SOME PROBLEMS CONCERNING THE TAXATION OF CAPITAL GAINS IN SWEDEN

BY

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1. INTRODUCTION

Capital gains tax in Sweden is an integral part of the general income tax levied on individuals and companies. Chargeable capital gains are taxed together with other income, which may lead to high marginal taxation on the disposal of assets involving high capital gains. The highest marginal tax rate in Sweden is 75 per cent. Most kinds of disposal of assets subject to increase in value are chargeable under Swedish law. This fact and the fact that marginal taxes are so high give the rules for calculating the size of capital gains practical importance. The rules are also very detailed compared to those of other countries.

This paper will examine the introduction and development of the present rules as well as the underlying governing principles, and will also present a few of the more important rules and problems pertaining to one particular area of capital gains tax law, viz. capital gains on real property.[1]

2. THE DEVELOPMENT OF CAPITAL GAINS TAX

Swedish legislation on income tax (*kommunalskattelagen*, the Municipal Taxation Act of 1928) is based on the source doctrine. The computation of income from various kinds of gainful activity takes place at six different sources. Five of these concern income which is considered to emanate from steady sources, whereas the sixth concerns temporary income such as capital gains. According to the source doctrine temporary capital gains are not considered as income giving rise to tax-paying ability. Therefore they were formerly subject to taxation only in extreme cases: capital gains from the disposal of an asset were chargeable only when the asset had been acquired with a profit-making motive, since such gains were considered very close to profits from professional trading. However, as it was difficult to establish any intent to make a profit, the rules were in practice formed so that only such disposals were chargeable which took place within 10 years after the acquisition in the case of real estate, or 5 years in the case of other assets.

[1] The paper is based on the present author's dissertation *Kapitalvinstbeskattningens problem—företrädesvis vid fastighetsförsäljningar* (The Problems of Capital Gains Tax with Particular Reference to Disposal of Real Estate), Stockholm 1986.

Capital gains tax has been given a broader ambit through several amendments after the Second World War. Today, capital gains are looked upon as a fairly common kind of income constituting tax-paying ability just like regular income. The original restricted taxation now only concerns disposals of chattels for personal use.

The main reason for widening the ambit of capital gains tax in Sweden was the notion that such gains provide an income which gives rise to the same ability to consume as other kinds of income do. The legislator has thus departed from the source doctrine and adopted the standpoint of e.g. Haig-Simon's income-tax concept, which is also the fundamental income-tax concept of the U.S.A. Reasons of fairness speak in favour of the same taxation for all kinds of income. Among the more politically-oriented arguments bearing on the shape of capital gains tax, mention could be made of social policy with its aim of fair distribution of the standard of living, which has been regarded as indicating an increase in capital gains tax, whereas commercial policy calls for restraint in levying excessive taxes on capital gains from the disposal of shares. Reasons of convenience have also contributed to the granting of standard reliefs from taxation.

The legislator has also had to face conflicting goals; and the resulting solution has been, somewhat simplified, that gains from the disposal of shares have enjoyed considerably milder taxation than gains from the disposal of real property or income from work.

The formation of a system of capital gains tax is also complicated by the connection with the taxation of regular income from capital (including interest, annuities, dividends, etc.), which calls for a harmonization of these two systems of taxation. Particular problems have occurred through the combination of what has so far, in the main, been an unlimited right of deduction for interest on loans and a relatively limited taxation of the yield from real property for personal use (home ownership). The tax advantages made possible through the possession of such real property have influenced the formation of capital gains tax in a direction of increased taxation. On the other hand, the heavy tax on capital gains from the disposal of real property has created severe "boxing-in" effects, which in their turn have necessitated rules on hold-over relief on the capital gains from the disposal of a home when a substitute home is acquired.

The attempts to reach a continuity in the taxation of income from capital and capital gains entail further rules on capital gains tax. The task of drawing the demarcation line between current income and capital gains is another complex problem the solution of which has been referred to court practice.

3. PROBLEMS OF CONSTRUCTION

The widening capital gains tax has led to complex rules for solving the ensuing problems. An increasing number of cases from the tax courts have also dealt with several further complications not clearly spelled out in the statutes. Since the tax on capital gains in Sweden, as elsewhere, is charged on the disposal of the property, the problems are mainly connected with the issue of how to regard the various components of the transactions constituting disposals.

As already mentioned the legislator has introduced a number of standard rules in order to satisfy various political and practical demands on the capital gains tax system. Such deviations from a theoretically correct assessment of capital gains should, however, not occur when the courts create solutions to problems not settled by statute law. The primary task of a court should be to attempt to assess the capital gains as correctly as possible. In spite of the differences between the various rules for assessing capital gains on the disposal of various kinds of property, most of the fundamental problems for the courts to solve are the same. In what follows, some of the problems will be discussed which have been, or might be, subject to adjudication.

4. VARIOUS METHODS FOR THE CALCULATION OF THE GAIN

Swedish income tax legislation offers four different sets of rules for calculating chargeable capital gains depending on what kind of property has been subject to disposal. In the case of real estate, the principle is that only the "real" capital gain is chargeable, i.e. items of allowable expenditure are index-linked. In the case of disposal of stocks and other shares a nominal profit is calculated and, depending on the time elapsing since it was acquired, the whole, or 40 per cent, of the profit is chargeable. In the case of tenant-owner rights the nominal profit is calculated and, depending on the time lapsed since it was acquired, the whole or a decreasing part of it is chargeable. If the tenant-owner right was acquired more than four years ago 25 per cent of the nominal gain is chargeable. Profits from the disposal of other assets are seldom subject to taxation, as the disposal, in order to be chargeable, must take place within 5 years of the acquisition.

The rules for the calculation of capital gains on the disposal of real estate are complex and ambitiously drafted. Clearly, the legislator has aimed towards a theoretically correct calculation of the profits from the sale. Mainly for this reason, these rules have been subjected to closer scrutiny.

In what follows, some problems of principle concerning capital gains tax will

be discussed. They have a bearing on the disposal of any kind of property, but the examples are primarily connected with the disposal of real property.

There are few statute law rules regarding calculation of the disposal consideration from real estate, whereas the rules on expenditure are meticulously drafted. All expenditure for acquisition as well as for improvements (minus deductions allowed for depreciation in value) of the real estate is considered deductible. Such "historic" allowable expenditure is index-linked. The purpose is hence not to tax paper profits, but only real ones.

Apart from these consistent rules there are, however, a number of exceptions and elections of a standard nature. Thus, tax relief is achieved through rules exempting from taxation any increase in value which has occurred more than 20 years before the disposal, and through rules granting certain, albeit limited (SEK 3,000 per annum), artificial deductions per year of holding, on the disposal of owner-occupied dwellings.

> An increase in the taxation was introduced in 1981, partly so that the deduction just mentioned will not be allowed for holdings after 1981 and partly so that the indexing of allowable expenditure will not include inflation during the first four years of holding. This "over-taxation" of the profits from the disposal of real estate was explained with the argument that this was the easiest way of partly offsetting the advantages enjoyed by the owner at current taxation of the yield from the real estate, where the whole interest paid is tax-deductible, even though some of the costs incurred must be regarded as compensation for inflation.

All in all, the rules on the calculation of chargeable capital gain from the disposal of real estate have led to a considerable difference between the real capital gain and the chargeable capital gain.

5. VARIOUS KINDS OF CONSIDERATION FROM DISPOSAL

As mentioned above the Swedish tax statutes contain very few rules on the calculation of the disposal consideration for real estate. In principle, however, the consideration is taken to be the market value of the asset.

It is common that dwellings are exchanged. Should the objects of the exchange be owner-occupied homes or tenant-owner rights, the market value of the assets should be regarded as included in the calculation of the disposal consideration. The result is consequently similar to that of a cash transaction. However, if a rented flat is exchanged for an owner-occupied home, a distinctly different result will follow.

In Sweden rented accommodation for dwelling purposes is subject to rent control and in central urban areas the rents thus fixed are substantially lower than what would be the result of a free market, mostly because of demand. As

a consequence tenancy rights fetch a price in the market, but the Rent Act forbids the requiring of any premium on grant or assignment of a tenancy right. In consequence, the value of such a dwelling can only be realized in a black market. However, the law does allow assignments by way of exchange for *inter alia* an owner-occupied home or a tenancy right. In such an exchange the value of the tenancy right may be included in the consideration by way of deduction from the cash price of the owner-occupied home,[2] which in practice means the realization of the value of the tenancy right. The question whether the value of the tenancy right is to be included in the calculation of the consideration for the disposal of the real estate for purposes of capital gains tax has been decided by the Supreme Administrative Court. The Court held that because of the Rent Act prohibition of the requirement of premium for the assignment of a tenancy right, the consideration consisting of the value of the tenancy right should not be included in the calculation.

In one of the cases (RÅ 1987 ref. 89 II) the seller was consequently allowed to set off the ensuing loss on the disposal against other capital gains. In this case the seller had acquired a tenant-owner right for SEK 62,000. The cash consideration for the disposal was, however, only SEK 7,000, since the tenancy right was assigned the remaining value. In consequence a loss of 55,000 was calculated, since the value of the tenancy right was not included in the consideration for the disposal when the capital gain was calculated.

In practice a tax-avoidance scheme is thus constructed, entailing first that a tenancy right can be purchased in spite of statutory prohibitions and secondly that the purchase price can be transformed to a capital loss which can be used for set-off against other capital gains. It seems, however, that such transactions will be difficult to prevent by way of statute law, and the problem is likely to remain so long as rent control continues to be operative. Theoretically this might be regarded as an example of unexpected asymmetries in taxation because of other legal rules creating real values not represented by lawful (nominal) values.

The difference between nominal and real values is obvious in cases where the consideration for the disposal consists of an interest-free promissory note. The calculation of the value of such promissory notes is not expressly regulated in statute law, which is the case in e.g. American tax law. How the value should be assessed has long been unclear, and older court practice is somewhat contradictory. Developments in court practice, however, show that in principle the market value of such promissory notes should be used as the basis for the assessment. This is clearly evident from the case RÅ 1987 ref. 102.

[2] It is generally considered that such a transaction does not constitute a contravention of this prohibition, but the matter has not yet been the subject of case law.

The use of market value instead of nominal value will prevent transactions where such promissary notes can be used to reduce chargeable gains or create deductible losses.

6. WEAR ON OWNER-OCCUPIED HOMES

In Sweden the income from capital for anyone occupying his own home is taxed in the form of a standard imputed income from real property. This income will in principle correspond to the rental value of the real property after deduction for costs of operation as well as depreciation in value of the property. For taxation purposes the decrease in value is not calculated openly, but is implicit in the standard imputed income. In the case of disposal all costs for acquisition and improvement are deductible regardless of the fact that they have lost a certain value during the time of ownership. This constitutes a difference in relation to the taxation of other kinds of real estate, where deductions for depreciation are openly allowable and therefore decrease deductible expenditures in the calculation of the capital gain. It seems unclear whether the legislator was aware of this difference in taxation when the rules on standard imputed income were introduced in 1953. No amendments have been made since, in spite of the fact that the difference has been noted on several occasions. Any change would lead to an increase in the taxation of capital gains for owner-occupied homes and would also probably call for more complex rules than those now in force.

However, even the present rules demand extensive and in practice cumbersome investigations of any improvements undertaken in an owner-occupied home during the time of ownership, which may be several decades. The checking of such claims for deductions seems, however, in practice to be limited, and the assessment seems to vary widely among tax inspectors.

This problem is basic to any taxation of capital gains which must take into account a number of transactions made over a period before the time of the chargeable disposal, and is one reason why the calculation of capital gains must to some extent be of a standard kind.

7. PROBLEMS OF PART-DISPOSALS OF REAL ESTATE AND OF SEVERAL OWNERS

Only one more problem connected with the calculation of expenditure for the purposes of capital gains taxation will be discussed: that of distribution when only a part of an asset is subject to disposal. For part-disposals in general,

common expenditure for the acquisition and improvement of the property must be related proportionally to the part disposed of and the part remaining in ownership. There are explicit rules as to this for the disposal of real estate and of shares. According to one particular rule, applicable only to real estate, the calculation must be based on the circumstances at the time when each expenditure was made. According to another rule, which is elective for disposals of real estate and mandatory in the case of shares, the proportioning must take place on the basis of the respective values at the time of disposal. Neither method is more theoretically correct than the other: in the case of disposal of real estate unfair results may occur, the effects of which the taxpayer can mitigate through the right of election between the two rules.

In court practice particularly, the problems connected with the sale of part of a land holding have come to the fore. If several owners own parts of a land holding, the ownership does not pertain to any particular physical part of the real estate. Improvement or deterioration of the holding thus affects the owners equally. In practice, however, the right of user to the real estate may have been divided between the owners so that each covers the expenses for the improvements pertaining to their own use of the real estate. The consequences of such investment for the internal economic settlement between the owners may in many cases be unclear and might lead to difficult problems of assessment in connection with the calculation of capital gains tax on the disposal. All such problems have, however, been avoided in legal practice by disregarding the real economic meaning of the transactions and allowing deduction for any part-owner who has actually defrayed the expense. In this way profit sharing has also become possible, for example between closely related part-owners such as married or co-habiting couples, in a way which is advantageous from a tax point of view.

8. WHEN IS CAPITAL GAINS TAX CHARGEABLE?

The decisive reason against taxing capital gain already at the point when an increase in value occurs lies in the problems of how to assess the capital gain objectively and the ability to pay the tax. These issues constitute the basis for the principle of realization, and they also apply when matters concerning the actual time for the taxation of various kinds of consideration for the disposal are to be settled.

The rule for defining when the capital gain is chargeable is actually quite primitive, as it is not related consistently to the occurrence of any ability to pay the tax. The rule is that the whole capital gains tax is chargeable upon first payment of any part of the consideration. This rule opens a possibility of

deferring taxation by deferring payment. In one particular case (RÅ 1985 1:43) the payment was made in interest-free promissory notes, which were not due until the death of the buyer. It was held that capital gains tax was not chargeable until then, or earlier, upon the transfer of the promissory notes. On the other hand the rule entails the disposer being taxed on a gain calculated on the full amount of the consideration receivable even though this may be payable in instalments over a long period.

Cases where the assessment of the value of the consideration is unclear have become the subject of more flexible treatment according to rules developed in court practice. Should the size of any part of the consideration depend on any future event, the taxation of the gain arising out of this is postponed until the matter of the size of the consideration can be clarified. In cases where the size of the consideration has been regarded as clear, but later shown to be erroneous, e.g. because of the insolvency of the buyer, the assessment is adjusted.

The line of reasoning pursued in court practice concurs with what was said at the beginning of this section concerning the bases for the principle of realization: ability to pay and objective assessment constitute the criteria for when capital gains tax is chargeable.

9. PROBLEMS OF DELIMITATION

Problems of delimitation prevail in any legal area with rules on large differences as to legal consequences between transactions, the real meaning of which is similar. In capital gains tax four issues of delimitation stand out:

- between disposals for a trade or profession and private disposals;
- between the granting of a right and the transfer of ownership;
- between yield and consideration; and
- between gift and sale.

The first mentioned delimitation differs from the others by being, it seems, in the main artificial, whereas the differences in the other three cases appear to be real ones. In consequence the delimitation between disposal for a trade or profession and private disposals has, in some cases, been made according to standard rules in the Municipal Tax Act.

9.1. *Disposals for a trade or profession and private disposals*

In Sweden the main differences between professional disposals of real property and private ones are in the following respects. Upon professional disposals the

whole nominal profit is chargeable. If the seller is an individual, social insurance payroll tax and contributions are also chargeable on such income (i.e. profits of a trade or of a profession). On the other hand there are some advantages too, since during the time of holding 15 per cent of the costs for acquisition and improvement may be written off and deducted as capital allowance.

In court practice it seems that these functional differences have not served as a basis for the delimitation, but, rather, the basis has been the general characteristics of a business such as size of turnover. The standard rules of the Income Tax Act also have a similar meaning.

9.2. *The disposal of or granting of a right in real estate*

Income from the granting of a lease is taxed successively as the income occurs. The price paid at the sale of a land holding is a function of the expected future yield. Upon disposal this value is immediately taxed as capital gains. The delimitation between disposals and the granting of e.g. leases is consequently in Sweden based on the real economic difference between grant and disposal. Transactions which under private law are regarded as grants are, therefore, taxed as disposals if the grant is made in perpetuity for a fixed consideration.

Contracts on sale can also regulate the distribution of accrued and future yield from the land in such a way that some modifications may be necessary in the assessment of the yield as well as the capital gain for taxation purposes. One example is where the seller has collected rents payable in advance before the buyer takes possession of the property, something which should reduce the price the buyer is willing to pay. Normally, accounts should have been balanced in the contract, but where this has not been done the calculation of capital gains should be corrected for this. This matter has not been regulated in statute nor has it been subject to adjudication, but the principle seems clear.

On the other hand it seems more uncertain how to handle cases where the seller has reserved the right to a certain future yield, e.g. by reserving a right of user free of rent. This might be regarded as a reserved value constituting part of the consideration for the disposal, which would also entail it being included in the calculation of the chargeable capital gain. The normal uncertainty concerning the value of any future yield, however—as in the cases discussed earlier in section 8—seems to warrant taxes not being charged until the value can be assessed with more assurance.

Questions of delimitation will inescapably arise so long as capital gains are taxed at the time of disposal instead of on accrual basis, and this is also difficult to regulate in statute law. It is furthermore remarkable that the questions here discussed have not been clarified in court practice, not even

with reference to such a frequent situation as the collection of the yield of real property during the time between the sale and the buyer's taking possession.

9.3. *Disposal by way of sale or gift*

When property is transferred by will, bequest or gift no capital gains tax is charged on the estate or the donor. The continuity in taxation, however, is maintained in that the acquirer steps into the transferor's tax situation, and, therefore, will be taxed for any capital gains on the acquisition of the transferor. When a land holding has been acquired by will or bequest, however, one option is to use an imputed value deemed to be the allowable expenditure for acquiring the asset, and this value would in theory be equal to the market value at the time of death. In this way the capital gains tax on any increase in value before the death of the owner is avoided; death wipes out capital gains.

The delimitation between sale on the one hand and gift on the other has been drawn in court practice. Two main methods are used.

For transfers of real estate, the so-called principal effect rule is applied, viz. the transaction is deemed to be a gift where the consideration paid is lower than the market value of the property. The value of the real estate is considered to be the assessed value and is normally set at about 75 per cent of the market value. This rule can lead to a number of unsatisfactory results. Transfers which may be described as only partly gifts are treated as gifts with the result that the transferee in the future may be charged for a capital gain which is bigger than the combined value of the gift and the increase in value after the gift was made. On the other hand the use of the taxable value as the assessed market value makes it possible to induce fictitious losses in capital gains by selling to closely-related persons at prices below the cost of acquisition or the market value but above the taxable value.[3]

For transfers of shares, the so-called partition rule is applied, which means that if the transfer takes place at an undervalue it is treated as consisting of a part-gift and part-market-value transaction. This method is difficult to apply to transfers of assets where the market value is uncertain. Furthermore, one may assume it will lead to the over-charging of the donor, since the difference between his acquisition cost and the consideration he receives may exceed the capital gains he is charged for.

The principles of delimitation between sale on the one hand and gift on the other hand were developed mainly at a time when capital gains were not considered to be income and consequently no tax was charged on the sale of

[3] Effective from November 9, 1987, such losses do not constitute allowable deductions.

property acquired by way of bequest, will or gift. These principles can no longer be regarded as serviceable. However, in Sweden, the tax courts have shown considerable restraint in overruling older decisions. The inactivity of the legislator is attributable to the fact that the matter should typically be solved in court practice.

10. CONCLUDING REMARKS

Popular discussion of capital gains tax does not primarily concern questions such as those treated here: in Sweden it is basic tax reforms that are the current focus of debate. As far as capital gains tax is concerned, however, views differ widely. According to the prevalent view the main purpose of any reform must be to increase the parity between income from capital and income from work. This could be achieved by a general lowering of the tax rates in combination with somewhat less advantageous rules for the calculation of capital gains. Another view stresses the point that capital is more easily movable than labour, which would warrant Swedish adjustment of capital gains tax to the prevalent international level. This would entail a lowering of the tax rate. Yet another opinion is that capital gains tax as a whole, including the taxation of capital gains as well as the taxation of income from interest and the corresponding right to deduct interest, gives no yield for the revenue. Scrapping capital tax altogether or introducing a standard tax would seem to be feasible alternatives.

As to the details of capital gains tax, public interest is mainly in the housing sector, particularly in the taxation of tenant-owner rights where the calculation of gains, seen against the background of the recent dramatic increase in urban prices, seems too advantageous compared with that of real estate. On the other hand the absence of a right to defer capital gains tax chargeable on the disposal of a tenant-owner right constitutes a major drawback, creating severe "boxing-in" effects.