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Stylised facts of the Swedish pension system

The Swedish pensions system rests on three pillars: social security, mandatory occupational pension schemes SOPS) and private life insurance policy. Both the social security system and the mandatory occupational pension schemes have collective insurance schemes for sickness insurance and early retirement/disability pensions.

Social security

Since the enactment of a new social security pension system 1999, two parallel pension systems are in force in Sweden and a gradual transition between the two systems will take place for people born between 1938 and 1953. The public pension system combines retirement pensions, disability pensions, and survivor pensions in one unified approach. The old system consists of a flat rate no means-tested, defined benefit scheme, *national basic pension scheme* enacted in 1947), and an additional income-related *national supplementary pension scheme* ATP, enacted in 1962). The old ATP supplementary pension system gives benefits at a replacement rate of 60 per cent of average annual earnings of the fifteen best years up to a ceiling. For full pension, 30 years of qualifying earnings are required. Benefits and as well earnings are indexed by the general price index. ATP is a PAYG system finance by pay-roll taxes on earnings. The ATP was supplemented with a buffer fund to cope with demographic fluctuations.

The new system consists of two defined contribution system. One has been called a notional defined contribution PAYG system (NDC) and the other is a funded defined contribution (DC) system. Individual accounts have been set up to record how much each individual contributes to the two systems. The accounts in the NDC system are notional in the sense that contributions are not accumulated in individual funds, but used to pay today's pensions. The DC system works as a private premium savings scheme or savings in a mutual fund with individual accounts and it is compulsory in the social security system. The new system has also a guarantee pension for people without any or low income from employment. The contribution rate is 18.5 per cent of earnings up to a certain level and 16 per cent go to the NDC system and the reaming 2.5 per cent to the DC system.

The individual can choose to invest hers contributions to the DC system in one to five out of some 500 registered funds. These funds are managed by Swedish and foreign banks, insurance companies and other mutual funds. For those who not choose funds actively the contributions are invested in a default fund. The yearly brokerage fee for fund management varying between 0.15 to 1.5 per cent of the value of the portfolio and it is also possible to switch funds without charge.

On retirement an annuity is calculated for every individual based on her balance for the NDC and DC account, unisex life expectancy and the real average wage trend in the economy. However, the annuity can be adjusted in the future if the total contributions paid in to the pension system are less than the pension going out of the system. A special balance index has been construed that measures the present value of assets and liabilities in the system.

Mandatory pension system

Private employer-based occupational pensions in Sweden comprise of the ITP plan for salaried employees and the STP plan for wage earners. Occupational pensions normally provide 10 per cent extra compensation in relation to final salary for incomes below an upper limit. The ITP plan includes both a defined benefit and a defined contribution component. The defined benefit part of the scheme is based on the final salary and the amount is at least 10 per cent of earnings. After a certain ceiling for the final salary high-income earners receive additional amount. The other part of the ITP plan is a funded defended contribution system and the yearly contribution by employers is 2 per cent of the salary. This is called the ITPK pension and the fund can be held with any financial provider, and the accumulated balance can be used for either a temporary 5-year pension or an annuity.

The STP plan for wage earners started in the early 1970s and up to the end of the 1990s it provides benefits equal to 10 per cent of earnings up to a certain limit, based on the average of the highest three years of earnings between age 55 and 59. The normal retirement age under the old STP plan was 65, and early retirement was not allowed. The STP plan is being replaced 2000 by a new defined contribution system, under which employers will contribute 3.5 per cent of earnings to an individual account for the employee. The individual is then free to choose from a number of different providers and investment plans.

Government employees are covered by agreements similar to ITP in the private labour market. The main part is a defined benefit pension, based on the average during the last five active years and pension coverage is the same as in ITP and there is the possibility of receiving a reduced pension from the age of 60, or a bigger pension if work is continued until

70. The defined contribution part of the pension scheme is 1.5 per cent of the yearly salary and can be increased by an agreement with the employer, or by voluntary contributions.

The new PFA98 agreement applies to roughly 1 million local government employees is made up of a notional defined contribution system and a funded contribution system. 3.5 per cent of the earnings up to a certain limit and 1 per cent of the earnings above the limit are earmarked for the NDC part. To the individual funded DC system 1 per cent of the wage sum is deposit and a private provider can be chosen for manage the account. A reduced pension can be granted from the age of 61, and if payments start after the age of 65 there will be a bonus. Sick benefits and a family coverage in the case of death are also available.

Private pension system

Since the early 1950s, Swedish tax law has classified private life insurance policy as either private pension insurance annuity plans, or endowment insurance. Pension insurance premiums are tax deductible up to a specific amount. Amounts paid out from the pension insurance policy are taxed. For endowment insurance policies, it is just the opposite, premiums are not deductible and payments from the policies are not taxed. The policyholder's balance in private pension insurance is exempt from private wealth tax, which is not the case for the endowment insurance.

Life insurance companies that operate in Sweden pay a yield tax on the assets they manage for the insured. In calculating the tax, a standardised method is used; the balance is multiplied by the average governmental bond rate during the calendar year. The yield arrived at is taxed at 15 percent for pension insurance and 27 percent for endowment insurance. For endowment insurance with a non-Swedish company, it is the insured and not the insurance company that pays this tax.

(Avsnitt om Kapitalpension)

Before the tax reform in the early 1990s the yearly return on private pensions plans was untaxed. Thus, a consumption tax treatment was applied.[1] After the reform insurance

[1] The different principles of taxation of private pensions insurance and other types of savings gave rise to a possibility for tax arbitrage through a leveraged investment. The boom in the demand for private pension insurance in the second half of the 1980s can partly be explained by the possibility of tax arbitrage. See Agell *et al* (1995) for a discussion.

companies pay a yield tax of 15 percent, a rate well below the normal flat rate of 30 per cent rate on personal capital income.

3) Tax treatment and life cycle period

3.1 *General*

Evidently, occupational pension benefits form part of an employees total remuneration for work performed during his or her employment period. Thus occupational pension contributions and benefits serve to reallocate income from the employment period to the retirement period of an employee. Moreover, a person may save funds for his or her retirement on a private and voluntary basis ("private pensions" as opposed "occupational pensions" and "state pensions") with a similar effect. Hence, pension savings, whether occupational or private, can be regarded as "life cycle savings"[2].

The Swedish pension system adheres in principle to the "three pillar system" dominant among member states in the EU, where the first pillar represents state pensions, the second pillar occupational pensions and the third individual private pensions (referred to below as individual private pensions)[3]. In order to encourage non-state funding of future pensions and thus increase savings within the second and third pillars, the Swedish legislator has implemented a favorable tax regime allowing employers and individuals to deduct contributions to occupational and individual private pension schemes for income tax purposes. Consequently, the Swedish legislator has thus so far accepted and been encouraging the partial reallocation of income over the entire life cycle of an individual.

However, while thus offering a powerful tax incentive to encourage long term pension savings, the Swedish legislator has been anxious to maintain tax neutrality to some extent between pension savings and ordinary savings vehicles[4]. In order to achieve this, pension capital is subject to a certain yield tax which, in theory at least, is a substitute for income taxation on savings, i.e. on dividends, capital gains etc[5].

Hence, the Swedish regime for pension taxation can be characterized as an ETT-system, i.e. contributions are deductible, the pension capital is taxed during the investment period and paid out benefits are generally taxable as personal income at progressive rates[6].

The following discussion follows the "life cycle" of a pension scheme, i.e. in section 3.2 the treatment of contributions is discussed, section 3.3 outlines the treatment of pension capital during the investment period and in section 3.4 the treatment of payments is described. In addition, certain issues regarding privileged and unprivileged plans and principal discrepancies and assymetries are discussed in section 3.5 and 3.6 respectively.

3.2 *Tax treatment of contributions*

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[2] SOU 1991:89 p. 89.

[3] See the communication from the European Commission 2001-04-19 to the Council, the European Parliament and the Economic and Social Committee; The elimination of tax obstacles to the cross-border provision of occupational pensions, COM (2001) 214.

[4] Prop. 1989/90:110 p. 483 onwards, SOU 1989:33 part II p. 213 and prop. 1992/93:187 p. 154

[5] Prop. 1989/90:110 p. 759

[6] Meaning "Exempt, taxed, taxed", see COM (2001) 214. This is however strictly true when considering only the income tax treatment and the yield tax. It should in this context be noted that pension payments and contributions qualifying for beneficial income tax treatment are subject to yet another special tax, the "special wage tax", which purpose is to attain neutrality between pensions and ordinary wages in the context of social security contributions.

3.2.1 General

Both contributions for occupational pensions and contributions to individual private pension schemes are, according to the Swedish Income Tax Act (ITA)[7], in principle deductible for income tax purposes under certain conditions and within certain limits. Moreover, employer contributions to occupational pension schemes are explicitly exempt from income tax for the employee, i.e. the employee is not taxed for the contribution per se. Thus, income taxation of pensions, occupational as well as private, may in principle be deferred until payment of the pension benefit following the investment period.

However, this favorable tax regime is not supposed to allow for deferral of taxation of income over time in general and certainly not for employers and employees to obtain such deferral merely by labeling a payment or contribution as "pension contribution". Hence, the beneficial tax treatment is in principle contingent upon the contribution and pension scheme having a genuine "pension purpose", i.e. that the contribution is made in order to satisfy a real pension requirement[8].

The qualification for such beneficial tax treatment is not achieved by way of a legal definition of "pension" or "pension contribution" in the ITA. Instead, a contribution must be based on a pension commitment fulfilling two sets of requirements in order be tax deductible, the so called "qualitative" and "quantitative" requirements. A pension commitment or contribution adhering to these requirements is thus deemed to be of a genuine pension nature making it eligible for favorable tax treatment[9]. The qualitative and quantitative requirements are explained in more detail in sections 3.2.2 and 3.2.3 below.

An employer contribution to or reservation for a qualified pension commitment satisfying the qualitative and quantitative requirements is in principle a security for future pension payments. It has therefore been deemed necessary to restrict employer deduction for such expenses to certain legal institutions for safeguarding of pension commitments[10]. Hence, in addition to adhering to the qualitative and quantitative requirements, an employer pension contribution must also be made within the scope of such a legal framework to be deductible.

3.2.2 Qualitative requirements

The qualitative requirements form the fundamental basis for pension taxation in Sweden, since they determine whether a pension policy, scheme, vehicle etc is eligible for beneficial tax treatment for income tax purposes as well as for Yield Tax and Wealth Tax purposes (see below sections 3.3.1 and 3.3.2). In the discussion below the term "qualified" will be used to indicate pension insurance policies, schemes, vehicles etc satisfying the qualitative requirements and thus are eligible for beneficial tax treatment.

Life insurance policies, annuities etc not complying with the qualitative requirements do not receive beneficial tax treatment, i.e. contributions to such schemes are, as a general rule, not deductible for income tax purposes. As a consequence however, paid out amounts are tax exempt.

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[7] *Sw: inkomstskattelagen (1999:1229)*
[8] Prop. 1950:93 p. 167-168 and prop. 1975/76:31 p. 112, 128 and 132.
[9] Note in this context SOU 1975:21 p. 93-95 and Dir. 2004:99.
[10] See for instance Dir. 2004:99.

According to the qualitative requirements, a pension scheme or agreement must display certain features and contain certain conditions in order for the contribution to be deductible[11]. For instance, the scheme may only contain retirement, health and spousal benefits[12]. Retirement benefits may not be payable until the beneficiary has reached the age of 55[13]. Moreover, retirement and spousal benefits must be paid out during a period of at least five years[14], i.e. it is not possible for a scheme to allow such a benefit in the form of a lump sum payment at a certain time. During the five year period, paid out amounts may not decrease. Evidently, the purpose of the qualitative requirements is to ensure that a pension scheme receiving beneficial tax treatment satisfies a genuine pension commitment.

It should be noted that the qualitative requirements contain a provision to the effect that a pension insurance policy or scheme must be provided by a pension institution domiciled in Sweden or maintaining a PE in Sweden[15]. Consequently, pension contributions made to pension institutions domiciled outside Sweden with no PE in Sweden, are treated as unqualified for income tax purposes under the ITA regardless of whether the relevant scheme complies with the remainder of the qualitative requirements. Of course, this provision does not aim at ensuring that the contribution or scheme is of a genuine pension nature, but is motivated solely by Swedish tax base protection concerns[16]. This provision will be referred to as the "establishment requirement" in the following discussion and the issue whether it is compatible with the EC treaty will be discussed below in section 6.6.2.2 below.

3.2.3 Quantitative requirements

Regardless of whether a pension scheme fulfills the qualitative requirements and the contribution is made within the designated legal framework, the rules do not allow for excessive pension benefits receiving beneficial tax treatment. The rules are intended to allow favorable tax treatment only for schemes providing "reasonable" pension benefits[17]. Hence, the rules contain certain thresholds, and contributions exceeding those thresholds are non-deductible, even if they comply with the qualitative requirements. These thresholds constitute the quantitative requirements.

For employers, the main rule is that the contribution may not exceed 35 per cent of the employees salary nor the equivalent of 10 "base amounts" on a yearly basis[18]. In order to allow for some flexibility in this context, there are certain exceptions from this rule[19].

For individuals making contributions to private pension schemes, the contribution may, as a main rule, not exceed 0.5 base amounts on a yearly basis.

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[11] See chapter 58, 2-16 §§, 21 - 30 §§ and chapter 28 of the ITA.
[12] Chapter 58, 6 § ITA.
[13] Chapter 58, 10 § ITA.
[14] Chapter 58, 11 and 14 §§ ITA.
[15] Chapter 58, 4 § ITA. There are some exceptions from this main rule, see Chapter 58§ 5 ITA. These exceptions are explained in chapter 6.2 below.
[16]Prop. 1969:162 p. 24-30 and prop. 1993/94:85 p. 34.
[17] Prop. 1997/98:146 p. 61.
[18] Chapter 28, 6 § ITA. The "base amount" is decided every year by the National Social Security Agency and is used to calculate several different social security benefits etc. Currently, the base amount is SEK 39,700.
[19] The so called "complementary rule" in Chapter 28, 7 - 12 §§ ITA allows an employer to deduct contributions exceeding the thresholds under certain circumstances where previous pension commitments have not been properly funded.

3.2.4 Legal framework

As noted in section 3.2.1 above, in addition to adhering to the qualitative requirements, an employer contribution must also be made within a certain legal framework in order to be deductible. An employer may deduct a premium paid on a pension insurance policy adhering to the qualitative requirements[20]. The employer may also deduct a contribution to pension trust (*Sw: pensionsstiftelse*) established in accordance with the Swedish Act on the Safeguarding of Pension Commitments (SPCA)[21]. Furthermore, premiums and contributions paid on non-Swedish pension contracts and to non-Swedish pension institutions may be deducted, provided that the pension contract and the pension institution are similar to a Swedish pension insurance policy and a Swedish pension trust respectively. Deductibility in these cases is also contingent upon the non-Swedish institution conducting business in Sweden through a permanent establishment (PE)[22]. Finally, the employer may deduct a reservation for pension payments provided that the reservation is combined with credit insurance or state or municipal guarantee.

3.2.5 Deduction for unqualified schemes

While an unqualified contribution to an occupational pension scheme made outside the legal framework mentioned above and which does not comply with the qualitative requirements is not deductible as a "pension cost", it may be deductible on other grounds, notably as "salary cost"[23]. Typically this is the case where the cost can be regarded as a cost for acquiring or maintaining income. Hence, occupational pension schemes and vehicles not complying with the provisions outlined above are not precluded from deductibility in principle.

Contributions to unqualified individual private pension schemes should however normally be non-deductible, since such contributions are deemed to constitute ordinary living expenses.

3.2.6 Special Wage Tax

As mentioned above in section 3.1, employer contributions complying with the qualitative and quantitative requirements are subject to a special tax under the Act on Special Wage Tax on Pension Costs[24]. As also mentioned, the purpose is to achieve tax neutrality in the treatment of ordinary wages and pension costs with regard to social security contributions.

According to the Swedish Act on Social Security Fees[25], a salary payment is currently subject to social security fees at a flat rate of 32,28 per cent. Special Wage Tax is levied on qualified employer pension contributions at 24,26 per cent. The Special Wage Tax was originally intended to correspond to the part of the social security fees which are not linked to social

[20] Chapter 28 § 3 ITA.
[21] *Sw: lagen (1967:531) om tryggande av pensionsutfästelser*
[22] These provisions have recently been implemented in the context of adapting the Swedish legislation to the Directive (2003/41/EEC) on Pension Funds. The purpose is to make the Swedish tax legislation compatible with the EC treaty, see prop. 2005/06:22. The provision that the institution is conducting business in Sweden through a PE is an aspect of the establishment requirement mentioned above and is of course controversial from an EC legal perspective. This will be discussed in chapter 6 below.
[23] A prerequisite for deductibility on such grounds is most likely that the contribution is irrevocable, i.e. that the employer is unable to retrieve the contributed funds, see RÅ 2000 ref 28.
[24] *Sw: lagen (1991:687) om särskild löneskatt på pensionskostnader*.
[25] *Sw: socialavgiftslagen (2000:980).*

security cover for income loss due to disability etc[26]. In other words, the Special Wage Tax was supposed to resemble the "tax part" of the social security fees. However, since social security fees currently are charged on wages exceeding the cap for social security benefits, there is a discrepancy, i.e. not neutrality, between ordinary wages and pension costs in this regard. This discrepancy will be further discussed below in section 3.6.2.

3.3 *Tax treatment of pension capital during the investment period*

3.3.1 Yield Tax

In accordance with the Swedish Act on Yield Tax on Pension Capital[27] (YTA), the Yield Tax is levied on pension capital during the investment period. Legally, the subject to the Yield Tax is the pension institution[28] or the employer where the latter has made a reservation in the books for qualified pension commitments[29]. Pension institutions domiciled outside Sweden are subject to Yield Tax only to the extent they maintain a PE in Sweden.

However, since the pension institution is sure to obtain compensation for the Yield Tax via the pricing of pension products, the economic burden of the tax is in fact borne by the policyholders/beneficiaries. This is in line with the basic principles of the Yield Tax in that it is, as mentioned above in section 3.1, supposed to be a substitute for income tax on savings.

The Yield Tax is charged on a deemed yield on pension capital. The tax is levied at a rate of 15 per cent on qualified pension capital[30], and at 27 per cent on unqualified capital[31].

The amount taxable under YTA is calculated in two steps[32]. First, the "capital base" is assessed corresponding to the total value of assets held on behalf of policyholders/beneficiaries less financial debt. Secondly, the taxable yield is calculated by multiplying the capital base with the average yield on Swedish state bonds during the year preceding the income year.

The Yield Tax is thus charged basically on the value of assets held. This means that the tax is always payable regardless of yields, dividends and ultimately the development on equity and bond markets. Consequently, the Yield Tax arguably resembles an "asset tax" or "wealth tax" rather than an "income tax", at least from a technical legal perspective.

3.3.2 Wealth Tax

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[26] Prop. 1989/90:110 p. 491 and prop. 1990/91:166 p. 43 and 45. As opposed to ordinary wages, pension payments do not generate social security benefits.
[27] *Sw: lagen (1990:661) om avkastningsskatt på pensionsmedel,* SFS 1990:661.
[28] In Sweden the pension institution is typically a life insurance company or enterprise providing pension insurance (*Sw: försäkringsförening* or *pensionskassa*) or a pension trust established by the employer in accordance with the SPCA (see above section 3.2.4).
[29] 2 § YTA.
[30] 9 § YTA. With regard to the issue of neutrality in taxation between qualified pension capital and ordinary savings, see below in section 3.6.3.
[31] Consequently, unqualified life insurance products with a savings element, for instance ordinary annuities and similar, are subject to Yield Tax at a rate of 27 per cent. The rationale for this regime is that these products are regarded as comparable to normal savings products such as shares. Health and casualty products are, as a main rule, exempt (3 § third section YTA).
[32] 3 § YTA.

Under the Act on State Wealth Tax (SWTA)[33], Wealth Tax is levied on the value of financial assets (shares, bonds etc), property etc held, as a main rule, by individuals. The tax is levied at 1.5 per cent on the value of total assets held exceeding certain thresholds. Albeit the taxable assets include life insurance policies, qualified pension insurance policies are exempt from Wealth Tax[34].

3.3.3 Possibility to opt for lower Yield Tax and Wealth Tax exemption

Following a ruling from the Swedish Supreme Administrative Court[35], new legislation was implemented allowing an individual to opt for beneficial treatment for Yield Tax and Wealth Tax purposes in exchange for not deducting the premium for income tax purposes[36]. Hence, a customer and a life insurance provider may agree to treat a life insurance policy as unqualified for income tax purposes even if the policy complies with the qualitative requirements and thus forfeiting the right for the customer to deduct the premium. However, such a policy is subject to the lower Yield Tax charge at 15 per cent and is exempt from Wealth tax.

According to the ruling, the higher Yield Tax Charge and Wealth Tax on non-Swedish life insurance policies constitute a restriction of the freedom to provide services according to Article 49 in the EC treaty were the policy concerned complies with all the qualitative requirements but the establishment requirement (see below in section 6.3). The following legislation amending the Swedish tax regime for pensions in this respect was however not restricted to non-Swedish policies in order not to unnecessarily impose a disadvantage for Swedish pension institutes from a competition perspective in relation to providers domiciled in the EU or the EEA[37].

3.4 *Tax treatment on pay out of pension benefits*

As follows from the discussion in section 3.2 above, pension benefits paid under qualified pension insurance policies and schemes are taxable for the retiree/beneficiary as personal income and thus at the progressive income tax rates. The employer may not deduct the paid benefit to the extent that the employer has obtained deduction for the contribution, which typically is the case with regard to qualified pension schemes. Special Wage Tax is not payable on the benefit to the extent it has been paid on the contribution. For unqualified schemes, the reverse applies, i.e. paid benefits are generally deductible for the employer and Special Wage Tax is payable.

For qualified private pension schemes, the same applies insofar that paid out amounts are taxable as personal income at the progressive rates. However, premiums paid on unqualified private life insurance policies are non-deductible and paid out amounts non-taxable.

3.5 "*Privileged" and "unprivileged" pension plans*

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33 *Sw: Lagen (1997:323) om statlig förmögenhetsskatt.*
34 3 § section 8 SWTA.
35 RÅ 2004 ref. 84.
36 SFS 2005:1172, prop. 2004/05:31.
37 It should be noted that this new possibility to opt for beneficial Yield Tax and Wealth Tax treatment in exchange for forfeiting the deduction for income tax purposes has given rise to a new, very popular life insurance product in Sweden called "kapitalpension". It could be argued that the Kapitalpension is partly eroding the basis for the Wealth Tax.

Sweden do not maintain a formal system where the Swedish Tax Agency "approves" or "disapproves" of "pension plans" and thus grants beneficial tax treatment on an individual basis. However, pension insurance policies and schemes adhering to the qualitative requirements can surely be viewed as "tax privileged pension plans" in a broad sense, since such policies and schemes receive beneficial treatment for income tax, Yield Tax and Wealth Tax purposes. It should also be mentioned that all major collective occupational pension plans on the Swedish labor market are based on the qualitative and quantitative requirements mentioned above in order to ensure beneficial tax treatment.

Employers actually use unqualified pension solutions, i.e. pension instruments not adhering to the qualitative requirements and outside the legal framework described above in section 3.2. These solutions can be categorized as "unprivileged pension plans". These unqualified solutions are used for the benefit of executives or highly skilled professionals or similar, i.e. employees with salaries exceeding the normal "collective bargaining agreement spread". Typically, the employer makes a pension commitment to the employee or executive with generous conditions outside the scope of the qualitative requirements and sometimes exceeding the quantitative requirements. In order for the employee to obtain sufficient security for the corresponding pension claim, the employer acquires an unqualified life insurance policy with the employee as the insured and pledges the policy to the employee. Thus, in the event of the employer being unable to satisfy the pension commitment, the employee can receive payment through the life insurance policy. These solutions are called "direct pensions" (*Sw: direktpensioner*).

Since direct pensions are unqualified, the employer may, as a main rule, not deduct the premium for the life insurance policy[38]. During the investment period, the employer must pay Yield Tax on the value of the policy at the higher rate, i.e. 27 per cent. Normally, the employer is not liable to Wealth Tax on the policy[39]. The employer may deduct any amounts of pension actually paid out to the employee, provided of course that the corresponding contribution was treated as non-deductible. As mentioned above in section 3.2.6, pay out of pension triggers liability to Special Wage Tax. Of course, the employee is taxed for pension received at the progressive rates.

3.6 *Principal discrepancies and assymetries*

3.6.1 General

One of the purposes underlying the reform of the Swedish tax system undertaken in 1990 was to make the tax system adhere to certain principles of tax neutrality[40]. According to these principles, economic decisions that are equal pre-tax, should be equal post-tax as well. This means, inter alia, that different forms of remuneration for work performed should be treated equally for tax purposes. Since pensions are regarded as remuneration for work performed,

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[38] As mentioned in section 3,2.5, the fact that a pension scheme is not qualified does not in itself preclude deductibility. Thus, it could possibly be argued that the employer may deduct the premium for the life insurance policy. However, such argument is likely to prevail only where the employer is unable to repurchase the policy. The Supreme Administrative court has allowed deductibility in a similar case where the employer made irrevocable contributions to a pension trust domiciled on Guernsey (RÅ 2000 ref 28).

[39] As mentioned above in section 3.3.2, Wealth Tax is generally payable only by individuals. However, in the context of closely held companies, direct pension commitments to active owners may under certain circumstances trigger Wealth Tax liability in that they might not be deemed deductible from the value of the shares held by the owners.

[40] Prop. 1989/90:110 p. 294 and 388 and SOU 1989:33 part 1, p. 52 onwards.

i.e. "deferred salary"[41], pensions should in principle be treated no different than salaries for tax purposes.

Furthermore, the tax system should in principle be neutral concerning investment decisions and the choice between different investment products. According to these principles, it should ideally be of no consequence from a tax perspective whether an individual chooses to invest in shares or bonds or units in mutual funds. In particular, the legislator wants to avoid the tax free "piggy bank effect"[42] on what is called indirect savings, meaning investments in "middleman vehicles" like mutual funds and, arguably, life insurance companies[43]. If yields on capital invested in such vehicles are not somehow taxed, indirect savings are arguably more favorably treated compared to direct savings, since dividends, yields and gains on such savings are taxed at the investor level. As noted above in section 3.1, this is the rationale for the Yield Tax[44].

Finally, it could also be argued that a pension taxation system should maintain neutrality between different pension products and vehicles as long as the pension purpose, i.e. the qualitative requirements, is fulfilled[45]. According to this argument, a pension insurance policy issued by a life insurance company should in this context be treated equally for tax purposes with a pension savings account provided by a bank. This would arguably result in an optimal market for pension products characterized by competition and consumer choice.

3.6.2 Social security costs in relation to pensions and ordinary salaries

As noted above in section 3.2.6, social security fees are payable on ordinary salaries at a flat rate of 32.28 per cent, while Special Wage Tax is levied on qualified pension contributions and on pension payments at a rate of 24.26 per cent. As also noted, the purpose of the Special Wage Tax is to achieve tax neutrality between ordinary salaries and pensions and that the Special Wage Tax was originally supposed to correspond to the "tax part" of the social security fees, i.e. to the part of the fees not linked to certain social security benefits. However, social security fees are currently levied in full on salaries exceeding the cap for social security benefits. Hence, the part of the salary exceeding the cap and thus not generating social security benefits is nevertheless subject to social security fees. Salaries exceeding the cap for social security benefits are thus subject to higher charge of social contributions compared to pension contributions and payments. Consequently, the Swedish tax system does not maintain tax neutrality in this respect.

The effect of a "switch" from salary to a qualified pension commitment is thus twofold; the social security charge is lower than on normal salaries and the income taxation of the employee is deferred until payment of the pension benefit. Since pension contributions thus are less expensive for the employers in a social security context, there is an incentive for employers to compensate employees by way of pensions and pension commitments rather than by ordinary salaries. For employees with salaries below the cap for social security benefits an increased pension commitment at the expense of part of the normal salary, which

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[41] SOU 1989:33 part II p. 201 and Dir. 2004:99.
[42] *Sw: Sparbösseeffekt*
[43] SOU 1989:33 part II p. 199.
[44] It should in this context be noted that Sweden also has a special regime for taxation of investments in mutual funds and certain public investment companies intended to make such investments tax neutral visavi direct investments in shares etc, i.e. eliminating the piggy bank effect.
[45] See Ds 1992:45, prop. 1992/93:187 p. 88 onwards, prop. 1993/94:85 p. 32 onwards and SOU 2000:11 p. 260.

generates social security benefits, is probably not very interesting. For employees with income above the cap however, it might be interesting to accept a partial switch to pension commitments, presupposing that they will be subject to lower marginal tax rates in retirement. Moreover, it can always be argued that deferred tax is better than paid tax, regardless of marginal tax rates.

Swedish case law has taken a fairly liberal position on the "switch" from salary to pension commitments and contributions. Basically, an employer and an employee can agree on transforming part of an agreed salary, notably a vested bonus, to a qualified pension commitment or contribution prior to the amount actually being paid out[46]. Not surprisingly, this has resulted in "switching" from salary to pension commitments or contributions becoming more common among highly remunerated employees[47].

3.6.3 Yield Tax and ordinary income tax on savings

As noted above in sections 3.1 and 3.6.1, the purpose of the Yield Tax is to establish a certain level of neutrality in taxation between pensions and ordinary savings. As mentioned in section 3.3.1 above, qualified pension capital is subject to Yield Tax at a rate of 15 per cent. Yields, dividends, capital gains etc on ordinary savings are however subject to income tax at a flat rate of 28 and 30 per cent for corporate and individual investors respectively. Arguably, qualified pensions are thus more favorably treated compared to ordinary savings. The reason for this is that pension savings is long term and generally recognized as beneficial from a social, political and economical perspective[48].

Nevertheless, it is frequently argued that qualified pension savings should be treated no different than ordinary savings for tax purposes in this respect and that the Yield Tax rate thus should be increased to 30 per cent[49]. However, this argument fails to take into account that qualified pension savings are locked for a very long time, i.e. the individual beneficiary is normally unable to access the funds during the investment period, and also that the qualified products contain an insurance element not present in ordinary savings products. Furthermore, the Yield Tax differs significantly from regular income tax in that it is calculated on a discretionary basis making it resemble a "wealth tax" rather than an "income tax". Consequently, the issue whether the Yield Tax on qualified pension capital is more favorable than regular income tax on ordinary savings is not uncomplicated. However, it must be acknowledged that a qualified, unit linked life insurance policy contains a dominant savings element and that a credible case for "equal treatment" with ordinary savings products thus certainly can be made on tax neutrality grounds.

3.6.4 Tax neutrality between pension products

As noted above in section 3.6.1, it could be argued that strict tax neutrality should be observed between different pension products as long as the qualitative requirements are fulfilled. In the

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[46] RÅ 2000 ref. 4, "the bonus case". See also the ruling from the Board for Advance Rulings on May 6, 2003 RSV:s case law protocol 31/03. The argument is that the employer and employee can agree on transforming a bonus payment or similar to a pension contribution before the employee obtains actual access to the actual funds.

[47] This has caused some irritation within the Ministry of Finance and the tax authorities , see Dir. 2004:99, and it is not inconceivable that future pension taxation reform will contain either an abolishment of the difference in treatment of salaries and pensions in this regard and/or a tightening-up of the possibilities to switch salary for pension commitments or contributions.

[48] Prop. 1989/90:110 p. 489-490 and SOU 1989:33 p. 214.

[49] See for instance SOU 2002:47 p. 463-464.

Swedish pension taxation system however, this is not always the case. While it is fully possible for a Swedish individual to deduct payments to a pension savings account with a bank qualifying under the qualitative requirements[50], an employer may not deduct such payments on behalf of an employee. Hence, pension savings accounts can be used for private pensions with retained tax deferral, but not for occupational pensions.

Of course an argument can be made for extending the beneficial tax treatment to pension savings accounts for occupational pensions. However, one should bear in mind that the pension insurance policy contains an insurance element, however diminutive, which is often relevant from a social perspective. Furthermore, the pension savings account is probably a feasible solution only for defined contribution commitments. Consequently, there are some major differences in the nature of the pension insurance policy and the pension savings account which arguably necessitate some differential tax treatment.

Finally, it can in this context be noted that there are some differences in the qualitative requirements between pension commitments secured by pension insurance and pension trusts, which arguably distorts the neutrality between those pension products.

[50] See chapter 59 § 2, chapter 58, §§ 21 - 33 the ITA and the Act on individual Pension Savings, *Sw: lagen (1993:931) om individuellt pensionssparande.*

6. International mobility of labor and capital

6.1 *General*

As noted above in section 3.1, the Swedish pension system corresponds in principle to the three pillar system as described by the Commission, i.e. it consists of state, occupational and private pensions[51]. As also noted, the Swedish legislator has implemented tax incentives in order to encourage long term pension savings. Hence, pension schemes adhering to the aforementioned qualitative requirements, which supposedly ensure that the pension scheme is of a genuine pension nature, receive beneficial tax treatment. This beneficial tax treatment consists of deductibility for contributions, which applies to occupational pensions as well as private, deferral of income tax, a lower Yield Tax charge and exemption from Wealth Tax.

The Swedish legislator has however displayed concern over the protection of the tax base and for the prevention of tax avoidance and what it regards as abuse of the favorable rules on pension taxation[52]. A plausible explanation for this concern is that Sweden maintains a highly ambitious welfare state and thus charges relatively high taxes[53]. Hence, the Swedish pension taxation system contains provisions and features designed to restrict the tax incentives to pension schemes issued by Swedish pension institutions. Inter alia, a scheme issued by a non-Swedish pension institution can as a main rule not qualify under the qualitative requirements, resulting in the scheme not obtaining beneficial tax treatment (see below section 6.6.2.2 on the establishment requirement). The main rationale for this regime is that the deductibility of pension contributions and the corresponding tax deferral have resulted in a huge "latent tax liability" for the tax payers and that it is of vital importance for Sweden to be able to ultimately collect this deferred tax[54]. From a Swedish fiscal perspective, collection of this deferred tax is of course significantly simplified if the tax deferral is restricted to Swedish pension providers, which are subject to regulations on tax reporting, tax withholding etc. Against this background, it is not very surprising that Sweden always aims to achieve source state taxation of pensions when negotiating double tax treaties[55].

Evidently, Sweden pursues an obvious tax base protection strategy, particularly regarding pensions. This strategy is of course controversial from an international perspective. The OECD model convention on taxes on income and capital ("the Model Convention") stipulates as a main rule that occupational pensions should be taxed in the State in which the individual receiving the payment is resident[56]. Furthermore, and perhaps more important today, the EU is arguably moving in the opposite direction compared to Sweden in this context, in that it is striving to achieve an "ever closer union"[57]. The EU in general and the Commission in particular have taken a special interest in cross-border pensions. The reason for this is

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[51] COM (2001) 214

[52] Predictably, the dreaded mobility of the tax base gives rise to much anxiety in Sweden, see for instance SOU 2000:11 p. 246 onwards with references and SOU 2002:47 p. 311 onwards.

[53] Swedish individuals pay income tax at 58 per cent in the highest income bracket. Corporate income tax is charged at a 28 percent flat rate and is thus relatively low. However, Sweden charges social security fees at 32.28 per cent. Swedish VAT is levied at 25 per cent.

[54] In the Skandia case (C-422/01), Sweden used this argument, amongst others, to support its claim that the difference in tax treatment of contributions to Swedish pension institutions visavi non-Swedish institutions is justifiable on compelling public interest grounds. See also Rehnberg i Skattenytt 2005 p. 649.

[55] SOU 2002:47 p. 354.

[56] Article 18 in the Model Convention.

[57] See the preamble of the EC treaty. The rules in the EC treaty are not directly applicable direct taxation in the member states. However, the powers retained by the Member States must nevertheless be exercised consistently with community law, see the cases C-279/93 (Schumacker) and C-80/94(Wielockx), amongst others.

presumably that the pensions market is deemed an important part of the financial services market and that it is of vital importance for EU, considering the demographic change etc, to create an effective and well functioning market within the community for occupational pensions in particular[58]. Consequently, the Commission has initiated several infringement procedures in accordance with article 226 in the EC Treaty against member states alleging that their pension taxation systems are discriminatory or otherwise in non-conformity with the EC treaty[59]. Thus, the Swedish tax base protection strategy and the intention of the Commission to achieve higher level of integration of the pensions market within the community can be regarded as conflicting trends.

Sections 6.2, 6.3 and 6.4 below describe the tax treatment according to domestic law of contributions to non-Swedish institutions, yields, dividends etc. during the investment period and of outbound pension payments. In sections 6.5 and 6.6, the impact of double tax treaties and EU law is discussed respectively.

6.2 *Treatment of contributions to non-Swedish pension institutions*

As noted above in section 3.2.2, the qualitative requirements in the Swedish regime for taxation of pensions stipulate that a pension contribution must be made to a pension institution resident in Sweden or a foreign institution maintaining a PE in Sweden (the establishment requirement)[60]. This means that such a contribution is not deductible for an employer as a "pension cost"[61]. The same applies for individual private pensions. The purpose of the establishment requirement is to ensure the taxation of pension payments corresponding to deductible contributions[62]. Please note however that the fact that a contribution is unqualified and thus not deductible as "pension cost" does not rule out the possibility of it being deductible on other grounds, notably as "salary cost", see above section 3.2.5. In the case where a non-Swedish occupational life insurance policy adheres to all qualitative requirements but the establishment requirement, the contributions are deductible for the employer[63].

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[58] See the preface in COM (2001) 214. See also Speech by Charlie McCreevy, European Commissioner for Internal Market and Services held in Dublin on September 22, 2005, on the subject Pension funds and asset management: a European Perspective. A copy of the speech is available on the Commissions homepage.
[59] On 20 December 2004, the Commission resolved to send a reasoned opinion to the Swedish government demanding certain changes in the Swedish regime for taxation of pensions, see below section 6.6.2.
[60] See chapter 58 § 4 ITA.
[61] Chapter 28 § 2 ITA.
[62] Prop. 1969: 162 p. 24-30 and prop. 1993/94:85 p. 33 onwards.
[63] See prop. 2004/05:31 p. 8 onwards. This conclusion is based on the outcome in the Supreme Administrative court case RÅ 2004 ref. 28 in which the court referred the issue of deductibility to the EC Court of Justice resulting in the verdict in the Skandia case (C-422/01) (the much discussed RÅ 2000 ref. 28 also indicates deductibility in this case). The ECJ ruled that it was contrary to EC treaty not to allow the employer to deduct contributions to a non-Swedish life insurance policy complying with the qualitative requirements but the establishment requirement. Following this verdict, the Supreme Administrative court ruled that *regardless of the treatment according to Swedish tax law* it is not in line with community law not to allow the deduction. Hence, it is still unclear whether the deduction is allowed as a "pension cost" or a "salary cost". This distinction is important, since a "salary cost" is subject to normal social security fees at a rate of 32,28 per cent while a "pension cost" is subject to Special Wage Tax at a rate of 24,26 per cent. Moreover, the Swedish Tax Agency has opted for the "salary cost" alternative and insists that it means that the beneficiary, i.e. the employee shall be taxed immediately for the contribution regardless of the fact that he or she is unable to access the funds prior to pay out. On this issue see also Schmid in Svensk Skattetidning 2004 p. 375 onwards.

There can be no doubt that a contribution to non-Swedish, and thus unqualified, occupational pension scheme is taxable for the employee[64]. The crucial issue is however the timing of such taxation. On the basis that qualified occupational pension contributions are, as noted in section 3.2.1 above, explicitly exempt from taxation, it is often argued that contributions to unqualified schemes, including contributions to non-Swedish institutions, are immediately taxable for the employee[65]. Indeed, that may seem logical if the contribution is deductible for the employer as a "salary cost". A recent ruling from the Board for Advanced Rulings can be interpreted as supporting this view[66].

The issue whether the employee is able to dispose of the funds can however in my view not be wholly ignored in this context. If the employee is unable to access the funds during the investment period, it can be argued that taxation is postponed until pay out[67]. This applies especially in a cross-border context involving a pension institution domiciled in another member state. In another recent ruling, the Board for Advance Rulings found that an occupational pension insurance policy issued by a life insurance company domiciled in another member state, which complied with all the qualitative requirements but the establishment requirement, must be treated as a qualified pension insurance policy for tax purposes. This means that the employee shall not be taxed until pay out[68]. The Board based its ruling on the EC legal principles, i.e. that the immediate taxation of the employee constituted a restriction to the freedom to provide services enshrined in Article 49 in the EC treaty and that there were no grounds for justification for the difference in treatment[69].

Finally, it should in this context be noted that there are some exceptions from the establishment requirement[70]. In the case where an individual has acquired a non-Swedish life insurance policy for mainly retirement, health or spousal benefits while domiciled outside Sweden, the policy is recognized as qualified pension insurance, provided that the individual obtained beneficial tax treatment for the policy abroad. The same applies to a non-Swedish occupational pension insurance policy acquired during residency or service outside Sweden provided that the insured person, i.e. the employee, has not been taxed for the benefit in the jurisdiction concerned. In addition, the Swedish Tax Agency may on application designate a non-Swedish insurance policy as qualified pension insurance in cases of "compelling reasons". The reason for this rule is mainly to enable foreign workers active in Sweden to

[64] See chapter 11 § 1 the ITA and prop. 1950:93 p. 4.
[65] See Rehnberg in Skattenytt 2005 p. 645 and Ewalds in Skattenytt 2003 p. 863.
[66] The Board rendered its ruling on November 16, 2005, dnr 15-05/D.
[67] There is case law supporting this view as well, notably RÅ 2000 ref. 4. The reason for the reluctance to postpone taxation in these cases can be traced to the fact that payments from unqualified life insurance policies are explicitly tax exempt according to chapter 8, § 14 ITA, which corresponds to the fact that premiums on such policies are generally non-deductible. It can however be argued that payments should be taxed on pay out nevertheless in accordance with chapter 11 § 1 ITA, if a payment obviously can be characterized as a "pension payment", see for instance Gefvert in Svensk Skattetidning 2006 p. 132. Another court case often discussed in this context is the aforementioned RÅ 2000 ref. 28, where the Supreme Administrative Court allowed a company to deduct contributions to an unqualified Guernsey pension trust. Furthermore, the court ruled that the beneficiaries should not be taxed directly upon contribution to the trust, on the basis that the beneficiaries were unable to dispose of the funds, but subsequently when the trust were to acquire unqualified life insurance policies on behalf of the beneficiaries. The outcome can arguably be explained by the fact that the Supreme Administrative Court feared that the beneficiaries, i.e. the employees, would escape taxation altogether for the "pension benefit" if they were not taxed for the premiums paid by the trust.
[68] The Board rendered its ruling on June 10, 2005, dnr 163-04/D.
[69] It should be noted that the verdict was not unanimous, a minority of the Board members opted for the immediate taxation approach. The ruling has been appealed to the Supreme Administrative Court, which has yet to rule on the matter.
[70] Chapter 58 § 5 ITA.

maintain existing pension arrangements[71]. In cases where a non-Swedish insurance policy is recognized as qualified pension insurance on these grounds, contributions may be deducted for tax purposes in Sweden and paid out amounts are taxable[72]. See also section 6.5.2 below on related double taxation issues.

To sum up, contributions to a non-Swedish pension institution which does not maintain a PE in Sweden are not, with a few minor exceptions, deductible as "pension costs". Deduction might however, depending on the circumstances, be allowed as a "salary cost". It can be argued that such contributions are immediately taxable for the employee according to the Swedish internal rules. A recent ruling from the Board for Advanced Rulings indicates however that taxation for the employee is postponed until pay out on EC legal grounds in case the pension scheme complies with the qualitative requirements but the establishment requirement.

6.3 *Treatment of yields, dividends etc during the investment period*

6.3.1 Yield Tax

Life insurance policies issued by non-Swedish institutions with no PE in Sweden and held by Swedish persons, whether individuals or others, are also subject to Yield Tax under YTA. For obvious reasons, the legal tax payer in this case is not the non-Swedish institution but the policyholder. This means that the policyholder, typically an employer or an individual, must disclose the amount taxable under YTA attributable to a non-Swedish life insurance policy in the yearly tax return[73]. Furthermore, the method for calculating the taxable deemed yield is also different for non-Swedish policies[74].

Consequently, there are procedural as well as material differences in treatment between Swedish and non-Swedish policies regarding the collection and calculation of the Yield Tax. These differences in treatment are arguably somewhat controversial from an EC legal perspective. See below section 6.6.2.3.

As mentioned above in section 3.2.3 and in section 6.2, due to the establishment requirement, pension contributions made to pension institutions domiciled outside Sweden with no PE in Sweden are treated as unqualified for income tax purposes under the ITA regardless of whether the relevant scheme adheres to all the qualitative requirements but the establishment requirement. Previously, YTA also differentiated between "Swedish" and "non-Swedish" pension capital in this regard in that the latter was treated as unqualified and thus subject to the higher Yield Tax rate, i.e. 27 per cent. The Swedish Supreme Administrative Court recently ruled that the difference in treatment for Yield Tax purposes between life insurance policies issued by institutions domiciled in Sweden and policies issued by non-Swedish institutions constituted a restriction to the freedom to provide services enshrined in article 49 of the EC treaty[75].

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[71] See prop. 1979/80:68 p. 21 onwards and Prop. 1995/96:231 p. 45.
[72] In the event that the individual has not been allowed deduction or has been taxed for the benefit, paid on other grounds, paid out amounts are however tax exempt, chapter 11 § 43 ITA.
[73] Chapter 3 § 1 the Swedish Act on Tax Returns and Income Statements; *Sw: lagen (2001:1227) om självdeklarationer och kontrolluppgifter.*
[74] According to 3 § sections 7 - 9, the "capital base" for non-Swedish life insurance policies is equal to the sum of the surrender value and the part of accumulated surplus funds attributable to the policy. With regard to unit linked products, the capital base is generally equal to the value of the assets held within the "insurance wrap".
[75] RÅ 2004 ref. 84. See also section 3.3.3 above.

Prompted by the ruling, Sweden has subsequently implemented legislation intended to equalizing the treatment for Yield Tax purposes of life insurance policies issued by domestic institutions and policies issued by institutions domiciled in other member states and in EEA states[76]. According to the new legislation, an insurance policy complying with the qualitative requirements, except the establishment requirement, issued by an institution domiciled in another EU or EEA member state, will be treated as a qualified insurance policy for Yield Tax purposes, i.e. the tax will be charged at the lower Yield Tax rate. However, this equal treatment is contingent upon the institution conducting business in Sweden in accordance with the Act on Foreign Insurers Business Operations in Sweden[77]. This means that a prerequisite for equal treatment for Yield Tax purposes is that the non-Swedish insurer conducts insurance business in Sweden in accordance with the EU insurance directives.

Finally, it should in this context be noted that the double tax treaties Sweden has concluded with other states generally do not encompass the Yield Tax.

6.3.2 Wealth Tax

As in the case of the YTA, the SWTA previously differentiated between Swedish and non-Swedish policies on the basis of the establishment requirement, i.e. the latter were not treated as exempt for Wealth Tax purposes even if the policy adhered to all the qualitative requirements but the establishment requirement. Of course, the issue was principally the same as regarding the Yield Tax, and was also resolved in the same way by the Swedish Supreme Administrative Court in the above mentioned case. The new legislation mentioned above consequently also covered the Wealth Tax with principally the same result. Hence, a life insurance policy issued by a life insurer domiciled in an EU or EEA member state complying with the remainder of the qualitative requirements is exempt from Wealth Tax. Also, this equal treatment is contingent upon the non-Swedish insurer conducting insurance business in Sweden through cross border operations under the EU insurance directives.

6.3.3 Exit taxation of cross-border transfers of qualified pension capital

In the event that a life insurance company domiciled in Sweden should transfer assets and liabilities attributable to a qualified life insurance policy to another life insurance company which do not provide qualified life insurance, the beneficiary is immediately taxed for the capital attributable to the policy[78]. Since non-Swedish pension institutions are unable to provide qualified pension insurance policies due to the establishment requirement, this rule in effect constitutes an exit tax on qualified pension capital. A transfer of qualified pension capital to a non-Swedish pension institution is thus systematically regarded as a "pension payment" which should be subject to immediate income taxation for the beneficiary. This applies regardless of whether the beneficiary is unable to dispose of the funds during the remainder of the investment period. Of course, this provision is highly controversial from an EU legal perspective, see below section 6.6.2.5.

6.4 *Treatment of outbound pension payments*

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[76] prop. 2004/05:31, SFS 2005:1172.
[77] *Sw: lagen (1998:293) om utländska försäkringsgivares verksamhet i Sverige.*
[78] Chapter 58 § 19 ITA.

If a person migrates and becomes resident in another state prior to pension payments being due, payments from a Swedish pension institution, or from a PE in Sweden of a non-Swedish institution, are subject to tax at source in Sweden according to the Act on Special Income Tax for non-residents (SINA)[79]. The tax is levied at a flat rate of 25 per cent and no deductions are allowed.

The person is taxed for occupational pension payments provided that the pension is attributable to former employment in Sweden and that the operations mainly were conducted in Sweden[80]. Only pension payments made under qualified schemes are subject to tax under SINA. This is logical since contributions to unqualified schemes generally are non-deductible for income tax purposes.

Occupational pension payments from Swedish pension institutions, which correspond to previously deducted (qualified) employer contributions to former employees who have migrated from Sweden, can thus be taxed in Sweden. The same applies when a Swedish pension institution pays pension under a qualified individual private pension scheme to a non-resident, where contributions has previously been deducted from income earned while resident in Sweden.

However, in the event that the pension payment is not made from Sweden but from a non-Swedish pension institution, the payment is most likely not taxable in Sweden regardless of whether the corresponding contribution was originally deducted from income taxed in Sweden[81]. Of course, that is of minor importance as long as Sweden maintains the above mentioned establishment requirement for deduction of contributions. It is however not inconceivable that Sweden might be forced to abolish the establishment requirement (see below section 6.6.2.2). In such case, it might be significantly more difficult for Sweden to collect the tax corresponding to deducted contributions to pension institutions in other member states in respect of migrant employees.

6.5 *The impact of double tax treaties*

6.5.1 General

As noted above in section 6.1, Sweden always aims for source state taxation of occupational and private pension payments while negotiating tax treaties with other states. Considering the deduction for qualified contributions, it is regarded as a vital Swedish interest to retain the right to tax pension payments from Swedish pension institutions where the pension is attributable to work performed in Sweden and private pension savings made in Sweden. However, as noted above in section 6.1, Article 18 in the Model Convention stipulates that pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that state. Hence, the OECD has opted for the opposite approach compared to Sweden, i.e. the right to tax is granted to the residency state[82]. Sweden is not always successful in the aforementioned strategy (see below).

[79] § 5 p 6 SINA. *Sw: lagen (1991:586) om särskild inkomstskatt för utomlands bosatta.*
[80] § 5 p 7 SINA.
[81] See Ewalds in Skattenytt 2003 p. 865.
[82] The reason for this is that the residency state is in a better position to determine the recipients overall ability to pay tax, which depends on worldwide income and personal circumstances such as family responsibilities, see paragraphs 1 and 17 in the Commentary to the Model Convention as amended 2005. It should be noted that the ECJ accepted this general principle as inherent in Community Law in case C-279/93 (Schumacker).

According to the Nordic Tax Treaty of 1996 (hereinafter referred to as the Nordic Treaty), the right to tax occupational and individual private pensions is granted to the source state[83]. The treaties with Canada and Italy also grant the right to tax occupational and private pensions to the source state. The tax treaty concluded between Sweden and Ireland allows both source and residency taxation of occupational and private pensions, but the residency state must grant credit for tax levied in the source state. In the tax treaty with the United Kingdom, the right to tax occupational and private pensions is granted to the source state, albeit the right to tax is granted to the residency state in case where the recipient is a citizen of that state. Furthermore, only 80 per cent of the pension is taxable according to the treaty. The treaties with the United States, Germany, France, the Netherlands and Austria all stipulate residency state taxation of occupational and private pensions. This is also the case regarding the treaties with the Baltic States, albeit the source state may tax the pension where the tax charge in the residency state is insignificant.

6.5.2 Deduction for contributions to home state pension schemes

As has been explained in section 6.2 above, the Swedish regime for taxation of pensions contains provisions for allowing deductions for contributions to non-Swedish pension schemes in cases where non-Swedish individuals are working in Sweden on a short time basis.

In addition, Sweden has accepted deductibility for contributions to pension institutions resident in another Contracting State under certain special circumstances in certain tax treaties, notably in the treaties with the United States, France and the Netherlands[84]. In addition, Sweden and Denmark have recently concluded an agreement with similar effect, see below section 6.5.3.

6.5.3 Certain issues regarding the Nordic Treaty

Article 18 in the Model Convention does not encompass individual private pensions, since such pensions do not derive from past employment[85]. Such pensions are instead covered by article 21 in the Model Convention governing Other Income. Then again, in many tax treaties the concept of "pension" is not restricted in this way. This is the case in the Nordic Treaty amongst others[86]. Hence, occupational as well individual private pensions are normally subject to source state taxation according to the Nordic Treaty. Thus, Sweden may tax occupational and individual private pension payments from pension institutions domiciled in Sweden to individuals resident in other Nordic states in accordance with the rules in SINA described above in section 6.4.

This means that where a pension institution domiciled in Sweden pays a qualified occupational or private pension to an individual resident in another Nordic country, Sweden levies Special Income Tax at a rate of 25 per cent, provided that the pension derives from service performed in Sweden or savings made while the individual was resident in Sweden.

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[83] See article 18 p 1 in the Nordic Treaty.
[84] These provisions provide mechanisms for recognizing non-Swedish pension schemes as qualified for tax purposes and are thus of the same nature the recommended provisions in paragraphs 37 and 38 in the Commentary to Article 18 in the Model Convention.
[85] Paragraphs 3 and 7 in the Commentary to the Model Convention.
[86] Notably the treaties with Germany and Mexico.

While the Nordic Treaty grants the right to tax pensions to the source state, there is a general provision in Article 26 p 2 in the same treaty to the effect that the residency state may tax income in the case where the source state does not tax the same income. Thus, in a situation where the Nordic Treaty grants the right to tax a pension payment to the source state but the source state does not tax the payment in accordance with domestic rules, the residency state may tax the pension payment.

When a pension institution domiciled in Norway makes a pension payment to a person not resident in Norway, Norway is unable to tax such pension according to domestic rules. If the recipient of such pension is resident in Sweden, Sweden is allowed to tax such pension according to the above mentioned Article 26 p 2 in the Nordic Treaty. However, Sweden must grant a deduction of SEK 20 000 annually, provided that the recipient would have been entitled to a deduction for age or disability in Norway[87]. The deduction may in any case not exceed the pension.

As noted above in section 6.5.2, Sweden and Denmark have recently agreed upon an amendment to the Nordic Treaty between the two states regarding, inter alia, the tax treatment of contributions to pension schemes in the Contracting States (hereinafter referred to as "the Agreement")[88]. According to the Agreement, an individual earning income taxable under the Nordic Treaty in one Contracting State, and paying pension contributions to an institution in the other Contracting State may, under certain circumstances, deduct the contributions in the Contracting State taxing the income. The same applies to contributions to an occupational pension scheme, with the addition that the beneficiary shall not be taxed for the contribution. However, in order for these provisions to apply, the income that may or shall be taxed in only the first Contracting State must amount to at least 75 per cent of the individuals total income. Furthermore, deduction is only allowed within the restrictions stipulated in the domestic legislation of the Contracting States.

6.6 *The impact of EU law on the Swedish regime for taxation of pensions*

6.6.1 Background

While concluding in the cases C-204/90 (Bachmann) and C-300/90 (Commission v. Belgium) that the Belgian tax rules for taxation individual private pension schemes constituted a restriction on fundamental EC treaty freedoms, the European Court of Justice (ECJ) found that the restriction of the right to deduct contributions to pension institutions domiciled in Belgium was necessary in order to preserve the fiscal cohesion of the Belgian tax system. "Fiscal cohesion" in this context meant that there was a direct link between the deductibility of pension premiums and the taxation of pension payments. Hence, if an individual was allowed to deduct premiums, the subsequent pension payments were taxable, whereas the pension payments were tax exempt were the individual had not been allowed to deduct the premiums. In the case C-118/96 (Safir) the ECJ ruled that the Special Premium Tax that Sweden previously levied on non-Swedish life insurance policies[89] constituted a restriction to the freedom to provide services in article 49 EC.

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[87] See Article 26 p. 4 in the Nordic Treaty.
[88] Agreement of 29 October 2003 between Sweden and Denmark on certain tax issues, SFS 2004:639, prop. 2003/04:149, bet. 2003/04:SkU31.
[89] The tax was levied under the Act on Certain Premium Payments Act (TCPA), *Sw: lagen (1990:662) om skatt på vissa premiebetalningar.*

In the case C-422/01 (Skandia), the issue was whether the Swedish tax treatment of non-Swedish occupational pension insurance policies is compliant with the EC treaty. It will be remembered that contributions to such policies according to Swedish tax law are not deductible as "pension cost" and that the tax effects under domestic tax law for the employee possibly include immediate taxation for the contribution.

The ECJ held that the Swedish rules are liable both to discourage Swedish employers from acquiring non-Swedish occupational pension insurance policies and non-Swedish pension institutions from offering their services on the Swedish market[90]. Furthermore, the ECJ found that there was no such direct link between the deductibility of premiums and the taxation of pension payments as in the Bachmann case. Since the employer, according to the ECJ, was unable to deduct the contribution[91], there was no compensatory measure to offset the disadvantage that the employer suffers compared with an employer who acquires a comparable insurance policy issued by an insurance company domiciled in Sweden[92]. The differential treatment could thus not be justified on overriding public interest grounds. The ECJ rendered the following ruling:

> *Article 49 precludes an insurance policy issued by an insurance company established in another Member State which meets the conditions laid down in national law for occupational pension insurance, apart from the condition that the policy must be issued by an insurance company operating in the national territory, from being treated differently in terms of taxation, with income tax effects which, depending on the circumstances in the individual case, may be less favorable.*

Following the ruling by the ECJ, the Swedish Supreme Administrative Court ruled that community law entitled Skandia to deduct the premiums on the policies (RÅ 2004 ref. 28). However, as noted above, it is not clear from the ruling if such deduction is allowed as "pension cost" or "salary cost". Furthermore, the issues regarding the taxation of the employee were not addressed by the court for procedural reasons.

In a subsequent case before the Swedish Supreme Administrative Court (RÅ 2004 ref. 84), the court upheld the establishment requirement for income tax purposes with regard to individual private pension insurance policies citing the above mentioned Bachmann case.

On December 20th, 2004, the Commission resolved to send a reasoned opinion to the Swedish government requesting that Sweden amend its allegedly discriminatory pension tax legislation[93]. According to the Commission, Swedish employers wishing to arrange occupational pension schemes for their employees with insurers established outside Sweden rather than acquiring the policies from Swedish providers suffer non-deductibility of premiums[94] and more burdensome compliance requirements.

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[90] Paragraph 28.

[91] Arguably, it seems that the ECJ rendered its ruling under the somewhat misleading impression that employer contributions to non-Swedish schemes are not deductible at all according to Swedish tax law. As has been seen, the contributions in this case were most likely deductible, albeit the uncertainty on whether the cost is of pension or salary character remains.

[92] paragraphs 33-35. The ECJ also rejected the Swedish arguments regarding fiscal controls, see paragraphs 42 and 45.

[93] See the Commissions pressrelease IP/04/1500.

[94] Again, probably a misconception of the relevant Swedish rules, see above footnote 90.

The Commission has initiated proceedings against Denmark before the ECJ alleging that the Danish system for taxation of pensions is contrary to the EC treaty[95]. The Advocate General submitted her opinion on June 1st, 2006, in which she proposed a ruling to the effect that Denmark has failed to fulfill its obligations under Articles 39, 43 and 49 EC on the free movement of employees, freedom of establishment and the freedom to provide services. The case involves the Danish treatment of pension contributions, which contain an equivalent of the Swedish establishment requirement. Not surprisingly, Sweden has intervened in the case supporting Denmark.

6.6.2 The compatibility of the Swedish system for taxation of pensions with community law

6.6.2.1 Preface

The EC Treaty and the development of the ECJ case law have already had significant impact on the Swedish tax regime for pensions and life insurance. The Special Premium Tax mentioned above was abolished even before the ECJ rendered its ruling in the Safir case[96]. Moreover, Sweden has recently implemented legislation equalizing the treatment of life insurance policies issued by life insurers resident in other EC or EEA Member States that comply with the qualitative requirements except for the establishment requirement with qualified Swedish pension schemes for Yield Tax and Wealth Tax purposes. However, in several areas, the Swedish regime for taxation of pensions is still arguably in non-compliance with fundamental EC Treaty freedoms. These issues will be discussed below.

6.6.2.2 The establishment requirement

As explained above, a Swedish employer acquiring a non-Swedish pension insurance policy compliant with all qualitative requirements but the establishment requirement, will be able to deduct the contributions. Consequently, it can be argued that the establishment requirement no longer is obviously discriminatory or constitutes a restriction in the meaning of Article 49 EC with regard to occupational pensions. One should however bear in mind that it is unclear whether the deduction is allowed as a "pension cost" or as a "salary cost". As noted above, a salary cost is subject to a higher charge of social security fees. Moreover, as also has been mentioned above, a salary cost is possibly immediately taxable for the beneficiary[97].

Supposing that the contention that the beneficiary according to Swedish domestic tax law should be taxed for any contribution to a non-Swedish occupational pension scheme immediately regardless of whether it adheres to the qualitative requirements except for the establishment requirement is correct, there definitely exists a difference in tax treatment between Swedish and non-Swedish pension schemes. As has been seen, a beneficiary to a Swedish qualified pension scheme is not taxed until payment of the pension. This differential treatment is most likely liable to discourage Swedish employers and employees to make occupational pension arrangements with non-Swedish pension providers and such providers to enter the Swedish market. Hence, the Swedish tax rules probably constitute a restriction to

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[95] OJ C 190 of 24.7.2004, Case C-150/04.
[96] Prop. 1995/96:231.
[97] The Swedish Tax Agency, as well as representatives of the Ministry of Finance (Rehnberg in Skattenytt 2005 p. 647), have taken the position that such a contribution to a non-Swedish pension institution is a salary cost and that it is immediately taxable for the beneficiary regardless of whether it adheres to all the qualitative requirements except for the establishment requirement.

the freedom to provide services under Article 49 in the EC and possibly also on the free movement of labor and capital under Articles 39 and 56 EC in this regard.

It can be argued that the explicit exemption from immediate taxation for an employee for a contribution to a Swedish qualified scheme according to chapter 11 § 6 ITA, is directly linked to the subsequent taxation of pension payments to that same employee and that the principle of fiscal cohesion thus applies to the Swedish regime in this respect[98]. The basis for this argument is that the "tax benefit", i.e. non-taxation of the contribution, corresponds to a latent future tax claim, i.e. taxation of future pension payments. Hence, the absence of taxation for the contribution is compensated for by the taxation of the subsequent pension payment. However, it is not certain that the beneficiary of for instance a pension insurance policy is the employee benefiting from the exemption from immediate taxation. Qualified pension payments can also be made to for instance surviving spouses. In such case, there arguably is no direct link between the exemption from immediate taxation and the taxation of pension payments[99].

Furthermore, it is far from certain that the principle of fiscal cohesion as it is expressed in the Bachmann case is at all applicable to occupational pensions in this respect. While the Swedish Supreme Administrative Court expressly refrained from ruling on the taxation of the beneficiary in the case following the ECJ:s ruling in the Skandia case[100], the ECJ:s ruling in fact encompassed that issue. While the ECJ:s reasoning admittedly is centered on the issue of the employers right to deduct the contributions, the ruling itself is not so restricted. On the contrary, the wording of the ruling[101] seems to indicate that *any* difference in tax treatment making a non-Swedish pension scheme complying with all the qualitative requirements except for the establishment requirement *less favorable* (my emphasis) than a Swedish qualified pension scheme, is contrary to the EC Treaty. This reasoning arguably covers also the tax consequences for the employee[102].

In fact, the crucial meaning of the ECJ:s ruling in the Skandia case might arguably not concern the deductibility of contributions to non-Swedish pension institutions or indeed the tax treatment of the employee as isolated issues. An alternative interpretation of the ruling is that occupational pension contributions to pension schemes issued by pension institutions domiciled in other Member States, complying with all the qualitative requirements but the establishment requirement, must be treated, in all respects, as qualified contributions to Swedish pension institutions, *i.e. as pension costs and not as salary costs.* Hence, this interpretation implies that such contributions, on EC legal grounds, are deductible for the employer and the contributions are subject to Special Wage Tax and not social security fees. The beneficiary is not taxed immediately upon contribution but on subsequent payment of pension. In my view, this interpretation is the one most consistent with the wording of the ruling. Consequently, according to this interpretation, the ECJ has already found the principle

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[98] Rehnberg in Skattenytt 2005 p. 648 onwards.
[99] The ECJ has on several occasions reiterated that the fiscal cohesion principle requires reciprocity regarding the tax benefit and taxation for the same tax payer, see for instance case C-35/98 (Verkooijen), paragraph 42. However, the ECJ has possibly in recent case law adopted a somewhat more nuanced approach to this issue, see Ståhl and P Österman p. 153 onwards and cited case law.
[100] The above mentioned RÅ 2004 ref. 28.
[101] See above section 6.6.1.
[102] Of course, what is more or less favorable in this situation is open to discussion. From a pure economical perspective, it depends on marginal tax rates at the time of contribution and at the time of payment of the pension. However, it can in my view be argued that postponed tax is always more favorable than actually paid tax.

of fiscal cohesion not applicable to such occupational pensions encompassed by the ruling. The ultimate conclusion of this line of reasoning is thus that the ECJ, in effect, already has deemed the Swedish establishment requirement incompatible with EC law with regard to such occupational pensions.

The analogy with the Bachmann case seems more solid with regard to individual private pensions. The Swedish regime for taxation of individual private pensions is similar to the Belgian system as well as the Danish system, in that there is reciprocity between deductibility of premiums and taxation of payments[103]. This indicates that there indeed exists such a direct link between the deductibility of premiums and the taxation of pension payments as in the Bachmann case[104]. However, this does not necessarily mean that the differential treatment of individual private pensions under the establishment requirement can be justified on compelling public interest grounds. In addition, the regime must pass the proportionality test, i.e. it will still be regarded as contrary to EC law if the purpose of the regime can be fulfilled by less restrictive measures[105].

Finally, as has been previously noted, the establishment requirement can be viewed as the cornerstone in the Swedish strategy to retain the ability tax future pensions. The various methods for ensuring the collection of these taxes that have been proposed by the ECJ and several Advocate Generals, notably the procedure according to the Directive (77/799/EEC) on Mutual Assistance and the collection of evidence submitted to support claims for deduction[106], are regarded as insufficient in this respect by the Swedish Tax Agency and the Ministry of Finance[107]. There have been developments indicating that that the deductibility of pension contributions is viewed, in some quarters at least, as contingent upon Sweden being able to retain the establishment requirement[108]. In the event that the ECJ renders a ruling in accordance with the opinion of the Advocate General in the Commission v. Denmark case, the prospects for Sweden succeeding in retaining the establishment requirement look rather bleak.

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[103] It should be noted that there are inconsistencies in this "reciprocity". The quantitative requirements explained above in section 3.2.3 constitute a cap for the deductibility of premiums, while of there of course is no cap on the amounts of pension payments subject to tax. Moreover, it can be argued that the Yield Tax levied on the pension capital during the investment period and the subsequent income taxation of pension payments in effect results in a kind of double taxation of the premiums.

[104] See the Advocate Generals proposal for ruling in case C-150/04 (Commission v. Denmark), paragraph 82.

[105] In her opinion in the case C-150/04, the Advocate General argues that the non-deductibility for premiums to non-Danish institutions is disproportionate, since individuals that have acquired such policies and remain resident in Denmark are also disallowed the deduction, regardless of the fact that the taxation of payments in such case, according to the Advocate General, is in principle secured (paragraph 84). It might be worthwhile in this context to recall the ECJ:s subtle reservation in the Bachmann case that the ruling is based on "...Community Law as it stands at present...", see paragraph 27 in the Bachmann ruling. If the ECJ accepts the Advocate Generals interpretation of current EC law in this respect, it could possibly be argued that the ruling constitutes a shift in the position of EC law on this issue considering the ECJ:s ruling in the Bachmann case. It might however also be argued that such a ruling is simply the result of a different outcome of the proportionality test. The Advocate General, and possibly the ECJ, might be forgiven for supposing that 15 years of development would allow for more sophisticated fiscal controls compared to what was available to the Belgian authorities at the time of the Bachmann ruling.

[106] See for instance the ruling in the Skandia case and the opinion of Advocate General Jakobs in case C-216/00 (Danner). See also COM (2001) 214.

[107] See Rehnberg in Skattenytt 2005 p. 649.

[108] A Government Committee that was investigating possible changes in the Swedish tax regime for pensions was, among other thins, contemplating to abolish the deduction for contributions to individual private pension contributions (Dir. 2004:99). The Committee was however recently abolished.

6.6.2.3 Yield Tax on non-Swedish insurance policies

One of the grounds for the ECJ:s ruling in the Safir case regarding the previous Swedish Special Premium Tax was that the holders of non-Swedish life insurance policies was forced to account for the policies in their tax returns and to facilitate the tax payment themselves, while it was (and still is) the insurance companies that reported and paid Yield Tax attributable to Swedish life insurance policies. Albeit the Special Premium Tax has been abolished, yield tax attributable to Swedish policies is still paid by the life insurance companies, while holders of non-Swedish policies must report and pay the yield tax themselves. Admittedly, the ECJ pointed out several other factors as discriminatory in its ruling in the Safir case, but there can be no doubt that the issues mentioned above were important.

Hence, there is a distinct possibility that that the Yield Tax constitutes a restriction to the freedom to provide services in Article 49 EC and that the restriction cannot be justified on compelling public interest grounds[109]. It should also be noted in this context that it can be very complicated to calculate the Yield Tax with regard to non-Swedish traditional life insurance policies, resulting in a possibly unacceptable administrative burden on the policyholder. Quite possibly, this may also in itself constitute a restriction to fundamental treaty freedoms[110].

6.6.2.4 Treatment of outbound dividends for foreign pension funds

Swedish life insurers and pension trusts are exempt from ordinary corporate income tax and are subject only to a relatively low Yield Tax charge. Outbound dividends received by non-Swedish pension funds are however subject to withholding tax at a flat rate of 30 per cent, albeit sometimes mitigated in bilateral tax treaties. Arguably, this difference in treatment perhaps constitutes an infringement of the free movement of capital according to Article 56 EC[111].

6.6.2.5 Exit taxation of qualified pension capital on cross-border transfers

As mentioned above in section 6.3.3, a transfer of qualified pension capital from a Swedish pension institution to a foreign institution results in immediate taxation for the beneficiaries of qualified pension schemes. It should also be noted that such transfers are possible between Swedish pension institutions without triggering immediate taxation[112]. Since this provision in essence is but another aspect of the establishment requirement, it can be argued that it is contrary to the EC treaty on the grounds specified above. However, it can also be argued that this rule in itself is contrary to the free movement of labor in Article 39 EC, considering that

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[109] Ståhl and P Österman; EG-skatterätt, second edition p. 86 onwards, Mutén in Svensk Skattetidning 2002 p. 569 and Schmid in Svensk Skattetidning 2004 p. 393. It has recently been discussed to make the Yield Tax EC compliant by shifting the tax liability from the life insurance companies and pension trusts to the individual policyholders/beneficiaries and thus making the treatment of holders of non-Swedish policies the main rule, see DS 2003:65. The proposal has however not yet been implemented due to practical problems mainly concerning tax collection, see prop. 2004/05:31 p. 12.

[110] The Safir case can be interpreted as supporting such a view, see also Ståhl and P Österman p. 86 onwards.

[111] See the ECJ cases C-234/01 (Gerritse) and C-265/04 Bouanich, see also Discriminatory treatment of EU Pension funds; Executive summary of the report supporting the complaint filed with the EC by the European Federation for Retirement Provision and PriceWaterhouseCoopers.

[112] Chapter 58 § 18 3rd indent ITA.

people migrating within the Community might want to change their pension arrangements accordingly, and the free movement of capital in Article 56 EC[113].

6.6.2.6 Establishment of branches and cross-border sales

As has been described above, a Swedish life insurance company is subject to Yield Tax on capital attributable to the policyholders. The Yield Tax in this regard is calculated on all assets held on behalf of the policyholders. There is no "carve out" for insurance capital attributable to a branch office in another jurisdiction or to cross-border sales in another jurisdiction in accordance with the EC insurance directives. It is the legal entity as such that is subject to YTA, with no distinctions for different parts of business operations. Swedish life insurers wishing to conduct business outside Sweden is therefore in fact forced to establish legal entities, i.e. full blown corporate subsidiaries, in the jurisdictions concerned[114]. It can thus perhaps be argued that YTA is contrary to the freedom of establishment in Article 43 EC and the freedom to provide services in Article 49 EC[115].

[113] See COM (2001) 214 p. 12.

[114] It should in this context be noted that it is generally perceived as more cost effective to conduct cross-border insurance operations by way of branch structures due to capital requirements, the EC rules on home state supervision etc. Consequently, YTA constitutes a significant competition disadvantage for Swedish life insurers.

[115] See Schmid in Svensk Skattetidning 2004 p. 393. The Board for Advanced Rulings has recently in a case regarding a Swedish insurers branch in another Member State (Ruling 2006-06-29, dnr 56-05/D), found that these rules are consistent with the fundamental freedoms in the EC Treaty. The Board held that the difference in taxation, which might occur when business operations are conducted by a subsidiary instead of through a branch office or by cross-border sales, is a result from the difference in tax systems in the Member States, and that the EC Treaty does not preclude Member States from differentiating between legal entities finding themselves in different situations due to the applicability of separate international tax laws. The ruling has been appealed to the Supreme Administrative Court.