SWEDISH NATIONAL AUDIT OFFICE

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Investment savings account

– a simple form of saving in a complex tax system

Summary and recommendations

Background and grounds

An investment savings account (ISK) is an account that can hold financial instruments, such as shares and fund units, that was introduced in 2012 and which is taxed according to special rules. This type of account has quickly become popular among Swedish households and the influx of money into the accounts has greatly exceeded the Government's expectations. The overall impact on the State' tax revenues has not been accounted for since its implementation.

The purpose of the ISK was to make it easier for natural persons to save and invest in shares and other financial instruments. The simplification consists of the individual not being taxed for actual income, gains and losses. Instead, a standard revenue is taxed, which is the estimated standard return. This means that the individual does not need to report a gain or loss upon sale, which was considered to be a major simplification.

The standard revenue is calculated by multiplying a standard interest rate by a capital base, which is based on the market value of the account's assets. The standard interest rate was set at the government borrowing rate at the time of introduction. The

Government justified the choice of standard interest by there being good reason to make the account attractive, also for investment assets with slightly lower risk and therefore lower expected return, and that the long-term savings of households should be encouraged. The standard interest rate has been increased twice since the introduction of ISK. Both increases were assessed by the Government as increasing the tax neutrality between different forms of saving. According to the Government the ISK would, compared to conventional taxation, remain tax-favoured after the increase.

In light of this, the Swedish NAO considers it justified to audit the effects of the ISK as a form of saving.

Questions

The Swedish NAO has reviewed whether the effects that the Government and the Riksdag predicted upon introducing the ISK and increasing the standard interest rate have been realised. The questions are as follows:

1. Has the ISK made it easier for natural persons to save and invest in shares and other financial instruments?
2. Has the taxation level made the ISK an attractive form of saving and has it encouraged households to save in directly-owned financial assets?
3. Have the 2016 and 2018 increases in standard interest rate led to increased tax neutrality between different forms of saving?
4. What impact has the reform had on the state's tax revenues?

Conclusions

The asset values in an investment savings account are great

Since the introduction, almost 2.2 million private individuals have opened an ISK. There are no official, separately reported statistics for the assets in ISKs. However, based on the income statements reported to the Swedish Tax Agency, the capital base can be calculated, which is a rough estimate of the total asset values on ISKs. The capital base amounted to SEK 707 billion in 2017. This corresponds to one third of the asset values in financial instruments that may be held in an ISK.

There are statistics on fund unit savings in ISKs, as published by the Swedish Investment Fund Association. According to these statistics, which are not entirely comprehensive, the fund unit holdings in ISKs amounted to SEK 306 billion in 2017. This corresponds to 26 per cent of the values in households' directly-owned fund units and 43 per cent of the capital base. Of the fund unit holdings in ISKs, 37 per cent were invested in equity funds, 49 per cent in balanced funds and 12 per cent in bond and money market funds.

The ISK has simplified the tax return process for shareholders but has increased the complexity of the tax system

According to the assessment of the Swedish NAO, the introduction of the ISK has led to a simplification as regards saving in shares. It has become easier to file tax returns as an income statement is submitted with the standard interest rate and the individual account holder does not have to submit a report in this respect. The declaration of gains and losses has previously been a great source of error in the tax return process. According to the Swedish Tax Agency's randomised checks, more than 50 per cent of the persons who sold shares during 2005–2007 had misreported figures. There is no information on how serious this problem has been in the years that followed.

The ISK has furthermore simplified saving in shares wherein the saver does not need to take tax considerations into account when reinvesting within an ISK. The transaction costs associated with reinvestments have therefore decreased.

Certain aspects of saving in shares have, on the other hand, become more complicated. This applies to participation in certain new share issues and initial public offerings, where an ISK is not always an option. It also applies to when a company distributes shares in a subsidiary and the subsidiary has not been listed at the appropriate time. Before the subsidiary is listed, the shares are so called non-investment assets and may only be kept in an ISK for a limited period.

The Swedish NAO finds that the introduction of the ISK has not led to as clear simplifications for those saving in funds as for those saving in shares. Before the introduction of the ISK, it was already simple to declare the sale of fund units, as since 1997 an income statement is submitted regarding gains and losses.

Furthermore, the application of parallel tax regulations for financial instruments means that savers who do not want to pay more tax than necessary must evaluate whether or not an ISK is a beneficial form of saving from a tax perspective. This entails costs in the form of analysis work. Performing such an analysis is not entirely simple, as the principles of taxation differ between an ISK and conventional taxation.

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An ISK is not evidently favourable from a taxation standpoint

The Swedish NAO has audited the taxation of an ISK and compared this to conventional taxation for three common financial assets: Swedish shares, equity fund units and bond fund units.

According to the Swedish NAO, the taxation of bond fund units within the context of an ISK was favourable when the ISK was introduced, except for in the case of long holding periods. The increases in standard interest rate have, however, made an ISK not favourable, in respect of taxation, for saving in bond funds, regardless of holding time. Furthermore, the increases in standard interest rate have been so significant that the tax neutrality in relation to conventional taxation has decreased for bond fund savings. These conclusions are based on calculations of effective tax rates for the return that, in a normal interest rate situation, can be expected on savings in funds that invest in Swedish government bonds.

The effective tax rates on the return that, in a normal interest rate situation, can be expected on investments in shares and equity funds are, according to the calculations of the Swedish NAO, significantly lower in an ISK than for conventional taxation, apart from in the case of very long holding periods. In an ISK, however, the account holder bears the entire risk associated with investing in shares, as the tax is calculated as a standard amount and must be paid regardless of whether the assets increase or decrease in value. With conventional taxation, actual income (dividends and capital gains) is taxed and deductions can be made for capital losses. The investor therefore does not bear the entire risk, but rather shares this with the State. When this difference in the distribution of risk is considered, it is not clear at what standard interest rate an ISK can be deemed tax favoured. It is for this reason also unclear whether an ISK is tax favoured regarding investments in shares and equity funds. This applies both before and after the increases in standard interest rate. It is therefore unclear if the increases in standard interest rate have led to increased or decreased tax neutrality in relation to conventional taxation with respect to saving and investing in shares and equity funds.

With a long saving horizon, there is room for long holding periods for individual financial instruments. This only entails tax benefits for the saver in the case of conventional taxation. The Swedish NAO thus draws the conclusion that the taxation level in an ISK has not encouraged households' long-term saving in directly-owned financial assets.

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The reform has had significant impact on the State's tax revenues

According to the Swedish NAO, the introduction of the ISK has entailed forgone tax revenue of SEK 23 billion over the period 2012–2017. In addition, capital gains generated during the period but not realised before the end of 2017 will lead to further forgone tax revenue of SEK 19 billion over the subsequent years. The estimated forgone tax revenue is based on a model calculation and shall only be viewed as a computational example. Despite uncertainty in the calculations, it is the Swedish NAO's assessment that the ISK's effects on tax revenue have been significant.

Prior to the introduction of the ISK, the Government assessed that the reform would lead to a decrease in tax revenues in the long term. However, between 2012 and 2015, the reform was expected to result in increased tax revenues. The Government's assessment of the tax revenue impact differs considerably from that of the Swedish NAO. The reasons for this include the net inflow in ISKs exceeding expectation. In combination with the unexpectedly high return on stocks, this has given rise to significant capital gains that would have been taxed if the investment savings account had not been introduced.

During the period 2012 and 2017, the return on stocks has been unusually high. There is nothing to say that the return will be as high in the coming years. The Swedish NAO's assessment of the reform's effects on the tax revenues thus gives no information on the scale of the impact in coming years. However, the calculation does indicate that it is extremely difficult to predict the effects of this type of reform and its radical changes to the tax regulations.

The popularity of ISKs suggests that the long-term effects of ISKs on tax revenue in accordance with the Government's assessment will be negative. The scale of the long-term impact is difficult to predict as this is largely determined by how popular these accounts will be in the long run. This issue has not been the focus of the audit.

Recommendations

The effects on taxation should be reported

The results of this audit indicate that the ISK's effects on tax revenues for the period 2012–2017 have been significant and that they greatly differ from the assessment of the Government upon proposing the introduction of the ISK to the Riksdag. For these reasons, the Swedish NAO suggests that the Government should regularly inform the

Riksdag of the taxation effects of the ISKs. This is best done in the Government's accounting of tax expenditures.

The possibility of further simplification should be reviewed

The introduction of the ISK has resulted in certain aspects of saving and investing in shares becoming more complicated. The Swedish NAO suggests that the Government should review whether it is possible to simplify saving and investing in shares in an ISK with regard to, firstly, participation in new share issues and initial public offerings, and secondly, holdings of shares in subsidiaries that have been distributed.

Certain aspects should be considered during a more comprehensive review

The Swedish NAO finds that the ISK has primarily simplified saving and investing in shares. However, it may still be difficult to declare capital gains and capital losses on shares that are transferred to an ISK. The introduction of the ISK has also led to a radical change in how the return on directly-owned financial assets are taxed. This change and the increases in the ISK's standard interest rate have made it more difficult for individual savers to get an overview of the consequences when choosing between an ISK and conventional income taxation and in their choice of financial instruments.

The difficulties outlined above cannot, according to the Swedish NAO, be overcome by only changing the rules for ISKs. Given that a representative of the Government has alluded to a need for a tax reform,[1] the Swedish NAO suggests that the following aspects be considered within the framework of such a reform:

- With the aim of simplifying the tax return process, the rules for reporting capital gains and capital losses on shares should be changed. Such a simplification is desirable regardless of whether or not the shares are transferred to an ISK.
- The consequences of different principles of taxation should be comprehensively highlighted.
- Deviations from tax neutrality between different forms of saving should be clearly justified.

[1] Dagens industri, 14/03/2018.