RE: Withholding Tax: The A-Z of Grossing Up

(Rejoinder by Dr. Bode Oyetunde)

'Taxspectives' by **Afolabi Elebiju** | Originally published in *ThisDay Lawyer, 30th October 2012, p.12*

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In his article *'Withholding Tax: the A-Z of Grossing Up'*, published in *THISDAY LAWYER of February 16, 2010*, Mr. Elebiju considers grossing-up provisions in relation to withholding taxation. He disagrees with the view expressed elsewhere that contractual provisions that shift the tax burden of withholding taxes from the payee to the payer are illegal. Rather, he suggests that the incidence of withholding taxes may be determined by the bargaining power between the payer and payee in line with *TOTAL v AKINPELU.*

In *TOTAL v AKINPELU [2004] 17 NWLR (Pt. 903) 509*, the Court of Appeal held that a lessee of a property was required to pay, out of its own resources, the 10% withholding tax imposed under the Personal Income Tax Act (PITA), even though this tax liability was that of the lessor, as the recipient of the taxable income. The Court held that PITA's provisions could not frustrate the contractual agreement between the parties that the lessee should pay the 10% withholding tax on behalf of the lessor. In his lead judgment, Omage J.C.A. appeared concerned that the *"deduction of 10% withholding tax on the rent paid, reduces the rent in the hands of the lessor."*

With all due respect, the Court of Appeal erred in this decision. On the contrary, withholding taxes, like all taxes, *are specifically designed to and actually do reduce the value of income in the hands of the recipient*. Income taxes raise revenue for government by driving a wedge between the value paid by the payer and that received by the recipient. A withholding tax is essentially a compulsory unrequited payment to government levied on income and imposed at source whereby a third party is charged with the task of deducting tax from certain payments and remitting tax to the government. As modern taxing systems imposing personal and corporate income taxes were first introduced by the British in Nigeria prior to Independence, it may be useful to consider the development of the withholding tax under English law.

The origin of the withholding tax in England was examined at length by *Prioska E. Soos* in his seminal treatise on *"The Origins of Taxation at Source in England."* Soos traces the application of withholding tax in England to the early sixteenth century through pioneering use to collect levies on servants' wages and various clerical subsidies. As the 'backbone' of the individual income tax, Soos observes that withholding has become a central feature of the modern income tax and a principal means of collecting it throughout the world. Soos indicates that the essence of tax withholding is that the government collects the tax, not directly from the recipient of value, but from the payer of value, who deducts tax from income paid to the recipient. Soos notes that tax withholding is based on the agency principle in that the payer is merely a conduit who collects from the payee and pays it over to the government.

It is obvious that withholding tax is a tax on the income of the payee and not the payer. In an earlier case, the Court of Appeal placed this issue beyond cavil. In *7UP BOTTLING CO. PLC v. L.S.B.I.R [2000] 3 NWLR (Pt. 650) 565, Nzeako JCA* explained that *"the withholding tax system is a form of tax administration which enables tax authorities to recover at source from taxable persons tax from payment made for certain services which such persons render to another... Now if so deducted, when the taxable person's tax for the year is duly assessed, whatever had been deducted is credited to him in a manner that he does not pay tax twice on the same income accruing from that payment... Under both the PAYE and the withholding tax system, the employer or payer pays for the services of his employee/taxable person, by way of emolument or the cost of supplies or other services to a taxable person, is obliged to deduct and remit tax so deducted (from source) to the tax authority. He is the Agent of the tax authority as it were... It must be realised that the employer/person deducting the tax from source is not the assessable person or the tax-payer under the tax laws."*

This distinction is extremely important in sophisticated tax systems, high value commercial transactions and in international tax law situations. As *Nzeako JCA* rightly observed, whose levy the withholding tax is determines who would be entitled to tax credits. As the withholding levy has already brought the income of the recipient of value to tax, this party should be entitled to a tax credit when his global income is assessed for tax purposes to avoid double taxation in respect of the same income.

The identity of the source of income may very well determine whether liability to withholding tax arises at all. In the UK case of *WESTMINSTER BANK EXECUTOR AND TRUSTEE CO (CHANNEL ISLANDS) LTD v NATIONAL BANK OF GREECE* SA 46 TC 472, the identity of the recipient of value was critical in determining whether the interest payment in dispute had a UK source (thus liable to UK withholding tax) or a non-UK source (thus exempt from UK withholding tax). The House of Lords (as it then was) held that the interest had a non-UK source and as such was not liable to UK withholding tax despite contractual provisions requiring interest to be payable in London and the choice of English law as the governing law for the transaction. The court was persuaded by the facts that the loan obligation was undertaken by a principal debtor which was a foreign corporation, the loan was guaranteed by another foreign corporation which had no place of business in the UK, the loan was secured by foreign lands and public revenues and the discharge of the principal's debtor's obligation would have necessarily involved a remittance from Greece.

When transnational entities structure international transactions to take advantage of treaty relief to avoid double taxation, the incidence of any withholding tax is significant. Where a tax treaty provides relief against double taxation of cross-border payments, if the *exemption method* is used the country of residence exempts the foreign income in question from tax whereas where the *credit method* is used, the state of residence of the recipient gives credit for source state tax against tax imposed by the recipient's state of residence. If there are delays in processing treaty claims or other difficulties in accessing tax credits, a beneficiary of the exemption system will obtain the advantage of the time value of money over a beneficiary of the credit system.

In this regard, *grossing-up* is a useful tax planning tool and involves re-computing the net amount from which tax has been, or is deemed to have been, deducted to arrive at the original pre-deduction gross amount. In international debt transactions, grossing-up clauses are inserted to impose a requirement for the debtor to increase the amount of interest payable in the event that a withholding tax becomes payable such that the creditor receives the same amount after tax as would have been received without the imposition of tax. In relation to international employee secondments, grossing-up may be utilised in tax equalisation agreements to ensure that an employee's net salary is increased to take account of taxes imposed by the host State.

Returning to *TOTAL v. AKINPELU,* Omage J.C.A. stated there that *"it requires only the turn of the mind and a determination of the (lessee) to actually take the money from his purse... (and) to regard it as an extension of the agreed rent."* I beg to differ. What it does require is the *skilful turn of a tax-planner's pen* to draft an appropriate grossing-up clause, the operation of which is to increase the amount of the payment due to the recipient of value such that, after the application of any withholding taxes, the recipient is left in no worse economic condition than he would have been had the withholding tax not been levied. That was the position this author argued for in the *'Legality of Gross-Up Clauses in Nigeria'* article in Olaniwun Ajayi's *Legal Aspects of Finance in Emerging Markets*, contrary to Mr. Elebiju's views.

Although economic neutrality is an attribute of a good tax, taxes are by definition taxing in nature and the Revenue will insist on having its pound of flesh. In law, this pound will always be that of the taxpayer, who, for the purpose of withholding tax is the recipient of value, and not the payer. As Jean-Baptiste Colbert said, the art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the smallest possible amount of hissing. Whose feathers are plucked depends on the existence of an effective grossing-up clause to ensure that though the tax liability remains that of the payee, the economic burden falls on the payer of value.[1]

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[1]This was one of two rejoinders to my Taxspectives article, *'Withholding Tax: the A-Z of Grossing Up'*, published in *THISDAY LAWYER, February 16, 2010*.