The Development of the Concept of Income in Nordic Income Tax Law

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1 Introduction

The concept of income is, of course, of basic importance in any income tax regime. However, as all tax lawyers know, the concept is very complex and complicated, and its content varies from country to country and from time to time.

Most legal works within the field of income taxation deal with aspects of the concept of income. So does this article. However, instead of investigating specific aspects of the concept in detail, an attempt is made to study the development of the concept historically and comparatively in the four Nordic countries Denmark, Finland, Norway and Sweden.[1]

The core subject of the article is how the taxable gross income and the right to deductions are defined. The development of the tax rates is not covered except to the extent that the tax rate structure is of importance for the understanding of the concept of income. The same applies to the rules concerning taxable individuals and legal entities and special tax questions relating to specific subjects such as the taxation of companies and their owners. In addition, timing issues are left outside.

As a modern phenomenon, the income tax is less than 150 years old in the Nordic countries. However, in Denmark/Norway and in Sweden short-lived income taxes existed from 1810 and some years thereafter. They were remarkably sophisticated as to their structure with a rather elaborate income concept. However, they turned out to be premature as the tax administration was not able handle such a complicated tax at that time.

Income taxes re-emerged in the second half of the century. Important examples are the Copenhagen tax law 1861 in Denmark, the municipality tax

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1 The article is based on my book *Inntektsbegrep og rettsutvikling. Hovedtrekk i utviklingen av begrepet inntekt i nordisk skatterett* (The Concept of Income and the Development of Law. Main Features of the Development of the Concept of Income in Nordic Tax Law), Oslo 1982, and the article *Inntektsbegrepet og rettsutviklingen i nordisk skatterett* (The Concept of Income and the development of Nordic Tax Law), in Jussens Venner 1988 p. 229.

law of 1863 and again of 1882 in Norway and in 1865 (for the countryside) and 1873 (for the cities) in Finland. In Sweden, the old taxes levied the on the proceeds of various income sources were reformed in 1861 in the direction of an income tax. Income taxes to the state are a somewhat younger phenomenon: Such taxes emerged in Norway 1892, in Sweden 1902, in Denmark 1903 and in Finland 1921.

In the first two decades of the 20th century, the income tax consolidated its position and the statutes enacted in this period, formed the basis for the further development of the income tax throughout the century. As main reasons for the emergence of the income tax as an important tax in this period, two factors can be highlighted: First, the old taxes on land was not suited for being levied on the emerging industrial businesses to the same extent as to agriculture; thus, the farmers felt that an undue share of the tax revenue was paid by them. Secondly, the emerging labour class was unsatisfied with so much of the revenue being collected through import duties, leading to expensive commodities. Introducing or increasing the income – and net wealth – taxes were an adequate answer to these challenges. At the same time, the public administration had developed to be sufficiently qualified to handle such a complicated tax, contrary to the experience with the 1810 income taxes.

2 Some Analytical Remarks

2.1 In General

As already mentioned, a main problem in all income taxes is that “income” is such a complex and complicated concept. There is no great need for a precisely defined income concept as long as the tax rates are low and the assessment can be made on the basis on an evaluation by locals. Therefore, in the first income tax statutes from the 19th century the concept of income was very vague and rather general in its form. As tax rates was raised, and in particular with the introduction of the tax return, the need for a more precise definition of the concept became urgent: The taxpayer must know what he shall declare as income. The unsuccessful income taxes of 1810 show that many of the basic questions relating to the concept of income were well known at an early stage. However, in the last part of the 19th century and in the beginning of the 20th, a development and refinement of the concept took place, under the influence of economic theory.

Important, but far from all, features of the concept of income may be focused upon from two main perspectives, which are here called the *extent* and the *structure* of the concept of income.

2.2 The Extent of the Concept of Income

Under this subsection, the question is: which elements of income and which costs are included in the concept for income tax purposes? This is, of course, a main issue. A distinction between narrow and wide concepts of income is important.

Narrow concepts of income exist in many versions. A characteristic feature is that they encompass only income, which has been created in specific ways or are of a periodic nature. The rationale is mainly that income tax should be levied only on items that are income from a public economy point of view, such as labour and business income and capital yield. Thus, capital gains, whether realized or unrealized, are excluded. The same applies to capital transfers, such as inheritance, gifts and life insurance amounts.

Most important of the narrow concepts of income in the Nordic countries is probably the source principle. According to this principle, to be taxable the income must emerge from a lasting source of income. Thus, the focus is on the creation of the income. Perhaps the most consistent use of this principle is found in the tax law of Prussia of 1891, and it is assumed that this law has been a model for the Danish tax law of 1903 and it probably also influenced Swedish and Finnish tax legislation at that time. In income taxes based on the source principle, taxable income is often calculated in two steps: First, the surplus or deficit of each source of income is calculated. Secondly, there is a separate issue as to which extent the results of all sources can be pooled together. The Swedish tax law is structured in this way – more so until 1991 than after the reform of that year.

Another type of narrow income concepts focuses on the periodicity of the income. Only recurring items of income should be included. The Norwegian professor T.H. Aschehoug defended this approach – perhaps somewhat moralizing – by pointing to the fact that the economically wise taxpayer would save one-time items of income and consume only the recurring ones.[2] In this respect, it is interesting to note that in Norwegian tax law – which is not based on a narrow income concept – recurring income is taxed to a larger extent than one-time income. Thus, for instance inheritance and gifts are income tax free, whereas inheritance and gift in the form of periodical payments are taxable as income.

Wide concepts of income are most often associated with the name of G. *von Schanz* who, in an important article from 1896, framed an income tax concept which focused on the taxpayer and the values that he receives.[3] A Scandinavian predecessor was the Swede *David Davidson* who some years earlier had argued along the same lines as von Schanz.[4] In US theory, these ideas were later developed into what is commonly referred to as the Schanz-Haig-Simon concept. According to this concept, what counts is what the taxpayer receives, not the form, the origin or the periodicity of the income. The ability to pay depends on the taxpayer's receipts and not on form or origin of the items of income:

2 Aschehoug, T.H., *Afkastning og Indtægt* (Yield and income), in: Statsøkonomisk tidsskrift 1898 at 229.

3 von Schanz, G., *Der Einkommensbegriff und der Einkommensteuergesetze*, in Finanz-Archiv 1896 at 1.

4 Davidson, David, *Om beskattningsnormen vid inkomstskatten* (On the Taxation Norm in Income Tax), Upsala 1889.

> "Wir wollen wissen, welche selbständige wirtschaftliche Kraft eine Person in einer bestimmten Periode derstellt, wollen wissen, welche Mittel sie in dieser Zeit zu ihrer Disposition hat, ohne dass sie ihr eigenes Vermögen verzehrt oder fremde Mittel (Schulden) hinzunimmt."

The focus is on the net increase of the assets of the taxpayer in the period in question, the *"Zugang von Reinvermögen"*. Therefore, also unrealised capital gains should be included into the concept. The same applies to capital transfers such as inheritance and gifts.

This wide income concept has to a considerable extent influenced the Norwegian Income Tax Act of 1911.

In practice, of course, no income tax concept is found in its pure form. Compromises have to be made for practical and also political reason. In particular, even if the basis is a wide concept, unrealized capital gains and inheritance and gifts are normally not included. On the other hand, experience has shown that systems based on a narrow concept, need capital gains taxation to some extent at least in order to prevent obvious tax avoidance possibilities.

2.3 The Structure of the Concept of Income

The main issue under this heading is whether the concept of income is constructed on the basis of the different sources of income or whether it is formulated generally. The difference may have significance in various connections.

First, the significance may of a purely *technical* nature. Traditionally, the Swedish tax act has been based on a separation into a number of types of income – six until 1991, three thereafter – and each with its own income definition. In the Norwegian tax act, by contrast, there is a general definition of income; however, it refers to various kinds of income (first of all from labour, capital and business).

Secondly, there can be a *differentiation of rules* meaning that there are, to a smaller or larger extent, different rules for the various types of income. The classical example is capital gains, for which special rules as regards taxability, tax rates and rollover often apply. Other common examples are certain provisions that can be made only on the basis of business income or standard deduction only from labour income. Of course, such differentiation of rules may take place not only in countries where the tax statute technically is based on a separation of various types of income but also in countries where a general definition of income exist.

Thirdly and most far-reaching, the separation into various income sources may have significance for the possibility of *pooling together* the income from the various sources into one net income. The most important aspect refers to the effect of the progressive tax rates and the influence on the possibility of deducting a loss from one source of income from profits of another source.

Of course, there are degrees of integration and disintegration. In the one end of a scale, an income tax where the integration is very low is often referred to as a *schedular* tax. At the opposite end of the scale, an income tax where the integration is high is often referred to as a *global* tax.

Over the years, an income tax concept can integrate from being a schedular type of tax to becoming a global type of income tax. It is fair to assume that the income tax concepts used in the Nordic countries moved in this direction in the last part of the 19th century and the first decades of the 20th. Conversely, a global income tax may disintegrate into an schedular type of tax. Tendencies to such disintegration have been rather obvious the later years, the so-called Nordic Dual Income Tax System being the most important feature; see subsection 4.5 below.

In the following chapters, the development along these two lines of the concept of income in tax law in the Nordic countries will be studied more closely.

3 The Development of the Income Concept – the Extent of the Concept

3.1 Until approximately 1920

In the old income taxes, little attention seems to have been given to the extent of the concept of income. This is probably due to the fact the tax rates were low and that the taxpayers should file no tax return. Characteristically, in the preparatory works of a Norwegian city income tax act of 1863, a tax return system and, therefore, also a more elaborate concept of income was proposed. However, the Ministry of Finance, in its proposition to the Parliament, did not follow the proposal of a tax return system and, consequently, the concept of income was written in a much more sweeping way, referring only to the amount of money which the taxpayer was assumed to have earned during the year in question.

The concept of income in many of these old statutes seems to have included capital transfers and other one-time items, such as gifts, inheritance, lottery prizes, finder’s rewards etc., but not capital gains. Thus, taxability as income for gifts was found in the tax act for Copenhagen of 1861. In the old Swedish tax acts, inheritance and gifts were taxed as income and according to the Finnish municipality tax statutes of 1883/98 the same applied. The concepts in the old Norwegian municipality tax statutes may have included gifts but this is unclear. In Sweden and Norway, gifts soon disappeared from the concept of income. In Finland and Denmark, they have had a longer life. In Finland, gifts and inheritance to other persons than ascendants, descendants and spouses, were taxable income by the municipality taxation until 1996 and in Denmark, the point of departure still is that gifts are a part of the concept of income (admittedly with important exceptions) and this forms a special feature of the Danish income tax. Lottery prizes have survived as part of the income concept in Denmark, Norway and Sweden.

However, towards the end of the 19th century, the definition of income for tax purposes seems to attract greater attention and a clear development in the direction of adherence to narrow income concepts can be observed. This is certainly due to the development of and influence from German economic theory and tax practice at that time. A characteristic example is found in the preparatory works (of 1879) of the Norwegian municipality tax acts of 1882. Here, the parliamentary committee expresses that gifts, inheritance, lottery prizes and life insurance amounts in practice have been "confused with income and taxed as such". To prevent this, it was suggested to include a special rule in the statute "in order to lead the opinion in the right direction". On the other hand, it was found unnecessary to include a statute rule to the effect that capital gains could not be taxed as income, as this was regarded as obvious (except for gains on inventories in business).

As already mentioned, the Prussian tax act of 1891 was based on a narrow income concept, namely the source principle. This act is supposed to have had a significant influence on the Danish tax act of 1903, which in turn was the basis for the later development in Denmark. Even if the preparatory works of the Swedish act of 1928 and it predecessors are pragmatic, it is assumed that also the Swedish tax act was significantly influenced by the Prussian law. Finnish law at that time was also influenced by the source principle.

The development in Norway mainly followed the same pattern until the turn of the century. The municipality tax acts of 1882 were based on a narrow concept of income and the same applies to the state income tax act of 1892. In his thesis from 1898,[5] T.H. Aschehoug – professor at the university and one of the leading lawyers and economists in the country at that time – strongly defended this approach. But then surprising things happened. A royal commission, which had as its main task to explore the possibilities to introduce a tax return system, had been established in 1899. The commission presented its proposal in 1904 and here the concept of income was based on the wide concept as presented by von Schanz only a few years earlier. Though no explicit reference is made to von Schanz¸ strong influence is obvious. Significant parts of the text in the report of the commission are almost translations of von Schanz' article. The commission members had obviously studied the article closely.[6]

However, the final text, which was enacted as law in 1911, was much less radical. The commission itself had decided against including inheritance in the concept of income, referring to the fact that an inheritance tax was levied on such receipts. In the final act, also gifts were excluded; including gift was considered too radical and in addition as an interference of private matters. As far as capital gains are concerned, the committee had – on the basis of practical reasons – argued against tax on unrealized capital gains and proposed that realized gains and losses should be included in cases where the realization took place less than five years after the acquisition. In the final act, even this rule was left out; thus, capital gains were included in income only to the extent it emerged from business, from speculation or from sale of building plots; the rationale of the last mentioned rule is that a business or speculation purpose could be

5 *See* footnote 2.

6 The copy of Finanz-Archiv which now belongs to the University Library in Oslo was earlier in the Ministry of Finance were a very outspoken member of the commission (Thomle) was employed at that time.

presumed in such cases. On the other hand, lottery prizes and finder's rewards were included in the income concept.

Even if the Norwegian act of 1911 fell very short of living up to the wide income concept, the fact that this concept was the point of departure have nevertheless had an important impact on the further development in Norway; some aspect of this will be shown in the following.

3.2 Further Development of the Capital Gains Taxation

The further development of the concept of income has mainly been concentrated on capital gains. In all the Nordic countries, the extent to which capital gains are included in the concept of income has increased considerably. Today, it is fair to say that the main rule in all the countries is that capital gains and losses are included in principle.

In view of the above, in Norway this development can be considered as a follow-up of the general position taken in 1911. Nevertheless, the development has taken considerable time and even today there are significant exceptions. Originally, it was not clear whether the business rule was restricted to capital gains on inventories or whether it included also capital gains on fixed assets and shares attached to business. This became a very important question during World War I when values on ships and shares in ship-owning companies soared. The Supreme Court decided that such capital gains were included in the concept of income and since then this rule has been undisputed.

For similar reasons, already in 1918, the five-year rule, which had been suggested by the commission in 1904 but left out in 1911, was introduced into the act. The speculation rule had turned out to be too inefficient (proving speculative intent is difficult). However, for shares, this did not last very long. Around 1920, the value of shares fell sharply and in order to avoid large deductions of losses, both capital gains and losses on shares were again excluded. The five-year rule was retained for other assets (outside business). Only in 1971 was capital gains taxation on shares reintroduced. Until 1992 a two-, three- or five-year rule applied and losses could be deducted from share capital gains only. From 1992 capital gains on shares are taxable without any time limit and losses are deductible in any item of taxable income. Also in 1992, a special rule on calculating the gain or loss was introduced.[7] The rationale of this complicated system is to avoid double taxation of company profits; therefore, profits retained in the company can be added to the acquisition price of the shares. Similarly, distributions are deducted from the acquisition price, thereby preventing an obvious tax planning option (emptying the company via distributions and selling the shares with a loss).

For other assets (including farms and forestry), the five-year rule – in 1946 expanded to a ten-year rule – , the speculation rule and the building plot rule prevailed until 1976. The speculation rule had long ago ceased to have any significance and it was repealed this year. The main rule was put on its head and

7 *See* Gjems-Onstad, Ole, *Computing Capital Gains on Shares: A Ten-year old – and successful (?) experiment*, in Bulletin for International Fiscal Dokumentation 2002 at 364.

has since been that also capital gains on non-business assets are taxable. However, there were and still are important exceptions. Farm and forestry still follow the ten-year rule and movable property outside business is excluded from taxability. The ten-year rule applied to owner-occupied dwelling houses; however, following a reform of 1987, the gain is tax free (and a loss cannot be deducted) if the taxpayer has owned the house for at least one year and used it as his prime dwelling-house for at least one of the two last years.

Before the tax reform of 1991, the tax rates were very high. Therefore, all kinds of special rules had emerged, in particular lower tax rates for some capital gains and rollover rules. The significant lowering of the tax rates to 28 % in 1992, paved the way for abolishing such rules.

In the other countries, as a the point of departure capital gains were not included in the income concept. This also applied to fixed business assets (as opposed to inventory), the rationale being that capital gains on such assets had more in common with capital gains on non-business assets than with ordinary business income. However, the development has shown that this position was difficult to defend in the long run. The borderline between the yield of capital (which was taxable) and capital gains (which were not taxable) became increasingly difficult to draw. But first of all, the development of the depreciation rules seems to have paved the way for the introduction of capital gains taxation for such assets. The introduction of liberal depreciation rules, such as those enacted in Sweden in 1938, made necessary at least rules to secure the recapture of depreciations at the time of realization of the assets. Such rules were introduced in Sweden in 1938 and in Denmark in 1939 on machinery and similar asset. In Finland, only recaptured depreciations on machinery etc. could be taxed until the enactment of the Business Tax Law of 1968, which extended the rules to cover the capital gains on such assets. Today, the rule in all these countries is that capital gains on machinery etc. are fully taxable. However, rollover rules, which are not covered by this article, typically apply to gains on such assets.

For capital gains on real estate and on shares connected with business, the development has been somewhat slower, probably due to the fact that depreciations have less significance for real estate than for movable property and no significance for shares. In addition, capital gains on real estate to a smaller or larger extent will encompass inflation gains and – with particular importance for shares – the right to deduct losses must be taken into consideration as well. Thus, in Denmark, while recaptured depreciations have been included in the income concept for decades, long time (seven years) capital gains on real estate even when utilized as fixed assets in business were tax free until 1993 and after that preferential taxation applies; however, these rules are to a large extent now repealed and will be phased out towards 2008. Capital gains on shares still follow the rules that apply also to shares which are not attached to the business (see below); however, in cases where the taxpayer conducts acquisition and sale of shares as a business and in cases where shares are received as compensation, the capital gain on such shares is taxable as ordinary business income.

In Finland, long-term capital gains on real estate (ten years) and shares (five years) used for or attached to business was tax-free until 1992; since then, such gains are generally taxable. In Sweden, so-called eternal capital gains taxation, meaning that gains are not tax-free after a holding period, was introduced in

1966 for shares and in 1967 for real estate; these rules apply to all shares and real estate regardless of whether they are attached to business or not.

It should be mentioned that special rules often apply as to the computation of the gains and losses, the rules of timing (rollover-rules) and tax rates. For instance, in Sweden, only 90% of the capital gain on real estate utilized in business is taxable and only 63% of the loss is deductible.

Outside business as well, the rules in Denmark, Finland and Sweden have developed towards including the capital gains in the concept of income. This is most obvious in Sweden. Here, according to the 1928 act, capital gains were included only if a speculation transaction was at hand, which was presumed to be the case if the asset was sold within a time limit (five or ten years) except in cases where the asset was acquired by gift or inheritance. As already mentioned, gains on shares and real estate for many decades have been taxable without any time limit. This even applies to owner-occupied dwelling houses; however, special rules apply to such gains: only half of the gain is taxable (and only half of a loss is deductible) and there are liberal rollover rules. For gains on other assets, a five-year rule was repealed in 1991; in principle, therefore, even gains on movable property outside business owned for many years are taxable. Even if the rule was expected to be difficult to apply in practice, it was considered as a matter of principle that all capital gains should be taxable. This attitude clearly illustrates that in Sweden, legal thinking has gone a long way since 1928. However, there is an exception for asset owned for personal use.

In Finland too, today gains are taxable also outside business; however, the gain on the sale of the taxpayers' permanent home is tax-free if the taxpayer has used it as his permanent home for at least two years and gains on personal movable property are taxable only above a certain amount.

In Denmark gains on short time shares (owned for no more than three years) are always taxable. For long time-shares (owned more than three years), the gain is tax-free if the seller is a company unless the shares have a character of being inventories in the business. If the seller is an individual, then the gain is always taxable. As regards real estate, there is a very liberal exemption for one or two family dwelling houses: The gain is tax-free if the taxpayer at any time has used it as his permanent home.

It may be concluded that today, capital gains and losses are in principle included in the concept of income in all the countries. This development, in turn, seems to reflect a change in the view of the ability to pay principle: from focusing on the creation of lasting new economic benefits, the focus has been changed to consider the benefits received by the taxpayer in question. The main exception in all the countries is gains on owner-occupied dwelling houses, which are taxed very liberally in all the countries. This exception cannot today be supported by reference to the underlying concept of income of the tax statutes; in stead, their rationale must be found in labour marked and housing policy considerations.

3.3 Other Aspects

Even if the development from narrow to wide concepts of income is most obvious in the field on capital gains taxation, there are also other aspects of the concept of income, which illustrate the difference. Particularly illustrating is consumption of one's own products (typically from agriculture), work carried out for the benefit of one self (for instance building a house for personal use as dwelling house) and yield of one's own capital assets (typically benefit of using one's own dwelling house).

In Norway, the wide income concept is clearly shown in the rules governing such issues: They are all in principle included in the concept of income. Thus, consumption of one's own products is taxed at – in principle – their market price and owners of dwelling houses are taxed for their own use (admittedly, for political reasons at a very low value). The value of house work carried out by the taxpayer and his family is expressly excluded from the income concept and so is spare time work on the taxpayer's own dwelling house; these exceptions confirm that in principle the concept of income encompasses such items of income. This also emerges from the fact that in practice, taxpayers taking leave from their ordinary work to build their home are taxed for benefits rendered to themselves. These rules are essentially unchanged since 1911.

The narrow concept of income based on the source principle has a significantly different approach to most of these issues. According to this concept, only the yield of lasting sources of income shall be included in the concept of income. This, in turn, raises the question of what the source really is. If the purpose of the source is to create products for sale, then a personal use of products for consumption etc. will not be taxable income. This point of view is still followed in Danish and Finish law regarding consumption of own products: The taxpayer will not be taxed for the consumption of own products (but the deductions of costs to produce them will be reversed). However, within agriculture the taxpayer in Danish law is taxed at the market price, reflecting the fact that farmers traditionally have consumed part of the crop. In Sweden, however, consumption of own products are generally taxed at the market price. Further, in Danish law taxpayers are generally not taxed for work performed for one's own benefit because this benefit does not originate from a lasting source. However, joiners and carpenters are taxed when they build a house for their personal use; for them, this is a yield of a lasting source; however, it is expected that this rule will be repealed. In Finnish and Swedish law, work for the taxpayer's own benefit is not taxed at all.

The principle is shown also in the rules concerning taxation of owner-occupied dwelling houses. This benefit is in principle included also according to the narrow source principle because the rationale of the source of income in this case is to provide dwelling possibilities. The fact that Denmark, Finland and Sweden for efficiency reasons rather recently have transformed the taxation of this benefit into a real property tax does the influence the basic point.

As opposed to what has been described above for capital gains, there has been little development in the rules discussed in this subsection. The obvious reason is that these rules are of much less practical importance than the capital gains rules, with a possible exception for taxation of benefit from owner-occupied dwelling houses. Consequently, the rules have only to a small extent been altered and, therefore, differences between wide and narrow income concept is seen more clearly here than concerning capital gains.

3.4 Deductions

Both wide and narrow income concepts are net concepts. The rationale is that the net income is the best standard for the ability to pay of the taxpayer. This means that a right to deduct the costs should exist. In addition, there are normally several rules granting right to deduction which do not concern costs. The following remarks are limited to the deduction for costs (including capital losses) and interest.

A core condition for a right to deduction is that the cost in question in one way or another is connected with the income producing activity of the taxpayer. Thus, in principle, in income tax regimes applying a wide income concept, more costs may be deductible than in cases where a narrow income concept applies. This is most obvious as regards capital losses. As shown in subsection 3.2 above, symmetry normally exists for the taxation of capital gains and right to deduct capital losses. Thus, the more extensive the capital gains regime is, the more extensive the right to deduct losses will be. The current Swedish rules has some interesting deviations from the principle of symmetry: In several cases, the right to deduct losses is restricted to 70% of the loss whereas a gain is taxable to 100%. The rationale for this restriction is that the taxpayer is in a position to decide when gains and losses shall be realized; the tax rules will give an incentive to realize the losses as fast as possible and postpone realizations that would lead to a capital gain. Therefore, the symmetry can be regarded as more formal than real and the reduced right to deduction reflects this.

For other expenses, there is no question of symmetry; what counts is the degree of connection between income and the cost. In all the four countries, the right to deduct costs is not restricted to costs incurred in order to earn or secure income, even if this is the core of the rule. In principle, the right to deduction also encompasses certain losses, for instances losses caused by damage or by embezzlement. It could be expected that regimes with a wide income concept, which also includes one-time items of income, will accept the deductibility of extraordinary losses to a larger extent than regimes with a narrow concept. To some extent this seems to apply. Thus, in Danish law, the deductibility is dependant on the loss being a result of a normal risk of the activity, whereas no such condition is set in Norwegian law.

In all jurisdictions, a dividing line has to be drawn between deductible costs and living expenses. In all the countries, costs of a personal nature are not considered deductible even if they in a sense are necessary for earning income. Thus, expenses for clothes and food are not deductible and expenses for childcare are deductible according to special rules only and within certain limits. Beyond such issues, a large body of practice exists and it is difficult to compare in more detail where the countries draw the line. However, the impression of the author is that also on this issue, Danish law is somewhat more restrictive than Norwegian law and this may be due to the difference in the basic income concept. In Danish practice, it has been expressed that the connection between income and the cost in question must be qualified. Thus, in a Danish case from 1989, a history teacher was denied a deduction for costs to participate in a study tour to Egypt, whereas deduction was accepted in a rather similar Norwegian Supreme Court case from 1991.

Another important dividing line has to be drawn to expenses, which refers to the source of income itself rather than to the income. In principle, such costs are not deductible in any of the countries (but may, except in some cases in Denmark, be capitalized for later deduction). In Sweden, this is often expressed in a language which refers to the source principle: The right to deduction applies only to expenses within a source of income but not to expenses to acquire or develop the source of income. In all the countries, deduction for expenses incurred for basic education is denied on this basis but an increasingly difficult dividing line has to be drawn against cost incurred to maintain the competence of the taxpayer.

The right to deduct interest expenses is a special issue. In Danish and in Norwegian law, a general right to interest deduction emerged very early. The Copenhagen Tax Act of 1861 contained a general right to such deduction and so did the Norwegian municipality tax acts of 1882. In Sweden, a similar right was introduced for state taxation purposes in 1902 but for municipality taxes only in 1920. Finland is a special case. Only in 1922, a limited right to interest deduction was introduced. And again, since 1974, there has been restrictions in this right. However, this should be regarded as a parallel to interest income being to some extent tax-free until 2000. The current rules accepts a right to deduction for interest on debt on the taxpayer’s dwelling house and debt incurred for studying purposes, in addition to debt that have a cost character. This implies that interest on debt incurred for other private purposes, including leisure time houses, are not deductible. In the other countries, there is no such restriction on the right to interest deduction. Important reasons for this approach are the practical difficulties in separating interest of a cost character from other interest, regard to symmetry with taxation of interest income and a wish to treat those who must borrow and those who have capital on an equal basis. However, the unlimited right to deduct interest has been an important policy issue in all countries for decades, in particular when seen in connection with the lenient taxation of the benefit of owner occupied dwelling houses. But instead of an outright restriction as in Finland, an approach of a more structural nature has been introduced under the name of the Nordic Dual Tax System, which also applies in Finland. The core of this approach is to reduce the tax value of the interest deduction; this will be discussed in more detail in subsection 4.5 below.

It is tempting to regard the relatively early break-through of the interest deduction in Denmark and Norway relative to Finland and Sweden as a result of the difference in general approach to the concept of income. Within the framework of an income concept based on the source principle, it seems logical that only interest referring to activities within a certain source is deductible, whereas a general right to deduct interest fits well into an income tax based on a general income concept.

4 The Development of the Concept of Income – the Structure of the Concept

4.1 Introduction

As indicated under subsection 2.3 above, structure may refer to different aspects of the concept of income. The following analysis is mainly focused on differentiation of rules, including tax rates, and the degree to which income from the various sources are or can be pooled together.

From a policy point of view, a schedular type of income tax is often regarded as easier to handle in practice than a global income tax. It is easier to fix the result of one source of income than the total income of a taxpayer. On the other hand, in a schedular type of tax it is difficult to take into account the ability to pay of the taxpayer. This is so for at least two reasons: First, the taxpayer may have a loss on one of his sources of income but profits from other sources. In a schedular system, this loss will not be deducible from the profits (but may perhaps be deducted from possible profits from the same source in a later year). Secondly, without a pooling together of the total income of the taxpayer, it is difficult to fix a tax-free amount in net income for individuals in order to protect a minimum income from being taxed and to introduce progressive taxes.

4.2 The Early Development

The development of the Nordic income taxes in the 19th century and the beginning of the 20th, illustrates the policy issues and the development from a schedular towards a global income tax.

The global income taxes in Denmark, Norway and Sweden around 1810 proved to be inefficient, as mentioned, mainly because the administrative system had not reached the stage of development necessary to handle these rather complicated taxes.

The following development in Sweden is particularly illustrative. The old taxes – which did not call themselves income taxes ("allmänna bevillningen") – until 1861 was based on eight different kinds of income, partly with different tax rates and tax-free amounts. The system was reformed in 1861 and the number of kinds of income reduced to two, namely income of real estate and income on capital and labour (including business). There was a common tax-free amount for income of labour and capital. Losses from one source of income could not be offset against profits of another. A further step in the direction of a global income tax was taken in 1902; this year, a global and progressive income tax was introduced. The development was fulfilled in 1910 for the state tax and 1920 for municipality taxes. These years, the old taxes ("allmänna bevillningen") were abolished and the principles of a global income tax to a large extent prevailed. However, there were still some features of a schedular tax for municipality tax purposes. Thus, losses from one source of income could not be deducted from profits from another source of income. In addition, there was a minimum tax on real estate. The purpose of both these rules was to secure the revenue for the municipality. The minimum tax on real estate was in force until 1986. As far as losses are concerned, the general rule still is – also for state tax purposes – that they can be deducted only from profits from the same source of income; but there are several exceptions to this rule.

The trend in Denmark and Norway shows basically the same development even if the schedular character of the early taxes was not so obvious as in Sweden.

4.3 Capital Gains and Losses

As indicated in subsection 3.2 above, capital gains and losses were to an increasing extent made taxable and deducible. However, for several reasons, it turned out to be difficult to apply the same rules to capital gains and losses as to other income and deductions. Gains were accumulated over a number of years and it was considered as unreasonable that high progressive tax rates should apply to such gains. In addition, these gains were to a large extent paper gains due to the inflation. Further, the sale of an asset often was meant to be followed by a reinvestment in a similar asset; heavy taxation might jeopardize such reinvestment. For shares, there was a danger that heavy losses might undermine the tax revenue from income of other sources.

For such reasons, an array of special tax rules for capital gains and losses emerged as more and more gains became taxable and the ordinary tax rates increased considerably, thus increasing the schedular elements of the income tax. This development is most obvious in Denmark where capital gains and losses were not integrated into the general income tax law but regulated in a separate act ("lov om særlig indkomst") from 1958. Only in 1996 was this act repealed and capital gains included in the general concept of income.

This development cannot be followed in any detail here. Some aspects of the development in Norway are presented as an illustration.

For several capital gains, special tax rates applied. This was notably the case for capital gains on shares; when taxability for such gains were reintroduced in 1971, the tax rate was proportional and varied over the years between 30 and 50%. Also, for compulsory realizations, such as by expropriation or according to the special Norwegian regime of *odelsrett* (the right of members of a family to re-purchase a farm estate that has been sold out of the family), a special and proportional tax rate applied, the rationale being that the progressive tax rates where unreasonable since the taxpayer had been derived of the possibility to choose not to realize (thus, the rule, in effect, institutionalized the lock-in effect of capital gains rules). Also, for gains on building plots a proportional tax rate applied even on gains on ordinary sales. As such gains were taxable without any time limit, the gain had accrued over a lot years and should therefore not be taxed by high progressive rates in the year of realization. The special problems for capital gains also resulted in liberal rollover rules, in particular for gains on business assets and on owner occupied dwelling houses.

The tax reforms of the early 1990s (see subsection 4.5 below) resulted in most of such special rules being abandoned. They were considered unnecessary in view the moderate tax rate that was applicable to capital income generally.

4.4 Owner Occupied Dwelling Houses

As indicated in subsection 3.3 above, all the countries used to tax the benefit of owners for using their own dwelling house. This is consistent both with the narrow and wide income concept. However, throughout the 1990s, Denmark, Finland and Sweden have, for practical reasons, abolished the income taxation of such benefits and now instead tax these benefits through a real property tax.

In view of the fact that all countries used to tax the net benefit schematically, the difference may seem small. However, the fact that such income is no longer pooled together with other income and deductions in these countries, means that losses of such income cannot be deducted from other income and vice versa: losses from other income cannot be deducted from such income. This certainly adds to the schedular character of the income tax. In addition, taxing the benefit of dwelling houses through a real property tax seems somewhat illogical to the extent that it taxes both owner occupied and rented dwelling houses equally; in view of the fact that the rent is taxed as income, this in a way means that the benefit from rented houses are taxed twice.

4.5 Towards the Nordic Dual Income Tax System

In the middle of the 1980s, the tax systems of the Nordic countries were generally characterized by high progressive tax rates on individuals, a lot of special timing rules like accelerated depreciations and rollover rules and an unlimited right to deduct interest (except in Finland). Often combined with the use of limited partnerships, the use of such rules for tax planning had emerged as a serious problem, creating the so-called zero taxpayers. Further, the system was considered to create disincentives to saving and economically unfortunate incentives more generally.

As in most other OECD countries, the Nordic countries in the second part of the 1980s therefore embarked on a tax reform process, to a large extent both inspired and necessitated by the tax reforms in the US, the UK and other countries. The mantra of these reforms was: lower tax rates, broader tax base. In the Nordic countries, a special model emerged from these reforms, the so-called Nordic Dual Income Tax System. This system implies a significant schedular element: the difference in tax rates between earned income and capital income.

Among the Nordic countries, Denmark first carried out a tax reform along these lines. Effective from 1987, the highest tax rate for earned income was 68%. The tax rate for capital income was ordinarily 50%. However, to the extent that capital income exceeded capital expenses (first and foremost interest), another 6% tax apply, bringing the tax rate up to 56%. But interest deduction was effective as to 50% only. Mainly in order to secure a right to full deduction of interest on business loans, a special and voluntary business tax arrangement was created. – Through new tax reforms of 1993 and 1998, this trend was reversed and the difference in tax rates between earned and capital income became less significant. Instead, a reduction of the tax value of certain deductions (in particular the interest deduction) has taken place and the tax values of such deductions are 33% from 2002. – Thus, in a sense, Denmark was the first country to introduce the Nordic Dual Income Tax System but also the first to leave it.

In Sweden, the tax reform was introduced as from 1991 and its dual character is clear. The tax rate for capital income is proportional and 30%; the tax rate for earned income is progressive and reaches approximately 55% at the highest (depending on municipality tax rates). However, during the reform process, it was considered important that the tax burden on capital and earned income should be approximately equal. It was calculated that for approximately 85% of the taxpayers, the marginal tax rate for earned income would be around 30%. Taking into consideration pay-roll taxes and other social charges on the one hand and the effect of inflation on the other, the effective tax rate on capital can easily exceed that of earned income, even in the highest bracket.

In Norway, a similar system was introduced one year later, as from 1992. The capital tax rate was – and still is – 28% and the highest marginal tax rate was approximately 50%, later increased to approximately 55%. The low tax rate on capital was considered necessary because of the international competition for capital. One important aspect was that the tax value of the interest deduction was reduced to 28% and – in contrast to the Danish solution – with no special rules for interest on business loans. The same restriction in deductibility applies to cost incurred by employees. Thus, the Norwegian system contains a significant element of taxation of the gross income. –The difference in tax rates between capital and earned income was not defended on a principle basis. The main reasons brought forward was on the one hand the international competition for capital and the need to reduce the tax value of the interest deduction and on the other hand that for revenue and equity reasons, a further reduction of the marginal tax rates on earned income was not possible. However, the Swedish considerations on this issue seem to have a bearing in a Norwegian context as well.

Another year later, in 1993, the Finnish tax reform was put into force. Here, the difference between the tax rates for capital income and earned income respectively are even greater than in Sweden and Norway. The tax rate for capital income was 25%, later increased to 29%. The top marginal tax rate for earned income was 63%.

At the time of writing (August 2002), the future of the Nordic Dual Income Tax System may seem unclear. Even if not vigorously discussed when enacted, the model has later been criticized on the basis of lack of equity and lack of efficiency. Admittedly, the tax rate structure may at least partly be defended with reference to the inflation factor, as indicated above. In addition, wealth tax is levied on capital and in Norway, the fact that part of the difference in tax rates is due to the social security contribution, adds to the explanation. However, the rate difference is not set in relation to these factors and for real estate, the inflation loss is normally compensated by the increase in value. Moreover, the relatively low tax rate on capital income will generally favour the high-income taxpayers because they have relatively more capital income than other taxpayers.[8] The efficiency loss is mainly due to the practical problems of keeping capital income and earned income apart. In Norway in particular, where this separation in many instances has to be carried out for company income as well, transforming earned income to capital income through tax planning has turned out to be rather straightforward in many cases. Therefore it is anticipated that a governmental tax commission, which will deliver its report at the end 2002, will propose a considerable narrowing down of the gap in the tax rates for capital income and earned income. If this materializes and is enacted into law, this schedular feature of the system will be reduced.

5 Concluding Remarks

It is certainly fair to conclude that the concept of income for income tax purposes has developed from a rather narrow concept to a wide one. The exceptions from a wide concept of income which is found today, are not the result of theoretical considerations as to the “right” extent of the concept but based on practical and often non-tax reasons. The lenient taxation of capital gains on dwelling houses is a typical example. – Until the tax reform in the beginning of the 1990s, this development towards a wider concept of income was counterbalanced by liberal timing rules and – for some capital gains – special tax rates. However, many of those rules were abolished in the tax reforms, whereby a more clear-cut wide income concept emerged.

The development of the structure of the concept of income seems less linear. Whereas in the early days of the income tax a development from schedular to global income taxes is clearly seen, the later development, and the emergence of the Nordic Dual Income Tax System in particular, implies a reintroduction of schedular elements. However, in Denmark this system was rather short-lived and it remains to be seen whether it will survive in the other countries.

One may ask whether it is, in the beginning of the 21th century, worthwhile to study the origin almost 150 years ago and the later development of the concept of income for income tax purposes. Several arguments can be advances in favour of engaging oneself in such an activity.

First of all, history is interesting in itself.

Secondly, the historic perspectives help the understanding of current law as a (temporary) result of a historic process in which old and new theories, the economic development and the political process with lobbyists and compromises are involved. Thus, the historic perspective underlines the dynamics of the subject and therefore makes it more interesting for students and practitioners – even is the history itself is not part of the curriculum.

Thirdly, historic studies help to explain seemingly strange rules and unmotivated differences in rules in the various countries. Thus, for instance the Danish rule including gifts in the concept of income (albeit with many exceptions) can be explained as a rest of the income concept from the

8 See for instance Bavila, Alessandro, *Moving away from global taxation; dual income tax and other forms of taxation*, in European Taxation at 216-17 who finds the system contrary both to horizontal and vertical equity.

Copenhagen tax act of 1861, which was not removed by the emergence of the narrow income concept, based on the source principle. Similarly, the difference in the taxation of the taxpayer's work for himself is also explained: In Denmark, only joiners and carpenters are taxed for the benefit of building a dwelling house for themselves. For other taxpayer, benefits from such activity do not come from a source of income. This rule has survived even if the narrow income of concept is generally abandoned. In Norway, where the wide concept of income was introduced early, there is no similar restrictions on the taxability of such benefits.

Fourthly, history can have an impact in tax policy considerations. Arguments may emerge from knowledge of the historic development and considerations made at earlier stages. Such insight gives a basis for a critical evaluation of the existing rules and proposals for new rules. In fact, the tax expenditure school of thinking, which has been so influential in the last two decades, is firmly based on theoretical and historical studies of the concept of income.