, art. 1 (May 10, 1986), *reprinted in* TAXATION LAWS OF INDONESIA IT-161 (Asian-Pacific Tax and Investment Research Centre Supp. 4, 1987).

<sup>224</sup> *Id.*

<sup>225</sup> Law No. 7 Year 1983, art. 21(1)(d); Elucidation, *supra* note 208, at 135; Gov't Reg. No. 36 Year 1983, art. 15 (Dec. 31, 1983), *reprinted in* NATIONAL TAXES, *supra* note 207, at 195, 202; Elucidation on Gov't Reg. No. 36 Year 1983, *reprinted in* NATIONAL TAXES, *supra* note 207, at 205, 216.

<sup>226</sup> Chapter Indonesia, *supra* note 208, at 106-08; Decision of the Director General of Taxes No. KEP-41/PJ.23/1988, art. 8 (Apr. 20, 1988), *reprinted in* TAXATION LAWS OF INDONESIA, *supra* note 223, at IT-222 (Supp. 6, 1989) [hereafter Decision No. KEP-41]. The provisions on wage and salary withholding apply to individuals performing personal services as employees. *Id.* at IT-224-27.

<sup>227</sup> Decision No. KEP-41, *supra* note 226, art. 5, at IT-225-26; Chapter Indonesia, *supra* note 208, at 106-07.

<sup>228</sup> Law No. 7 Year 1983, art. 21(1); Elucidation, *supra* note 208, at 134-36; Decision No. KEP-41, *supra* note 226, art. 2, at IT-224-25; Chapter Indonesia, *supra* note 208, at 106.

entities.<sup>229</sup> The persons required to withhold are taxable and nontaxable entities, but individuals may also be appointed as tax collectors for this purpose.<sup>230</sup> Technical services to which these provisions apply include providing information about industrial, commercial, or scientific know-how, such as designing a building or supervising its construction.<sup>231</sup>

The customs administration must remit the tax collected the day after collection, and other collecting agents must do so on a monthly basis.<sup>232</sup> Tax collectors must also file periodic returns, usually monthly, but not necessarily at the time of remittance.<sup>233</sup> The tax collected is creditable against the taxpayer's final tax liability, and excess prepayments are refunded.<sup>234</sup>

It is not clear what effect these withholding provisions have had on tax receipts or compliance. Before the tax reform of 1984, the performance of most taxes in Indonesia, including those on income, was poor. Evasion was thought to range from 50% to 80% of realized tax revenues.<sup>235</sup> A study of the Indonesian tax system in the 1970s attributed its poor performance chiefly to excessive tax rates, serious weaknesses in tax administration, and low compliance.<sup>236</sup> Although these defects in the tax system were acknowledged, little pressure for change existed because of the

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<sup>229</sup> Law No. 7 Year 1983, art. 23(1); Elucidation, *supra* note 208, at 137-38.

<sup>230</sup> Law No. 7 Year 1983, art. 23(2); Elucidation, *supra* note 208, at 137-38.

<sup>231</sup> Director of Direct Taxes Circular No. SE-08/PJ.222/1984 (Mar. 15, 1984), *reprinted in* TAXATION LAWS OF INDONESIA, *supra* note 223, at CIR-08 (Supp. 1, 1984).

<sup>232</sup> Decree of Minister of Finance No. 948/KMK.04/1983, *reprinted in* NATIONAL TAXES, *supra* note 207, at 245-46.

<sup>233</sup> *Id.* at 247-48.

<sup>234</sup> Law No. 7 Year 1983, arts. 20, 28, 29, 31.

<sup>235</sup> Lerche, *Efficiency of Taxation in Indonesia*, 16 BULL. INDONESIAN ECON. STUD. 34, 48 (1980).

<sup>236</sup> *Id.* at 38. The study measured tax performance in terms of "legal tax potential." The study defined "legal tax potential" as the amount of revenue that would be raised by each tax, on certain assumptions about the size of the tax base, if all taxpayers paid the tax legally due. *Id.* at 34. The study estimated that in 1974-75, 16% of the legal tax potential of the individual income tax and 24% of the legal tax potential of the corporate income tax were realized. The overall rate for all taxes was 28%. *Id.* at 37-38. The study cautioned that these estimates should be regarded as indicators rather than as precise estimates. The difficulty in making more precise estimates was due to the complexity of the Indonesian tax system and the scarcity and unreliability of the data. *Id.* at 36.

large amount of government receipts coming from the oil sector.<sup>237</sup>

The principal objectives of the 1984 tax reform were to improve the administration of taxes and to facilitate taxpayer compliance.<sup>238</sup> Some progress has since been made in the administration of the value-added tax, introduced as part of the 1984 tax reform.<sup>239</sup> There was, however, no appreciable improvement in the administration of the income tax during the first three years of the tax reform: in late 1985 non-oil income tax collections were only about 40% of those forecast.<sup>240</sup>

## 2. Pakistan

The Income Tax Ordinance of 1979, as amended, governs the taxation of income in Pakistan and applies to income derived by individuals, companies, and other taxable persons.<sup>241</sup> Individual income is taxed at progressive rates ranging from 10% to 45%, and the rate for companies is 30%.<sup>242</sup> The law contains broad provisions for the advance collection of tax. Advance collection applies, for example, to wages and salaries, interest on securities and bank deposits, dividends, rents, business income, and payments to nonresidents.<sup>243</sup>

Withholding and "reverse withholding" are used in connection with business income derived by resident individuals and compa-

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<sup>237</sup> Gillis, *Comprehensive Tax Reform: The Indonesian Experience, 1981-1988*, in TAX REFORM IN DEVELOPING COUNTRIES 79, 80-81, 89 (M. Gillis ed. 1989). From 1973 to 1981 more than half of government receipts — in some years more than two-thirds — came from the oil sector, including liquified natural gas. *Id.* at 81.

<sup>238</sup> *Id.* at 92.

<sup>239</sup> *Id.* at 107-08.

<sup>240</sup> *Id.* at 108.

<sup>241</sup> Income Tax Ordinance, 1979 §§ 2(32), 9 (as amended) (Karachi Law Publishers 1989). See generally INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION, TAXES AND INVESTMENT IN ASIA AND THE PACIFIC, ch. Pakistan (1989) [hereafter Chapter Pakistan] (discussing Pakistan's tax system).

<sup>242</sup> Income Tax Ordinance, 1979, 1st sched. pt. I §§ A, C. Companies are also subject to the super tax. *Id.* pt. II § A.

<sup>243</sup> Income Tax Ordinance, 1979 § 50. An unusual provision relates to public auction sales of property (other than land) belonging to the government, local authorities, public companies, certain foreign companies, and foreign contractors, consultants, or consortiums. In such cases, the seller must add 3% of the sale price to the amount due by the purchaser as advance income tax. *Id.* § 50(7-A); *id.* 1st sched., pt. I § H.

nies. Withholding applies to payments for the supply of goods and the execution of contracts when the total annual value of the goods or contracts exceeds Rs. 50,000.<sup>244</sup> Withholding also applies to fees for services, including professional services, if the total annual value exceeds Rs. 10,000.<sup>245</sup> The payors required to withhold are the government, local authorities, companies, and foreign contractors, consultants, and consortiums.<sup>246</sup> Private companies with paid-up capital of less than Rs. 2 million and individuals, including most self-employed individuals, are excluded as withholding agents.<sup>247</sup>

The general rate of withholding on payments for goods, services, and the execution of contracts is 3%.<sup>248</sup> Tax officials, however, may grant exemptions upon application by the income recipient after making such inquiry as they deem appropriate.<sup>249</sup> In addition, the Central Board of Revenue (CBR) may specify lower withholding rates and may exempt certain classes of payors or recipients from withholding.<sup>250</sup> For example, the CBR has exempted from withholding persons not likely to have a tax liability for the year and persons for whom further withholding would result in the overpayment of tax.<sup>251</sup>

Commissions and brokerage fees that exceed Rs. 50,000 in any

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<sup>244</sup> Income Tax Ordinance, 1979 § 50(4).

<sup>245</sup> *Id.*; COMPLETE INCOME TAX LAW 121 (S. Salam ed. 1987) [hereafter Salam].

<sup>246</sup> Income Tax Ordinance, 1979 § 50(4). "Companies" includes public and private companies organized under the laws of Pakistan, companies organized under the laws of another country, and provincial governments. *Id.* § 2(16). A company is a public company if its shares are publicly traded and if 50% or more of its shares are owned by the government. Chapter Pakistan, *supra* note 241, at 55.

<sup>247</sup> Income Tax Ordinance, 1979 § 50(4); *id.* 2d sched., pt. IV § 2.

<sup>248</sup> *Id.* 1st sched., pt. I § E.

<sup>249</sup> *Id.* § 50(4)(b). The Income Tax Ordinance does not specify the standards for granting or denying applications for exemption. *See* Salam, *supra* note 245, at 123.

<sup>250</sup> Income Tax Ordinance, 1979 § 50(4)(c). The CBR has authorized lower rates on payments for supplies of rice, cotton, cottonseed, and edible oils (1%), and on payments for the supply of other goods (2%). Salam, *supra* note 245, at 123-24; *see also* Chapter Pakistan, *supra* note 241, at 74. The lower rate (2%) applies to supplies of goods, even if made under a contract. The 3% rate, generally applicable to payments for the execution of a contract, does not apply in this situation. Salam, *supra* note 245, at 124.

<sup>251</sup> Salam, *supra* note 245, at 124-25. Taxpayers qualifying for exemption from withholding must obtain exemption certificates from the appropriate tax official. *Id.* at 125. Payments to provincial governments, local

year are subject to withholding at 10%.<sup>252</sup> The persons required to withhold are the same entities and companies required to withhold on payments for goods, services, and the execution of contracts.<sup>253</sup> Reduced rates and exemptions from withholding are unavailable.

The tax on business income is also collected through "reverse withholding" by designated government officials. Customs officials collect tax from importers by adding 1.5% or 2% of the value of imported goods to customs duties.<sup>254</sup> This provision was introduced to enable the tax administration to reach an increasing number of tax-delinquent importers who were difficult to locate.<sup>255</sup> The CBR is authorized to exempt goods or importers from withholding<sup>256</sup> and under this authority has exempted certain importers, including those not likely to have a tax liability for the year.<sup>257</sup>

Collectors of the motor vehicles tax must also collect income tax from persons engaged in transporting passengers or goods. They do so by adding specified amounts, based on the carrying capacity of the vehicle, to the motor vehicles tax due.<sup>258</sup> Persons who have paid income tax under these provisions are not subject to withholding on payments received for services rendered under

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authorities, and to companies for the supply of electricity, gas, or crude oil are also exempt from withholding. *Id.* at 124-25.

<sup>252</sup> Income Tax Ordinance, 1979 § 50(4-A); *id.* 1st Sched. § EE. This provision was added in 1989. *Id.* § 50(4-A).

<sup>253</sup> Income Tax Ordinance, 1979 § 50(4-A).

<sup>254</sup> *Id.* § 50(5); *id.* 1st sched. § F. The lower rate applies if the importer is required to make installment tax payments during the year. Importers that qualify for the lower rate must obtain a certificate from the appropriate tax official. Salam, *supra* note 245, at 128.

<sup>255</sup> NATIONAL TAXATION REFORM COMMISSION OF PAKISTAN, FINAL REPORT 72 (1986) [hereafter FINAL REPORT].

<sup>256</sup> Income Tax Ordinance, 1979 § 50(5).

<sup>257</sup> Salam, *supra* note 245, at 129-30. Other importers that have been exempted include provincial governments and local authorities, foreign companies, and certain companies importing plant, machinery, fixtures, equipment, or oil. *Id.*

<sup>258</sup> Income Tax Ordinance, 1979 § 50(6). For persons transporting passengers, the tax is Rs. 20 per seat per year if the vehicle seats at least 10 passengers, and Rs. 25 per seat if it seats 20 passengers or more. *Id.* 1st sched. § G. Persons owning passenger transport vehicles that are more than 10 years old are exempt from this provision. *Id.* § 50(6). For persons transporting goods, the tax is Rs. 300 per year if the carrying load of the vehicle is less than 2,030 kilograms, and Rs. 1,200 if the carrying load is 2,030 kilograms or more. *Id.* 1st sched. § G.

a contract.<sup>259</sup>

Withholding agents and other tax collectors must remit the tax collected within one week after collection and submit monthly statements.<sup>260</sup> The tax collected is provisional and creditable against the taxpayer's liability for the year.<sup>261</sup> Taxpayers required to make quarterly tax installments during the year may deduct the tax collected by third parties from the installments due.<sup>262</sup>

The National Taxation Reform Commission of Pakistan assessed the operation of the withholding system in its final report submitted in December 1986.<sup>263</sup> The Commission found that withholding on wages and salaries, interest on securities, and payments to nonresidents was well accepted and working reasonably well.<sup>264</sup> The Commission found problems, however, with the operation of the provision requiring withholding on payments for the supply of goods and services and the execution of contracts. This provision was one of the major causes of the "accounting chaos" in the Income Tax Department.<sup>265</sup> The problem resulted primarily from the vast number of transactions subject to withholding.<sup>266</sup> After these collections were centralized at Karachi and a few other tax offices, the Income Tax Department became more successful in monitoring withholding agents to insure compliance with their obligations.<sup>267</sup> The problem of excessive delays in crediting taxpayers for tax withheld and issuing refunds, however, had not been resolved.<sup>268</sup> Similar delays were experienced

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<sup>259</sup> Salam, *supra* note 245, at 125. If the tax paid to the collector of the motor vehicles tax is less than the tax that would be withheld by the payor for services rendered under a contract, the payor must withhold the difference. *Id.*

<sup>260</sup> Income Tax Rules 50, 61 (1982), *reprinted in* GAZETTE OF PAKISTAN, June 27, 1982, at 812-20. Tax collected by or on behalf of the government must be remitted on the same day. *Id.* Rule 49. *See* Chapter Pakistan, *supra* note 241, at 73.

<sup>261</sup> Income Tax Ordinance, 1979 §§ 50, 54.

<sup>262</sup> *Id.* § 53. Taxpayers whose assessed income for the previous year exceeded specified amounts must pay quarterly installments of tax during the year. *Id.* § 53(1). The government pays interest on the installments at 6% per annum from the date of payment until the end of the tax year. *Id.* § 53(4).

<sup>263</sup> FINAL REPORT, *supra* note 255.

<sup>264</sup> *Id.* at 69-70.

<sup>265</sup> *Id.* at 71.

<sup>266</sup> *Id.*

<sup>267</sup> *Id.* at 71-72.

<sup>268</sup> *Id.* at 72-73. Taxpayers do not receive credit for the tax deducted or a

by salary and wage earners and importers from whom the Collector of Customs had collected tax.<sup>269</sup> The delays in issuing refunds were due in part to accounting difficulties in the department, but were also caused by a reluctance to issue refunds on the part of tax officials whose performance was evaluated on the basis of net annual collections.<sup>270</sup>

### 3. Egypt

Egypt introduced the income tax in 1939. After 1952, when the coverage of the tax was expanded and rates increased, the income tax grew in importance as a revenue source.<sup>271</sup> The income tax is schedular, with separate schedules and tax rates for six types of income: salaries, commercial and industrial profits, noncommercial profits, income from movable capital, general income, and company profits.<sup>272</sup> The current income tax, enacted in 1981, contains broad provisions for the advance collection of tax by third parties.

Income from business is taxed under one of three schedules. The tax on company profits, generally levied at 40%, applies to profits of private sector companies (*e.g.*, joint stock companies, limited liability companies), foreign companies (including their branches in Egypt), public sector companies, banks, and general organizations (*e.g.*, utilities).<sup>273</sup> The tax on commercial and industrial profits is levied at progressive rates from 20% to 40%, and applies to profits of self-employed individuals operating as

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refund until the local tax office has been notified of the deduction and has made the appropriate entries. The delays in giving taxpayers credit for tax deductions were even longer when the government withheld tax and transferred it by book adjustment. *Id.*

<sup>269</sup> *Id.* at 70-72.

<sup>270</sup> *Id.* at 72-73.

<sup>271</sup> H. ASKARI, J. CUMMINGS & M. GLOVER, *TAXATION AND TAX POLICIES IN THE MIDDLE EAST* 145 (1982).

<sup>272</sup> See generally INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION, *AFRICAN TAX SYSTEMS*, ch. Egypt § B (1984) [hereafter Chapter Egypt] (describing Egypt's income tax system); M.H. DAVIES, *BUSINESS LAW IN EGYPT* 73-78 (1984); Shawki & Gajek, *Egypt: The Tax System*, 9 MIDDLE EAST EXECUTIVE REP., July 1986, at 9 (same).

<sup>273</sup> Law 157 of 1981, arts. 111-112 (Sept. 10, 1981), amended by Law No. 87 of 1983 (July 5, 1983) (copies on file with U.C. DAVIS L. REV.). A lower rate (32%) applies to profits of industrial companies derived from their industrial and exporting activities. Profits of oil exploration and production companies are taxed at 40.55%. See Chapter Egypt, *supra* note 272, at 4.



sole proprietors or partnerships.<sup>274</sup> The tax on noncommercial profits is levied at progressive rates from 18% to 30%, and applies to income derived by individuals engaged in the practice of an independent profession or occupation.<sup>275</sup>

Withholding and "reverse withholding" apply to business income derived by self-employed individuals engaged in commercial or industrial activities, private sector companies, and foreign companies.<sup>276</sup> Payors must withhold tax from payments made to such individuals and companies for contracting, supplying, and purchasing goods and services.<sup>277</sup> The rate of withholding varies from 1% to 10%, depending on the transaction. For example, the rates are 1% on payments for contracting, supplying, and purchasing goods, 3% on payments for services, and 10% on commissions.<sup>278</sup>

The law designates two groups of entities as withholding agents:<sup>279</sup>

*Group I* includes government ministries and agencies, local authorities, general organizations, public sector companies, companies, branches of foreign companies, cooperative societies, press institutions, educational institutions, associations, clubs, federations, hospitals, and hotels.

*Group II* includes specified firms, regardless of legal structure, whose capital exceeds E£5,000: contractors,

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<sup>274</sup> Law 157 of 1981, arts. 13-14, 31, amended by Law No. 87 of 1983. Commercial and industrial profits include brokerage or agency commissions; rents from the leasing of property or equipment; and profits from real estate dealings, mining and quarrying, craft trades, and many agricultural activities. *Id.* arts. 15-22. Lower rates (20-32%) apply to profits of industrial enterprises derived from industrial and exporting activities. See Chapter Egypt, *supra* note 272, at 6-7.

<sup>275</sup> Law 157 of 1981, arts. 73-75. See Chapter Egypt, *supra* note 272, at 8-9. The tax also applies to income from other professions or activities not subject to any other schedular tax. *Id.* at 8.

<sup>276</sup> Law 157 of 1981, arts. 44-54, 127, amended by Law No. 87 of 1983. Withholding and "reverse withholding" do not apply to business income derived by public sector companies and general organizations. *Id.* art. 127, as amended.

<sup>277</sup> *Id.* art. 44.

<sup>278</sup> Minister of Finance Dec. No. 166 of 1982, art. 1 (May 10, 1982) [hereafter Fin. Dec. 166] (copy on file with U.C. DAVIS L. REV.); *id.* sched. 1. The rate is 5% on discounts, grants, and commissions paid by oil companies to their agents (distributors). *Id.*

<sup>279</sup> Law No. 157 of 1981, art. 44.

suppliers, commercial agents, import-export offices, and tourist agencies and offices.<sup>280</sup>

Small firms and individual consumers are excluded as withholding agents.

“Reverse withholding” applies to business income derived by those self-employed individuals, private sector companies, and foreign companies that are engaged in selling or manufacturing. Entities in Group I must add a certain percentage to the invoice when selling or distributing commodities, industrial products, or agricultural products for resale or use in manufacturing.<sup>281</sup> A detailed schedule indicates the percentages to be added.<sup>282</sup> The customs administration also collects tax from businesses importing items to be sold or used in manufacturing by adding 2% of their value to the customs duties payable.<sup>283</sup>

“Reverse withholding” is also used in other situations to collect tax from self-employed individuals engaged in commercial or industrial activities, private sector companies, and foreign companies. If these individuals or companies rent premises equipped for selling, manufacturing, offering services, or preparing food, the owners of the premises must add 5% to the rent. This requirement applies only to owners specified in Groups I or II.<sup>284</sup> Slaughterhouses must collect tax when charging for slaughtering.<sup>285</sup> Persons granting licenses for trading in vegetables, fruits,

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<sup>280</sup> Minister of Finance Dec. No. 175 of 1982, art. 1 (May 10, 1982) (copy on file with U.C. DAVIS L. REV.).

<sup>281</sup> Law 157 of 1981, art. 45.

<sup>282</sup> Fin. Dec. 166, *supra* note 278, art. 2; *id.* sched. 2. The schedule specifies the percentages for foodstuffs (.5-4%); metal, metal products, mines, quarries, and gas (1-5%); chemicals, chemical products, plastics, and polyester (1-2%); paper and paper products (1-3%); construction materials and products, porcelain, china, and pottery (2-3%); glass and glass products (2%); wood and wood products (1-3%); spinning, weaving, and woven products (1-3%); leather and leather products (1-3%); household equipment (1%); electronic equipment, transformers, motors, batteries, tools, and electric fittings (1-2%); haberdashery, soap, sports equipment and clothing (.5-3%); machinery (1-2%); cars, other means of transport, and related products (2-4%); spare parts (2%); and junk (3%). *Id.* sched. 2.

<sup>283</sup> Law 157 of 1981, art. 49; Minister of Finance Dec. No. 170 of 1982, art. 2 (May 5, 1982) [hereafter Fin. Dec. 170] (copy on file with U.C. DAVIS L. REV.).

<sup>284</sup> Law 157 of 1981, art. 46; Minister of Finance Dec. No. 174 of 1982, art. 1 (May 10, 1982) [hereafter Fin. Dec. 174] (copy on file with U.C. DAVIS L. REV.).

<sup>285</sup> Law 157 of 1981, art. 50.

and cereals or for engaging in craft activities must collect tax from licensees when the license is granted or renewed.<sup>286</sup> In addition, traffic departments must collect tax from owners of taxis or transport vehicles when issuing, renewing, or transferring licenses on such vehicles.<sup>287</sup>

Both withholding and "reverse withholding" are used to collect the tax on noncommercial profits realized by individuals such as lawyers, doctors, engineers, reporters, authors, lecturers, accountants, consultants, translators, composers, artists, photographers, calligraphers, individuals in the entertainment business, models, customs brokers, and typists.<sup>288</sup> Persons making payments of E£10 or more to such individuals must withhold 10% on fees up to E£500, and 15% on fees of E£500 or more.<sup>289</sup> The payors required to withhold are the entities and firms designated in Groups I and II, as well as syndicates, professional societies and offices, publishers, movie producers, theaters, and entertainment establishments.<sup>290</sup>

Other designated persons must also collect the tax on noncommercial profits through "reverse withholding." For example, the customs administration must collect the tax from customs brokers submitting customs statements.<sup>291</sup> Court offices are required to collect the tax from lawyers filing lawsuits or appeals.<sup>292</sup> Hospitals must collect the tax from surgeons who use hospital operating facilities in connection with their private patients.<sup>293</sup>

Each taxpayer must obtain a tax card from the tax authorities. The tax card contains information about the taxpayer, such as the taxpayer's file number, the taxes to which the taxpayer is subject, and the district tax office where the taxpayer is registered.<sup>294</sup> The card is of crucial importance because other taxpayers and entities may deal only with taxpayers who hold current tax cards.<sup>295</sup> These rules enable collecting agents to obtain the information

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<sup>286</sup> *Id.* art. 48; Fin. Dec. 174, *supra* note 284, arts. 2-3.

<sup>287</sup> Law 157 of 1981, art. 51.

<sup>288</sup> Minister of Finance Dec. No. 169 of 1982, art. 1 (May 10, 1982) (copy on file with U.C. DAVIS L. REV.).

<sup>289</sup> Law 157 of 1981, art. 89.

<sup>290</sup> *Id.*

<sup>291</sup> *Id.* art. 92.

<sup>292</sup> *Id.* art. 90.

<sup>293</sup> *Id.* art. 91.

<sup>294</sup> *Id.* art. 128.

<sup>295</sup> *Id.* art. 129, *amended by* Law No. 87 of 1983.

needed to collect tax and pay it to the correct tax office. Collecting agents must remit the tax quarterly, with returns, to the tax office where the taxpayer is registered.<sup>296</sup> The tax collected is provisional and creditable against the taxpayer's tax liability for the year.<sup>297</sup> Taxpayers subject to the tax on commercial and industrial profits, on noncommercial profits, or on company profits must file returns at the end of the year.<sup>298</sup>

These provisions for withholding and "reverse withholding" are far-reaching. Payments in connection with most transactions between businesses are subject to either or both methods of collection, and almost all entities and firms are collecting agents. This gives rise to "cross-collection," where both parties to a transaction collect tax from each other. For example, a shoe manufacturer supplying shoes to a wholesaler adds 1% to 3% to the purchase price, and the wholesaler in turn withholds 1% from the amount paid to the manufacturer. Similarly, when the wholesaler sells the shoes to a retailer, the wholesaler adds a percentage to the invoice, while the retailer withholds tax from the payment it makes to the wholesaler.

"Reverse withholding" also results in the collection of tax unrelated to the receipt of income. For example, the tax on commercial and industrial profits is collected from retail food store proprietors by their suppliers. When proprietors rent business premises, their landlords also collect tax. Proprietors who have no taxable income are entitled to a refund at the end of the year.<sup>299</sup>

It is not known how effective this withholding system is or how well it is administered and enforced. It was recently reported, however, that almost half of total income tax receipts, excluding the tax collected through wage withholding, is collected through this system.<sup>300</sup>

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<sup>296</sup> *Id.* arts. 53, 93; Fin. Dec. 166, *supra* note 278, art. 3; Fin. Dec. 170, *supra* note 283, arts. 4, 5; Fin. Dec. 174, *supra* note 284, art. 5.

<sup>297</sup> Law 157 of 1981, arts. 53, 93.

<sup>298</sup> *Id.* arts. 34, 85, 121; *see* Chapter Egypt, *supra* note 272, at 4, 7, 9.

<sup>299</sup> In October 1989 high-level tax administrators in Egypt describing these methods for the advance collection of tax could not remember a case where a refund had been made. *See* Letter from Professor O. Oldman, Harvard Law School, to author (Oct. 18, 1989) (copy on file with U.C. DAVIS L. REV.).

<sup>300</sup> *Id.*

*C. Withholding Limited by Industry*

The United Kingdom, Ireland, and Australia enacted withholding legislation specifically to counter tax evasion by self-employed individuals in certain industries. The tax deduction schemes in these countries apply to the construction industry. Australia's Prescribed Payments System applies as well to other industries where compliance was known to be low, such as the motor vehicle repair and road transport industries. Although primarily directed at self-employed individuals, these schemes generally require withholding on payments to both individual and corporate contractors in the specified industries. The United Kingdom, for example, found inclusion of companies necessary to prevent some of the abuses that had occurred before 1977.

These countries limit withholding to payments for work or services in specified industries, and they did not intend that withholding apply to payments for materials or supplies. In the United Kingdom withholding applies to gross payment less the cost of materials. In Australia contractors may enter into separate agreements for the labor and materials components of a project, in which case withholding applies only to the labor agreement.

The rates under these industry-specific schemes are higher than the rates under the withholding systems in the countries discussed above. Contractors, however, may avoid the higher rates or avoid withholding altogether. Tax officials in Australia may authorize a lower rate of withholding in certain cases, and contractors in Ireland may obtain monthly refunds if the tax withheld is excessive. In addition, in each country the tax administration may exempt from withholding contractors with satisfactory tax records and proper business operations. In the United Kingdom, for example, over 72% of the contractors in the construction industry have exemption certificates. Such exclusions reduce even further the scope of these relatively narrow withholding schemes.

Both the United Kingdom and Australia have found that withholding has improved taxpayer compliance in the affected industries. Both countries were able to collect substantial amounts of tax which otherwise would have been evaded. In Australia numerous delinquent nonfilers were discovered, and income reporting improved. The number of individual tax returns in the construction and road transport industries in Australia also

increased significantly, as did the tax assessed on taxpayers in those industries.

### 1. The United Kingdom

The United Kingdom enacted the Construction Industry Tax Deduction Scheme in 1971 to stop the increasing loss of revenue due to tax evasion in the construction industry.<sup>301</sup> The number of independent workers in the construction industry had increased substantially, as both contractors and workers sought to avoid the employer-employee relationship. The Inland Revenue had difficulty keeping track of the industry's highly mobile group of workers.<sup>302</sup> The tax deduction scheme required contractors to deduct tax from payments made to subcontractors, unless the subcontractor was organized as a company or held an exemption certificate issued by the Inland Revenue.<sup>303</sup>

The 1971 legislation had some effect, but its weaknesses were widely exploited.<sup>304</sup> The exclusion of subcontractor companies enabled subcontractors to avoid withholding by purchasing "shell" companies and channelling payments through them. The limited liability status of the shell companies allowed the resulting tax debts to remain unpaid and uncollectible.<sup>305</sup> Another weakness related to the standards for issuing exemption certificates:

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<sup>301</sup> Board of Inland Revenue, *The Construction Industry Tax Deduction Scheme: A Consultative Document*, 104 TAXATION 495 (1980) [hereafter *Consultative Document*].

<sup>302</sup> Ilersic, *supra* note 16, at 694. Contractors could hire independent workers and avoid normal employee costs and related problems (e.g., national insurance contributions, redundancy or compensation payments, layoffs on completion of work). *Id.* Most contractors also found that independent workers had a higher output than employees and were more likely to complete the work on time. *Id.* Workers wanted independent contractor status so that they could negotiate their own terms with contractors and report income as business income, against which they could claim expenses and on which they could defer tax liability. *Id.* The building trade unions were very hostile to the independent workers in the construction industry, referring to them as the "lump," because these workers were outside the union and were regarded by employers as more productive than the average union member. *Id.*

<sup>303</sup> *Consultative Document*, *supra* note 301, at 495. Subcontractor companies, however, were required to apply the scheme to their individual subcontractors and, where appropriate, deduct tax from payments to them. *Id.*

<sup>304</sup> *Id.*

<sup>305</sup> *Id.*; COMMITTEE ON ENFORCEMENT POWERS, *supra* note 116, at 122.

the Inland Revenue was authorized to deny exemption certificates to applicants with poor tax records, but in many cases was obliged to issue certificates to applicants with no recent tax record or with no tax record at all.<sup>306</sup> The misuse of exemption certificates in these cases was a principal factor in the breakdown of the tax deduction scheme.<sup>307</sup> For example, many subcontractors with certificates could not be traced after they had received payment in full or sold their certificates.<sup>308</sup> The certificates did not contain personal details about the holder, which resulted in widespread impersonation in the industry.<sup>309</sup> Many subcontractors used forged, purchased, or stolen certificates to receive payment without deduction of tax. Fraud and other serious irregularities continued on a large scale, despite an increase in prosecutions by both the Inland Revenue and the police.<sup>310</sup> Enforcement of the tax deduction scheme had virtually collapsed by 1974, and estimates of revenue loss ranged from £10 million to £100 million per year.<sup>311</sup>

The legislation was amended in 1975 to bring subcontractor companies into the tax deduction scheme, tighten conditions for obtaining exemption certificates, and improve the security of tax certificates.<sup>312</sup> These changes took effect in April 1977<sup>313</sup> and had positive results. In the first year under the new scheme, about £78 million in tax was deducted from payments to subcontractors, as compared with £21 million for the final year under the old scheme.<sup>314</sup> In addition, the annual total of known misused

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<sup>306</sup> *Consultative Document, supra* note 301, at 498-99. Some applicants claimed that they had no tax records, or no recent tax records, because of unemployment, sickness, or absences from the country. This was true in some cases, but in others applicants had no tax record because they had disregarded their tax obligations in the United Kingdom. *Id.*

<sup>307</sup> *Id.*

<sup>308</sup> *Id.* at 495.

<sup>309</sup> *Id.* at 497.

<sup>310</sup> *Id.* at 495.

<sup>311</sup> *Id.*

<sup>312</sup> *Id.* Certificates were issued only to subcontractors who had been either employed or self-employed in the United Kingdom throughout the three-year period immediately preceding their application and who had a satisfactory tax record during that time. *Id.* at 498-99. Each certificate was engraved with a photograph of the authorized holder, except in the case of certain companies. *Id.* at 497. The improved document security virtually ended the "thriving market in forged official documents." *Id.* at 495.

<sup>313</sup> *Id.*

<sup>314</sup> *Id.*

certificates fell from about 15,000 under the old scheme to about 400 in the early 1980s.<sup>315</sup> Nevertheless, some misuse of certificates issued to companies persisted.<sup>316</sup>

The Construction Industry Tax Deduction Scheme in effect today is basically the scheme enacted in 1971 and amended in 1975. Contractors must deduct tax from payments made to subcontractors — companies, individuals or partnerships — under a contract for construction operations, unless the subcontractor holds an exemption certificate.<sup>317</sup> “Contractor” includes businesses engaged in construction operations, local authorities, public bodies, property developers, and certain other businesses and entities, but excludes private householders and nonconstruction businesses.<sup>318</sup>

Tax is withheld essentially from the labor portion of the contract. Tax at the prescribed rate, currently 25%, is deducted from the gross payment, less the cost of materials, but without any allowance for normal trading expenses or other tax reliefs.<sup>319</sup> Contractors must remit the tax withheld every month. The tax withheld is provisional and creditable against the subcontractor’s tax liability for the year.<sup>320</sup>

Subcontractors holding exemption certificates are exempt from withholding.<sup>321</sup> The conditions for obtaining certificates were relaxed somewhat in 1980.<sup>322</sup> To qualify for a certificate now,

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<sup>315</sup> COMMITTEE ON ENFORCEMENT POWERS, *supra* note 116, at 126.

<sup>316</sup> *Consultative Document*, *supra* note 301, at 498. In 1980 the Inland Revenue investigated about 37 companies suspected of abuse involving payments of £20 million for the 1977-78 and 1978-79 tax years. *Id.*

<sup>317</sup> BOARD OF INLAND REVENUE, PUB. NO. IR14/15, CONSTRUCTION INDUSTRY TAX DEDUCTION SCHEME: ADVICE ON HOW TO OPERATE THE SCHEME 1-9 (1982) [hereafter INLAND REVENUE BOOKLET IR14/15]. “Construction operations” covers almost any work done to a permanent or temporary building or structure, including site preparation, construction, alteration, repair, dismantling, and demolition. *Id.* at 9.

<sup>318</sup> *Id.* at 4-5. A nonconstruction business may, however, be regarded as a contractor in certain cases (*e.g.*, if it spends more than £250,000 per year on construction operations). *Id.*

<sup>319</sup> *Id.* at 6, 31-34; *Consultative Document*, *supra* note 301, at 499; *see also* Letter from D.J. Bale, Inland Revenue Operations Division M4, to author (Oct. 3, 1989) [hereafter Bale Letter] (enlarging on Inland Revenue Booklet IR14/15; noting changes in Construction Industry Tax Scheme since 1975) (copy on file with U.C. DAVIS L. REV.).

<sup>320</sup> INLAND REVENUE BOOKLET IR14/15, *supra* note 317, at 3, 34-35.

<sup>321</sup> *Id.* at 10.

<sup>322</sup> Bale Letter, *supra* note 319.



subcontractors must have satisfactory tax records, operate their business properly,<sup>323</sup> and have been employed or self-employed in the United Kingdom for a continuous three-year period during the six years prior to application.<sup>324</sup> A certificate is valid for three years,<sup>325</sup> but may be cancelled for cause.<sup>326</sup> The denial or cancellation of a certificate may be appealed.<sup>327</sup> Subcontractors holding exemption certificates must give the contractor a voucher (receipt) for each payment received without deduction of tax. Contractors must send the vouchers within fourteen days of receipt to the Inland Revenue.<sup>328</sup> Contractors must also submit annual returns giving details of payments made to subcontractors, whether or not tax was withheld.<sup>329</sup>

Contractors are liable for the tax they have deducted or should have deducted from payments, but in certain cases may be excused from liability for the tax not withheld.<sup>330</sup> The fact of contractor liability, however, does not affect subcontractor tax liability. Whether or not subcontractors hold exemption certificates, they are subject to tax on all payments received.<sup>331</sup> If tax has been withheld, subcontractors are entitled to a tax credit, otherwise not. Since both the contractor and subcontractor may have a tax liability on any given payment, it is possible for the Inland Revenue to collect the tax twice.<sup>332</sup> To avoid double taxation in

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<sup>323</sup> BOARD OF INLAND REVENUE, PUB. NO. IR40, CONDITIONS FOR GETTING A SUB-CONTRACTOR'S TAX CERTIFICATE 1, 3 (1982). A business is operated properly if it is run (1) from proper premises with adequate inventory and other facilities, (2) through a bank account, and (3) with complete and accurate business records. *Id.* at 1.

<sup>324</sup> *Id.* at 1-2. If there are any gaps in the subcontractor's employment record from the end of that three-year period to the date of application, the subcontractor must show that the gaps were due to unemployment, sickness, or absences abroad. *Id.* at 2-3. Special rules apply to individuals who have recently completed school and entered the work force. *Id.* at 4.

<sup>325</sup> COMMITTEE ON ENFORCEMENT POWERS, *supra* note 116, at 127.

<sup>326</sup> INLAND REVENUE BOOKLET IR14/15, *supra* note 317, at 14, 41, 51-52.

<sup>327</sup> *Id.* at 13; *id.* Supp. 1989 (noting introduction of right of appeal against cancellation of subcontractor certificate, effective July 23, 1987).

<sup>328</sup> INLAND REVENUE BOOKLET IR14/15, *supra* note 317, at 14, 18, 20, 37. The subcontractor is given matching vouchers at the time the certificate is issued. *Id.* at 14.

<sup>329</sup> *Id.* at 37-38.

<sup>330</sup> *Id.* at 39-40. Contractors are excused from liability if they show that they exercised reasonable care and acted in good faith. *Id.*

<sup>331</sup> *Consultative Document*, *supra* note 301, at 500.

<sup>332</sup> *Id.*

these cases, the Inland Revenue may waive the contractor's liability if the subcontractor reported the payment for tax purposes and the contractor did not deliberately fail to deduct tax.<sup>333</sup>

The tax deduction scheme has resulted in increased revenues. In 1986 it was estimated that without the scheme the Inland Revenue would not have collected £100 million of the total £240 million collected under the scheme.<sup>334</sup> In 1989 about 655,000 subcontractors had exemption certificates, and about 250,000 subcontractors did not.<sup>335</sup> Of those holding certificates, about 109,000 were companies, and the remainder individuals and partnerships.<sup>336</sup> The principal known abuses today are contractors selling their certificates and vouchers, and contractors allowing subcontractors to use them in exchange for a percentage of the payment.<sup>337</sup>

The United Kingdom's withholding system is not without its critics. The Sub-Contractor's Trade Protection Association (SCTPA), which was formed to oppose aspects of the tax deduction scheme, has claimed that the rate of withholding is much too high.<sup>338</sup> The SCTPA has also charged that the scheme is "too complicated for the level of intelligence and education of people

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<sup>333</sup> INLAND REVENUE BOOKLET IR14/15, *supra* note 317 at 40. As a practical matter, there have been few cases of double taxation of this kind. *Consultative Document*, *supra* note 301, at 500-01. The possibility of an additional charge on the contractor must remain in order to reduce opportunities for collusion. *Id.* at 500.

<sup>334</sup> CATA REPORT, *supra* note 102, at 65.

<sup>335</sup> Bale Letter, *supra* note 319. In 1987-88 contractors paid about £3 billion to subcontractors not holding certificates. *Id.*

<sup>336</sup> *Id.*

<sup>337</sup> Letter from D.J. Bale, Inland Revenue Operations Division M4, to author (Jan. 8, 1990) (copy on file with U.C. DAVIS L. REV.).

<sup>338</sup> COMMITTEE ON ENFORCEMENT POWERS, *supra* note 116, at 133. The SCTPA proposed a rate of 15%, arguing that the lower rate would reduce cash flow difficulties and hence lessen "the pressure to commit illegalities." *Id.* The Committee on Enforcement Powers of the Revenue Departments agreed and recommended that the rate of withholding be reduced to half of the basic rate. The Inland Revenue argued for the 30% rate, the basic rate of the income tax in 1983, on several grounds. The tax deduction had to cover liability for both the income tax and national insurance contributions. In addition, the Inland Revenue had found that in many cases the tax withheld was in fact the final tax paid, since many subcontractors did not later claim a credit or a tax refund. Thus, a lower withholding rate would probably mean a straight tax loss of the difference between 30% and the lower rate. *Id.*; see also *Consultative Document*, *supra* note 301, at 499-500.

working in the construction industry.”<sup>339</sup> Some subcontractors without exemption certificates have complained that contractors refuse to enter into contracts with them.<sup>340</sup> Yet the tax deduction scheme for the construction industry “remains an important defence against significant tax evasion” in the United Kingdom.<sup>341</sup>

## 2. Ireland

Ireland introduced a tax deduction scheme in 1970 to curb tax evasion by self-employed subcontractors in the construction industry.<sup>342</sup> The scheme required contractors to deduct tax from payments to subcontractors, but well-established subcontractors with satisfactory tax records received certificates exempting them from withholding.<sup>343</sup> Widespread abuse of the certificates occurred, and a new scheme was introduced in 1976 to eliminate this abuse.<sup>344</sup>

The new scheme requires “principal contractors” to withhold tax at 35% from payments made to a subcontractor — individual, partnership or company — under a contract for “construction operations,” unless the subcontractor holds an exemption certificate.<sup>345</sup> “Principal contractors” includes persons engaged in building and related activities<sup>346</sup> and certain other persons, but not ordinary householders and clients of contractors.<sup>347</sup> “Con-

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<sup>339</sup> COMMITTEE ON ENFORCEMENT POWERS, *supra* note 116, at 124.

<sup>340</sup> *Consultative Document*, *supra* note 301, at 501.

<sup>341</sup> PARL. DEB. H. C. (5th Ser.) 405 (1989) (reading of Standing Committee G report on clause 114 of 1989 Finance Bill regarding regulation of subcontractors).

<sup>342</sup> FIFTH REPORT OF THE COMMISSION ON TAXATION: TAX ADMINISTRATION, Parl. 3142, at 305 (1985) [hereafter IRISH TAXATION COMMISSION].

<sup>343</sup> *Id.*

<sup>344</sup> *Id.*

<sup>345</sup> W. MCATEER & G. REDDIN, *INCOME TAX 328* (4th ed. 1987); *see also* REVENUE COMMISSIONERS, PUB. NO. C24A, EXPLANATORY NOTES FOR PRINCIPAL CONTRACTORS (1982) [hereafter EXPLANATORY NOTES] (discussing withholding procedures and forms).

<sup>346</sup> Related activities include the manufacture, treatment, or extraction of materials for use in construction operations (*e.g.*, concrete, tiles, doors, glass, paint). W. MCATEER & G. REDDIN, *supra* note 345, at 328-29.

<sup>347</sup> *Id.*; IRISH TAXATION COMMISSION, *supra* note 342, at 306. “Principal contractor” also includes persons who have a construction contract with a client and subcontract some of the work, local authorities, government ministers, certain statutory bodies, and persons who carry on any gas, water,

struction operations” includes most operations in or related to the construction industry.<sup>348</sup>

The tax authorities may issue exemption certificates, which are valid for one year.<sup>349</sup> Subcontractors qualify for a certificate if they have satisfactory tax records for the immediately preceding three years, run their businesses properly, and keep proper books and records.<sup>350</sup> The denial of a certificate may not be appealed, and a certificate may be cancelled for cause.<sup>351</sup> Under the certificate system, subcontractors with certificates must present them to the principal contractor, who in turn applies to the tax authorities for a “construction payments card.” The principal contractor may make payment in full only upon receipt of the card.<sup>352</sup> Principal contractors record details of the payments made to a subcontractor on this card and return it to the tax authorities at the end of the year.<sup>353</sup>

Principal contractors must remit the tax withheld every month and provide details of the deductions to the tax administration.<sup>354</sup> They are liable for tax they have deducted, or should have deducted, and must file annual returns showing payments to all subcontractors.<sup>355</sup> The tax withheld is provisional and creditable against the subcontractor’s tax liability for the year, but subcon-

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electricity, hydraulic power, dock, canal, or railway undertaking. W. McATEER & G. REDDIN, *supra* note 345, at 328-29; EXPLANATORY NOTES, *supra* note 345, § 10(a).

<sup>348</sup> “Construction operations” includes alteration, repair, or demolition of buildings, structures, and works forming part of the land (*e.g.*, walls, roads, power lines, runways, railways, and pipelines). W. McATEER & G. REDDIN, *supra*, note 345, at 329. The term also includes other activities, such as the installation of heating, lighting, and ventilation systems and the external and internal cleaning of buildings and structures. *Id.*; EXPLANATORY NOTES, *supra* note 345, § 10(b).

<sup>349</sup> W. McATEER & G. REDDIN, *supra* note 345, at 330. The provisions relating to exemption certificates are summarized in REVENUE COMMISSIONERS, PUB. NO. C24B, SUB-CONTRACTORS IN THE CONSTRUCTION INDUSTRY: PAYMENTS FROM PRINCIPAL CONTRACTORS (1989).

<sup>350</sup> IRISH TAXATION COMMISSION, *supra* note 342, at 306-07. The business must be run from a fixed place of business with adequate equipment, inventory, and facilities. The Revenue Commissioners must also have good reason to expect that the applicant will continue to keep proper records in the future. *Id.*; W. McATEER & G. REDDIN, *supra* note 345, at 330.

<sup>351</sup> IRISH TAXATION COMMISSION, *supra* note 342, at 307.

<sup>352</sup> *Id.* at 307-08.

<sup>353</sup> *Id.* at 308.

<sup>354</sup> EXPLANATORY NOTES, *supra* note 345, § 5.

<sup>355</sup> *Id.* §§ 3, 7.

tractors may obtain monthly refunds during the year if the tax withheld is excessive.<sup>356</sup>

The Construction Industry Federation criticized the scheme as being too complex and requiring too many details to be recorded.<sup>357</sup> The Revenue Commissioners responded that the scheme is reasonably simple and that further simplification would only be at the risk of increased evasion.<sup>358</sup> The Irish Commission on Taxation agreed. It concluded, based on Ireland's experience before 1976, that tax evasion in the construction industry can be controlled only by very stringent requirements.<sup>359</sup> The Commission recommended against any relaxation of the existing rules.<sup>360</sup>

### 3. Australia

Australia introduced the Prescribed Payments System (PPS) in 1983 to stem substantial losses of revenue from the cash economy, caused in particular by income tax evasion among self-employed individuals not subject to wage withholding.<sup>361</sup> As in other countries, widespread avoidance of the employer-employee relationship had resulted in a significant increase in the number of independent workers.<sup>362</sup> Moreover, entire industries had organized on an independent contractor basis. The use of independent contractors was pervasive in certain industries, such as building, computers, market research, and trucking.<sup>363</sup>

Before 1983 the Australian government had become increasingly concerned about the possible loss of revenue.<sup>364</sup> In 1982

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<sup>356</sup> IRISH TAXATION COMMISSION, *supra* note 342, at 306; T. COONEY, J. McLAUGHLIN & P. TAGGART, 1985/86: A SUMMARY OF TAXATION IN THE REPUBLIC OF IRELAND 76-77 (1986).

<sup>357</sup> IRISH TAXATION COMMISSION, *supra* note 342, at 112.

<sup>358</sup> *Id.* at 113.

<sup>359</sup> *Id.*

<sup>360</sup> *Id.* at 113, 115. The Commission did, however, recommend that subcontractors be allowed to appeal the denial of exemption certificates. *Id.*

<sup>361</sup> AUDITOR-GENERAL, *supra* note 109, at 1.

<sup>362</sup> Szekely, *Converting Employees to Contractors*, 12 AUSTL. TAX REV. 259 (1983). Employers could reduce their overhead cost of employing labor. An Australian Industries Development Association study estimated this cost at 44% of average hourly earnings in 1982 and expected it to be over 50% by 1990. *Id.* Independent workers could avoid wage withholding, could claim more and larger deductions for businesses expenses, and would have greater opportunities for tax avoidance and evasion. *Id.* at 265-68; *see also* D'Aloisio, *Independent Contractors or Employees*, 19 TAX'N AUSTL. 257 (1984).

<sup>363</sup> Szekely, *supra* note 362, at 259.

<sup>364</sup> AUDITOR-GENERAL, *supra* note 109, at 6-7.

the government estimated that the building industry accounted for about 40% of all cash payments for labor and services. The government also estimated that persons in the building industry, including companies, would pay only about A\$400 million, or 55% to 60%, of the approximately A\$700 million of income tax due on their 1981-82 income.<sup>365</sup> Thus, the PPS was directed at the building industry and certain other industries where evasion was known to be significant.<sup>366</sup> Its long-term objective was the filing of accurate returns by taxpayers in these industries.<sup>367</sup>

The PPS applies to payments for work or services within prescribed industries: building, construction and related professional services, such as engineering; architecture; surveying; road transport; motor vehicle repair; joinery and cabinetmaking; and cleaning.<sup>368</sup> Regulations specify the types of activities within each industry that are covered by the PPS.<sup>369</sup>

The PPS requires withholding on intra-industry payments, where a payor in a prescribed industry pays for the work or services of a person — individual, company, or partnership — in the same industry.<sup>370</sup> Withholding applies to payments for labor only or for labor and materials; it does not apply to payments for materials alone.<sup>371</sup> Payors withhold tax at 20% from the gross payment if the payee has properly completed a deduction

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<sup>365</sup> *Id.* at 7, 23.

<sup>366</sup> AUSTRALIAN WHITE PAPER, *supra* note 15, at xii, 38.

<sup>367</sup> CATA REPORT, *supra* note 102, at 65.

<sup>368</sup> I. WALLSCHUTZKY, AUSTRALIAN INCOME TAX LAW 310-11 (2d ed. 1988); 1989 AUSTRALIAN MASTER TAX GUIDE 917 (CCH Australia Ltd. 1989).

<sup>369</sup> For example, activities in the building and construction industry include a wide range of work or services (*e.g.*, construction, repair, modification, painting, installation of systems or devices, demolition) performed in connection with structures, roadworks, or thoroughfares. I. WALLSCHUTZKY, *supra* note 368, at 310-11. Activities in the motor vehicle repair industry include the servicing, repair, and maintenance of motor vehicles or any of their parts or accessories. *Id.* at 311.

<sup>370</sup> 1989 AUSTRALIAN MASTER TAX GUIDE, *supra* note 368, at 917.

<sup>371</sup> TAXPAYER ASSISTANCE BRANCH, AUSTRALIAN TAXATION OFFICE, LEAFLET No. NAT 1530.8.89, ORGANISATIONS AND BUSINESSES: PRESCRIBED PAYMENTS SYSTEM 4 (1989). Separate contracts for the labor and goods or materials components of a project are acceptable. Withholding applies only to payments made under the contract for labor, or for labor and materials. Payments made under a contract for supply of materials only are not subject to withholding. 1989 AUSTRALIAN MASTER TAX GUIDE, *supra* note 368, at 917.

form,<sup>372</sup> and at 48.25% if the payee has not.<sup>373</sup> The tax withheld is provisional and creditable against the payee's tax liability for the year.<sup>374</sup>

In certain situations the PPS also requires withholding on payments made by persons outside a prescribed industry to persons within that industry. Persons outside the building and construction industry must withhold tax from payments made in connection with building or construction projects whose total cost exceeds A\$10,000.<sup>375</sup> Thus, customers or clients of building contractors may be required to withhold. Similarly, "householders" who are "owner builders" must withhold tax from payments made under a construction project costing more than A\$10,000.<sup>376</sup> In addition, persons outside the road transport industry must withhold tax from payments to road transporters whom they use on a regular daily basis, if the transport involves the exclusive use of the transporter's vehicle.<sup>377</sup>

Payees who hold deduction exemption certificates are exempt from withholding. Payees qualify for an exemption certificate if they have a "satisfactory history," including a good tax record.<sup>378</sup>

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<sup>372</sup> See *infra* notes 382-83 and accompanying text.

<sup>373</sup> *Practice Alert*, Austl. Fed. Tax Rep. (CCH Austl. Ltd.) Tax Week Rep. No. 757, at 2 (June 23, 1989). Before July 1, 1989, the standard rate was 15%, and the penalty rate was 30%. 1989 AUSTRALIAN MASTER TAX GUIDE, *supra* note 368, at 921.

<sup>374</sup> 1989 AUSTRALIAN MASTER TAX GUIDE, *supra* note 368, at 914, 932.

<sup>375</sup> *Id.* at 917.

<sup>376</sup> TAXPAYER ASSISTANCE BRANCH, AUSTRALIAN TAXATION OFFICE, LEAFLET NO. NAT 1529.6.89, THE OWNER BUILDER: PRESCRIBED PAYMENTS SYSTEM 2, 5 (1989). A "householder" is an individual who has undertaken a private or domestic construction project (*e.g.*, major home improvement) costing more than A\$10,000. 1989 AUSTRALIAN MASTER TAX GUIDE, *supra* note 368, at 925, 926. A householder must register with the tax office, report payments made under the project (but not withhold tax), and notify the tax office upon completion of the project. *Id.* at 925. "Owner builders" are "householders" who have been issued a construction or building permit in connection with a private or domestic construction project or who arrange for most or all of the work to be done. *Id.* at 927-28.

<sup>377</sup> 1989 AUSTRALIAN MASTER TAX GUIDE, *supra* note 368, at 917-18. This provision typically affects businesses that regularly engage road transport contractors, such as breweries, oil companies, brick and pre-mix concrete firms, and newspapers. Phillips, *Division 3A—Collection of Tax in Respect of Certain Payments for Work*, 18 TAX'N AUSTR. 126, 130 (1983).

<sup>378</sup> 1989 AUSTRALIAN MASTER TAX GUIDE, *supra* note 368, at 929-30. For example, applicants must show that, during the previous three years, they conducted their business properly and complied with their tax obligations.

Alternatively, withholding may be at a reduced rate, including a nil rate, if the payee holds a deduction variation certificate, which is issued to an applicant who shows that withholding at the standard rate (20%) will result in overpayment of tax.<sup>379</sup> Exemption and variation certificates may be revoked for cause,<sup>380</sup> and the denial or revocation of a certificate may be appealed.<sup>381</sup>

The Australian Taxation Office, which administers the PPS, obtains information about payments within the prescribed industries, whether or not tax is withheld. Payees, including those holding exemption or variation certificates, must fill out a deduction form for each payor for each month during which they receive payments, indicating the payee's name, address, income tax file number, certificate number (if any), and applicable rate of withholding.<sup>382</sup> Payees give the deduction form to the payor, who completes the payor's portion of the form. The payor forwards the completed forms to the tax office every month, together with the tax withheld and a reconciliation form.<sup>383</sup> The tax office may in certain cases grant a reporting exemption to a payee holding an exemption certificate, in which case both the payee and payor are exempt from reporting payments on a monthly basis.<sup>384</sup>

Australia experienced initial difficulties in implementing the PPS. Between the time of its announcement and its effective date in September 1983, industry groups mounted strong and protracted opposition to the PPS.<sup>385</sup> The government expended significant resources to defend the new system. The Australian Taxation Office had little time to publish information about the PPS, to process the more than 100,000 applications for exemption and variation certificates, or to provide rulings on a wide

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Applicants must also provide certain information about the most recent year of income for which they filed a return. *Id.*

<sup>379</sup> *Id.* at 928-29.

<sup>380</sup> *Id.* at 931-32.

<sup>381</sup> *Id.* at 933-34.

<sup>382</sup> *Id.* at 918.

<sup>383</sup> *Id.* at 920-23. On their part of the Deduction Form, payors must show their name, address, reference number, gross amount of payment, tax deducted, payment period, and nature of the work. As a once-only requirement, payors must file a Paying Authority Notification Form within a specified time after entering into a contract under which withholding is required. *Id.*

<sup>384</sup> *Id.* at 931; see also AUDITOR-GENERAL, *supra* note 109, at 16-17.

<sup>385</sup> AUDITOR-GENERAL, *supra* note 109, at 1, 5; CATA REPORT, *supra* note 102, at 57.



range of issues.<sup>386</sup> There were also delays in processing the income tax returns of taxpayers claiming a PPS tax credit.<sup>387</sup>

The Auditor-General of Australia conducted an audit of the PPS from March to September 1985<sup>388</sup> and submitted his report in September 1986. The report was critical of the way that the Australian Taxation Office had implemented the PPS. For example, according to the report the tax office had granted exemption and variation certificates too readily and had not established a comprehensive system for checking that payees with such certificates reported the payments received.<sup>389</sup> The report also noted the large amount of unclaimed PPS credit, an indication that tax might have been evaded on undisclosed income.<sup>390</sup> The report concluded that the PPS had not achieved its objective of curbing the bulk of the enormous revenue losses in the prescribed industries.<sup>391</sup>

The Commissioner of Taxation disagreed with the findings of the audit and asked for a more balanced presentation.<sup>392</sup> According to the Commissioner, the audit had been conducted at a "difficult time."<sup>393</sup> The tax office was aware of most of the problems mentioned in the report and was making progress in dealing with them.<sup>394</sup> In the Commissioner's view, the PPS was working and was a "substantial success."<sup>395</sup> During 1987-88 the criteria for granting exemption and variation certificates were tightened significantly, and most of the other recommendations made by the

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<sup>386</sup> CATA REPORT, *supra* note 102, at 57.

<sup>387</sup> AUDITOR-GENERAL, *supra* note 109, at 9. In January 1985 more than 70,000 tax returns for 1983-84 were delayed in processing because of differences between the PPS tax credit claimed by taxpayers and the amount of tax shown to have been received from payors. About one-third of the discrepancies were resolved when discrepancy tolerances were increased. *Id.*

<sup>388</sup> *Id.* at 6.

<sup>389</sup> *Id.* at 2, 16.

<sup>390</sup> *Id.* at 15, 17. As of June 1985, the amount of tax withheld under the PPS during 1983-84 for which no credit had been claimed was A\$87.2 million, or about 30% of all PPS collections. This percentage was expected to decline to 21%. The tax office estimated that this percentage represented A\$470 million in unreported PPS income and about A\$120 million in uncollected tax. *Id.* at 17.

<sup>391</sup> *Id.* at 4.

<sup>392</sup> *Id.* at 62.

<sup>393</sup> *Id.* at 4-5.

<sup>394</sup> *Id.* at 62.

<sup>395</sup> *Id.* at 5.

Auditor-General were implemented.<sup>396</sup>

The PPS has resulted in additional tax revenues as well as improved tax compliance within the prescribed industries. During the first nine months of operation in 1983-84 tax receipts from the PPS were about A\$250 million.<sup>397</sup> In 1984-85 tax collections under the PPS were about A\$400 million, about half of which represented tax that had previously been evaded.<sup>398</sup> PPS collections increased to A\$515 million in 1985-86, A\$765 million in 1986-87, and A\$958 million in 1987-88.<sup>399</sup>

The PPS has also identified delinquent nonfilers, improved compliance with the filing requirement, and raised the level of income disclosures by payees in the prescribed industries.<sup>400</sup> In 1983-84 almost 56,000 applications for income tax file numbers were submitted. Seventy-one percent of the applications examined in detail involved taxpayers who should have filed income tax returns for prior years.<sup>401</sup> By June 1985 the tax office had identified about 22,300 nonfilers, mostly in the building industry, and had issued assessments of tax and penalties totaling almost A\$14 million.<sup>402</sup> After three years of the PPS, the number of tax returns from individuals in the building and construction industry had increased by 111%, from 49,000 in 1983-84 to 103,000 in 1986-87, and the net tax assessed increased by 279%, from A\$85 million to A\$321 million.<sup>403</sup> In the road transport industry the number of individual tax returns increased by 50%, from 20,000 in 1983-84 to 32,000 in 1986-87, and the net tax assessed increased by 145%, from A\$41 million to A\$102 million.<sup>404</sup>

#### IV. ISSUES IN WITHHOLDING ON BUSINESS INCOME

The previous section examined the provisions or proposals of

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<sup>396</sup> COMMISSIONER OF TAXATION, ANNUAL REPORT 1987-88, at 46 (1988) [hereafter COMM'R REPORT 1987-88].

<sup>397</sup> COMM'R REPORT 1986-87, *supra* note 103, at 19.

<sup>398</sup> *Id.*; AUSTRALIAN WHITE PAPER, *supra* note 15, at 38.

<sup>399</sup> COMM'R REPORT 1987-88, *supra* note 396, at 173.

<sup>400</sup> AUDITOR-GENERAL, *supra* note 109, at 1.

<sup>401</sup> *Id.* at 17. The rate had fallen to 45% by April 1985. This decrease was consistent with the expectation that most nonfilers would be detected in the initial stages. *Id.*

<sup>402</sup> *Id.* at 24.

<sup>403</sup> COMM'R REPORT 1986-87, *supra* note 103, at 20.

<sup>404</sup> *Id.*

nine countries for withholding on business income. This section identifies the major issues in withholding on business income and analyzes them with reference to the withholding systems discussed in Section III. These issues relate to the scope of withholding, the rate of withholding, the selection of withholding agents, and the administration and enforcement of withholding provisions. The discussion compares the ways in which the nine countries have dealt with these issues. The discussion also evaluates their withholding provisions in light of tax policy considerations, such as fairness to taxpayers, efficiency in withholding, and ease of administration. The discussion illustrates the complexities in withholding on business income and indicates how governments have sought to overcome them.

### *A. Scope of Withholding*

#### 1. General Considerations

The positive impact of withholding on taxpayer compliance and its other advantages support broad withholding on business and other income.<sup>405</sup> The broader the withholding net, the greater the number of taxpayers who are likely to file returns, report income correctly, and pay the tax owed. Broad withholding, especially on business income, also furthers the principle of equity in taxation, given the extensive use of withholding on wages and salaries.

Fairness in taxation means, among other things, equality in the treatment of taxpayers. In the context of withholding, this means that taxpayers should be required to pay tax with the same frequency and should have the same choices about complying with their tax obligations. When tax is withheld, tax is paid concurrently with the receipt of income through compulsory collection from the income recipient. When tax is not withheld, taxpayers not only can defer payment of tax, but they also have the option of disregarding their obligation to pay. Taxpayers not subject to withholding may thus decrease their tax burden through both legitimate and illegitimate means, but taxpayers subject to withholding can do neither.

The greater the time lag between the receipt of income and the payment of tax, the greater the advantage to those taxpayers able

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<sup>405</sup> See *supra* notes 97-118 and accompanying text.

to defer payment. Current payments systems<sup>406</sup> reduce but do not eliminate the disparity between taxpayers who pay through withholding and those who do not. Under current payments systems taxpayers not subject to withholding make estimated payments during the year; they do not pay tax upon each receipt of income. In addition, they have the option of not making estimated payments at all, albeit at the risk of penalties. In Japan, for example, estimated payments need only be made twice during the year (on July 31 and November 30), each payment being one-third of the estimated tax due.<sup>407</sup> In the United States and Australia estimated payments are made quarterly.<sup>408</sup>

A broad withholding system that covers business income is particularly important to reduce the inequities between wage and salary earners, whose incomes are almost always subject to withholding, and self-employed individuals, whose incomes often are not. In the United Kingdom, for example, the tax on wages and salaries is paid currently through withholding, but the tax on business and professional profits is deferred for at least nine months and often much longer.<sup>409</sup> Moreover, employees have virtually no options for reducing their tax liabilities. At the same time, other taxpayers, especially the self-employed, enjoy greater opportunities for avoidance and evasion and are thought to be taking considerable advantage of them. As a result, the burden of the income tax tends to fall most heavily on wage and salary earners.<sup>410</sup> This discrimination against employment income has caused resentment among wage earners, who believe that they

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<sup>406</sup> Some countries complement their withholding provisions with current payments systems, which require taxpayers deriving income not subject to withholding to make estimated or provisional tax payments during the year. See generally INCOME TAX COLLECTION LAGS, *supra* note 101 (discussing current payments systems in OECD countries).

<sup>407</sup> JAPANESE TAXES, *supra* note 156, at 60-61. The amount of estimated tax due is based on the preceding year's liability. *Id.* at 61.

<sup>408</sup> INCOME TAX COLLECTION LAGS, *supra* note 101, at 52; I. WALLSCHUTZKY, *supra* note 368, at 308.

<sup>409</sup> See INCOME TAX COLLECTION LAGS, *supra* note 101, at 48-51; J. KAY & M. KING, *supra* note 77, at 30. The tax year in the United Kingdom is from April 6 through April 5, and the tax is assessed on the preceding year's profits. The tax so assessed is payable in two equal installments on January 1 and July 1. Thus, the first payment is due between 9 and 20 months after the receipt of income, and the second payment between 15 and 26 months. INCOME TAX COLLECTION LAGS, *supra* note 101, at 50-51.

<sup>410</sup> See AUSTRALIAN WHITE PAPER, *supra* note 15, at 19; see also Bahl, *Jamaican Tax Reform*, *supra* note 31, at 129, 133.

are treated unfairly and bear a disproportionately high tax burden.<sup>411</sup> In Japan the New Salaried Men's Party was founded on the single issue of fairness to salaried workers, and in 1984 it won two seats in the Japanese Parliament.<sup>412</sup>

A broad withholding system also minimizes the economic side effects and distortions caused by a limited application of withholding. Withholding is often unpopular with taxpayers and withholding agents. If withholding is limited to certain types of income, to certain income recipients, or to certain payors, taxpayers and withholding agents may arrange their affairs so as to avoid withholding. For example, in the United States, United Kingdom, and Australia, principals and workers have avoided wage withholding, as well as other consequences of the employer-employee relationship, by classifying workers as self-employed individuals.<sup>413</sup> Similarly, principal contractors in the United Kingdom have refused to do business with nonexempt subcontractors in order to avoid the obligation to withhold.<sup>414</sup> A broad withholding system reduces the possibility for making economic or business decisions based solely or primarily on a desire to avoid withholding.

It might be suggested that the disparity in the treatment of taxpayers caused by a narrow application of withholding could be eliminated, not by broadening withholding, but by abolishing it. This is not a realistic proposal, and no government would seriously consider doing away with withholding. Withholding plays an essential role in the administration and enforcement of the income tax, and withholding on wages and salaries is central to the imposition of the individual income tax.<sup>415</sup> In the United States, for example, "[t]here is probably universal agreement that the provisions for wage withholding form the backbone of . . . [the] income tax system and should be retained."<sup>416</sup>

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<sup>411</sup> See OECD, *supra* note 2, at 48; Hirao & Aguirre, *supra* note 101, at 310, 313; Dixon, *supra* note 100, at 36; JAPANESE TAXES, *supra* note 156, app. I at 271; Kaneko, *supra* note 22, at 32.

<sup>412</sup> Shoup, *supra* note 22, at 229 n.40 (citing Ryan, *Personal Income Tax . . .*, FRANKLY SPEAKING, April 1985, at 10).

<sup>413</sup> See *supra* notes 181-85, 301-02, 362-63 and accompanying text.

<sup>414</sup> See *supra* note 340 and accompanying text.

<sup>415</sup> See *supra* notes 97-118 and accompanying text.

<sup>416</sup> Vitez, *supra* note 111, at 204; see also Goode, *Implementing Tax Reform*, *supra* note 8, at 610.

## 2. Limiting the Scope of Withholding

The reasons that support broad withholding must be weighed against other considerations that require limiting the scope of withholding. It is neither practical nor feasible to extend withholding to all payments and all payors, and no country does so. Similarly, no country extends withholding to all payments of business income. The types of business payments subject to withholding are often limited for reasons relating to fairness to taxpayers, efficiency in withholding, and ease of administration.

Of the countries discussed in Section III, Egypt and Pakistan have the fewest limitations on withholding on business income. In Egypt withholding applies broadly to payments for goods and services and execution of contracts, although some payments are excluded from withholding because of the nature of the payor.<sup>417</sup> Egypt also makes extensive use of "reverse withholding," which increases the scope of withholding.<sup>418</sup> The provisions in Pakistan are somewhat narrower. "Reverse withholding" is much less widely used there, and the provisions for withholding establish thresholds for its application: Rs. 50,000 per year for supplies of goods, execution of contracts, and commissions, and Rs. 10,000 per year for services.<sup>419</sup> These thresholds increase efficiency by excluding small occasional payments, on which withholding is not cost-effective for the withholding agent or the tax administration. Thresholds are also a method for taking into account costs incurred by the supplier or provider.

Indonesia also has broad withholding provisions, but they are considerably narrower than those of Egypt and Pakistan. "Reverse withholding" is restricted to tax collection by the customs administration, and payments for goods are subject to withholding only when the government is the payor and the purchase price exceeds Rp. 50,000.<sup>420</sup> Payments by the government for services are also subject to the Rp. 50,000 threshold.<sup>421</sup> Indonesia's other provisions for withholding on fees for services are broader, but are limited to fees paid to individuals in specified professions and occupations and to fees for technical or manage-

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<sup>417</sup> See *supra* notes 276-90 and accompanying text.

<sup>418</sup> See *supra* notes 281-93 and accompanying text.

<sup>419</sup> See *supra* notes 244-45, 252-59 and accompanying text.

<sup>420</sup> See *supra* notes 211, 215-20 and accompanying text.

<sup>421</sup> See *supra* notes 218-21 and accompanying text.

rial services.<sup>422</sup> In some cases, the fees are subject to a threshold of Rp. 8,000 per day.<sup>423</sup>

The withholding provisions in the Philippines and Japan apply broadly to fees for services, but neither country provides for withholding on payments for goods or supplies or for “reverse withholding.”<sup>424</sup> The reasons for excluding payments for goods or supplies may relate to the difficulty in establishing a rate of withholding which is both fair and cost-effective. Because of the cost of goods sold, only a portion — the seller’s markup — of the gross payment is likely to represent income to the seller. Since it is not possible to establish a general rate that accurately reflects taxable profits from sales of goods, only a very low rate that prevents overwithholding in most cases is fair to taxpayers. On the other hand, the yield from such a low rate may not justify the work involved for withholding agents or the government. Besides Egypt, Pakistan, and Indonesia, only few countries (*e.g.*, Bangladesh, Colombia, Ghana, Israel, Malawi, Sudan, and Thailand)<sup>425</sup> provide for withholding on payments for goods or supplies.

The narrowest provisions for withholding on business income operate in the United Kingdom, Ireland, and Australia. In the United Kingdom only payments for work in the construction industry are subject to withholding.<sup>426</sup> In Ireland withholding is limited to certain professional fees paid by the government and to payments for work in the construction industry.<sup>427</sup> In Australia withholding applies only to payments for work within the prescribed industries.<sup>428</sup> The scope of withholding in the United Kingdom, Ireland, and Australia is further limited by exemptions from withholding granted to taxpayers with “good tax records.”<sup>429</sup> Such exemptions may significantly reduce the number of taxpayers affected by withholding. In the United Kingdom, about 650,000 (over 72%) of the approximately 900,000

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<sup>422</sup> See *supra* notes 222-31 and accompanying text.

<sup>423</sup> See *supra* notes 226-27 and accompanying text.

<sup>424</sup> See *supra* notes 126-47, 159-64 and accompanying text.

<sup>425</sup> See *supra* note 197 (listing source materials on withholding in Bangladesh, Colombia, Ghana, Israel, Malawi, Sudan, and Thailand).

<sup>426</sup> See *supra* notes 301-03, 317-18 and accompanying text.

<sup>427</sup> See *supra* notes 171-74, 342-48 and accompanying text.

<sup>428</sup> See *supra* notes 361-69 and accompanying text.

<sup>429</sup> See *supra* notes 323, 350, 378 and accompanying text. Such exemptions are not available under the provisions in Ireland for withholding on professional fees. See *generally supra* notes 171-77 and accompanying text (discussing withholding on professional fees in Ireland).

contractors in the construction industry are exempt from withholding.<sup>430</sup>

These exemptions are difficult to justify, except perhaps on political grounds. The exemptions create new opportunities for noncompliance and evasion and thus require increased vigilance and enforcement by the tax administration. Most of the problems experienced by the United Kingdom and Ireland with their first tax deduction schemes were due to misuse of exemption certificates. Abuses in both countries were so serious that they necessitated major changes in the legislation.<sup>431</sup> Abuse of exemption certificates in the United Kingdom before 1975 resulted in substantial losses of revenue and was so great that the withholding scheme virtually broke down.<sup>432</sup> Abuse of certificates issued to companies continued even after the scheme was tightened in 1977.<sup>433</sup> Misuse of exemption certificates is currently the principal known abuse of the tax deduction scheme in the United Kingdom.<sup>434</sup>

Exemptions from withholding also add complexity to a withholding system and increase the workload of tax administrators and withholding agents. Tax administrators must, for example, process applications for exemption, rule on them, cancel exemptions where appropriate, and defend their actions upon appeal by taxpayers. The Australian tax office had over 100,000 applications for exemption and variation certificates to process in 1983, when the Prescribed Payments System was introduced.<sup>435</sup> Withholding agents, in addition to their other obligations, must check the exemption certificates held by payees, fill out separate forms, and submit reports about payments from which no tax was withheld.

Finally, exemptions may cause unfairness to taxpayers not exempt from withholding. Exemptions that allow some contractors to defer payment of tax create disparities among taxpayers in the same sector of the economy, which may lead to competitive disadvantages for contractors not exempt from withholding. Exemptions may also result in discrimination against taxpayers not exempt from withholding, as in the United Kingdom where

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<sup>430</sup> Bale Letter, *supra* note 319.

<sup>431</sup> See *supra* notes 304-12, 344 and accompanying text.

<sup>432</sup> See *supra* notes 304-11 and accompanying text.

<sup>433</sup> See *supra* note 316 and accompanying text.

<sup>434</sup> See *supra* note 337 and accompanying text.

<sup>435</sup> See *supra* note 386 and accompanying text.



principal contractors have refused to enter into construction contracts with nonexempt subcontractors.<sup>436</sup>

The exemptions from withholding in the United Kingdom, Ireland, and Australia seem to be based on the assumption that withholding is a punitive measure that should be reserved for noncompliant taxpayers. Withholding, however, is simply a method for collecting the tax that is owed. It is inconceivable, for example, that a withholding system would exempt "good" taxpayers from withholding on their wages and salaries.

### *B. Accuracy in Withholding*

One of the difficulties in withholding on business income is determining how much tax should be deducted from a single payment. The notion of withholding is that the tax owed on a particular receipt of income is collected through withholding by the payor. The amount withheld should, in principle, equal or approximate the tax due on that income. Withholding the correct amount of tax is complicated by the progressive structure of most income tax systems. Even in flat rate systems, progressivity is built into the system through such devices as personal exemptions and deductions for dependents. In order to withhold the correct amount of tax from a single payment, a payor theoretically must know the recipient's total taxable income for the year and how much of the payment is net income.

The factors that make accuracy in withholding possible when tax is withheld from wages and salaries are not usually present when tax is withheld from business income. In an employment situation, there is a continuing relationship between the employer and employee, and the employer usually knows the annual remuneration of the employees. In most cases, few if any deductions are allowed from employment income,<sup>437</sup> so that gross compensation is usually taxable compensation. Graduated withholding tables take into account personal exemptions and certain other allowances, and can estimate fairly accurately the tax due. Thus, in most cases employers are able to withhold the correct amount

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<sup>436</sup> See *supra* note 340 and accompanying text.

<sup>437</sup> See, e.g., J. KAY & M. KING, *supra* note 77, at 30 (United Kingdom); Yoingco, *supra* note 121, at 47 (Philippines); Noël, *Contract for Services, Contract of Services—A Tax Perspective and Analysis*, in CANADIAN TAX FOUNDATION, REPORT OF PROCEEDINGS OF THE 29TH TAX CONFERENCE 712, 715 (1978) (Canada).

of tax from wages paid to employees.<sup>438</sup> The most finely tuned method for withholding on wages and salaries is cumulative withholding, which is used in the United Kingdom and Ireland.<sup>439</sup>

In contrast to wage and salary earners, persons engaged in business typically do not have a single or major source of income. They may receive payments from many different payors, with whom they may or may not have ongoing relationships. Payors ordinarily have no way of knowing the recipient's annual income or what portion of a payment is net income. Withholding is by necessity based on gross payment, which bears no uniform relationship to net income because of variable deductible expenses, such as overhead, wages paid to employees, and cost of materials or goods sold. Withholding is usually at a flat rate because graduated withholding is not feasible for payments of business income. Yet any single rate will result in underpayment of tax in some cases and overpayment in others.

Most of the countries discussed in Section III compensate for taxpayers' expenses and allowances by establishing either low rates of withholding or a reduced base for withholding. There is still the question of what the rate should be. On the one hand, the rate should be low enough to prevent overwithholding in most cases. On the other hand, the rate should be high enough to make withholding worthwhile for both withholding agents and the government. Even a token rate, however, might improve

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<sup>438</sup> For these reasons, some countries (*e.g.*, Colombia, Indonesia, South Korea, the Philippines) provide that the tax withheld from wages is the final tax on that income if certain conditions are met, *e.g.*, the employee has only one job during the year and no significant income from other sources. See McLure, *Analysis and Reform of the Colombian Tax System*, in TAX REFORM IN DEVELOPING COUNTRIES 44, 66, 68, 70 (M. Gillis ed. 1989); Morgan, *supra* note 206, at 214 (discussing Indonesia); MINISTRY OF FINANCE, KOREA, *supra* note 119, at 73; Chapter Philippines, *supra* note 121, at 87.

<sup>439</sup> CHANCELLOR OF THE EXCHEQUER, *supra* note 115, at 52. Under cumulative withholding, the tax deducted in a particular pay period is determined by total year-to-date earnings and apportioned allowances. The amount of tax withheld is the tax on total taxable earnings to date reduced by the tax previously withheld. Thus, at any point in the tax year, the amount of tax withheld by the employer is the appropriate proportion of the employee's likely tax liability for the entire year. In contrast, under a noncumulative withholding system, the amount of tax withheld during a pay period depends only on an employee's personal exemptions and earnings during that pay period. Previous earnings are not considered. Year-end adjustments are usually required in noncumulative withholding. *Id.* at 52-53.

compliance by bringing some taxpayers into the tax system.<sup>440</sup>

A higher rate may be intentionally set in some cases. For example, a higher rate may be appropriate if experience indicates that certain income is not reported properly. This was the case in the United Kingdom, where the Inland Revenue supported a higher rate for the Construction Industry Tax Deduction Scheme because many subcontractors in the industry did not file tax returns.<sup>441</sup> A higher rate may also be established to force taxpayers to reveal information about their operations to the tax administration in order to qualify for refunds.<sup>442</sup>

If accuracy in withholding on business income is not possible, then measures are needed to prevent hardship or unfairness to taxpayers caused by excessive withholding of tax. The countries in Section III prevent overwithholding in the long run by providing for a refund at the end of the year if the tax withheld exceeds the taxpayer's tax liability for the year. Some also have measures to prevent overwithholding in the first place or to grant taxpayers relief from overwithholding before the end of the year. Construction contractors in Ireland may obtain interim refunds,<sup>443</sup> and tax officials in Australia may authorize lower rates if withholding at the standard rate will result in the overpayment of tax.<sup>444</sup> Tax officials in the Philippines, Pakistan, and Indonesia may in certain cases exempt taxpayers from withholding.<sup>445</sup> Under the United States proposal for withholding, independent contractors could avoid overwithholding by instructing the payor not to withhold.<sup>446</sup>

"Reverse withholding" presents special problems of accuracy. One important difference between withholding and "reverse withholding" is the relation between the collection of tax and the receipt of income by the taxpayer. Under withholding there is a direct relation, because tax is deducted from a payment that presumably is taxable income to the recipient. The relation in the case of "reverse withholding" is more tenuous, because tax is

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<sup>440</sup> See ISSUES IN CLASSIFICATION, *supra* note 181, at 38.

<sup>441</sup> See *supra* note 338 and accompanying text (discussing rate proposals and underlying rationale).

<sup>442</sup> See Bird, *Income Tax Reform in Developing Countries: The Administrative Dimension*, 37 BULL. FOR INT'L FISCAL DOCUMENTATION 3, 6 (1983).

<sup>443</sup> See *supra* note 356 and accompanying text.

<sup>444</sup> See *supra* note 379 and accompanying text.

<sup>445</sup> See *supra* notes 141-42, 221, 249-51, 256-57 and accompanying text.

<sup>446</sup> See *supra* note 191 and accompanying text.

added to an expenditure made by the taxpayer, rather than withheld from the taxpayer's income. There may be an indirect relation, however, if the transaction is expected to result in taxable profits, as when importers, wholesalers, or retailers purchase goods for resale. There is also an indirect relation when tax is collected from persons renting commercial property or owning commercial transport vehicles. In these situations, the advance collection of tax may be justified on grounds of presumed or anticipated income, without regard, however, to the degree of the taxpayer's success.

Hardship or unfairness to taxpayers caused by "reverse withholding" may be prevented by measures similar to those described above with reference to withholding. For example, importers in Pakistan are exempt from "reverse withholding" if they are unlikely to have a tax liability for the year.<sup>447</sup> The question remains, however, whether it is fair to force taxpayers to pay tax when their circumstances do not clearly indicate the receipt of taxable income. The relatively infrequent use of "reverse withholding" suggests that many governments have decided this issue in taxpayers' favor.

### C. Selection of Withholding Agents

The scope of a withholding system is determined not only by the types of payments subject to withholding but also by the designation of withholding agents. For example, professional fees subject to withholding in Ireland are broadly defined, but the withholding provisions are narrow because only government agencies are required to withhold tax from such fees.<sup>448</sup> The same reasons that support broad withholding on all income also support withholding by all payors. Yet it is neither practical nor administratively feasible to require all payors to withhold. Limiting the withholding obligation to carefully selected withholding agents is necessary to insure the smooth operation and successful implementation of a withholding system.

Two basic principles govern the selection of withholding agents.<sup>449</sup> First, withholding agents should be fewer in number than the taxpayers from whom they collect tax. One of the advan-

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<sup>447</sup> See *supra* note 257 and accompanying text.

<sup>448</sup> See *supra* note 174 and accompanying text.

<sup>449</sup> See, e.g., L. YUDKIN, A LEGAL STRUCTURE FOR EFFECTIVE INCOME TAX ADMINISTRATION 32-34 (1971) (discussing basic principles of withholding).

tages of withholding is that it centralizes in withholding agents the responsibility for paying tax, thus reducing the number of tax payments to be processed.<sup>450</sup> This advantage is lost when the number of withholding agents approximates or exceeds the number of taxpayers, as would be the case if many small occasional payors were designated as withholding agents. Second, only "suitable persons" — those who have the necessary accounting and bookkeeping capabilities and are otherwise able to carry out the task of withholding — should be designated as withholding agents. Withholding agents must deduct the correct amount of tax, remit it to the government, file periodic returns, and account to taxpayers for the tax withheld. Withholding agents may also have additional responsibilities, as do some principal contractors in the United Kingdom, Ireland, and Australia who, for example, submit reports to the government about payments to subcontractors exempt from withholding.<sup>451</sup>

Wage withholding typically achieves the first objective of designating as withholding agents relatively few payors to collect tax from many taxpayers. In the United Kingdom, for example, roughly 1.2 million employers withhold tax from about 28 million wage and salary earners.<sup>452</sup> In Japan about 3.2 million employers withheld tax from about 34.9 million employees in 1983.<sup>453</sup> Wage withholding also realizes the second principle for designating withholding agents, since employers have proven capable of performing this function. Employers in the United Kingdom and Japan often withhold exactly the right amount of tax, thereby increasing the efficiency of withholding for the government. Under cumulative withholding in the United Kingdom, employers withhold the correct amount of tax for five out of six employees, requiring no adjustment at the end of the year.<sup>454</sup> Similarly, the "year-end adjustments" made by employers in Japan<sup>455</sup> mean

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<sup>450</sup> See ISSUES IN CLASSIFICATION, *supra* note 181, at 23.

<sup>451</sup> See *supra* notes 329, 353, 382-83 and accompanying text.

<sup>452</sup> CATA REPORT, *supra* note 102, at 10.

<sup>453</sup> Aoki, *National Taxation System*, *supra* note 24, at 121.

<sup>454</sup> CHANCELLOR OF THE EXCHEQUER, *supra* note 115, at 52. For a description of cumulative withholding, see *supra* note 439.

<sup>455</sup> JAPANESE TAXES, *supra* note 156, at 68. Employers must make year-end withholding tax adjustments when making the final salary payment of the year. The employer determines the total tax due on the salary paid during the year and adjusts the tax withheld from the last payment so that the total tax withheld during the year equals the employee's tax liability. Year-end adjustments are required with respect to all employees except

that the correct amount of tax is withheld from most employees, who therefore do not have to file returns.<sup>456</sup> In 1986, out of almost 50 million individuals who paid income tax in Japan, 42 million did so exclusively through withholding by their employers.<sup>457</sup> The tax administrations in the United Kingdom and Japan are thus spared the cost of processing final returns, issuing assessments, and making refunds in connection with the tax liabilities of most wage and salary earners. Indeed, in the United Kingdom, cumulative withholding has been compared to a “vintage Rolls Royce, which the [Inland] Revenue laboriously . . . maintains, which the employer is required to drive . . . and in which the taxpayer rides in reasonable comfort and for free.”<sup>458</sup>

In contrast, it is difficult for institutions and entities to play a role in withholding on business income comparable to that played by employers in wage withholding. Business income is more amorphous than employment income; it consists of many types of payments received for a variety of activities. Withholding on business income, therefore, often involves more withholding agents than does wage withholding. Persons making payments of business income who may, in principle, be designated as withholding agents fall into four categories: individuals, unincorporated enterprises (*e.g.*, self-employed individuals, partnerships), legal entities (*e.g.*, corporations, companies, institutions), and the government.

Countries that withhold on business income usually exclude as withholding agents individuals in their capacity as consumers, consistent with both principles mentioned earlier: individual con-

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workers employed on a daily basis and those whose annual salary exceeds ¥15 million. *Id.*

<sup>456</sup> JAPANESE TAX ADMINISTRATION, *supra* note 6, at 23. Out of 34.9 million wage and salary earners in 1983, only 3.8 million were required to file returns. Aoki, *National Taxation System*, *supra* note 24, at 121. The figures for 1982 are comparable: out of 33.8 million employees, 3.6 million were required to file returns. Aoki, *Survey*, *supra* note 24, at 445.

<sup>457</sup> H. ISHI, *supra* note 22, at 78. About 7.7 million individuals, including wage and salary earners whose annual earnings exceeded ¥15 million, were required to file returns in 1986. *Id.* This result was not what the tax reformers had in mind when the Japanese tax system was reformed after World War II. They did not intend that most of the individual income tax be collected through withholding, without employees being required to file returns. Shoup, *supra* note 22, at 221.

<sup>458</sup> INLAND REVENUE COMMISSIONERS, REPORT FOR THE YEAR ENDED 31ST MARCH 1977, 1978, CMMD. No. 7092, at 28.

sumers are too numerous and not sufficiently capable as a class to be suitable withholding agents. One important result of excluding individual consumers is that most retail establishments (*e.g.*, food and clothing stores, hotels, restaurants, dry cleaners, parking garages) remain unaffected by withholding. This is true even in countries with broad provisions for withholding on business income, such as Egypt, Pakistan, and the Philippines. Egypt, however, reaches many retail establishments through "reverse withholding," whereby suppliers add tax to the amount due for the goods supplied.<sup>459</sup>

Individual consumers in Japan and Australia are required to withhold in certain cases. In Japan individual consumers become withholding agents for business income if they are withholding agents for employment income.<sup>460</sup> In Australia homeowners who are "owner builders" are required to withhold from payments to contractors if the construction contract exceeds A\$10,000.<sup>461</sup> The rationale behind these provisions appears to be that individuals who serve as withholding agents for other purposes or engage in certain sophisticated transactions are suitable persons for withholding on business income.

Most countries designate unincorporated enterprises as withholding agents for withholding on business income. Individuals engaged in business in the Philippines, Japan, and Indonesia are required to withhold tax.<sup>462</sup> Similarly, individuals in the prescribed industries in Australia and individual contractors in the construction industry in the United Kingdom and Ireland must withhold.<sup>463</sup> Small unincorporated enterprises in Egypt are excluded as withholding agents, and individuals engaged in business there are required to withhold only in certain cases.<sup>464</sup> Self-employed individuals in Pakistan are not required to withhold, unless they are foreigners.<sup>465</sup>

In principle, self-employed individuals should be suitable withholding agents, since persons capable of managing a business should also be able to withhold tax from payments made in the course of business. Yet it may be advisable not to designate self-

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<sup>459</sup> See *supra* notes 281-83 and accompanying text.

<sup>460</sup> See *supra* note 165 and accompanying text.

<sup>461</sup> See *supra* note 376 and accompanying text.

<sup>462</sup> See *supra* notes 140, 165, 225, 228, 230 and accompanying text.

<sup>463</sup> See *supra* note 317-18, 346-47, 370 and accompanying text.

<sup>464</sup> See *supra* notes 279-80, 286 and accompanying text.

<sup>465</sup> See *supra* notes 246-47 and accompanying text.

employed individuals as withholding agents in certain cases. For example, if the books and records of certain enterprises are generally unreliable, they are likely to be inaccurate or unreliable for withholding purposes as well.<sup>466</sup> Similarly, self-employed individuals in a particular country or sector of the economy who are known for evading tax obligations might likewise evade withholding obligations.

Legal entities and government agencies are the most suitable persons for withholding and are widely used as withholding agents in those countries that withhold on business income. Legal entities usually include public and private sector corporations, as well as tax-exempt organizations such as educational institutions and hospitals. Some legal entities, however, are excluded as withholding agents, as are small private sector companies in Pakistan.<sup>467</sup> Government agencies in general are designated withholding agents in the Philippines, Ireland, Indonesia, Pakistan, and Egypt.<sup>468</sup> Only certain government agencies serve as withholding agents under the Construction Industry Tax Deduction Scheme in the United Kingdom.<sup>469</sup> In Australia's Prescribed Payments System the government is not specifically designated as a withholding agent. There, the government withholds only to the extent that persons outside the prescribed industries are required to withhold.<sup>470</sup> In other cases withholding is exclusively by government agencies. For example, payments for the purchase of goods in Indonesia and payments for professional services in Ireland are subject to withholding only when made by the government.<sup>471</sup>

A related issue, only mentioned here, concerns the compliance costs and compensation of withholding agents.<sup>472</sup> Withholding agents receive some compensation in that their costs are deduct-

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<sup>466</sup> See Bird, *supra* note 442, at 5.

<sup>467</sup> See *supra* note 247 and accompanying text.

<sup>468</sup> See *supra* notes 140, 174, 213-15, 220, 225, 246, 254, 279, 280 and accompanying text.

<sup>469</sup> See *supra* note 318 and accompanying text.

<sup>470</sup> See *supra* notes 375, 377 and accompanying text.

<sup>471</sup> See *supra* notes 174, 213-15, 220 and accompanying text.

<sup>472</sup> See generally CHANCELLOR OF THE EXCHEQUER, *supra* note 115, at 41; C. SANDFORD, M. GODWIN & P. HARDWICK, *ADMINISTRATIVE AND COMPLIANCE COSTS OF TAXATION 80-95* (1989); Godwin, Hardwick & Sandford, *PAYE: Costs v Benefits*, 94 *ACCOUNTANCY* 107 (1983); F. VAILLANCOURT, *THE ADMINISTRATIVE AND COMPLIANCE COSTS OF THE PERSONAL INCOME TAX AND PAYROLL TAX SYSTEM IN CANADA*, 1986, at 47-70 (1989).



ible in computing their taxable income and in that they have use of the tax withheld for some time before remitting it to the government. Beyond this, withholding agents are generally not compensated. The People's Republic of China, however, pays withholding agents a service fee of up to 3% of the tax withheld as compensation.<sup>473</sup> The Irish Commission on Taxation did not favor compensation for withholding agents because it could not "envisage any tailor-made method of compensation that would be both fair and simple."<sup>474</sup> Another view is that further compensation beyond the deduction and use of funds is inappropriate because the demands made on withholding agents are within the bounds of the just demands society makes upon its citizens.<sup>475</sup>

#### *D. Administration and Enforcement*

The various advantages of withholding can be realized only if the withholding system is correctly implemented by withholding agents and properly administered and enforced by the government. For their part, tax administrators must prepare and distribute forms, instructions, and informational brochures, and otherwise educate, advise, and supervise withholding agents. Tax administrators must also post the tax remitted to the correct taxpayer accounts, process returns filed by withholding agents, issue refunds, and enforce the system against noncompliant withholding agents. The work of tax administration is eased by withholding agents who fulfill their responsibilities correctly and with minimum supervision. Voluntary compliance by withholding agents is as important as voluntary compliance by other taxpayers.

From the government's perspective, withholding shifts the problem of noncompliance from taxpayers to withholding agents. Noncompliance by withholding agents includes the failure to withhold, understatement of income subject to withholding, and failure to remit the tax withheld. The government stands to lose

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<sup>473</sup> Li, *supra* note 119, at 169, 171; INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION, TAXES AND INVESTMENT IN ASIA AND THE PACIFIC, ch. China 116-18 (1989).

<sup>474</sup> IRISH TAXATION COMMISSION, *supra* note 342, at 134. The Commission recommended that the government and tax administration reduce compliance costs as much as possible by simplifying the tax system, as well as by simplifying forms and procedures, and providing adequate information to businesses. *Id.*

<sup>475</sup> L. YUDKIN, *supra* note 449, at 38-39.

in several respects if withholding agents do not comply. If they do not withhold at all, the government loses the benefits of withholding, although it may later collect the tax from the taxpayer or the withholding agent. If the agent withholds tax but does not remit it, the government may recover the tax from the agent. Whether or not the government recovers the tax from the withholding agent, however, it must usually give taxpayers credit for the tax withheld.<sup>476</sup> If withholding results in the overpayment of tax, the government suffers a further loss when it gives the taxpayer a refund, but is unable to recover the tax from the withholding agent.

Much of the known data concerning noncompliance by withholding agents relates to wage withholding, although there is some data relating to other types of withholding. In the United Kingdom audits were conducted of some employers and contractors required to withhold under the Construction Industry Tax Deduction Scheme.<sup>477</sup> The percentage of audits leading to the recovery of additional tax, including national insurance contributions, increased steadily from 33% in 1977 to 43% in 1981. At the same time, the yield from negotiated settlements resulting from audits increased from £9.1 million in 1979 to £14.6 million in 1981.<sup>478</sup> More recently, a 1986 report found irregularities in 24,000 out of 69,000 audits of employers; the tax recovered, excluding penalties, was £78.5 million.<sup>479</sup>

In Canada the problem of employer noncompliance was so serious that special legislation was enacted in 1981 making corporate directors personally liable in certain cases for tax withheld but not

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<sup>476</sup> See, e.g., *ABA Compliance Report*, *supra* note 12, at 367; see Kroft, *The Liability of Directors for Unpaid Canadian Taxes*, in CANADIAN TAX FOUNDATION, REPORT OF PROCEEDINGS OF THE 37TH TAX CONFERENCE 30:1, 30:13 n.52 (1986). An exception is Sri Lanka, where employees are not given a credit for tax withheld unless the employer remits it to the government. CATA REPORT, *supra* note 102, at 28.

<sup>477</sup> COMMITTEE ON ENFORCEMENT POWERS, *supra* note 116, at 301-03. About 13% of total inspections were audits of contractors in the construction industry. *Id.* at 302.

<sup>478</sup> *Id.* at 302-03 Tables 30, 31. The figures do not reflect amounts recovered on account of assessed penalties or national insurance contributions. *Id.*

<sup>479</sup> CATA REPORT, *supra* note 102, at 8. Penalties totalling £2.6 million were assessed in 2,700 cases, and 11 inspections resulted in criminal prosecutions. *Id.*

remitted.<sup>480</sup> Some Canadian industries had devised elaborate schemes to avoid remitting the tax withheld from employees.<sup>481</sup> From 1979 to 1981 the losses attributable to uncollectible source deductions involving inoperative corporations totalled almost Can\$18 million.<sup>482</sup>

In the United States the failure of employers to remit withheld employee taxes, both income and social security, is “[o]ne of the most persistent and difficult problems in collecting taxes.”<sup>483</sup> Since at least 1981, 35% to 40% of all tax delinquent accounts have involved employee taxes withheld but not paid over, comprising 40% to 45% of the amount due on all tax delinquent accounts.<sup>484</sup> From 1982 to 1987, the amount of employee taxes withheld but not remitted to the government increased 49%, from \$2.5 billion to \$3.7 billion.<sup>485</sup>

Other countries reporting employer delinquencies in connection with wage withholding include Zimbabwe, India, Sri Lanka, Fiji, Malta, and Kenya,<sup>486</sup> as well as Malawi, Malaysia, and Swaziland.<sup>487</sup> In Sierra Leone, public corporations, local authorities, and government-assisted educational institutions are among the employers failing to remit the tax withheld. The reason often given by these entities is that they retain the tax to offset grants or

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<sup>480</sup> See Kroft, *supra* note 476, at 30:14-:15; Ladd, *Verification and Collection Issues*, in CANADIAN TAX FOUNDATION, REPORT OF PROCEEDINGS OF THE 35TH TAX CONFERENCE 771, 775 (1984); Lefebvre & Lalonde, *Recent Issues in Tax Collection*, in CANADIAN TAX FOUNDATION, REPORT OF PROCEEDINGS OF THE 38TH TAX CONFERENCE 41:1 (1987).

<sup>481</sup> Kroft, *supra* note 476, at 30:14-:15. In some cases, corporations were formed to complete particular contracts, and they paid wages net of tax but made no payment to the government. By the time the government became aware of a potential problem, the contract was over and the company had gone out of business. In other cases, contractors formed three companies for their activities: one to hold fixed and other assets, another to obtain contracts and perform accounting services, and a third to provide labor. The second company obtained the contract and subcontracted the labor component to the third company for an amount equal to wages net of tax. *Id.* at 30:15 n.58 (citing internal memoranda prepared by Department of National Revenue).

<sup>482</sup> *Id.* at 30:14 n.57.

<sup>483</sup> *ABA Compliance Report*, *supra* note 12, at 367.

<sup>484</sup> *Id.*

<sup>485</sup> INTERNAL REVENUE SERVICE, U.S. DEP'T OF THE TREASURY, FACT SHEET NO. 88-3, EMPLOYMENT TAX EXAMINATION PROGRAM (1988).

<sup>486</sup> CATA REPORT, *supra* note 102, at 12-16, 27-33.

<sup>487</sup> CATA BACKGROUND PAPERS, *supra* note 119, at 71, 76, 140.

other amounts due them from the government.<sup>488</sup> Many countries have also experienced noncompliance by employees who, for example, overstate the number of dependents in order to reduce the amount of tax withheld by employers.<sup>489</sup>

Not much is known about the administration of withholding on business income in either developed or developing countries, and there is a dearth of published material on the subject. Thus, the extent to which taxpayers and withholding agents comply with withholding requirements is difficult to determine, and government enforcement efforts difficult to evaluate. Information about the overall results of withholding, however, is available. The data consistently show that withholding enhances taxpayer compliance.<sup>490</sup>

Developing countries seem to make greater use of withholding, and their withholding systems are often broader and more complicated than those of industrialized countries. Many of the withholding systems examined in Section III are those of developing countries. Indeed, the broadest provisions for withholding on business income are found in developing countries such as Egypt and Pakistan. This may seem paradoxical, since developing countries are often characterized by weak tax administrations<sup>491</sup> and are thus more likely than industrialized countries to have problems enforcing withholding requirements.

This paradox may be explained by the role played by third parties in the public and private sectors in implementing withholding. As discussed above, the effectiveness of a withholding system depends as much on the work of withholding agents as it does on enforcement by the government. To the extent that withholding agents perform their responsibilities, withholding results in the collection of tax and stimulates compliance. Even when withholding agents do not comply fully, withholding may still promote compliance if taxpayers believe that the government obtains information about their income from withholding agents.

It may be precisely because of their limited administrative

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<sup>488</sup> *Id.* at 124.

<sup>489</sup> CATA REPORT, *supra* note 102, at 41.

<sup>490</sup> See *supra* notes 96-118 and accompanying text.

<sup>491</sup> Bird, *The Administrative Dimension of Tax Reform in Developing Countries*, in TAX REFORM IN DEVELOPING COUNTRIES 315, 329 (M. Gillis ed. 1989). See, e.g., Gillis, *supra* note 237, at 80-81, 89 (discussing tax reform in Indonesia); McLure, *supra* note 438, at 63, 70 (discussing tax reform in Colombia).

capacity that developing countries rely more on withholding to collect tax and combat evasion. Because of difficulties in locating taxpayers, verifying returns, and enforcing payment, the tax collected through withholding may represent revenue which would otherwise be lost to the government. For example, Egypt's broad and complicated withholding provisions would probably be difficult for any government to administer. Much of the tax in Egypt, however, is collected through withholding and "reverse withholding," and the withholding provisions play an important role in the administration of the income tax there.<sup>492</sup> Egypt's withholding provisions are in accord with the view that "the key to success [of the income tax] in any country is as comprehensive a withholding system as possible."<sup>493</sup>

#### RECOMMENDATIONS AND CONCLUSION

This Article has examined tax evasion by self-employed individuals, the role of withholding in the administration of the income tax, and the use of withholding on business income by developed and developing countries. Withholding on business income is important, perhaps essential, for the successful use of the income tax. In a world of perfect compliance, withholding on business income promotes equity in taxation and reduces the disparity among taxpayers, especially between wage and salary earners and self-employed individuals. In a world of imperfect compliance, which is very much the case, withholding on business income reduces evasion. The Prescribed Payments System in Australia and the Construction Industry Tax Deduction Scheme in the United Kingdom are examples of withholding systems that have improved compliance and collected tax that otherwise would have been evaded. There is insufficient information about the other withholding systems examined in this Article to conclude with certainty that they have reduced evasion; more empirical research is needed to determine how the systems operate in practice. Where a country's experience with withholding has been documented, however, the data consistently show that withholding has improved taxpayer compliance.

Withholding on business income involves complex issues, and many policy decisions must be made in designing such a system. The withholding system must be suited to the particular country's

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<sup>492</sup> See *supra* notes 299-300 and accompanying text.

<sup>493</sup> Bird, *supra* note 491, at 329.

administrative capabilities and must take other factors into account, such as the level of literacy and the extent to which reliable accounting procedures are used. Whether or not the goal is a broad system for withholding on business income, the system should initially be limited to few types of payments and payors. The system can be expanded gradually to other payments and payors as withholding agents and the government gain experience in withholding on business income.

The scope of withholding should be limited to fees for services that are compensatory in nature and hence similar to wages. Withholding should not apply to payments for goods or supplies. To make withholding more cost-effective, it should be limited, especially at first, to relatively large fees, such as fees paid to independent professionals, persons in the entertainment business, and professional athletes. Withholding on professional fees in Ireland is an example of a narrow withholding system restricted to certain types of payments. As an alternative, withholding may be limited to payments within particular sectors of the economy, such as the construction industry, as in the United Kingdom and Ireland, or certain prescribed industries, as in Australia. A narrow withholding system is not as fair as a broad one that reaches most, if not all, taxpayers. Trade-offs and compromises are necessary, however, and a government must balance the objective of fairness with the goal of administrative feasibility.

The selection of withholding agents is perhaps the most important aspect of a system for withholding on business income. Withholding agents who properly perform the task of withholding can make the difference between a withholding system that is administrable and one that is not. The government, including government owned or controlled corporations, should be designated as a withholding agent on the theory that the government should both serve as a role model for other withholding agents and do as much as possible to help itself. Other suitable withholding agents are corporations and other legal entities, especially larger ones likely to have efficient accounting systems. In addition, persons already serving as withholding agents for other purposes, such as employers and financial institutions, should be designated as agents for withholding on business income. Individual consumers should be excluded as withholding agents, as should individually operated enterprises, especially if they are known for noncompliance or poor recordkeeping. Such enter-

prises, however, should be designated as withholding agents if they are employers required to withhold on wages.

The rate of withholding should be high enough to make withholding worthwhile for withholding agents and the government. The rate should also be tied to the income tax rates applicable to individual and corporate income, as in Japan, where the basic rate of withholding is the lowest marginal rate for individuals. A higher penalty rate should be established, as in Australia, for payees who do not identify themselves correctly. Only a few rates should be set in order to keep the withholding system simple and to prevent its manipulation by the recharacterization of payments. The tax withheld should be creditable against estimated tax payments and the taxpayer's liability for the year. A procedure should be available, similar to Australia's, whereby the tax administration may authorize a lower withholding rate to avoid overpayment of tax. Exemptions from withholding should be granted only to prevent overwithholding, not for other reasons such as "good tax records."

This Article does not generally recommend "reverse withholding." It could be used, however, to a limited extent to reach retail establishments, which are not affected by the usual provisions for withholding. If "reverse withholding" is used, it should be restricted to collection by government agencies or government-regulated companies, such as utilities, that have regular contact with, or supervisory authority over, retail establishments. For example, licensing boards might collect tax when issuing or renewing licenses.

These are recommendations for the essential features of a system for withholding on business income. There are many possibilities for designing such a system, and the specific features depend on the administrative, economic, and political circumstances of the particular country. In general, however, a broad system for withholding is more effective in securing compliance than a narrow one, and some withholding on business income is more effective than no withholding at all.

