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Discussion Paper
on
Taxation of Income from Government Bonds

Background

Foreign investors are critical to the development of liquid bond markets for several reasons. First, attracting foreign investors increases the investor base and therefore demand for government bonds, which lowers the government's cost of borrowing. Second, foreign investors diversify the investor base, increasing the likelihood that a government bonds market will have adequate levels of buyers and sellers, which helps minimize volatility and thereby create greater price stability. Reducing volatility makes the market even more attractive to all investors, further increasing liquidity in a virtuous cycle. In addition, foreign investors frequently have different investment perspectives and motivations from those of domestic investors (and from one another). These different perspectives can result in foreign investors becoming counterparties for transactions at times when domestic investors may be moving in the same direction, thus generating market liquidity when otherwise there would be none.

Virtually every mature bond market has recognized the importance of foreign investors by eliminating the most significant obstacle to foreign participation – tax on the interest income that foreign investors receive from their investments. Eliminating local tax on foreign investors is not meant to give them an advantage over domestic investors; most foreign investors will have tax obligations on their foreign-source interest income in their home countries. However, for a variety of reasons discussed below, local taxes tend to keep foreign investors and the benefits they bring out of a market.

Foreign Investors' Aversion to Tax Withholding

For most international investors, return is critical as they can, and do, compare returns across jurisdictions. A country that imposes tax on the interest income from its government bonds must pay a higher rate of interest than a country that does not impose tax (assuming the same risk profile and market liquidity) to attract international investors.

A couple of practical examples help illustrate this point. Germany introduced tax withholding on interest from bonds, including government bonds, in January 1989. As soon as that withholding plan was announced in the Fall of 1988, demand for German government bonds dropped and yields increased by about 50 basis points – even before the effective date of the plan. In the first three months of 1989, foreign investors reduced their holdings of German government bonds by 7.5 billion Deutschemarks. In April of

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that year the government announced the repeal of the withholding plan and foreign investors responded immediately, increasing their holdings of German bonds by 4 billion Deutschemarks in April alone and driving down yields. The United States experienced a similar increase in demand for its bonds in 1984 when it eliminated tax on interest earned by foreign holders of its bonds.

Foreign tax credits that may be available in a bondholder's home country are not an adequate tool for offsetting taxes withheld in another jurisdiction. A number of major foreign investors, specifically pension funds and investment funds, are not subject to taxation in many of their home countries, making foreign-tax credit rules irrelevant to them. Even in the best case, foreign tax credits involve a timing cost to the investor due to the lapse of time between the payment of the foreign tax and receipt of the benefit of the home country tax credit.

ASIFMA's Position

ASIFMA's position is that exempting the interest income of foreign investors from tax in the country where the source of that income is located benefits the development of liquid bond markets.

As discussed below, the United States and most European countries have addressed this issue by exempting foreign investors from tax on bond interest income received from local issuers, while continuing to tax domestic investors on income from those sources. Other countries, particularly in Asia, have taken a different approach, exempting interest income on government bonds from taxation for both foreign and domestic investors. Below we have provided a summary of the approaches taken to this question by various countries, and also consider the advantages and disadvantages of these two approaches. Whether a country chooses to exempt only foreign investors or both foreign and domestic investors is a complex public policy choice.

A note on terminology may be helpful. Many people, including tax professionals, frequently use the term "withholding tax" as a short-hand expression for income tax withheld from income paid to foreign investors on domestic securities. In most jurisdictions, however, "withholding" is a method of collecting a tax, usually an income tax, rather than being a separate type of tax. This distinction is important because tax withholding practices vary significantly around the globe, and are used to collect a number of different types of taxes. For example, some countries require income tax to be withheld from interest payments to residents and foreign investors alike. It is therefore important to be clear that ASIFMA advocates the elimination of any tax, whatever it may be called and however it may be collected, on foreign investors' interest income from government bonds.

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Survey of Practices

The practices of assessing and collecting tax on income from government bonds differ significantly in various jurisdictions around the world. Although the details of the practices in various countries are too complex to attempt to cover here, those practices generally fall into one of three¹ basic groups: (1) countries that tax both residents and nonresidents, (2) countries which tax residents but exempt non-residents, and (3) countries that exempt all income from government bonds. Even within a particular country, however, the tax consequences of government bond interest may depend on additional factors, in particular whether the bondholder is a corporation or an individual.

The following survey looks at which of the above four groups a selection of key countries fall into, and provides a few examples of the subtleties that may determine when bond interest income is subject to tax in a particular country. It is not intended to be a comprehensive analysis of the tax rules in any of the jurisdictions mentioned. Because bond market investors tend to be institutions rather than individuals, and because many countries treat corporate bondholders and individual bondholders differently, countries below are grouped according to their treatment of institutional investors rather than individual investors.

Countries That Tax Both Residents and Nonresidents

Some countries tax both residents and nonresidents on their income from domestic government bonds. The countries that tax the income from government securities regardless of the recipient's residence include (**India** (20%), **Indonesia** (20-30%), **Philippines** (20%), and **Taiwan** (10% for residents, 20% for non-residents).

In **Korea**, the applicable rate of tax varies depending on the circumstances of the recipient of the income. For domestic corporations, the total tax on bond interest income is currently 27.5% of the amount paid. Except for certain financial institutions, that tax is collected in two steps: 14% is withheld by the paying agent, while the remainder is paid at the end of the corporation's tax year. Withholding is not required for payments to qualifying Korean financial institutions, which now will pay the entire 27.5% tax at the end of the tax year. Bond interest payments to resident individuals generally are subject to income tax withholding at the rate of 15.4%, as are payments to all foreign recipients, both corporate and individual.

Korea also has a special regime for interest on foreign-currency denominated bonds that are issued outside of Korea by the Korean government or Korean corporations. Under

¹ Apparently at least one country, Brunei, taxes foreign investors' interest income but does not tax interest income of residents. However, that practice clearly is out-of-step with the practices of the vast majority of countries.

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that regime, the interest from those bonds is not subject to Korean tax, which has resulted in a source of funding for Korean corporations that is less expensive than domestic issuances.

Vietnam exempts bond interest payments to resident and non-resident individuals, but imposes tax on the interest from government bonds paid to legal entities (with the exception of specific bonds that are designated tax-free). Domestic legal-entity investors include that interest income in the calculation of their taxable income from their business activities, while tax is withheld from foreign investors after an unusual tax calculation: when interest is paid, the foreign investor's bank must withhold tax computed at 0.1% of the interest payment *plus* 0.1% of the face value of the bond. A tax on interest payments that is based on the par value of the bond is, to the best of our knowledge, unique.

In all of these countries, foreign investors can take advantage of double tax treaties to reduce or completely eliminate the tax due on interest income. When the anticipated investment in a particular country reaches a sufficient level, large foreign investors frequently will structure their investments through an affiliate established in a jurisdiction that has a favorable tax treaty. Consequently, in practice these governments do not collect tax at the statutory rates.

All of these countries collect tax on interest payments to foreign recipients through a withholding mechanism, as expecting foreign recipients to file tax returns and pay the tax due themselves is obviously not practical.

Countries That Tax Residents but Exempt Non-Residents

The largest group of countries consists of those that tax residents on income from domestic government bonds, but exempt the interest income of non-residents from tax. Countries utilizing this approach include the **United States, Australia, Japan, Singapore, Thailand, Ireland, United Kingdom, France, and Germany**. Indeed, this is the approach generally taken throughout the **European Union**, subject to the exceptions discussed below.

In addition to non-resident individuals and corporations, **Singapore** exempts resident individuals from tax on interest income from Singapore government securities. Domestic corporations, however, are taxed at a rate of 10% on that income.

Thailand requires domestic corporations that receive interest income from government bonds to include that income in their year end tax declarations, but also requires that tax be withheld from that income at the rate of 1%.

In some jurisdictions the exemption from taxation is conditional. **Italy**, for example, exempts interest from government bonds only if the beneficial owner is resident in a

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country that has an agreement to exchange information with the Italian tax authorities. Cross border exchanges of taxpayer information among tax authorities in different countries clearly is a growing trend.

Pursuant to European Union Savings Directive (the “EUSD”), several European countries withhold tax from certain types of interest – including interest on government bonds – paid to *individuals* who are residents of another EU country. The EUSD generally attempts to eliminate tax evasion by residents of EU member states by requiring member states to automatically share information on interest paid in their respective states to residents of other member states. However, **Austria, Belgium, and Luxembourg** have been granted a transitional arrangement under which they are not required to provide information to other EU states. Instead, paying agents in those three countries must withhold income tax from interest paid to *individuals* who are resident of any other EU country. The original tax rate was 15%, but the rate increased to 20% as of July 1, 2008 (and will increase to 35% in 2011). Individuals subject to this withholding requirement can avoid withholding by agreeing to have their account information disclosed to the tax authorities in their home country. Although not members of the EU, **Switzerland, Monaco, Liechtenstein, Andorra, and San Marino** have entered into agreements with the EU that set out measures similar to the rules of the EUSD. All five of those jurisdictions have followed the withholding approach. Similarly, ten dependencies of EU members, including **Jersey, Guernsey, and the Isle of Man**, have entered into agreements with EU member states to adopt measures similar to those set out in the EUSD. These jurisdictions also have adopted the withholding approach.

Countries That Exempt All Interest Paid on Government Bonds

Neither residents nor non-residents are taxed on their income from government bonds. This approach is used in **Hong Kong and China**.

In **China**, bonds issued by the Ministry of Finance are exempt from tax if held to maturity, but accrued interest is subject to tax if the bond is sold in the secondary market. Income from bonds issued by the People’s Bank of China, however, is subject to tax.

Analysis of Exempting Foreign Investors from Tax on Government Bond Interest

As described above, most countries with mature bond markets have chosen to exempt foreign investors from tax on interest from bonds, both government and corporate. There are several reasons why this approach has generally been preferred by most governments.

First, this approach actually puts foreign and domestic investors on more equal footing. Although exempting foreign investors from tax may appear to give them an advantage over domestic investors, that advantage is illusory. Foreign investors generally do not

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escape taxation on this income because it is subject to tax in their respective home countries. In some cases the home country tax rate may be higher, while in other cases it may be lower, but each beneficiary of the income ultimately should be taxed at that beneficiary's home country's rate of tax.

Second, compared to completely exempting interest on government bonds from taxation, this approach has a smaller impact on tax collections. Exempting the interest paid to foreign investors obviously would reduce the amount of tax collected, but the government still would collect tax on the interest paid to domestic investors. That loss of tax revenue would be offset to the extent that elimination of the tax is likely to result in lower rates of interest paid out on government bonds.

Third, an exemption from tax on bond interest that applied only to foreign investors could be extended to include corporate bonds as well as government securities, thereby encouraging foreign investment and adding liquidity to the corporate bond market. If government bonds are exempt from tax while corporate bonds remain subject to tax, the spread for corporate bonds will be increased.

This approach requires a system for minimizing tax avoidance and evasion by domestic investors who may attempt to be treated like foreign investors. Investors would need to prove that they, or the beneficial owners of the assets, were in fact resident outside of issuing country to qualify for exemption. Know-your-client rules could serve this purpose as well as anti-money laundering purposes.

Analysis of Exemption for Interest on Government Securities

When a government taxes the interest that it pays on its own bonds, to some extent it effectively is moving funds from one pocket to another. Because investors use after-tax income when comparing investments, bonds that are subject to tax must carry a higher interest rate than comparable non-taxable bonds to attract the same investor demand.²

For example, if we assume (to keep the math simple) a 20% tax rate and an investor who wants a net after-tax return of 4%, a taxable bond will need an interest rate of 5% to attract that investor. Alternatively, if an equivalent government bond is exempt from tax, that bond would need an interest rate of only 4% to attract that investor. The amount of

² See S. Eijffinger, H. Huizinga, and J. Lemmen, *Short-term and long-term government debt and nonresident interest withholding taxes*, JOURNAL OF PUBLIC ECONOMICS 68, pp. 309-334 (1998). This study looked at the effect of tax withholding from interest income received by Japanese and American investors on the yields from government securities issued by various countries. The authors of this study found a significant correlation between the amount of tax withheld and the yields from government securities, and concluded that in many situations the economic burden of the tax is offset by higher yields paid to investors.

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revenue lost by exempting the bond from tax would be at least partially offset by the reduction in the government's interest cost, particularly when we consider that the government is unlikely to collect 100% of the tax due from interest payments on a taxable bond.

In addition, this approach avoids the costs that the government would have to pay to administer a system that exempts only foreign investors. Under this approach, the tax authorities would not need to monitor the residency of bondholders to ensure that those claiming an exemption were in fact entitled to do so.

Although this analysis applies to local as well as foreign investors, domestic financial institutions decide to buy local government bonds for a number of reasons other than the yield of those bonds, for example, to meet capital reserve requirements. Moreover, exempting government bond interest received by domestic investors from tax while continuing to tax interest from corporate bonds may increase spreads between the two asset classes. Some economists argue that this increased spread is an artificial distortion of the market that should be avoided.

Choosing an Approach

Ultimately, determining the net effects of eliminating tax withholding on government bonds requires a very complex analysis of a number of factors, which would be far beyond the scope of this paper. Moreover, practical political factors inevitably must be considered in determining which of the approaches discussed above works best in a particular situation. We therefore do not attempt to recommend one of these options as preferable to the other. At the appropriate time, ASIFMA would be pleased to have the opportunity to collect the views of the industry on any proposal and pass that viewpoint on to the interested policy makers.