The Development of Capital Income Taxation in Sweden 1928-2002[1]

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1 Income From Capital According to the KL of 1928

Modern income taxation took form in Sweden through the big law reform in 1928. In that year, a massive modernization took place, affecting both the municipal income tax and the state income tax. The main code, Kommunal-skattelagen ("KL", Municipal Income Tax Act, 1928:370) to which the state income tax law ("SIL", State Income Tax Act 1947:576, earlier 1928:373) made extensive reference, remained on the statute book, often amended, until 1999 when the present Income Tax Act ("IL", Inkomstskattelagen, 1999:1229) was enacted, replacing both KL and SIL.

During this period many changes took place in the Swedish tax system. This paper deals with the transformation of the tax on income from capital that was an important development over these years. The key word describing this development is the transition from a periodic source concept of income to a capital gains concept.

KL divided income into six schedules, but this was for computation purposes only – for residents, the tax base in principle was the global income from all sources, in other words, the tax was synthetic. The schedule for income from capital comprised basically one income source; yet, income from foreign real property or from business independently carried on abroad constituted a separate source of income.

Real property holdings abroad were treated very simply. No depreciation allowances but instant deduction for all costs was the rule, although with no loss carry back or carry forward. The same treatment was given business independently carried on abroad, but the cases where such income was declared,

1 This article is a somewhat revised translation of my contribution to the special 2001 issue of the Skattenytt, "Skattenytt 50 år 1951-2000". Its title is *Kapitalinkomstbeskattning under 50 år* (Taxation of capital income during 50 years).

particularly at the time we had foreign exchange restrictions, were rather few. In l988 the rules were adjusted and independent business abroad was removed to the business income schedule. In the IL, such income has been placed in the passive income category, but conceivably the right to make deductions for losses has been widened. We shall leave this issue aside, as well as the fact that renting of private real property has been included in the income from capital schedule.

What was understood to be income from capital was basically interest and dividends. Interest on loans given as well as on bank accounts was, of course, taxable under the schedule, and so was interest on bonds and similar securities. We shall soon notice, however, that the definition of the concept of interest was far from self-evident. With dividends also taxed under the schedule, definition problems came up here as well. One particularly tricky problem concerned the difference between current distribution of profits and distribution in liquidation or by reduction of the share capital. The latter could arguably fall under capital gains, but to ensure the economic double taxation, a special tax was levied on these events until the capital gains tax took over. Also, it was not easy to separate interest accruing to a business or real property operation and other interest, the latter falling under income from capital. Likewise, interest costs had to be allocated between the schedules. To be sure, at the time of synthetic taxation, the allocation to one schedule or the other was not important for the state income tax, but had significance for the allocation of income between local governments.

A characteristic problem attached to income from capital has always been that it has been possible to reduce the income by different kinds of tax arbitrage, using the right to make a deduction for interest costs (that right is now suspended and a tax rebate has come in its stead). Typically, this behavior led to deficits under this source of income. Until 1982, the net deficit could be deducted from income and represented a relief to the taxpayer in the amount of the deficit multiplied by the marginal tax rate that could in those days be in the region of 80 percent. After the reform, the tax reduction is computed at the 30 percent applied to income from capital, and if the deficit exceeds SEK 100 000, the reduction drops to 21 percent. Still, income from capital has been estimated to show a net deficit.[2] Evidently, it would be a mistake, however, to believe that as a consequence zero-rating of all income from capital would result in a gain to the Treasury. Tax arbitrage both on the income and the cost side would hardly be beneficial to the budget.

2 Capital Gains

How about the capital gains, now included under that name (the old name was “realization gain”) as part of the income from capital? The legislation rested on a concept of income generally referred to as the source theory. This implied that it was only the yield of the capital that was taxable, in other words the fruit of the tree but not the tree itself. Income tax was a tax on income, as Lord McNaughten

2 It is an illustration that as the rate of tax on income from capital was increased in 1995 from 25 to 30 percent, the budget impact was estimated to be negative.

once stated. Capital gains were not part of the tax base, and capital losses were not deductible.

At the time the KL was enacted, the concept of income for tax purposes had been under discussion both in the scientific world and by tax reform commissions. The concept of taxable income, defining the taxable base as the periodic income flowing to the taxpayer from his sources of income, be they his capacity to work, his real property, his business enterprise or his capital, was of the traditional type. The arguments presented by the Swedish professor David Davidson and his German public finance colleague Georg von Schanz, arguing in favor of a concept of income measured in accordance with the change of the taxpayer's net wealth, were certainly not easily dismissed, but they were not reflected in the 1928 tax law.[3] The two would later find followers in the US in R. M. Haig and H. Simons, but even there, at the time the income tax was first introduced, the time was not ripe for an income concept making no difference between income and capital gain.[4] Common to the four of them is the fundamental idea that taxation would in principle be applied to the amount that the taxpayer could have used up during the tax year without thereby diminishing his net wealth. It is another matter that the net wealth and its changes may be measured in different manners, for instance by regarding or disregarding the changes in the value of money. Just capital gains are particularly sensitive in that respect, since they are primarily measured as the difference between the nominal proceeds at alienation and the nominal acquisition cost – a nominal gain may, if measured in real terms, easily turn out to be a real loss.[5]

It was also a weakness of the capital accretion theory (Vermögenszugangs-theorie) of von Schanz that its logical beauty presupposed a comprehensive taxation of all that the taxpayer theoretically could consume during the year without thereby reducing his net wealth below what it was at the beginning of the year. This income concept presupposes tax on unrealized gains. The practical complications of imposing tax on unrealized gains are formidable, however. Spending the gains from a stock exchange boom on caviar and champagne before the gain has been realized, is unwise, according to tradition.[6] After all, reversing the procedure in a following bear market meets with difficulties. At the same time, sticking to a realization criterion puts a premium on a policy of "cutting your losses short and letting your profits run". The unfairness of this

3 Davidson, D., *Om beskattningsnormen vid inkomstskatten*, Uppsala 1889, von Schanz, G., *Der Einkommensbegriff und die Einkommensteuergesetze*, Finanzarchiv 1896, at 1.

4 Haig, R.M., *"The Concept of Income"* in *The Federal Income Tax*, ed. R.M.Haig, New York 1821 and Simons, H., *Personal Income Taxation*, Chicago 1938.

5 In the argumentation against index regulation of the capital gains tax, it has sometimes been maintained that nominal taxation of income from employment is as unfair. There is something to this argument in as much as basic exemptions and bracket limits in the progressive rate schedule of course may be modified with respect to inflation. Still, the capital gains case is special since the situation here quite often is that a nominal gain reflects a real loss.

6 Of course, it is still possible to take out a mortgage loan based on the new value, but with an inflation rate close to zero and with a much more stingy tax reduction for credits, it is not as tempting as it used to be to borrow against rate increases. The tax reform, indeed, was followed by a wave of debt repayments.

was seen by some as an argument for interpreting von Schanz as including unrealized gains and losses in the concept of income. Others argued that von Schanz being a practical man would never have proposed a tax on unrealized gains.[7]

With respect to the losses, they were never generously treated. In the old system, capital losses could be set off against capital gains only, and the same restrictions were applied as on gains. Even now, when all gains are taxed, there is a reduction to 70 percent of the loss that can form a basis for tax relief, the percentage computed on the compound net loss during the year on securities dealings and on each other loss of other kinds.

The concept of taxable income developed in the 1928 law was traditional. The income from capital was defined as the yield, taking the form of interest or dividends. Capital gains were by definition excluded from the concept of taxable income. There was, however, still an element of capital gains tax in the law, in as much as speculative gains were held taxable. The definition of speculative gains could, of course, not rest on the attitude of the taxpayer or the taxpayer's intentions. Objective criteria had to be applied. These were of two kinds: the mode of acquisition of the capital asset and the time span over which the asset had been held. The argument was that a taxpayer who had received his property by inheritance or gift had thereby not revealed a speculative mind, whereas a taxpayer who had bought his property or received it in exchange was more likely to be a speculator. If the taxpayer observed a long enough holding period, he would likewise disprove his speculative intention, whereas a short period of holding was an indication of a speculative mind.[8] These speculative gains were placed in another schedule, "Occasional earnings", for a long time together with occasional honoraria and diverse other incomes. It is a long way from this attitude to capital gains to the present state of affairs, where press and news service reports on business as a self-evident matter bundle dividends with capital gains to compute the effective yield on stock investment.

The rules for speculative gains were changed over time. One change was caused by the observation that spouses and other related persons evaded capital gains tax by transferring the property as a gift to the spouse or relative who later sold it tax exempt. The solution in Sweden like many other countries was (from 1951) the use of the original basis and the original mode of acquisition in these cases. The situation might sometimes be delicate if the recipient of the gift has to make inquiries by the donor about what the gift has cost him. In the US, the revenue service can help making the difficult question. On the other hand, the US applies a step-up for inherited property, where Sweden prescribes continuity,

7 In my doctoral thesis *Inkomst eller kapitalvinst* (Income or capital gain) (1959), I showed some theoretical sympathy for the concept. In his speech at the "disputation" dinner my tutor, the great economist Erik Lindahl, teased me, reminding me that the capital value of my future earnings had risen considerably that day, and that my willingness to pay tax for such an unrealized gain might be modest. Of course he was right.

8 *A fortiori*, gains from professional business activities including the buying and selling of securities have always been taxable under the business income schedule, but there is hardly any case of an individual falling under this rule that instead applies to brokers, banks, and the like, virtually always operating in corporate form.

i.e. the use of the basis applicable to the deceased. This element of US law keeps many old people from realizing their gains in their lifetime.

The original five-year rule implied a drastic difference between full taxability after 4 years and 364 days of holding and full exemption the day after. It was modified, also in 1951, by a tapering-off rule. In the last four years of the prescribed holding period, the taxable part of a gain was reduced by 25 percent per year. The holding period was rather long in international comparison, 5 years for securities, 10 years for real property and 15 years for waterfall rights.

It was not until the end of the 60's that the lawmakers were ready to abolish the tax exemption for long-term gains. First the rule was changed for real property, but then in connection with a later abolished correction of the basis for inflation. The next step was unlimited capital gains tax on securities as well. In both cases there were simplifying alternative rules for a taxpayer who could not establish the proper basis for his property. These rules are hardly generous, for real property based on the old assessed value of the property, for shares on an imputed cost basis of no more than 20 percent of the proceeds at the sale (48:15 IL). It was also a complicated task to establish the acquisition cost for shares acquired at different times and by different means.[9]

It is also striking that the Swedish lawmakers – to be sure before the constitutional prohibition of retrospective tax legislation was enacted in 1979 – felt that they could introduce capital gains tax without any limit to the holding period even on gains that could have been realized without tax before the new law. In many other countries, new capital gains taxes have been introduced with a "D-day provision" giving the taxpayer the right to use as basis the value of the property or the shares at the time the new tax entered into force. In Australia, one has gone even further and established tax exemption for old holdings. This generous rule has, of course, resulted in serious locking-in effects and in avoidance transactions where gains on new shares were injected into companies the shares of which had been held by the owners before the D-day.

After these changes in the law, what was left of the old distinction between income and capital gain was not much, basically just the restrictions on the deductibility of capital losses and the now obsolete distinction between capital loss and current loss in business. The new income tax law (IL) has changed the term previously used for capital gains, "realization gain", and introduced "capital gain", but without any ambition to keep the traditional borderline between current yield and capital gain.

It is important to note, however, that this distinction between current yield and capital gain has not disappeared in other contexts than tax law. If a deceased person in his will has bequeathed to the black sheep of the family the yield on a certain capital, but not the capital itself that instead goes to some less obnoxious

9 At the time the introduction of capital gains tax on long-term share transactions was considered, the largest Swedish newspaper arranged for a competition, who could compute the correct basis on a fictitious parcel of shares that had gone through a complicated story of splits, bonus shares and new emissions. I expected to win the price but did so only after arguing with a lawyer engaged by the newspaper, who had missed an obscure decision by the Supreme Administrative Court on a new emission of shares with different voting rights. The idea behind the whole exercise was to show that the poor taxpayers would not be able to cope with the new rules, but the minister of finance closed his ears.

legatee in succession, the interpretation under civil law of what is yield and goes to the black sheep and what is capital going to the legatee is in no way influenced by what the tax law regards as income from capital.

The same is the case with such foundations (trusts) as are according to their statutes allowed to spend the yield only and not their capital. In 1995, a government committee wanted to extend the requirement for tax exemption that a charity has to use around 80 percent of the net yield for its charitable purpose to be based on the yield in the tax sense. There was an outcry. Using capital gains for distribution would violate the statutes of many charities, and a permutation, so the government authority responsible for such decisions decreed, would not be granted.

It is an interesting issue to what extent the lawmaker has felt obliged to respect the wish of the taxpayers to keep their capital intact. Up to 1947, as the separate net wealth tax was enacted, such conflicts must have been extremely rare. The net wealth tax at the time had the form of an addition of 1/60 of the net wealth to the taxable income to state income tax thus ensuring progression for the highest fortunes and incomes with correspondingly lower tax on smaller wealth-holders with lower incomes.

As the net wealth tax was turned into a separate tax, there was still some regard taken to the wealth-holders with low-yielding assets. A maximum rule established that nobody should pay more than 80 percent of his income in income and wealth taxes, albeit with the reservation that net wealth tax should always be paid on one half of the net wealth. This implied – and still does – that some taxpayers with low-yielding assets will face the choice between borrowing to pay the tax and selling off some asset. Lawmakers used to look at capital gains as income and adhering to the principle that even unrealized gains should if possible be taxed would see no problem here. Moral scruples were, however, felt by those growing up in another tradition. An old lady feeling her deep responsibility for carrying over the capital of the family to future generations without diminishing it must often have reacted to the obligation of selling securities with the same indignation she would have felt, if advised by the tax authority to earn money to the tax by turning into immoral activities.

3 What is Interest?

The definitional problem of what is interest has not always been easy to deal with. If somebody sells a bond before maturity he is under common usage entitled to compensation from the purchaser for the interest accrued. Both the old law and the present Swedish law (42:8 and 41:11 IL) establish that this applies to the tax as well, the seller liable to tax on the compensation and the purchaser entitled to a deduction. If the bond has turned into a bad debt, however, the value of the compensation cannot be computed and the rule, accordingly, does not apply. The rule is of less importance than it used to be by virtue of the fact that capital gains, including those on bonds, are taxed at the same 30 percent rate as interest income.

Likewise, we face problems when the compensation for accrued interest takes an unusual form, for instance with respect to zero coupon bonds. The effective interest takes the form of a difference between the redemption price and the emission price of the bond. Formally, the bond runs without interest. Particularly during World War II and some years after, Sweden had a kind of savings bonds that were of this kind. To begin with, they were tax exempt, but in 1945 tax was imposed on the effective yield, something that was so much easier to do, as the bonds were personal and not negotiable. From 1960 the rules were further tightened, accruing interest being taxed each year. After that, the interest of the public in these savings bonds faded out.

Corresponding issues come up even with interest-yielding bonds, if part of the effective yield takes the form of a capital discount on the emission and/or a bonus at redemption. By the introduction of a capital gains tax with no time limit for the holding period much of this problem was eliminated, at least for the investors, since the tax result was the same regardless of whether the difference in the value of the bond between redemption and emission was treated as interest or as capital gain. The issue may, however, come up if a borrower who is not carrying on a business to which the loan applies incurs a cost through the difference between the rate at redemption and the rate paid on emission, and this cost is not referred to foreign exchange rate differences. It is, moreover, as we will soon see not at all evident how this rate difference should be treated, when it is reflected in the value of the bond on alienation during its lifetime.

The Supreme Administrative Court was possibly a bit imprudent as it first dealt with index bonds, i.e. bonds the redemption rate of which varies with the price index. The tax legislation in general in those days rested on a firm base expressed in the principle "one krona [the Swedish currency unit] is a krona". Inflation that had been kept down in the rigid price control system during WW2 took on another pace in the 1950's, beginning with the 1949 devaluation and the following "Korean" inflation. Later, it would to some extent influence tax legislation. Much earlier, however, as the issue was raised how to tax the holder of an index-based bond (with correspondingly lower nominal interest), the bondholder was told that not just the nominal interest but the index compensation as well should be taxed as interest. How to coordinate that rule with the absence of any system for computing accrued index compensation at alienation during the lifetime of the bond was an open question. One must guess that those holding index bonds saw to it that they sold off their bonds before redemption either to a dealer in bonds, who could deduct the purchase sum, or to a charity exempt from tax on interest. The verdict (RÅ 1943 ref. 19) long put a stop to all new efforts to issue index bonds.

The principle of regarding the yield on a zero coupon bond as interest was confirmed with the cases RSV/FB Dt 1983:3 and RÅ 1988 ref. 2. After section 29 paragraph 2 SIL in 1990 had codified the basic principle that capital gains and losses on bonds quoted in the market would be treated as interest, positive and negative, respectively, the principle was again confirmed in RÅ 1994 ref. 19.

The complicated character of the issue was illuminated particularly in the three cases under RÅ 1995 ref. 71, dealing with real interest bonds issued by the Government Debt Office. These are guaranteed a certain real interest rate, but they are constructed as zero coupon bonds. Price changes during the time of holding therefore could be ascribed to three factors, namely first, accrued interest according to the real interest rate, second, accrued nominal value change that, together with the accrued real interest, corresponds to accrued nominal interest, and third, rate variation corresponding to changes in the market interest rate.

It would be too optimistic a statement that these court rulings had answered all the open questions. Particularly, one could, as did Niclas Wirin – who as a member of the Revenue Law Commission announced a differing opinion in the cases[10] – ask whether gains and losses realized during the holding period should be seen as capital gains and capital losses, respectively, and accordingly not be counted as interest under income from capital. The technical problems accompanying an uncompromising labeling as interest of everything that happens to the real interest bonds are tricky, to say the least. The Revenue Law Commission saw in accordance with RÅ 1994 ref. 26 II (that dealt with share index bonds) that the treatment as interest would cause difficulties in applying the averaging method prescribed in §27:2 SIL (now 48:7 IL) and at the same time treating the rate change of this kind of bonds as interest. The dissidents in the Commission on that point, Gunnar Johansson and Peter Melz' were confirmed in their views by the Supreme Administrative Court.

Once our new tax law codification was ready in 1999 there was no attention paid to these subtleties. Instead, the text in 48:23 IL was enacted, decreeing that a "capital loss on other market-quoted Swedish debt claims than premium bonds is deductible in its entirety".[11] This wording expresses the radical understanding of what is income that sees no difference between income and capital gain but, on the contrary, sees capital gains as income. There is, in other words, no distinction under the tax law between such yield on the capital that takes the form of interest and such capital change that takes the form of capital gain.

An interesting implication of this is that in practice it has now turned exceedingly complicated to return to a differentiated treatment of capital gains in the traditional sense. It is, moreover, obviously impossible for civil law purposes to find any guidance in the use in income tax law of the term capital gain. That term is used in the IL with no regard to the distinction between what under civil law obviously constitutes capital gain as different from yield and such yield on zero coupon bonds that in analogy with bill discount even under civil law must be assimilated to interest.

Strangely, until this day, the expected probability value of winnings on premium bonds has not been treated as interest income. Instead, the gains have been exempt from income tax and were for many years subject to tax on lottery winnings. In accordance with this view, 29:2 SIL and 48:23 IL have abstained from making losses at the alienation of premium bonds an interest expense (while gain on their alienation has been labeled ordinary capital gain). The logic of this is easy enough to see if regard is taken to the interest of the government in cheap borrowing. In fact, however, this treatment is not any better as a tax rule than it would be to allow wage-earners to take out part of their wages in tax exempt lottery tickets. That winnings on premium bonds like lottery winnings should lie within the concept of taxable income is confirmed by 42:25 IL that

10 His comment in Svensk Skattetidning 1995 at 84-95 sheds further light on this.

11 Cf. also RÅ 1997 ref. 63.

explicitly makes winnings in foreign lotteries taxable above a *de minimis* threshold of SEK 100. It is interesting to note that this discrimination against foreign lottery organizers has been contested by the commission in a letter to the government of Norway (that as an EEA member has to observe the acquis in the tax field) as well as in a case from Finland now resting with the ECJ (Lindman C-42/02).

The question what is interest arises of course on the cost side as well. Here we meet with a distinction between what is interest in the narrow sense and what are costs of capital in general. The latter, if they refer to a source of income, may be regarded as deductible regardless of whether they constitute interest or not. In those cases where the cost of borrowing is deductible in its capacity as interest only – a rule with a long history but recently rather much limited – the right to deduct applies to nothing more than what is interest in a narrow sense. Note, however, RÅ 1999 ref. 14 where the cost of an interest rate guarantee was regarded as an interest payment in advance if the guarantee was connected with the loan contract, whereas the cost of a separate interest rate guarantee could not be deducted as an interest cost.[12]

The definition of interest also is of importance for letter of credit costs in connection with construction activities. Interest paid during the time of construction is simply interest and should be deductible as such with a corresponding right to tax reduction for part of the net deficit. If the interest is a cost in business activities, it is conceivable that it should rather be capitalized to form a basis for future depreciation allowances. If the letter of credit costs refer to a private home the question has to be solved with reference to the rules for income from capital. The attitude of the court in RÅ 85 1:14 was benevolent.

An interesting development took place in connection with some cunning taxpayers who had found out the trick of donating interest-bearing notes to their children. They wanted a deduction for the interest that with regard to the high marginal tax rates of the parents and the much lower rates of the children would be favorable. A periodic payment to the children would not be deductible. The scheme was declared non-valid in an *in pleno* decision by the Supreme Administrative Court (RÅ 1956 ref. 11) where it was stated that the interest as a part of the gift transaction was a periodic payment, and hence not deductible when paid to a member of the taxpayer's household. There were some civil law experts who felt that the interest on gift notes of this kind under civil law could be nothing but just interest, whereas those members of the court who dictated the outcome were of the opinion that the interest payments even under civil law were an element of the gift transaction. Among these Justices was Justice Hedfeldt, who shortly after was moved over to the Supreme Court, an appointment that could never have taken place if the other Justices in that Court had found him lacking in knowledge of civil law.

We must regard the unlimited right of deduction for interest as an outflow of the concept of income that attaches principal weight to the periodicity of income. Just as interest income is a typical example of what is income in the sense of a periodically flowing yield, the interest cost as a periodically occurring burden is a negative income. The same mode of thinking also gave rise to the rule on

12 Cf. also RÅ 1997 ref. 63.

deduction for periodic payments. These were for a long time not limited in any other respects than that they could not be given to members of the same household or for education or schooling. Neither for interest, nor for periodic payments was any evidence needed for the expense having been made to acquire income. Even interest on consumption debt was deductible, just as periodic payments, regardless of whether there was any court-declared obligation to pay alimonies or any separation settlement in the background.

4 Dividends

Income from capital also includes share dividends. The development in this regard has not been straightforward. In one year, 1994, the economic double taxation of dividends was in fact suspended. Before, since 1960, we had had the so called Annell Act that gave substantial relief on the corporation's side for distribution on newly emitted shares, and while the restitution of the double taxation was not accompanied by a revival of the Annell Act, there were from 1996 rules on "relief", this time enjoyed by the shareholder (Ch. 43 IL). As a general rule, however, the classical approach has been in force with tax on the corporation for its profit and with a second tax on the shareholder for the dividends he receives. The combination of a more than 50 percent corporation tax and a high marginal tax on dividend income made the retention of profits in corporations a rational policy, even for corporations with rather dim yield expectations. The corporation tax was also levied only on the profit shown. The free depreciation 1938-51 and generous rules for the valuation of stock-in-trade offered the corporations a unique freedom for themselves to decide how much tax they would like to pay, while at the same time dividend-starving shareholders were kept at bay with accounts closely related to the tax rules. In principle it could be shown that investors with high marginal tax rates were wise to place their money in corporations promising not to pay any dividends. That rule did not gain many proselytes, however. One reason might have been that business circles found it rational to put CEOs under certain pressure by maintaining a claim to dividends.[13]

As long as capital gains on shares were tax exempt after a holding period of five years (or after inheritance or gift from another person than a relative) it was tempting to take tax-exempt capital gains instead of taxable dividends. The technique could vary, but what in English is called "dividend stripping" was named "Lundin transactions" after a(n in)famous accountant by that name. He let his corporations "Odora" and "Mandarinverken" take care of corporations ready for emptying. After an initial success in the "Nordbäck case" (RÅ 1953 ref. 10) this kind of transactions were soon made less profitable, first by prohibitive law provisions, still kept in 24:18 IL, and later through the general anti-avoidance rule.

13 At least that was the explanation I got from the late Dr. Marcus Wallenberg at a seminar 1960 of the Industrial Institute for Economic and Social Research (IUI) as I tried to prove that distribution was a bad idea.

We shall not enter this problem field now, but what is interesting in this context is that the interchangeability between dividends and capital gains on shares was clearly established. The lawmakers felt that they were called upon to act when what should have been highly taxed dividend income turned tax exempt as long-term capital gain. Later on, and notably at the time the double taxation was suspended, one turned the question around and tried to find out what should happen to the capital gains tax on shares, if dividends were made tax exempt. If retained profits had been the only explanation of the rise of stock prices, the connection had been self-evident and 1994 would have brought us not only tax exempt dividends but tax exempt capital gains on shares as well. The price variations may, however, have other explanations, and after having taken a shy look on the far from simple but theoretically awesome Norwegian "JIK-rule" for adjustment of the basis with retained profits, one stopped at exempting just half of the capital gain. The reintroduction of the classical double taxation rule made the subject less topical but it remains a live issue with respect to the taxation of capital gains on subsidiary shares, the dividends on which are exempt to the parent company with the purpose of preventing more than double taxation. Legislation to make these gains tax exempt is under preparation in the ministry of finance.

5 The Schedular (Dual) Taxation After the 1990 Reform

In the course of the great reform work it was clear that the taxation of income from capital was a loss business for the fisc. Taxpayers saw to it that their incomes as much as possible took the form of tax exempt capital gains or winnings on premium bonds, or were placed in pension insurance. In contrast, the cost of loans in the form of interest was deductible, reducing the total income, with a tax rate on the highest bracket after 1947 and later reforms at times exceeding 80 percent. The matter did not provoke much of a reaction to begin with, but in 1982 the rule was introduced that a deduction for interest should not reduce the final tax due by more than 50 percent of its amount. The big tax reform changed the rule more radically, as we shall see soon.

Pension insurance was for a long time offered with all premium payments deductible, no tax on the yield on the insurance capital and full income tax on amounts paid out. Endowment insurance was then as well as now a somewhat less attractive scheme. There was hardly any right to deduct the premium payments, there was a low tax on the accumulated yield but no tax on amounts paid out. The situation has been changed drastically. Pension saving is no longer deductible without limits. The yield tax has been extended to pension insurance institutions, and the pension paid out is still fully taxed.

The big tax reform in 1990 brought significant change, particularly in the division of income into income from capital and earned income. In international comparison it is a bit funny to think about the fact that for most of the century we were looking down at those underdeveloped "schedular" tax systems, for instance in the Mediterranean countries and in Belgium, and saw it as a highly needed modernization when a growing number of these countries adopted a system of global income taxation with no distinction between different kinds of income. For our own part we had adopted a global income tax already in the first decade of the century.

Once this reform had been undertaken in almost all of those countries that had applied schedular taxation, the time had come for us to reinvent the wheel and split the income into two parts, one being regarded as earned income subject to progressive central government tax and proportional municipal tax, the other seen as income from capital subject to a proportional central government tax only. How could this happen?

The basic pattern was the annoying capacity of the capital income schedule to run at a loss to the fisc. Add to this that at the time of the tax reform there was nobody predicting that inflation would stop the way it later did. Counting 4 percent inflation rate and 10 percent nominal interest, 30 percent tax on the nominal interest would be equal to 3 percent leaving a real net yield of 3 percent. If, instead, the tax base were inflation-adjusted and only the real interest, 6 percent, were taxed, and if the tax rate applied on this real interest were the same as the top rate on earned income, then around 50 percent, the end result would be the same, i.e. 3 percent real interest net of tax. In that situation one could regard a tax rate of 30 percent without inflation adjustment as a practical approximation to a 50 percent tax on the real interest.[14]

Moreover, it was a practical simplification to let the tax on income from capital levied at the source in practice be a final tax.

Since this new system was introduced a number of unexpected changes have occurred. Inflation has come down to close to nothing. The inflation argument for the lower tax on income from capital compared to the tax on earned income has turned drastically weaker. Second, a good deal of the private savers seem to have looked for other outlets outside the borders. The tax there is often much lower than our 30 percent. The international effort to fight harmful tax competition about savings seems to have focused on an internationally applied minimum tax rate lower than the 30 percent we apply. Third, income from capital as a tax schedule is still running a deficit.

What we also have experienced is a considerable complication in the context of the distinction between income from capital and earned income. The rules for closely held corporations like those on positive and negative allocation of interest have come in as seriously complicating elements in the tax law. The reason is that the differentiation between incomes makes it an objective for taxpayers to have positive income classified as income from capital and negative income as deductible negative earned income.

The tax reform of 1990 also brought with it a principally important change with respect to the right of deduction of negative income from capital. The first

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14 The example is fetched from the committee report *”Inflationskorrigerad inkomst-beskattning”* (Inflation adjusted income taxation), SOU 1989:36 at 44. The main committee report, SOU 1989:33 at 68 et seq. exemplified the issue inter alia by 7 percent nominal interest and 3 percent real interest. With those assumptions, the 30 percent nominal tax represented 70 percent of the real interest. At 125 in the report it is said, however, that with a 20 percent nominal tax rate “the tax on the real yield will then be equal to the tax on earned income if the inflation is a modest 4 percent”. Here it must be the figures of the other committee that have played a part. That inflation in the future would be as insignificant as now (less than 2 percent per annum) nobody had been dreaming about.

step taken in 1982, limiting the effective tax reduction to 50 percent, was followed by a second step implying that the tax reduction for a deficit could be only 30 percent of the deficit, and if the deficit exceeded SEK 100 000, the reduction was limited to 21 percent of the exceeding amount. This, it was hoped, would at least put a stop to the fiscal deficit under income from capital. It would have been possible, after the pattern of, say, the US, to distinguish between interest on loans taken for investments, the yield of which was taxable, mortgage loans – where the property tax represents a standard assessment of the imputed income from the property – and other loans, taken to finance consumption. The tracing of for which purpose a loan has been made is far from simple, however. Even if a loan initially has been a mortgage credit, the failure to pay off the loan might have its background in the fact that the borrower has chosen to do other things with the money he could have paid off the loan with. If he has bought a car, a sailboat, art works, or cognac for the money, the deduction for interest is not as worthy a purpose as the purpose of the earlier mortgage. For the tax authority, however, the task of distinguishing what should in the future be regarded as interest on a consumption credit would be next to impossible.

With the tax reform, the former global (synthetic) system broke apart. Moreover, for good reason, it was chosen to make the formal tax rate on income from capital lower than the rate on earned income. This might seem surprising. In states without a net wealth tax, e.g. in the UK, there was for a long time a schedular tax that was higher on income from capital than on earned income. This was usually seen as a measure in lieu of the net wealth tax that used to be applied in the Nordic and many continental European countries.[15] A lower tax on income from capital such as in the present dual rate system raises new problems, however.

With the dual tax it was advantageous to take out as a dividend what would earlier have been taken out as a concealed dividend labeled as another kind of income (or, preferably, as not taxable at all). If in the old system tax auditors attacked excessive salaries to shareholders in closely held corporations, the fiscal interest was now the opposite, in other words limiting what the shareholders could take out as income from capital, taxing the dividend or capital gain as earned income instead.

What is important in this context is to arrive at an allocation rule that clearly distinguishes between what part of the income of an entrepreneur that constitutes yield on his capital investment and what is his earned income. If the result is such that no positive income from capital can be identified, but a real deficit on

[15] The net wealth tax in general seems to be on the decline. In Germany, the Federal Constitutional Court declared it incompatible with the constitution in the shape it then had, and the federal government found it simpler to let it fall than to undertake the reform of, among other things, the property evaluation that the court would have required for an approval. Denmark and the Netherlands have abolished it, the Netherlands, however, with income tax levied on an imputed net yield of 4 percent. In Sweden, the net wealth tax is a parody with exemptions offered to some select billionaires, with exemption for some of the shares on the stock exchange but not others, with exemption for business property and far-reaching exemptions for some other property. If the constitution had required an equitable tax, the net wealth tax would most certainly have been found “in obvious conflict” with the constitution, the condition for its being declared invalid.

the capital side may reduce the earned income declared, the allocation rule turns into a disadvantage to the taxpayer.

The allocation of interest has turned out as an excellent example of correct thinking ending in a big mistake. Of course it is a correct economic analysis that the entrepreneur's income basically consists both of the yield on his capital and the income he earns by his efforts. And of course, the entrepreneur should be free to use the lower tax rate to the extent it corresponds to reality. Yet, many small businessmen find the computation of what is one or the other unreasonably complicated. Note that the allocation rule is not constructed as an option for the entrepreneur who is free to abstain from using it if it seems too complicated. On the contrary, the entrepreneur is obliged to find out whether the rule is in his favor or not. If he does not apply it in the latter case, a civil penalty is threatening.

6 International Aspects

The international side of the taxation of income from capital was not very much in focus to begin with, and still less as WW2 came and the strict foreign exchange controls that would be with us until the end of the 1980's. These controls were such that those who wanted to place their money abroad usually had to resort to illegal means. Nor was Sweden known as a haven for foreign investors, even though from the outset we had established what should be an attractive rule: no Swedish tax is imposed on interest payments from Sweden to a recipient domiciled abroad. The reason for this astonishing restraint was that the lawmakers from the outset realized that a foreign investor would dictate his conditions for lending in terms net after Swedish tax and thus shift the tax burden onto the Swedish borrower.

Now that we see the council of ministers in the EU trying to establish an order in which all countries apply a system for exchange of information from the source country to the tax authorities in the country of residence, it seems natural that Sweden has pushed for that system instead of the taxation at the source preferred by a minority (Belgium, Luxembourg, and Austria). Not only is this the system we have in place, but it is also a system that at least in theory should make it possible to collect the full Swedish tax on the yield on money that Swedes have placed abroad. After the currency restrictions were abolished, these investments have reached a magnitude – the official guess is more than SEK 300 billion – that makes the tax on them very interesting from the point of view of the budget.

In turn one might ask in what manner Sweden would be able to live up to the requirements now established in the draft savings directive released on December 10, 2001 and supposed to be adopted before the end of 2002. The control system applied internally in Sweden has a minimal *de minimis* rule (just SEK 100 interest on one or more accounts in the same institution may go unreported, and retention at the source has the same limit). There are numerous persons with accounts in Sweden who don't have a Swedish tax identification number (TIN). Introducing a Swedish number for these non-residents would serve no practical purpose. The draft directive, Art. 3, presupposes that a foreign

TIN, if available, will be accounted for. For the Swedish banks it would be a most difficult task to report payments with an indication of the foreign TIN.[16] The computers of the banks are programmed to reject all TINs that do not conform to Swedish standards, and other countries normally have TINs with a different construction. Some other countries have no TINs at all, and the directive prescribes using the date and place of birth as a substitute. If another country has TINs of the same kind, they have to be prefixed to separate them as foreign, just as is now done with the TINs for purposes of VAT on community internal deliveries. Information without TINs will be virtually worthless to the receiving country.

It is certainly not an easy task to ensure that tax is paid on foreign income from capital received by Swedish residents. Until recently we had a rule on registration with the Swedish tax authorities of foreign bank accounts, if the account did not belong to a business firm. If a taxpayer wanted to have more than SEK 50 000 in his foreign bank account, he had to submit to the Swedish authorities a promise by the foreign bank to fulfill all the reporting obligations of a Swedish bank, as far as the depositor resident in Sweden was concerned. Needless to say, this rule was no success, first of all because the majority of depositors neglected it, trusting that they would not be discovered, and second because banks in a number of countries were prevented by the law of their country from issuing the type of information required by the Swedish authorities. Sweden now has to set its hope to the savings directive. The adoption of that directive, on the other hand, has been conditioned by the collaboration of a number of countries, including Switzerland and the US, from which collaboration does not seem to be forthcoming.

With respect to dividends, the Swedish attitude has been different. A tax claim is directed not just against resident holders of foreign shares, who are supposed to declare their foreign dividends as income, but also against non-residents deriving dividend income from Sweden. Since 1943 this requirement has been manifested in the coupon tax that historically also was seen as comprising a part levied in lieu of net wealth tax. The intense Swedish activity in negotiating double tax conventions has resulted in a virtually general reduction of the coupon tax and its abolition with respect to dividends to corporate shareholders.[17] Accordingly, for Sweden the implementation of the parent/subsidiary directive did not mean more than a light adjustment.

Capital gains are nowadays often seen as an alternative to dividend distribution, and yet Sweden has been content taxing the dividends paid to non-residents, leaving their capital gains untaxed. The exception is when the shares are part of the assets of a permanent establishment in Sweden. There are two further exceptions, both examples of the somewhat half-hearted way in which Sweden has implemented its rather ambitious basic principles.

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16 Cecilia Gunne and Kerstin Nyquist stressed this in a sharp separate opinion in the report of the commission on tax control, SOU 1988:12, at 455 et seq.

17 It was an illustration of this situation as the coupon tax was increased from 20 to 30 percent that the bill (prop. 1956:27 at 10) quoted a finding by the authority administering the tax in its comments to the bill that the tax increase would result in a very small revenue increase only that in turn would almost exclusively emanate from one individual, resident in Mexico, in other words the well-known financier Axel Wenner-Gren.

One exception concerns shares in corporations with real property in Sweden as their main balance assets. In a considerable number of tax treaties Sweden has negotiated this exception from the main rule in Art. 13 of the OECD model. It is not clear how much this has cost us in terms of concessions on other points. One hopes rather little, since the fiscal profit has been minimal. In fact, the exception in the treaty is not reflected in the national law (3:18 IL) and hence, in spite of the treaty provisions, no capital gains tax liability exists for non-residents on gains on shares in Swedish real property corporations provided the gains do not accrue to a permanent establishment in Sweden.

The other exception is somewhat more consistently carried through. It refers to gains on Swedish shares realized by somebody who during the last ten years has been taxable as a resident of Sweden. The purpose of this trailing rule, now in 3:19 IL, is easy to understand. It is not uncommon that in the distribution of major estates some heir ready to emigrate was selected as the recipient of Swedish shares with accrued gains – since the distribution of an estate is not a taxable event for capital gains tax purposes, he could even take more such shares than corresponded to his part in the estate. After emigration to a country not applying capital gains tax to his gains, he could sell the shares with no tax payable. The UK remittance rule could obviously serve a purpose in this respect.

To stop this abuse the liability to capital gains tax on Swedish shares was extended to ten years after emigration. The effectiveness of this provision is questionable. First of all it is incompatible with the OECD model, Art. 13:1, and it has therefore been up to the Swedish negotiators to gain acceptance of the rule. In most cases they have had to accept compromises. The time limit has more often than not been set at five years. It is, of course, not known which concessions have been made to bring it that far.

Looking at the practical side of it, however, we discover that the enforcement of this rule is hardly very efficient. Even in those cases where the shares remain in a Swedish bank depot, the bank, according to present Swedish law, is not bound to report the shareholding to the Swedish tax authorities, if the shareholder is resident abroad. The Central Tax Board may decide otherwise but has so far not done so. If the émigré has no other property in Sweden that makes him liable to file a tax return, he will not be disturbed by receiving a tax return form. If he goes to his computer to load down a form, the computer tells him that the main form is not available electronically (the reason being that a return form has to be coded to get into its right place in the organization). If he asks somebody in Sweden to go to the tax authority to get a return form for him, experience shows that he might be informed that no return form is needed since the person is out of the country. In these circumstances, compliance might well be incomplete.

The short conclusion of these international footnotes is that it is important to adapt the claims to tax and the rules on taxation to what is practically possible. When stressing this in another context I have been reminded that it would be a more positive contribution to indicate how the tax law could be changed to make it more efficient. That is certainly a valid point. A positive proposal of this kind could be that perhaps more money could be collected by directing the efforts towards those cases where the money is in Sweden and can be claimed here. In other words, the alternative of taxing at the source, rejected in the discussions of the savings directive, might have been preferable to the alternative now chosen, an information system in combination with taxation in the country of residence. In such a situation it would, however, be counterproductive to fix the tax level too high. One would have to stick to the minimum the EU member states could agree on.

Another positive point of view would be a follow-up of the accrued tax liability in the context of registration of emigration, of course with a liberal *de minimis* rule. An emigrant who when leaving the country has important Swedish shareholdings should be followed-up, possibly with an obligation to keep the shares in a Swedish depot, of course with information from the bank to the tax authorities, and on his own part with a remaining obligation to file a tax return until the time has elapsed during which Sweden can raise a claim to capital gains tax.

It is another issue whether it is worth spending so much powder on what is, after all, a relatively insignificant problem. Regrettably, with relatively high taxes we seem to have reversed the trend to re-immigration that was noticeable the first years after the tax reform. To turn that tide by domestic relief measures would of course be better and would in the long run offer more revenue than the trailing tax. If the ambition to use the tax system for redistribution prevails, other ways must be tried.

It would, however, be quite inappropriate with regard to human rights to make the emigration as such an event that implies liability to pay tax on unrealized gains on assets taken out. Of course, no other lesson than that of a warning example is told by the model developed in the US. There, the claim to tax is not only extended to all citizens regardless of residence. Moreover, a prolonged claim to tax is extended to those who have rescinded their US citizenship, provided they cannot prove that other reasons than tax caused the expatriation and their income and wealth exceeds certain threshold values (Sec. 877 I.R.C.).[18]

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18 More on this in the report *”Taxation Caused by or After a Change in Residence”* by Sanford H. Goldberg and 16 others in Tax Notes International, 7 August, 2000 at 643-59 and 14 August, 2000, at 741-66. Particularly thought-provoking is the statement at 657: “The U.S. system is exceedingly complex and is, like other trailing tax regimes, to a large extent unenforceable.” By “trailing“ the report refers to just such a system as Sweden has for the gains realized on Swedish shares by emigrating Swedes.