BANK OF FINLAND DISCUSSION PAPERS

8/90

Camilla Gustavsson

23.5.1990

TAXATION OF PERSONAL INTEREST INCOME IN 18 OECD COUNTRIES

SUOMEN PANKIN KESKUSTELUALOITTEITA • FINLANDS BANKS DISKUSSIONSUNDERLAG

Camilla Gustavsson
Bank of Finland Research Department
23.5.1990 8/90

TAXATION OF PERSONAL INTEREST INCOME IN 18 OECD COUNTRIES

Suomen Pankin monistuskeskus
Helsinki 1990
ISBN 951-686-247-0
ISSN 0785-3572

ABSTRACT

This paper compares the taxation of personal interest income in different countries with a fairly standardized point of view. The paper is based on the answers to a questionnaire sent to central banks in 17 OECD countries, and on the facts on the taxation of interest income in Finland. It focuses on the situation in 1989, but some information on systems prevailing in 1990 is also given.

CONTENTS

1	INTRODUCTION		7
2	GENERAL RULES APPLIED IN TAXING RESIDENTS' DOMESTIC INTEREST INCOME		9
	2.1	No tax on personal interest income	9
	2.2	Withholding tax on personal interest income	10
	2.3	Taxing interest income as personal income	12
	2.4	A combination of personal income tax and withholding tax on personal interest income	16
3	TAX EXEMPTION OF INTEREST INCOME		20
	3.1	Tax-exempt debt instruments	20
	3.2	Tax-exempt quotas in personal interest income	27
4	SPECIAL SAVING SCHEMES		30
5	TAX DEDUCTIBILITY OF INTEREST EXPENSES		33
6	TAX TREATMENT OF INTERNATIONAL FLOWS OF INTEREST INCOME		37
	6.1	Taxation of residents' foreign interest income	37
	6.2	Taxation of interest payments to non-residents	41
7	SUMMARY		45
	APPENDIX: SUMMARY TABLES		49 - 55

1 INTRODUCTION

Differences between countries in the taxation of capital income are a potentially important determinant of international capital movements. This is all the more true following the liberalization of cross-border capital movements in recent years. The present study seeks to compare the taxation of interest income in different countries from a fairly conventional point of view. The study focuses on the taxation of personal interest income; the taxation of dividends and corporate income are not considered here at all.

The recent wave of tax reforms in the OECD countries has made much of the existing literature on the systems of capital income taxation out of date, and therefore the questionnaire method seemed to be the best approach for the purposes of this study.

This preliminary report is based on the answers to a questionnaire sent to 17 central banks in the OECD countries, and on the facts on the taxation of interest income in Finland. The survey was carried out in November - December 1989. It focuses on the situation in 1989, but some information on systems in 1990 was also obtained.

The countries covered in this study were: Australia, Belgium, Canada, Denmark, Finland, France, the Federal Republic of Germany, Iceland, Italy, Japan, the Netherlands, Norway, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.

The paper is organized as follows. In section 2 there is a short description of the general rules applied in the 18 countries as regards the taxation of residents' domestic interest income. The countries are divided into four broad categories according to the main way in which they tax residents' domestic interest income: no

tax, a withholding or other similar[1] tax, taxing interest income as personal income and a combination of the latter two systems, i.e. both personal income tax and withholding tax. Section 3 lists the exceptions to the general rules, i.e. the occurrence of tax-exempt debt instruments (including partial tax-exemption and reduced rate of tax) and tax-exempt quotas in personal interest income. In section 4 we describe various special saving schemes whereby savings up to a given amount are deductible from taxable income. The tax deductibility of interest expenses is described in section 5. In section 6 we deal with the tax treatment of international flows of interest income, i.e. the taxation of residents' foreign interest income and the taxation of interest payments to non-residents. The paper contains five summary tables providing a more general picture of the taxation of personal interest income.

---

[1]Hereafter, for convenience, referred to as a withholding tax.

2 GENERAL RULES APPLIED IN TAXING RESIDENTS' DOMESTIC INTEREST INCOME

Our study suggests that although the tax treatment of residents' domestic interest income varies among countries, there are certain similarities in the general rules applied.

In this section we describe the various kinds of general rules or approaches applied in the taxation of personal interest income. Four main ways of taxing interest income can be distinguished:

(1) no tax,
(2) a withholding tax,
(3) taxing interest income as personal income, and
(4) a combination of personal income tax and withholding tax.

2.1 No tax on personal interest income

Of the 18 OECD countries covered in this study, only one country - Iceland - does not tax any kind of interest income. Iceland justifies this general tax-exemption on the grounds that interest income over a long period has mainly represented compensation for inflation. In the 1970s and 1980s, average annual inflation in Iceland ranged from 7 to 84 per cent (the peak occurred in 1983).

Iceland is, however, planning to change the taxation of interest income of individuals. According to the proposal, real interest income received will be subject to income tax. The tax will be collected on a withholding basis. However, the withholding tax will only be a payment towards the final tax, which will be levied on the basis of an income tax assessment in the same way as employment income is now.

2.2 Withholding tax on interest income

There are four countries in our sample in which personal interest income is taxed mainly by means of a withholding tax. These countries are Belgium, Italy, Japan and Turkey. In the following we briefly describe the actual domains and rates of withholding tax in these countries, as well as recent and forthcoming changes in the taxation of interest income.

Belgium. In principle all domestic and foreign interest accruing through a financial institution located in Belgium and all interest paid by a resident debtor are subject to a 25 per cent withholding tax. The individual taxpayer may mention this income in his income-tax return, but he is not obliged to do so. In practice, this is done only by the few people whose marginal tax rate is lower than 25 per cent. However, Belgian interest income exceeding BEF 490 000 (after deduction of the withholding tax) is subject to a complementary 25 per cent tax, unless the income is reinvested in specified forms. Before 1989, the complementary tax was calculated in a different, progressive way.

From March 1, 1990 the withholding tax on interest on new debt will be lowered to 10 per cent. The rate will remain at 25 per cent for dividends and on previously issued debt.

Italy. Interest income represents one of the main exceptions to the principle underlying the Italian Tax Reform of 1974 according to which revenue from any source should be subject to the progressive personal tax (IRPEF). Nearly all kinds of interest income are subject to a special regime, based on a withholding tax, implemented by the legal obligation, imposed on interest payers, to withhold the tax at source. Under a general rule, interest income is then subject to a proportional withholding tax. However, this is only the case as far as personal income tax is concerned.

The main tax rates are as follows:

Bank and Post Office current accounts	30 %
Saving accounts and certificates of deposit	25 %
Treasury Bills and other Government securities; bonds[2] issued by Special Credit Institutions and by the non-state sector (public corporations, etc.)	12.5 %
Bonds issued by private companies and by non-residents	30 %
Investment Funds[3]	0 %

In Italy, only interest from private loans is included in the personal income tax base. In this case the withholding tax (15 per cent) is compensated for by a corresponding tax credit on IRPEF.

No significant changes have taken place recently in the taxation of interest income in Italy. However, the Italian authorities point out that the completion of capital movements liberalization and the related questions of fiscal hamonization in the European Community concerning the taxation of interest income call for important changes. In this regard, Italy has backed the Commission's proposal for the application of a uniform withholding tax on interest income at Community-wide level.

Japan. Interest income is subject to a separate 15 per cent withholding tax and a separate 5 per cent withholding resident tax. (The separate withholding tax rate applied to redemption gains on discount financial debentures and discount government bonds is 18 per cent).

Interest income is taxed at source at the rate of 20 per cent (15 per cent income tax and 5 per cent resident tax) and is excluded

---

[2]As regards fiscal treatment, saving certificates and certificates of deposit with a maturity of at least 18 months are assimilated to other bonds.

[3]No withholding tax is levied on yields distributed by Investment Funds to individuals: taxes are withheld at source on interest received by the Funds.

from taxable personal income when filing a return. Prior to April 1988, interest income was, in principle, subject to a composite tax (20 per cent of it was withheld at the time of payment) and, at the taxpayer's option, a separate withholding tax at the rate of 35 per cent was applied (but exempted from resident tax).

Turkey. In principle, all interest income is subject to tax. Personal interest income on bank deposits denominated in both Turkish lira and foreign currency and on corporate paper is subject to a 10 per cent withholding tax.

2.3 Taxing interest income as personal income

The most common general rule applied in taxing personal interest income in the OECD countries is that of taxing interest income as personal income; that is adding interest income to the personal income tax base. It is observed that in most of the countries applying this principle, interest income is added to personal income after first making certain interest-income related deductions. However, in Australia, Canada and the United States there are no interest-income related deductions.

The taxation of interest income at the rate applicable to the taxpayer's total income implies that if total income is less than the standard deductions and credits allowed under the tax system, no tax will be charged on interest income.

The taxation of interest income differs most from ordinary personal income tax treatment in Denmark and Norway. In Denmark, all interest income is taxed in personal taxation at a standard rate. In Norway, separate taxes exist for net and gross personal income. Interest income is added to net personal taxable income after an interest-related deduction is made.

In Finland and Switzerland a withholding tax is applied to interest income. The withholding tax is, however, credited in final income tax as interest income is declared in the tax return.

In the following we describe the taxation of interest income in more detail, country by country.

Australia. The general rule applying to interest income is that it is assessable income, irrespective of its source, and is taxed at the taxpayer's marginal tax rate.

However, under provisions enacted on 25 November 1988, individuals will be required to quote their tax file numbers when making new investments or opening new accounts on or after 1 July 1991. Failure to do so will result in the application of withholding tax on payments of income at the top marginal rate of personal income tax (which, effective from 1 January 1990, is 47 per cent) plus the Medicare levy (1.25 per cent).

Canada. In general, all categories of interest income are taxable as personal income. The tax rate depends on the taxpayer's total taxable income. Specifically, at the federal level, the tax rates on personal income range from zero per cent (for taxfilers whose total income is less than the standard deductions and credits that are allowed under the tax system) through three brackets of 17 per cent, 26 per cent and 29 per cent.

Denmark. All categories of interest income are taxable in personal taxation at a standard rate of 50 per cent. However, this 50 per cent standard rate is lower than the marginal rates applied to other kinds of personal income, which in most cases are about 68 per cent.

Finland. The general rule as regards the taxation of interest income is that it is taxed as personal income. However, there is a tax at source (0, 25 and 50 %) on interest income subject to tax. The withholding tax rate depends on the amount of annual interest income subject to tax (1989: FIM 0-2000=0 %, FIM 2001-18000=25 %, FIM 18000 and more=50 %. 1990: FIM 0-2000=0 %, FIM 2001-38000=25 %, FIM 38000 and more=50 %).

The tax paid at source is compensated for in personal income taxation, which means that the final tax is equal to the personal income tax. Note, however, that interest income on most assets is currently tax-free.

Germany. At the beginning of 1989 a 10 per cent withholding tax on interest income from domestic sources was introduced. However, this tax was subsequently abolished. As from July 1, 1989 interest receipts are no longer taxed at source, but are instead added to other personal income components, after having made the deductions allowed.

The Netherlands. Net interest income (interest income - interest expenses) is added to personal income. The same increasing marginal tax rates apply; there are no special rates or deductions. There is, however, an allowance for tax-free personal income. For married couples, personal interest income is added to the income of the spouse who has the higher employment income.

The amount of taxable income is computed as follows:

Taxable income = taxable income from non-interest sources
+ MAX (net interest income minus NLG 1 000 or NLG 2 000, 0)
- tax-free personal income

Norway. Interest income is included in net personal income, after an interest-income deduction is made. Net personal income is the sum of employment and capital income, with a number of deductions for expenses (incurred in acquiring or maintaining taxable income) allowed. The flat local tax and the progressive "net tax" are based on that concept.

There is also a tax on gross personal income. Gross personal income is equal to employment income, with no deductions. Two kinds of taxes are based on that concept, namely a progressive "gross tax" and a flat premium to the National Insurance Institution. In 1989 the marginal tax rate on interest income (net personal income) is 45.6 per cent and on employment income (gross personal income) 62.0 per cent.

Sweden. Interest income is added to personal taxable income, after making the deduction allowed.

It is planned to implement a major tax reform in Sweden as from 1991. According to the proposal, in 1991 all categories of interest income

will be taxed at a 30 per cent withholding rate. Interest income from National Saving Schemes will, however, be taxed at a rate of 20 per cent.

Switzerland. The general rule as regards the taxation of interest income is that interest income is taxed as personal income. However, there is a tax at source of 35 per cent on all interest income paid to residents, with some exceptions. There is no withholding tax on interest income deriving from private loans. Neither is withholding tax applied to interest income, not exceeding CHF 50 per annum, deriving from personal savings account.

The tax at source is refunded once the taxpayer has declared the interest income as personal taxable income. This means that the final tax is equal to the personal income tax.

The United States of America. As a general rule, interest income to taxpayers subject to the federal personal income tax is included as part of the calculation of taxable income (income net of deductible expenses and personal exemptions). Income is taxed at the federal level on a marginal tax rate schedule with three rates of 15 per cent, 28 per cent, and 33 per cent. Many states also have income taxes that apply to interest income, at various rates generally at or below 10 per cent.[4]

2.4 A combination of personal income tax and withholding tax on personal interest income

In addition to the "pure" tax-systems mentioned above in this section, some countries apply a combined tax system to interest income. This means that some combination of personal tax and withholding tax is applied in taxing interest income. The combining can be done in various ways. In France the taxpayer can choose between either adding interest

---

[4]Federal tax may be withheld from interest paid by bank and thrift institutions and others, at the specification of the recipient. This withholding tax is not mandatory, however, unless the federal government has shown the recipient to have violated the tax laws applying to interest income in the past.

income to other personal income or letting the tax paid at source be final. However, the right to opt between these two tax systems is restricted to certain assets.

Another way of applying a mixed tax system exists in the UK and Spain. Currently in the UK tax paid at source is not refunded, but this will cease to be the case from April. Furthermore, the tax is not applied to all categories of investment income, and with effect from January 1991 a new type of account offering tax-free interest, within limits, will be available from banks and building societies. In Spain tax paid at source is usually refunded. There are, however, certain one to three-year financial assets for which tax paid at source is final.

France. In principle, interest income is taxed as personal income. As regards interest income on bonds and certain other interest-bearing investments, the investor may opt between either having the tax withheld at source (this tax at source would then become the final tax on the interest income) or including the interest income in his total taxable income subject to the normal graduated rates of personal income tax. As regards interest income on negotiable loan (money market) instruments (certificates of deposit, Treasury bills,[5] Treasury notes,[6] which are issued for a minimum period of 10 days and a maximum period of 7 years), the taxpayer may choose between either adding interest income to personal income or taxing it at source at a final rate of 32 per cent.

As regards interest paid on bons de caisse the taxpayer may choose between either adding interest income to personal income or taxing it at a final 45 per cent (registered bons de caisse)[7] or 50 per cent

[5]Billets de trésorerie, which are issued for a minimum period of 10 days and a maximum period of 2 years. They may not be issued by banks or other approved credit institutions.

[6]Bons du Trésor en compte-courant, which are loans issued by the French Treasury. They are, in contrast to other Treasury notes, not evidenced by a certificate. These loans are taken out for a maximum period of 7 years.

[7]Bons de caisse are loan instruments frequently issued by banks. They may not be issued for a period exceeding 5 years.

(bearer _bons de caisse_) tax at source. However, resident individuals pay an additional social contribution tax, which increases the withholding tax rates by 2 per cent.

The French tax-system will, however, change in 1990 as follows:

From 1 January 1990 a tax at source will be applied to fixed interest income assets, at a rate of 15, 35 or 50 per cent depending on the underlying assets (securities).

A 15 per cent withholding tax will be applied to:
- interest income on bonds, negotiable (interest-bearing) certificates of claim, certificates of participation, shares in mutual funds obtained from 1 January 1990 onwards.

A 35 per cent withholding tax will be applied to:
- yields on investments other than short- and long-term, interest-bearing securities, from 1 January 1990;
- yields on short- and long-term securities issued from 1 January 1990 onwards.

A 50 per cent withholding tax will still be applied to interest income on bearer securities (paper).

Spain. Under current Spanish fiscal legislation, all categories of interest income, whether explicit or implicit, and of repayments related to financial assets (shares, bonds, all categories of bank accounts, bills, notes, Government debt, etc.) are subject to the personal income tax. The applicable tax rate can range from 0 to 56 per cent. But as a rule, a 25 per cent withholding tax (raised from 20 to 25 per cent in July 1989) is applied to all categories of interest income from financial assets. This tax is credited to the Treasury by the payer and may be subsequently deducted by the payee from his annual tax return, in which this income is included in the total tax base. However, there is a special category of one to three-year financial assets issued at a discount by financial institutions and certain non-financial companies. A single 55 per cent withholding tax is applied to these financial assets on the difference between the amount received and the amount to be repaid at maturity. This difference must not be included as income in the annual tax return.

Treasury bills, notes and other securities issued by the Treasury or the Bank of Spain as money market regulating instruments, are all free from the withholding tax.

The United Kingdom. The following summary starts by describing the situation in 1989 and then goes on to discuss the substantial changes which are to take effect in 1990 and 1991.

In general, interest income is subject to tax at the taxpayer's marginal rate (currently 0, 25 or 40 %), but there are significant exceptions. Interest on retail bank and building society deposits by UK residents is subject to composite rate tax or CRT. The rate of CRT is currently 21.75 per cent (is to be 22 per cent in fiscal year 1990 - 1991, i.e. from 6 April 1990), being less than the basic rate of income tax (25 %) in recognition of the fact that some individuals paying CRT have a marginal tax rate of zero. Those liable to tax at the higher rate of 40 per cent are assessed to tax on the balance of 15 per cent (40 - 25), but those not liable to tax cannot reclaim the 21.75 per cent deducted. Interest paid to resident individuals on holding government and corporate bonds is usually subject to a withholding tax at a rate of 25 per cent (however certain government securities held on the National Savings Stock Register pay interest gross). Those subject to tax at the higher rate are assessed on the balance of 15 per cent but those with a marginal tax rate of zero can reclaim the withholding tax. Some national savings instruments offer a return which, whilst taxable, is not subject to a withholding tax. These instruments are obviously relatively attractive to those with a marginal tax rate of zero.

With the exceptions mentioned above, interest income is simply added to other (e.g. employment) income in the determination of an individual's tax liability. A wife's interest or investment income is assessed as that of her husband, so if the husband has a higher marginal tax rate than his wife, then their joint interest income (and other investment income) is subject to the higher of the two rates.

With effect from 6 April 1990 married couples will be subject to independent taxation. Each member of the married couple will be subject to tax on his/her individual total income, including interest

and other investment income. Thus, for example, if one member of the couple is in receipt of investment income below the personal tax allowance (GBP 2 785 per annum in 1989 - 1990) and has no other income, then there will be no tax liability on that income (other than possibly CRT) irrespective of the circumstances of their spouse.

From April 1991 CRT is to be abolished. Tax payers will be subject to a withholding tax at the basic rate of income tax. There will be arrangements whereby non-tax payers will be able to receive gross interest, but any non-tax payers unable to take advantage of these arrangements will be able to reclaim the tax withhold. From January 1991 new Tax Exempt Special Savings Accounts (TESSAs) are to be introduced. These are described in Chapter 3.

3 TAX EXEMPTION OF INTEREST INCOME

All of the countries in the sample allow tax exemptions of some kind or another. There may be totally tax-exempt debt instruments, partially tax-exempt debt instruments, reduced tax rates and/or tax credits. In some countries interest (capital) income up to a given nominal amount is deductible from taxable income (interest/capital income deduction).

Many of the debt instruments whose interest income receives preferential tax treatment are connected to savings for retirement, education or home ownership. The interest income of young people and small savers is also often treated in a more favourable way.

In the following we deal with those countries where there are or have recently been categories of interest income receiving preferential tax treatment.

3.1 Tax-exempt debt instruments

Tax exemption is defined broadly here. It also includes preferential tax treatment, such as partial tax exemption and reduced rate of tax. Some of these tax-exempt debt instruments are connected with the status of the recipient. In other words, all recipients are not entitled to the same favourable tax treatment.

Australia. There are no tax-exempt debt instruments. The government provides concessional tax treatment to superannuation schemes that comply to certain standards. These schemes are subject to tax at 15 per cent on their income, in the hands of the funds (as opposed to the 39 per cent company tax rate). Benefits paid in the form of lump sums are subject to tax at concessional rates, depending on the age of the recipient. Pension benefits are taxed as ordinary income.

Friendly societies and life insurance funds are also subject to special rates of tax. The investment income of friendly societies is subject to tax at the rate of 30 per cent while life offices are taxed at 39 per cent. Benefits received after 10 years, from both sources are exempt from tax in the hands of the individual.

Belgium. There are totally tax-exempt debt instruments (case 3 below), partial tax-exempt debt instruments (case 1) and debt instruments subject to a reduced rate of tax (case 2).

(1) Interest income on ordinary saving accounts is tax-exempt up to BEF 50000, and interest paid by cooperative societies is tax-exempt up to BEF 5000.

(2) The withholding tax rate is 20 per cent rather than 25 per cent on interest paid on special government bonds issued in 1981.

(3) Income on certain well-specified pension-saving accounts is tax-exempt.

Canada. There are a number of special saving schemes connected with retirement and education in which interest income can accrue without being subject to tax at all.

For persons, the federally-sponsored schemes include:

(1) The Registered Pension Plan, the Deferred Profit Sharing Plan and the Registered Retirement Savings Plan, all of which allow taxpayers to save for retirement.

(2) The Registered Education Savings Plan, which allows taxpayers to accumulate funds to pay for post-secondary education.

There also used to be a Registered Home Ownership Savings Plan, but this was terminated in 1985.

Denmark. Interest income on accumulated savings for retirement is not subject to personal taxation. Income from accumulated pension savings are, on the other hand, subject to a special real interest tax. The tax rate is set annually so as to allow an average after-tax real return of 3.5 per cent.

Apart from interest income on accumulated savings in pension schemes, there are no special saving schemes receiving preferential tax treat-

ment. However, savings for housing and education receive a government subsidized premium of 4 per cent per annum. A maximum of DKK 10000 can be deposited a year on accounts entitled to receive a premium.

Finland. There are totally tax-exempt debt-instruments (cases 1 - 5 below) and a special home saving scheme under which the extra interest paid in addition to "normal interest" is also tax-free.

The following debt instruments are totally tax-exempt:

(1) Ordinary deposit accounts, provided that the annual interest rate on such deposits is not higher than the Bank of Finland's base rate less four percentage points (1 January 1990: Base rate = 8.5 %).

(2) 24-month fixed-term deposits made between 1.1.1988 - 30.11.1989 provided that the annual rate of interest on the deposit is not higher than the base rate less two percentage points. Interest income on 24-month fixed-term deposits made in 1990 is tax-exempt if the annual rate of interest on the deposit is the base rate less one percentage point.

(3) Tax-exempt deposits made before the end of 1988 are tax-exempt until they mature.

(4) Bonds are tax-exempt, provided that (a) a decision on tax-exemption is made by the government, (b) the loan period of the bond is exactly 10 years, and (c) the annual interest rate of the bond is not higher than the base rate. This clause applies to bonds issued between 1.12.1989 - 31.12.1990; before, the tax-exemption required that the interest rate was not higher than the base rate less one percentage point. The government issues tax-exempt bonds regularly and has also allowed mortgage credit institutions to issue small amounts of these bonds.

(5) Tax-exempt bonds issued before 1989 will remain tax-exempt until they mature.

Apart from these totally tax-exempt debt instruments there is a special home saving scheme for young people which receives preferential tax treatment. The interest rate on home saving deposits is the base rate less 4.25 percentage points (currently 4.25 per cent).

The financial institution where the deposit is held pays additional interest at a rate of 1.25 per cent on deposits for the first five years. This means that the home saver receives tax-exempt interest income of 5.5 per cent on his home saving deposits. In addition to this, the State pays a home saving premium of FIM 4 500 once the home is purchased. This premium is raised by FIM 800 for each child living in the same household as the home saver.

France. Most of the debt instruments receiving preferential tax treatment in France are partially tax-exempt. Only in the case of home-ownership savings is the interest income compound totally tax-exempt.

(1) Interest income on certain, so-called CODEVI, deposits made at a bank or a savings banks (Caisses d'Epargne) is tax-exempt, but only up to FRF 10 000 per person. The interest paid is regulated at 4.5 per cent.

Interest income on certain deposits made at savings banks, post offices or mutual credit institutions (Credit Mutuel) is tax-exempt, but only up to FRF 80 000. The interest paid is 4.5 per cent.

(2) Interest income on French fixed-interest bonds is tax-exempt up to FRF 8 000 (single persons) or FRF 16 000 (married couples).

(3) Interest income on Government bonds issued in 1977 with an interest rate of 8.8 per cent is tax-exempt up to FRF 1 000 per household.

(4) Interest income on certain home-ownership savings.

(5) Interest income on certain well-specified pension-savings accounts, where the deposited amount is limited to FRF 600 000 per person, is tax-exempt if the money deposited is not withdrawn earlier than two years before the maturity date.

Germany. There are some totally tax free debt instruments. The following are non-taxable:

(1) Yields on long-term life-insurance contracts (i.e. contracts for 12 or more years), and

(2) Yields on special bonds issued before 1955.

Italy. There are quite a lot of totally tax-exempt debt instruments. The debt instruments the interest income on which is exempt from tax are:

(1) Government securities issued abroad.

(2) Bonds issued abroad by international organizations (B.E.I., B.I.R.S., C.E.C.A., EURATOM, etc).

(3) Government securities issued before 20 September 1986.

(4) Bonds issued by Special Credit Institutions from 3 July 1980 to 30 September 1982.

(5) Private sector bonds issued from 31 December 1980 to 30 September 1982.

Japan. There is a tax-exemption system for small personal savings and an incentive programme for employees' property formation.

The tax-exemption system for small savings changed in April 1988. Prior to that date, the system was open for any person who wished to take advantage of it. Today, the tax-exemption system for small savings is available for persons aged 65 years or over, bereaved wives of basic pension beneficiaries, beneficiaries of widow's annuity, and officially-designated physically handicapped. Under this system, interest and profit distributions received on personal savings in the following three forms

(1) bank deposits,

(2) joint trusts (loan trusts, money trusts), and

(3) securities (bonds and investment-trust beneficiary certificates) with a principal up to JPY 3 million are exempt from income tax.

The incentive programme for employees' property formation is built upon several pillars so as to encourage employees' voluntary saving and to promote home ownership. Under this system, interest paid on

savings principal up to JPY 5 million under an employee home saving contract is exempt from taxation if the necessary steps are taken to qualify for such tax exemption.

The Netherlands. Interest income on capital assurance is not taxed under certain circumstances. Besides this tax-exemption, there are some special saving schemes which receive extra, tax-free interest (interest premium).

The special saving schemes receiving extra, tax-free interest are:

(1) The youth saving scheme, on which extra interest of 10 per cent is paid (1989). This premium is tax-free. A maximum amount of NLG 480 can be saved each year for children between 15 and 27 years of age.

(2) Some special saving schemes in firms or governmental organizations. Only the premium is tax-free, and there is a maximum premium of NLG 750 per person per year per job.

(3) Some other forms of saving pay a tax-free premium as well: a special law (Wet Bezitvormingsfonds) subsidizes these savings.

Norway. There are no tax-exempt debt instruments.

Spain. As from 31 December 1989 there are no tax-exempt debt instruments. Until that date, interest income on electricity bonds was granted a 95 per cent tax allowance.

Sweden. There are three kinds of debt instruments receiving tax-exempt interest: the National Saving Scheme, the Youth Saving Scheme, and saving certificates (partial tax-exemption).

(1) As regards the National Saving Scheme (allemanssparande) the monthly deposits should not exceed SEK 800 per adult person, and the total deposits should not exceed SEK 75 000. The government-stipulated interest rate is for the time being the discount rate less 1 per cent, which is currently 8.5 per cent.

(2) The Youth Saving Scheme was introduced in 1988. The minimum interest rate is 9.75 per cent. In order to obtain a tax-free

3 per cent bonus on monthly net savings, one should save a sum of SEK 5 000 for at least three years. The maximum is SEK 800 per month. The Youth Saving Scheme is designed for young people aged 16 to 25 years.

(3) As regards saving certificates (sparobligationer), part of the interest income (a bonus) is tax-exempt. This bonus varies between 0.8 and 6 per cent.

Turkey. There is no tax on government bonds held by individuals.

The United Kingdom. Certain interest-bearing debt instruments, called National Savings Instruments, pay interest which is exempt from tax. These National Savings Instruments include deposits with the National Savings Bank. The interest rate paid on these instruments takes into account the fact that the interest paid is tax-exempt.

New Tax Exempt Special Savings Accounts (TESSAs) are to be introduced from January 1991. These will be bank and building society accounts available to all adults (whatever their tax rate) in which interest will accrue tax free. Each TESSA will last for five years at the end of which period the total amount in the account can be withdrawn free of all tax. Any amounts remaining in such accounts after five years will be subject to tax on further interest accruals in the usual way. During the five year life of a TESSA withdrawals equivalent to net of basic rate tax interest may be made without affecting the tax exempt status of the account. Whilst other withdrawals are permitted, they would result in a loss of all the tax advantages of a TESSA. (In most cases the saver would then be in the same position as if he had invested in a bank of a building society account subject to the usual tax rules.) The maximum amount that can be invested in a TESSA is to be GBP 3000 in its first year and GBP 1800 a year thereafter, subject to an overall limit of GBP 9000. Rsvh individual may only have one TESSA at any point in time, although at the end of the five year period it will be possible to transfer up to GBP 3000 into a new TESSA.

The United States of America. There are some debt instruments on which it is allowed to compound interest without tax until withdrawals are made from the account. These include personal individual retirement

accounts (IRAs), deferred compensation accounts, and employer-provided thrift plans.

In addition to the exemptions (or deferral) of interest income from taxation mentioned above, interest paid by state and local governments is generally exempt from federal income tax. Most states also make interest on their own bonds and on the bonds of their own subdivisions exempt from tax.

3.2 Tax-exempt quotas in personal interest income

Many of the OECD countries exempt specified amounts of interest and/or dividend income from taxation.

Australia. No tax-exempt quotas in personal interest income.

Belgium. There are no tax-exempt quotas in personal interest income. Up till 1988 interest income was tax-exempt,[8] with a ceiling equal to interest on incurred debts. Since 1989 however, this is no longer the case.

Canada. Before 1988, up to CAD 1 000 of interest and dividend income could be deducted from income before calculating any tax payable, but this deduction was eliminated by Stage One of the federal government's ongoing tax reform measures.

Denmark. No tax-exempt quotas in personal interest income.

Finland. There is a capital income deduction of FIM 10 000 (1990: FIM 20 000).[9] Thus, interest income is subject to tax according to the following rules, provided that the taxpayer has no other capital income for which he can make a capital income deduction:

---

[8]Any witheld tax at source could possibly be refunded.

[9]The capital income deduction is based on dividends, profit shares from investment funds, taxable interest and rental income. In 1990 dividends and interest on subscribed capital will be excluded from the capital income deduction, because of the adoption of the avoir fiscal system.

Annual interest income subject to tax	FIM 0-2 000	2 001-18 000	more than 18 000
	- totally tax-free	- 50% is tax-free - 50% is subject to tax at the personal income tax rate	- 100 % is subject to tax at the personal income tax rate

In 1990 the limits will be FIM 0-2 000, FIM 2 001-38 000 and more than FIM 38 000.

France. No tax-exempt quotas in personal interest income.

Germany. There is a capital income deduction of DEM 600 for single persons or DEM 1200 for married couples. This capital income allowance was raised from DEM 300 to DEM 600 for single persons and from DEM 600 to DEM 1 200 for married couples in 1989.

Additionally, there is a general deduction of DEM 100 (single persons) or DEM 200 (married couples) for interest income-related expenses.

In addition to these allowances employees with a total annual income of no more than DEM 24 000 (single persons) or DEM 48 000 (married couples) - in 1990 these limits will be raised to DEM 27 000 and 54 000 respectively - have a tax-free amount of DEM 800 (higher interest receipts, however, are fully taxable).

Iceland. No tax-exempt quotas in personal interest income. (But also no tax on interest income.)

Italy. No tax-exempt quotas in personal interest income.

Japan. No tax-exempt quotas in personal interest income.

The Netherlands. Net personal interest income (interest income minus interest costs) less than NLG 1000 for unmarried people and less than NLG 2 000 for couples is exempted from taxation.

The tax deductible amount of net interest income was increased from NLG 700/1 400 to NLG 1 000/2 000 as from 1 January 1988.

For children under the age of 18 there is a tax free amount of interest income of NLG 500.

Norway. There is a deduction of NOK 3 000 or NOK 6 000 (1989) for persons taxed in categories 1 or 2, respectively. (Category 1 includes single persons and couples where both have taxable income, whereas category 2 includes couples with only one taxable income and persons with children.)

Spain. No tax-exempt quotas in personal interest income.

Sweden. There is a tax-exempt quota for interest income of SEK 1 600 per year per person. However, in 1991 there will no longer be a tax-exempt quota for "bottom" interest income (1989, 1990 = SEK 1 600).

Switzerland. The Federal Income Tax Act, as well as most cantonal tax Acts, allow a deduction for interest received and insurance premiums paid. The maximum deduction allowed under this heading at the federal level is CHF 1 000 for single persons and CHF 2 000 for married couples.

The United Kingdom. No tax-exempt quotas in personal interest income.

The United States of America. No tax-exempt quotas in personal interest income.

4 SPECIAL SAVING SCHEMES

Many of the countries covered in this study have a system whereby savings are deductible up to a given amount or without limit from personal taxable income. In many cases the tax deductibility is related to savings for retirement and home ownership. Similarly insurance premiums are, in many of the cases, deductible from taxable income.

Belgium. Since 1986 and under certain conditions, deposits on pension-savings accounts have been deductible from personal taxable income up to BEF 20 000 per person. In addition, life insurance premiums are tax-deductible up to BEF 60 000.

Canada. In addition to interest on retirement plans being non-taxable, contributions made by taxpayers can also be deducted from taxable income.

Finland. Compulsory old-age pension insurance premiums are deductible without limit from taxable income. As regards voluntary old-age pension insurance premiums they are deductible up to 15 per cent of earned income. There are, however, certain voluntary pension insurance premiums that are not deductible from taxable income.

France. As regards life insurance premiums, 25 per cent of the premiums, up to FRF 4 000 plus FRF 1 000 per dependent, are deductible from taxable income.

Contributions to private pension plans are, within certain limits, fully deductible from taxable income.

Germany. Employees with a total annual income of no more than DEM 24 000 (single persons) or DEM 48 000 (married couples) may receive

a tax credit (Arbeitnehmer-Sparzulage) on special forms of savings which do not exceed DEM 936 per annum. In 1990 the income limit will be raised to DEM 27 000 and 54 000, respectively. On the other hand, the premium will be lower than before and restricted to equities (premium: 20 % of DEM 936) and saving for building purposes (10 % of DEM 936).

Iceland. There are two saving schemes that afford general income tax deductibility up to certain limits; compulsory savings schemes for employed young people for housing purposes, and special savings accounts for housing purposes, available to all ages.

Norway. Savings made according to special ten-year contracts are deductible from taxable income. However, the deductibility is limited to 25 per cent of the amount saved. The contracts specify the annual amount to be saved in a bank deposit account (maximum NOK 4 000 in category 1 and NOK 8 000 in category 2), and also that withdrawals can not be made till the end of the contract period. However, withdrawals can be made after four years if used for the purchase of a home. For persons less than 34 years of age, the maximum amounts per year are NOK 8 000 and NOK 16 000, respectively, with a tax rebate of 30 %. Life insurance premiums gain the same tax credit within the same maximum amounts (premiums + bank savings).

Sweden. In connection with life insurance (pensionsförsäkring), it is permitted to deduct premiums from taxable income up to an amount of SEK 27 900 per person per year. The right to deduct these premiums from taxable income will be reduced in 1990 to 75 % of SEK 27 900. In 1991 the revenues of insurance companies pension funds will be taxed. The tax will be 15 % for private pension insurance (privata pensionsförsäkringar) and 10 % for collective insurance (avtalsförsäkringar). Employers will also pay a tax of probably 22.5 % on the premiums paid for collective insurance (avtalsförsäkringar).

Switzerland. There is a special scheme promoting savings for old age and home purchases. Thus, savings in the amount of CHF 4 608 per year may be deducted from personal taxable income. Once the savings are withdrawn they are taxed separately from other personal taxable income at a lower rate.

<u>The United Kingdom</u>. Contributions to private pension plans and additional voluntary contributions to employers pension plans are, within certain limits, fully deductible from taxable income.

<u>The United States of America</u>. Between 1982 and 1986, all taxpayers could make tax-deductible contributions - up to USD 2 000 per year for an individual or USD 4 000 per year for a couple filing a joint return - to Individual Retirement Accounts (IRAs). The Tax Reform Act of 1986 repealed the tax-deductibility of contributions to IRAs for individuals with employer-provided pension plans, although interest earned on assets in IRAs continued to be tax-deferred.

5 TAX DEDUCTIBILITY OF INTEREST EXPENSES

This chapter is mainly concerned with the deductibility of interest expenses on loans raised for the purchase of securities. However, to a limited extent, we also consider the deductibility of interest expenses on loans raised for other purposes, e.g. housing loans and consumer loans.

In most of the countries in the sample personal interest expenses are deductible, although the deductibility is limited in many cases. The borrowing costs may be atomized and deducted over a given number of years as in Australia. The deduction may also be limited to the interest (capital, investment) income of the year (Belgium, the United States of America), to a given percentage of the expenses (Denmark, Sweden, Finland), and/or to a given sum as in Finland and Spain. In the United Kingdom, on the other hand, the deductibility of interest on loans for the purchase of a private residence is limited to a given sum of the loan.

Australia. In general, interest on loans is deductible to the extent to which it is incurred in gaining or producing assessable income or in carrying on a business for that purpose and is not of a capital, private or domestic nature. This includes the acquisition of securities and most other income-producing assets. The security given for borrowed money has no bearing on the deductibility of interest. The borrowing costs may be atomized and deducted over five years.

Belgium. Interest expenses are deductible from personal taxation up to an amount equal to real estate income. Before 1989, the ceiling encompassed all capital income, i.e. real estate income as well as interest and dividend income.

Canada. In general, interest expenses are deductible if paid for money borrowed to earn investment income. Carrying charges (fees for

management, accounting, counseling and safe custody of investments) are also deductible. Interest paid on loans raised in order to make contributions to special saving schemes is not deductible.

Denmark. All interest expenses are deductible from personal taxation at the standard 50 per cent deductible value.

In October 1986 a levy was imposed on net interest expenditures on loans for purposes other than housing and education. The effect of the levy is to reduce the tax deduction value of interest expenditures on such loans to 30 per cent rather than the standard 50 per cent mentioned above.

Finland. Interest expenses on loans raised for the purchase of tax-exempt securities are not deductible in personal taxation. Otherwise the taxpayer is able to deduct interest expenses on loans other than housing loans up to FIM 10 000 (1989). The total maximum deductible amount of interest expenses is FIM 25 000 (single parents and married couples with dependents) or FIM 22 000 (all others).

The deduction is not full however: Taxpayers' interest expenses exceeding FIM 900 (1990: 1000) are deductible up to a limit of 90 per cent (1990: 85 %) of the expenses.

France. Interest expenses for the purchase of securities are not deductible in personal taxation.

Germany. All interest expenses, except interest expenses on consumer loans, are deductible in personal taxation.

Iceland. Interest expenses are not deductible in personal taxation.

Italy. Interest expenses for the purchase of securities are not deductible in personal taxation.

Japan. No forms of interest expenses on loans are deductible from personal taxation.

The Netherlands. All interest expenses are tax deductible, irrespective of the purpose of the loan.

Norway. Interest expenses on loans for the purchase of securities are fully deductible.

Spain. Interest expenses on loans raised for the purchase of securities are deductible from the payee's tax base up to ESB 100 000 per fiscal year.

Sweden. In practice the taxpayer is able to deduct interest expenses on all loans. In 1989 a tax rate of 47 per cent was applied on taxpayers' net interest expenses (less SEK 1 600). The taxpayer thus pays 53 per cent of net interest expenses. According to the tax reform presented by the Government on 13 November 1989, a tax rate of 40 per cent will be applied on net interest expenses. In 1991 interest expenses will be treated per se. Up to SEK 100 000, a tax rate of 30 per cent is applied. For interest expenses above SEK 100 000, 70 per cent is deductible at a tax rate of 30 per cent, meaning a tax reduction of 21 per cent.

Switzerland. Interest expenses are deductible as long as the creditor of the loan is declared.

Turkey. Interest expenses are not deductible in personal taxation.

The United Kingdom. There is no tax relief in respect of personal loans other than loans for the purchase of an individual's principal private residence in the UK.

Interest on loans for the purchase of an individual's principal private residence can be deducted from income for tax purposes. This is currently limited to interest on the first GBP 30 000 of the loans. This limit applies to an individual or a married couple, a married couple cannot have two principal private residences. Similarly, the limit applies to the total of all loans on the residence irrespective of the number of individuals living in it, so people sharing a house receive only one lot of relief. Since the average price of a house

in the UK is now more than double the GBP 30 000 limit, the impact of the tax relief on marginal decisions is to some degree limited.

The United States of America. Interest expenses on loans raised for the purchase of securities would normally be considered "investment interest". Investment interest - which does not include consumer interest, qualified residence interest, or interest in certain other real estate or business activities - is deductible from income, in calculating taxable income, only to the extent of net "investment income" in that year. Investment income includes dividends, rents, royalties, gross interest income, capital gains on stocks, bonds, and investment properties. Excess investment interest deductions may be carried forward indefinitely.

Although mortgage interest on an owner's principal residence remained tax deductible in the Tax Reform Act of 1986, the deductibility of other mortgage and consumer interest was tightened or is being phased out. Deductibility of investment interest expense was also tightened.

6 TAX TREATMENT OF INTERNATIONAL FLOWS OF INTEREST INCOME

In most of the countries in our sample, residents' interest income from foreign assets is treated in the same way as domestic interest income. Residents usually receive full or partial compensation for tax paid to foreign governments. Only in Belgium, Iceland and Turkey is there no compensation for tax paid to foreign governments. Interest earned abroad should be mentioned in income tax returns. The authorities doubt that this is always the case, so that much of interest earned abroad may in effect go untaxed.

In the taxation of outward interest flows the picture is more varied. In seven of the 18 countries covered in this study non-treaty countries are not subject to a withholding tax on interest payments. The countries not taxing interest payments to non-treaty countries at source are: Denmark, Finland, Germany, Iceland, the Netherlands, Norway and Sweden. In all the other countries interest payments to non-treaty countries are taxed, with some exceptions. The withholding taxes applied vary between 10 and 35 per cent as regards non-treaty countries. In general, interest payments to treaty countries are taxed at a lower rate.[10]

6.1 Taxation of residents' foreign interest income

Australia. Resident taxpayers are assessable on interest income received from both foreign and domestic sources. Where the foreign interest received by the resident is reduced by the payment of foreign tax, the net interest amount is grossed up by the amount of that foreign tax for purposes of calculating the amount to be included in assessable income. A credit is allowable for the amount of the foreign tax not exceeding the amount of Australian tax payable on the foreign

---

[10] Coopers & Lybrand: International Tax Summaries. John Wiley & Sons, New York (1988).

interest income, i.e. the total tax rate is equal to whichever of the Australian and foreign tax rates is greater. However, if the taxpayer could have reduced his or her foreign tax by electing to have his or her liability determined on an assessment basis, rather than by deduction of the withholding tax, credit is available only for the reduced amount of foreign tax that would have been payable if the tax had been assessed.

Prior to 1990 - 1991, interest received by a resident indirectly through foreign subsidiaries was not subject to Australian income tax until remitted. From the 1990 - 1991 income year, Australian shareholders with substantial interests in Australia-controlled non-resident companies may be taxed on an accruals basis on their share of that non-resident company's income. These new rules will apply to most foreign source interest income of Australian residents sheltered in low-tax countries. A credit will be allowed for foreign taxes paid.

Belgium. Domestic and foreign interest income, earned through a financial institution located in Belgium, is subject to the same 25 per cent withholding tax. From March 1, 1990 the withholding tax will be lowered to 10 per cent in case of newly issued debt. Up till the end of 1988, there was a compensation - called in French "Quotité forfaitaire d'impôt étranger" - calculated on a lump sum basis for the withholding tax paid abroad. Since 1989, however, this compensation has been cancelled for individuals.

Canada. Residents' interest income from foreign assets is treated in the same way as domestic interest income. A foreign tax credit is available to residents who have paid tax on interest income at source to a foreign government.

Denmark. Residents' interest income from foreign assets is taxed according to rules similar to those applicable to Danish assets. Residents' are able to receive compensation for the tax paid at source to a foreign government on the basis of a tax treaty.

Finland. Residents' interest income from foreign assets is taxed in the same way as interest income from domestic assets.

Residents are able to receive compensation for tax paid at source to a foreign government on the basis of a tax treaty. Most of the Finnish tax treaties contain a stipulation according to which the foreign government is not entitled to tax the interest income at source, which means that the interest income is taxed in Finland as domestic income.

France. Residents' interest income from foreign assets is taxed in the same way as interest income from domestic assets. If there is a tax treaty, residents are compensated (in part or in whole) for tax paid to foreign governments.

Germany. Residents' interest income from foreign assets is taxed in the same way as interest income from domestic assets. Residents are able to receive compensation for tax paid at source to a foreign government on the basis of a tax treaty. Most of the German tax treaties contain a stipulation according to which the foreign government is not entitled to tax the interest income at source.

Iceland. Residents are tax free on interest income from abroad. No compensation for foreign withholding taxes is paid.

Italy. Residents' interest income from foreign assets is subject to a withholding tax levied at source by the Italian banks in charge of the interest transfer. In general, tax rates do not differ from those on domestic assets. Only foreign bonds are taxed at source at 30 per cent, against 12.5 per cent on domestic ones.

Residents are allowed to claim compensation for taxes withdrawn at source abroad.

Japan. Residents' interest income from foreign assets is taxed in the same manner as interest income from domestic assets (separate withholding taxation at the relevant rate of 15 %). Tax paid to foreign governments for interest income from foreign assets is deductible from domestic withholding taxation.

The Netherlands. Interest income from foreign assets is treated in the same way as interest income from domestic assets. A foreign

withholding tax is tax deductible in the Netherlands. When the foreign country is a tax-treaty country or the country is a Third World Country (more than 100 countries are considered as Third World Countries) a tax credit is applied. In general, a foreign withholding tax up to 10 per cent of the foreign interest income is restituted.

Norway. Interest income from foreign sources is taxed in the same way as interest income from domestic sources, normally with a deduction for withholding taxes paid in countries with which Norway has a tax treaty.

Spain. Relief from double taxation is governed by tax treaties that Spain has concluded with other countries. In addition, a foreign tax credit may be allowed for foreign-source income included in the Spanish tax return, computed as the lesser of the foreign tax paid on the foreign-source income, or the Spanish tax attributable to the foreign-source income.

Sweden. Residents' interest income from foreign assets is taxed in the same way as interest income from domestic assets.

In principle, if a resident pays withholding tax to foreign governments he may receive compensation for these under a double tax treaty. There are about 60 treaties.

Switzerland. The Residents' interest income from foreign assets is taxed in the same way as interest income from domestic assets. In cases where, despite a double tax treaty, a withholding tax is applied abroad, the taxpayer generally receives a tax credit in the amount of the foreign withholding tax.

Turkey. Interest income is not taxed at the personal level in Turkey, so that the withholding tax paid to foreign governments is final.

The United Kingdom. UK residents' interest income from foreign assets is taxed in the same way as interest income from domestic assets. Residents are able to receive full or partial compensation for the tax paid at source to a foreign government if an appropriate tax treaty exists, depending on the terms.

The United States of America. Residents' interest income from foreign sources is treated in the same way as interest income from domestic sources. As a rule, residents may claim a tax credit for taxes paid to a foreign government.

6.2 Taxation of interest payments to non-residents

Australia. A 10 per cent rate of tax is imposed on the gross interest income derived by foreign residents from treaty and non-treaty countries alike.

Belgium. For registered securities non-residents are not subject to tax on interest income from Belgian sources. For bearer securities non-residents are subject to the 25 per cent withholding tax for the non-treaty countries. The rate applied to treaty countries is reduced to 15 per cent (in most cases).

Since May 1989, the income from outstanding "linear bonds" (issued by the Treasury) is always exempt from any withholding tax as far as non-residents are concerned.

Canada. Non-residents are subject to tax on interest income from Canadian sources in Canada. The statutory rate is 15 per cent for residents of treaty countries and 25 per cent for others. There are, however, complete exemptions for interest income arising from several significant sources, including bonds issued by all levels of government and their enterprises (federal, provincial, municipal hospitals, educational institutions).

Denmark. Non-residents are not subject to tax on interest income from Danish bonds and bank deposits.

Finland. Non-resident individuals are not subject to tax on interest income from Finnish bonds and bank deposits.

France. Non-residents are not subject to tax in France on interest income on the following debt instruments:

- loans issued in France by international organizations,
- securities issued on the money market,
- French bonds issued on or after 1 January 1987,
- French State bonds issued from 1 October 1984 to 1 January 1987.

In contrast, there is a 10 per cent withholding tax on interest on other than State bonds issued on or after 1 January 1965. The withholding tax is 12 per cent on bonds issued before 1 January 1965.

As regards interest income on other debt instruments the withholding tax is 25 per cent (15 per cent from 1 January 1990).

However, if there is a tax treaty this withholding tax is either not applied at all (if expressly mentioned in the tax treaty) or reduced to 10 or 12 per cent (irrespective of it being mentioned in the tax treaty).

In practice, non-residents do not pay any taxes to the French authorities on their French portfolio investments today.

Germany. Non-resident individuals are not subject to tax on interest income from German sources in Germany (the former withholding tax has been abolished).

Iceland. Non-resident individuals are not subject to tax on interest income from Icelandic sources in Iceland.

Italy. Non-resident individuals are subject to a withholding tax on interest income. In principle, the tax rates do not differ from the domestic rates applied to residents (with the exception of bank deposits denominated in foreign currency and euro-lira, which are exempt). However, the majority of treaty-countries have maximum rates between 10 and 15 per cent. The Netherlands and the United Kingdom are exceptions to the rule for treaty countries, since interest income is subject to tax at source in the country of the issuer.

Japan. As for non-residents, in principle, their interest income from Japanese bonds and bank deposits is taxed in the same manner as

residents' interest income (separate withholding taxation, the relevant rate being 15 per cent). However, if Japan has a tax treaty with the non-resident's home country stipulating that interest income is not subject to withholding tax in Japan, there is no tax at source on the non-resident's interest income in Japan.

The Netherlands. There are no withholding taxes in the Netherlands. Non-residents are not subject to tax on interest income from Dutch saving accounts.

Norway. Interest income to non-residents is not taxed.

Spain. If there is a double-taxation treaty, tax treatment will be in accordance with that. If not, interest income from financial assets received in Spain by non-residents is subject to a 25 per cent tax rate, regardless of the type of asset. As a result, as the tax at source is generally 25 per cent, non-residents' obligation as regards the Spanish Treasury is fulfilled with the withholding tax applied by the payer.

Since March 1989 interest income from Treasury bills received by non-residents has also been subject to this tax.

Sweden. In principle, there is no withholding tax system for non-residents.

Switzerland. There is a tax at source on all interest paid to non-residents. The rate is 35 per cent for non-treaty countries, and 0 - 30 per cent for treaty countries.

Turkey. Non-resident individuals are subject to the same tax treatment as residents as regards interest income from Turkish sources, i.e. a 10 per cent tax at source. There are no differences between treaty and non-treaty countries.

The United Kingdom. In principle, there is a tax at source on interest paid to non-residents, with some exceptions (certain government securities). However, since the UK has a double taxation treaty with

all the countries in this study and in most cases this includes a "nil interest article", there is no tax deducted or withheld in the UK on interest paid to residents of these countries.

The United States. Non-resident aliens are subject to tax on interest income from U.S. sources in the U.S. at a 30 per cent rate, or at a lower rate where provided for by a tax treaty, except for interest on portfolio obligations issued after July 18, 1984. Portfolio obligations issued after that time are not subject to the 30 per cent tax. Therefore, a 30 per cent withholding tax applies unless the rate is lowered by a tax treaty or the interest is from a portfolio obligation issued after 18 July 1984.

7 SUMMARY

As the liberalization of capital movements across national borders proceeds, differences between countries in the taxation of capital income will become increasingly important. Our survey of the taxation of personal interest income in 18 OECD countries in 1989 has clearly demonstrated the enormous diversity of national tax systems. In view of this, it is hardly surprising that the issues of tax harmonization and international tax control are felt to be very urgent in many countries and international bodies. On the other hand, existing international differences in the tax treatment of interest income make it easy to understand why attempts at tax harmonization are bound to be very difficult.

A case in point here is the situation in the EC. As part of the creation of a single internal market with unlimited capital mobility by the end of 1992, the EC Commission proposed the implementation of a minimum withholding tax of 15 per cent on interest paid in EC countries. The proposal has, however, met with political resistance and as a result the Commission has had to abandon its implementation.

One can distinguish between four basic ways of taxing interest income: no tax, a withholding tax, taxing interest as personal income and a combination of personal income tax and withholding tax.

On the basis of our survey, it appears that the most common general rule applied in taxing interest income in the OECD countries is to tax interest as personal income, that is by adding interest income to the personal income tax base. This tax system is applied to taxable interest income in 10 out of the 18 countries in our sample. Two of these countries (Finland, Switzerland) apply a withholding tax, which is, however, refunded when the interest income is declared in the tax return. The final tax is thus equal to the personal income tax.

Another common principle of taxing personal interest income is that of taxing interest at source, at a final withholding tax rate. This was the practice in four countries, i.e. Belgium, Italy, Japan and Turkey. The tax paid at source varies between 10 and 30 per cent across the countries. In Japan and Turkey the same tax rate is applied to all interest-yielding assets. In Italy, on the other hand, the withholding tax rate depends on the interest-yielding asset in question. The lowest tax rate is applied to all kinds of Government securities, bonds issued by Special Credit Institutions and by public corporations etc. Bank and Post office current accounts and bonds issued by private companies are taxed at the highest rate.

In addition to the "pure" tax-systems mentioned above some countries apply a combined tax system to interest income. This consists of a combination of personal income tax and withholding tax. The taxes can be combined in various ways. In the UK tax paid at source on retail bank and building society deposits is currently not refunded to 'non taxpayers' but generates a tax credit for others. In Spain tax paid at source is usually refunded. However, there are certain one to three-year financial assets where tax paid at source is final.

Another way of applying a mixed tax system exists in France. In this country the taxpayer can choose between either adding the interest income to other personal income and having the tax paid at source refunded or letting the tax paid at source be final. The right to opt between these two tax-systems is restricted to certain assets. French system may be contrasted with the above-mentioned Finnish and Swiss system, where withholding tax is, in principle, never final.

Finally there is one country, namely Iceland, where no tax at all is paid on interest. However, according to a government proposal, real(!) interest income will be subject to personal income tax in Iceland in the near future.

In our survey we found numerous exceptions to the general rules of taxing interest described above. In all of the countries except one (Australia) there are tax-exempt debt instruments (including total tax-exemption, partial tax-exemption and reduced rate of tax) or tax-exempt quotas in personal interest income, or both.

Many of the debt instruments the interest on which receives preferential tax treatment are connected with savings for retirement, education or home purchase. Similarly, interest income of young people and small savers is in many cases treated in a more favourable way. In 14 out of the 18 countries there is some kind of tax-exempt interest. The most common tax-exempt assets are: government bonds, pension-saving accounts, home-ownership accounts and education accounts. In addition to these tax-exempt assets, interest on ordinary saving accounts is tax-exempt in Belgium, Finland and France. In Belgium and France tax-exemption is limited to a given amount of interest received and funds saved, respectively. In Finland and France the interest paid on the accounts is administratively regulated.

In 6 out of the 18 countries there are tax-exempt quotas in personal interest income. The size of these quotas is apparent from table 1 in the appendix.

An element of the so-called expenditure tax system exists in many countries where savings in certain saving schemes are deductible from taxable income. These favoured saving schemes are usually directed towards retirement or home ownership. A related feature is that life insurance premiums are, in many of the countries, deductible from taxable income.

In most of the countries in our sample interest expenses on loans are deductible from taxable income. The deductibility is often limited in various ways. However, in 12 out of 18 countries interest expenses on loans raised for the purchase of taxable securities are deductible.

The last question dealt with in this study concerns the tax treatment of international flows of interest income. As regards the taxation of residents' foreign interest income we find that all the countries except one (Turkey) tax residents' foreign interest income as domestic interest income. In 15 out of 18 countries the tax paid at source to a foreign government is compensated, wholly or to a limited extent. However, some respondents point out that it is not easy to control foreign interest income of residents, and much of it may thus be left undeclared in tax returns.

In 11 of the 18 countries interest payments to non-residents are taxed at source, provided that there is no tax treaty preventing this. However, in many of the countries there exist some tax-exempt assets. The most common tax-exempt asset as regards non-residents are government bonds. The withholding tax applied to outward interest payments varies between 10 and 35 per cent as regards non-treaty countries. In general, interest payments to treaty countries are taxed at a lower rate.

It may be noted that none of the Nordic countries taxes interest payments to non-residents at source.

APPENDIX

Table 1

THE TAXATION OF RESIDENTS' DOMESTIC INTEREST INCOME

Country	General rule of taxing interest income	Tax-exempt interest, if any 1)	Tax-exempt quotas in personal interest income
Australia	As personal income	On certain forms of saving for retirement	None
Belgium	Withholding tax	On ordinary saving accounts; interest paid by cooperative societies; on certain government bonds; on certain pension-saving accounts	None
Canada	As personal income	On certain saving schemes connected with retirement and education	None
Denmark	As personal income	On accumulated savings for retirement	None
Finland	As personal income	On certain bank deposits; on certain bonds; on home-ownership accounts	FIM 10000
France	Combination of personal income tax and withholding tax	On certain bank deposits; on French fixed-interest bonds; on certain Government bonds; on certain home-ownership savings; on certain pension-savings accounts	None
Germany	As personal income	On certain life-insurance contracts; on certain special bonds	DEM 600 (DEM 1200) DEM 100 (DEM 200) DEM 800
Iceland	No tax	All	None
Italy	Withholding tax	On Government securities issued abroad; on bonds issued abroad by international organizations; on certain Government bonds; on certain bonds issued by Special Credit Institutions; on certain private sector bonds	None

[1] Tax exemption is defined broadly here. It also includes preferential tax treatment, such as partial tax exemption and reduced rate of tax.

Table 1 cont.

THE TAXATION OF RESIDENTS' DOMESTIC INTEREST INCOME

Country	General rule of taxing interest income	Tax-exempt interest, if any	Tax-exempt quotas in personal interest income
Japan	Withholding tax	On qualified persons' savings in bank deposits; on savings in joint trusts; on bonds and investment-trust beneficiary certificates; on savings for formation of employees' assets	None
Netherlands	As personal income	On capital assurance (under certain circumstances); on certain special saving schemes (tax free premium)	NLG 1000 (NLG 2000) NLG 500
Norway	As personal income	None	NOK 3000 (NOK 6000)
Spain	Combination of personal income tax and withholding tax	None (since Dec. 31th 1989)	None
Sweden	As personal income	On the National Saving Scheme; on the Youth Saving Scheme; on saving certificates	SEK 1600
Switzerland	As personal income	None	CHF 1000 (CHF 2000)
Turkey	Withholding tax	On government bonds	None
United Kingdom	Combination of personal income tax and withholding tax	On certain debt instruments, so called National Savings Instruments	None
United States	As personal income	On personal individual retirement accounts, deferred compensation accounts and employer-provided thrift plans (until withdrawal); on State and municipal government bonds	None

Table 2

SPECIAL SAVING SCHEMES

	Savings for retirement		Savings for own home		Insurance premiums	
	Whether credited	Whether credit limited	Whether credited	Whether credit limited	Whether credited	Whether credit limited
Country						
Australia	___	___	No	No	No	No
Belgium	Yes	Yes	No		Yes	Yes
Canada	Yes	___	___	___	___	___
Denmark	___	___	___	___	___	___
Finland	No		No		Yes & No[2]	Yes & No[3]
France	Yes	Yes	___	___	Yes	Yes
Germany	___	___	Yes	Yes	___	___
Iceland	___	___	Yes	Yes	___	___
Italy	___	___	___	___	___	___
Japan	___	___	___	___	___	___
Netherlands	___	___	___	___	___	___
Norway	___	___	Yes	Yes	Yes	Yes
Spain	___	___	___	___	___	___
Sweden	___	___	___	___	Yes	Yes
Switzerland	Yes	Yes	Yes	Yes	___	___
Turkey	___	___	___	___	___	___
United Kingdom	Yes	Yes	No	No	No	No
United States	No		___	___	___	___

___ = missing information

[2] Old-age pension insurance premiums are deductible from taxable income. Life insurance premiums are, however, not deductible.

[3] Obligatory old-age pension insurance premiums are deductible without limit from taxable income. Voluntary old-age pension insurance premiums are deductible up to 15 per cent of earned income.

Table 3

TAX DEDUCTIBILITY OF INTEREST EXPENSES

	Securities		Owner-Occupied Housing	Consumer Credit
Country	Whether interest payments deductible	Whether deductibility limited	Whether interest payments deductible	Whether interest payments deductible
Australia	Yes	No	No	No
Belgium	No		Yes	No
Canada	Yes	___	___	___
Denmark	Yes	No	Yes	Yes
Finland	Yes and No[4]	Yes	Yes	Yes
France	No		___	___
Germany	Yes	___	Yes	No
Iceland	No		No	No
Italy	No		___	___
Japan	No		No	No
Netherlands	Yes	___	Yes	Yes
Norway	Yes	No	___	___
Spain	Yes	Yes	___	___
Sweden	Yes	No	Yes	Yes
Switzerland	Yes	___	Yes	Yes
Turkey	No		No	No
United Kingdom	No		Yes	No
United States	Yes	Yes	Yes	Yes

___ = missing information

[4] Interest expenses for loans raised for the purchase of other than tax-exempt securities are deductible from taxable income.

Table 4

THE TAXATION OF RESIDENTS' FOREIGN INTEREST INCOME

Country	Taxation of interest income from foreign sources	Compensation for tax paid to foreign government
Australia	As domestic interest income	Yes
Belgium	As domestic interest income	None
Canada	As domestic interest income	Yes
Denmark	As domestic interest income	Yes
Finland	As domestic interest income	Yes
France	As domestic interest income	Yes
Germany, Fed. Rep.	As domestic interest income	Yes
Iceland	As domestic interest income (no tax)	None
Italy	As domestic interest income	Yes
Japan	As domestic interest income	Yes
Netherlands	As domestic interest income	Yes
Norway	As domestic interest income	Yes
Spain	As domestic interest income	Yes
Sweden	As domestic interest income	Yes
Switzerland	As domestic interest income	Yes (if tax treaty)
Turkey	No tax	None
United Kingdom	As domestic interest income	Yes
United States	As domestic interest income	Yes

Table 5

THE TAXATION OF INTEREST PAYMENTS TO NON-RESIDENTS

Country	Withholding taxes applicable	Tax exempt interest, if any
Australia	10	None
Belgium	25, 15 or lower	On registered securities; on "linear bonds"
Canada	25, 15 or lower	On bonds issued by the government and their enterprises
Denmark	Nil	All
Finland	Nil	All
France	10, 12, 25 (15) 12 or lower	On loans issued in France by international organizations; on securities issued on the money market; on certain French bonds; on French State bonds
Germany, Fed. Rep.	Nil	All
Italy	12.5, 25, 30, 15 or lower	On bank deposits denominated in foreign currency and euro-lira; on certain institutions' bonds; on certain bonds issued abroad; on certain public enterprises' bonds
Japan	15 or lower	None
Netherlands	Nil	All
Norway	Nil	All
Spain	25, 15 or lower	None
Sweden	Nil	All
Switzerland	35, 30 or lower	None
Turkey	10	On Government bonds
United Kingdom	27 or lower	On certain government securities
United States	30 or lower	On portfolio obligations issued after July 18, 1984.

The withholding tax applicable to interest payments to non-residents varies between treaty and non-treaty countries. As a general rule, a lower tax rate is applied to interest payments as regards treaty countries.

BANK OF FINLAND DISCUSSION PAPERS

ISSN 0785-3572

1/90 JUHA TARKKA - ALPO WILLMAN Financial markets in the BOF4 model of the Finnish economy. 1990. 57 p. (ISBN 951-686-234-9)

2/90 JUHA TARKKA - HANNA-LEENA MÄNNISTÖ - ALPO WILLMAN Macroeconomic foundations and simulation properties of the BOF4 quarterly model of the Finnish economy. 1990. 57 p. (ISBN 951-686-235-7)

3/90 PETER BIRCH SÖRENSEN Tax harmonization in the European Community: problems and prospects. 1990. 70 p. (ISBN 951-686-238-1)

4/90 PETER BIRCH SÖRENSEN Issues in the theory of international tax coordination. 1990. 83 p. (ISBN 951-686-239-X)

5/90 ESKO AURIKKO Floating exchange rates and capital mobility. 1990. 25 p. (ISBN 951-686-242-X)

6/90 PERTTI HAAPARANTA - TARJA HEINONEN Re-opening of banks' certificates of deposit market. 1990. 16 p. (ISBN 951-686-244-6)

7/90 JUHA TARKKA - ALPO WILLMAN Income distribution and government finances in the BOF4 model of the Finnish economy. 1990. 46 p. (ISBN 951-686-246-2)

8/80 CAMILLA GUSTAVSSON Taxation of personal interest income in 18 OECD countries. 1990. 54 p. (ISBN 951-686-247-0)