

## **Background on U.S. Withholding Taxes**

**Definition:** In the international tax context, withholding taxes are the amount of tax required by U.S. law to be deducted by a company making a payment of interest, royalties or dividends from U.S. sources to a non-U.S. entity. The amount of the withholding tax is the payee's final U.S. tax liability on the income; the United States collects the tax by requiring the payor to withhold it from the payment of the income.

The rate of the withholding tax can be as high as 30% for payments to companies that are resident in a country that does not have a treaty with the United States, or zero if they the payees are resident in some countries that have more modern treaties (see appendix for list of countries and rates). Because the U.S. withholding tax is imposed on the gross amount of the income, it does not take into account the payee's expenses incurred in the production of such income. As a result, in the absence of relief granted by a bilateral treaty with the country in which the recipient resides, a taxpayer subject to these withholding taxes will face a potentially excessive effective rate of tax on the net income.

**History:** There was no withholding tax on payments to non-U.S. entities until 1937. At that time, Congress imposed a 12.5 percent withholding tax on all international payments. In 1942, as a temporary wartime measure, the withholding rate was increased to 30 percent. 65 years hence, the temporary withholding tax is a fixture of cross-border business except where it is lowered by the existence of a bilateral tax treaty or by statute.

***The Role of Tax Treaties:*** The United States has a long-standing policy of advocating the elimination or reduction of U.S. withholding taxes on interest and royalties via negotiation with its major trading partners. Bilateral tax treaties are basically roadmaps for clearly defining when one jurisdiction or another has the right to tax a cross-border payment. This effort to clearly define which party to the agreement is permitted to tax is aimed at avoiding double taxation – both parties taxing the same income -- and excessive taxation. At present, the United States has 58 such bilateral treaties. Many of the most recently updated treaties lower withholding taxes to zero but contain strict rules on the types of companies that qualify.