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The Swedish Dual Income Tax System and the Splitting Rules: Yesterday, Today, and in the Future

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Summary

TAX REVENUES do not materialize out of thin air. Successful entrepreneurs and the prosperity created in innovative and productive environments are indeed essential for the size of the tax base. The taxation of labor and capital incomes – alongside a number of other factors – determines Sweden's business climate and international competitiveness. However, a serious discussion on the long-term financing of the welfare state should not only concern the *level* of taxation, it should also focus on the *structure* of taxation and how different types of incomes should be taxed. With a properly designed tax system, Sweden would be able to combine strong incentives to create wealth with ambitious objectives to redistribute incomes.

The income tax system can be organized in different ways. In a pure *dual income tax* (DIT) system, earned income is taxed progressively (i.e., the average tax rate increases in relation to income) while capital income is taxed using a proportional "flat" tax (i.e., the average tax rate remains constant for all income levels). DIT systems were introduced in Sweden, Norway, and Finland at the beginning of the 1990s. There are good arguments in favor of using the DIT model in high-tax countries such as Sweden. In a flexible DIT system, the tax on the real return on capital can be kept at a relatively low level, while earned income, a more immobile tax base, can be taxed at a higher rate.

Unfortunately, however, DIT systems suffer from a well-known Achilles heel. The combination of high marginal taxes on labor and low taxes on capital results in incentives to convert highly taxed labor income into low-taxed capital income, a phenomenon often referred to as *income shifting*. However, not everyone is able to shift incomes. Ordinary employees have limited opportunities to do so, as their wages are reported by their employers and not by themselves. Business owners,

and in particular active owners of closely held corporations (CHCs) who themselves decide on the level of salaries and dividends, enjoy much better opportunities. (A CHC is a corporation in which no more than four shareholders own shares corresponding to more than half of the votes in the company.)

In the absence of rules limiting income shifting, a CHC owner would be able to entirely circumvent the progressive tax on earned income by choosing an appropriate amount of dividend instead of salary. There would also be very strong incentives to go from being employed to being a company owner for tax purposes. Therefore, a DIT system in which the marginal tax rate on earned income clearly exceeds the capital tax requires *income splitting rules*, which regulate how much income entrepreneurs may tax as earned and capital income, respectively.

The purpose of this report is to present a comprehensive overview of the Swedish DIT system and the income splitting rules. The latter are known to the Swedish public as "the 3:12 rules," referring to the section of the law in which they were originally presented. The splitting rules should be key in a discussion about the DIT system: the better we design these rules, the more flexibly we may tax labor and capital incomes. The two types of incomes differ not only in how sensitive they are to taxes, but also in how they are distributed in the population.

With poorly functioning splitting rules in place, it may seem necessary to tax earnings and capital incomes at the same nominal tax rates. Using well-functioning splitting rules, the policy conclusion may be radically different, enabling us to tax labor and capital at different rates. Therefore, the income splitting rules deserve to take center stage when discussing the future of income taxation. Here I discuss the DIT system and the "3:12 rules" from several perspectives: historical, theoretical, empirical, and practical.

A fascinating story

In 1991, Sweden introduced the DIT system in a reform often referred to as the "tax reform of the century." The development of the 3:12 rules since 1991 is a fascinating story that is highly relevant to the current challenges facing Swedish tax policy. At a very late stage in the preparations of the 1991 reform, the drafters realized that a gap between the marginal tax rates on labor and capital required rules preventing income shifting. Hence, special rules were introduced for active CHC owners (i.e., business owners who work in the firms they own). CHC owners may tax dividends within a certain *dividend allowance* at the lower dividend tax rate, while residual dividends are taxed according to the progressive schedule for earned income. The dividend allowance was obtained as an

imputed rate of return to business investments and unutilized dividend allowances could be carried forward.

The income splitting rules of 1991 imposed strong restrictions on lightly taxed dividend distributions, while capital gains were slightly more favored in terms of taxation. During the 1990s, the so-called wage-based allowance and certain relief rules were introduced to improve the tax situation for small businesses. However, these reforms had an unintended side effect in that they led to a more complex tax system, resulting in business owners facing substantial compliance costs. At the turn of the millennium, the 3:12 rules were heavily criticized by business owners – partly as the dividend allowances were considered too small and partly as the rules were too complicated when filing income tax returns.

In 2006, the income splitting rules underwent a fundamental reform that implied not only a more lenient taxation of dividends but also a simpler tax filing procedure. The pendulum now swung in the opposite direction towards more generous policies with regard to CHCs, thus making it difficult to underestimate the significance of the 2006 reform. A "simplification rule" was introduced, which made it easier for the majority of CHC owners to file their income tax returns. For those who chose the "main rule," the wage-based allowance rule was given much greater weight. In the post-2006 period, the system was reformed in a CHC-friendly direction, although some measures intended to limit tax avoidance activities were introduced at the beginning of the 2010s. Since the middle of the 2010s, however, not much has happened in this area.

Sweden's Nordic neighbors

In a discussion on the Swedish DIT system, it is natural to make comparisons with Norway and Finland. Similar to Sweden, these two countries introduced DIT systems at the beginning of the 1990s. Interestingly, however, the three countries have developed in sharply different ways. In 2006, Norway switched to a system in which all shareholder income exceeding a deduction of the normal rate of return is taxed at a relatively high rate, which is approximately at the same level as the top marginal tax rate on labor. Accordingly, dividends – regardless of ownership structure and the owner's activity level – are no longer split into labor and capital incomes.

Compared with Sweden and Norway, Finland stands out in an important respect: the Finnish splitting rules have been remarkably stable since the beginning of the 1990s. These rules cover all shareholders in unlisted companies, regardless of the owner's level of activity in the firm. An imputed return to capital is calculated by multiplying the net assets of the firm

by a predetermined interest rate (currently eight percent). Large amounts of dividends within this dividend allowance are taxed at a rate much lower than in Sweden.

What does the data say?

I have carried out a descriptive study of CHC owners' income reporting by using administrative data from Statistics Sweden for the period 2000–2018. The accumulated dividend allowances have literally exploded since 2006. Dividends and capital gains within the dividend allowance are taxed at a tax rate of 20 percent.

Dividends from CHCs have increased sharply in two rounds. First, there was a surge in the years following the 2006 reform when taxes on dividends were lowered. Second, dividends also increased in 2016–2017 when CHC owners expected higher future dividend tax rates. Prior to 2006, the sum of capital gains exceeded the sum of dividends, while the opposite holds true after 2006.

An interesting descriptive result is that the average tax revenue collected from CHC owners increased more than the average tax revenue from non-CHC owners during the 2010s. While average earnings in the two groups developed similarly, capital incomes increased considerably more among CHC owners.

Should we reform the system – and if so, how?

In the best of worlds, the splitting rules encourage productive investments and entrepreneurship while discouraging unproductive tax planning. Unfortunately, the current Swedish system offers a number of incentives for socially wasteful tax planning activities. In particular, the non-uniform taxation between CHCs and widely held corporations (unlisted corporations with dispersed/passive ownership) is problematic. Business owners may often lower their tax payments by moving in and out of the 3:12 rules. It is also common to point to income shifting among so-called "partner corporations" as a legitimacy problem. These firms consist of a large number of active owners (often lawyers, accountants, and consultants) able to benefit from the current tax rules, especially the wage-based allowance, by collaborating. Another potential problem is the generous possibility to accumulate dividend allowances via the simplification rule.

Still, however, the picture should not be drawn in overly dark colors. The average tax revenue collected from CHC owners, as already mentioned, has in recent years actually in-

creased faster than for the rest of the population.

In a constructive discussion on reforming the Swedish splitting rules, values such as neutrality, legitimacy, promoting entrepreneurship, combating income shifting, and simplicity need to be balanced. I discuss three highly different reform proposals: (1) "the simple solution," which removes the need for splitting rules, (2) a modified version of the existing Swedish system, and (3) a completely new system, heavily influenced by the current Finnish system.

The first proposal is fairly radical. Consider abolishing the 20 percent central government tax on earned income and phasing out the Swedish earned income tax credit. Moreover, suppose that we raise the tax on capital, including double-taxed dividends, to 35 percent. This would result in the combined corporation and dividend tax ending up at the same level as the highest marginal tax on labor (including social security contributions). Together, these tax changes would make income shifting unprofitable, and the splitting rules could thus be abolished. Such a system would exhibit similarities to the current Norwegian system, where dividends above the normal return are taxed at a tax rate roughly corresponding to the highest marginal tax on labor income.

The "simple solution" would obviously simplify the tax system considerably but could nevertheless be highly problematic. A tax system equalizing the dividend tax and the highest marginal tax rate on labor imposes strong restrictions on tax policy, and the flexibility of the taxation of different types of income, which is a great advantage of DIT systems, is lost. In particular, one may fear that dividend taxes will be too high, leading to lock-in effects and harmful tax planning.

A second reform proposal is to close loopholes inherent in the existing Swedish splitting rules, while retaining a gap between the tax rates on labor and capital. More restrictive 3:12 rules could, for instance, be balanced with reduced tax rates on dividends from CHCs. The wage-based allowance can be reformed in such a way that tax planning in partner companies becomes less attractive. Likewise, the generosity of the simplification rule can also be reduced. An advantage of this less radical reform alternative is that the effects are easier to predict. The downside of this reform path, on the other hand, is that it fails to offer a solution to the more fundamental problems created by the 1991 reform: the difference in the taxation of closely and widely held corporations.

A third reform proposal, which should be taken seriously, is to introduce a version of the Finnish income splitting model. In Finland, the dividend allowance is calculated on the basis of the value of the net assets in the firm's balance sheet. This method for determining the shareholders' return on capital to a greater extent reflects the firm's actual activity compared to the related method used in Sweden during

the period 1991–2005. Similar to Finland, the splitting rules should be applied to all shareholders of unlisted corporations, thus implying equal taxation of owners of both closely and widely held corporations.

If it were possible to travel back in time to 1991, I would without much hesitation have recommended the third proposal – the Finnish model. However, to introduce such a system *today* would come with several practical issues. Needless to say, radical reforms always result in transition costs, but this reform would involve a more specific challenge: How should we address the fact that a group of shareholders (i.e., current Swedish CHC owners) have accumulated enormous dividend allowances? The current aggregated stock of accumulated dividend allowances by far exceeds SEK 1,000 billion. Saved dividend allowances can be considered a right to distribute lightly taxed dividends and capital gains in the future, and it would seem unethical to suddenly reset these. In practice, introducing the Finnish system would probably require transition rules. The same also holds true for the first reform alternative – "the simple solution" – which also resets the value of carried forward dividend allowances.

Regardless of whether we choose to eliminate, develop, or radically reform the current splitting rules, we know at least one thing for sure: A discussion on Swedish income taxes looking upon the 3:12 rules as unimportant, or as a narrow technical issue, will be a dead end. In the Swedish context, a view on income taxes must always, in one way or the other, be accompanied by an idea about income splitting rules.

About the author

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