# A Harmonized Tax Response to the Sovereign Wealth Fund Phenomenon:

# Considerations and Challenges

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## I. INTRODUCTION

As part of its ongoing Freedom of Investment and National Security project, the Organisation for Economic Co-operation and Development ("OECD") has recently announced a set of "best practice" principles for recipient countries' policies towards investments from sovereign wealth funds ("SWFs"). With investment protectionism on the rise,[1] the principles aim to maintain open markets by stressing transparency and predictability, proportionality, and accountability with respect to investment regulation. The principles, while not heavy on operational guidance, are in line with the OECD's established general investment policy principles and are intended to complement the work done by the International Monetary Fund ("IMF") in establishing best practice guidelines for SWF self-governance. Together, these initiatives are intended to "provide the international community with a robust framework for promoting mutual trust and confidence and reaping the full benefits of SWFs for home and host countries."[2]

Discussions of the proper tax treatment of SWFs should be part of the debate surrounding an international scheme of SWF regulation. One might ask the threshold question whether tax should play any role at all in the regulation of SWFs. Because any taxation scheme, including none at all, inevitably affects SWF investment behavior, the real question is *what* role should tax play?

Even if the role is simply to "get out of the way" of the rest of the regulatory regime, significant questions of tax policy are raised. Indeed, the prevailing wisdom is for tax systems to simply "treat similarly situated investors in a similar fashion."[3] Despite undeniable rhetorical and analytical appeal, it is not at all clear what such a recommendation actually means in the context of taxing inbound sovereign wealth investments. This paper highlights some important tax policy considerations relevant to determining tax's proper role in a considered and fair regulatory response to SWFs.

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[1] David M. Marchick & Matthew J. Slaughter, Council on Foreign Relations, "Global FDI Policy: Correcting a Protectionist Drift," CSR No.34 (June 2008) at 2-3, *available at* http://www.cfr.org/publication/16503/.

[2] Organisation for Economic Co-operation and Development, "Sovereign Wealth Funds and Recipient Countries – Working together to maintain and expand freedom of investment" (October 11, 2008), *available at* http://www.oecd.org/dataoecd/0/23/41456730.pdf ("OECD Declaration").

[3] *Id.*, at 4.

The remainder of this paper proceeds as follows. Part II gives some simplified background information regarding SWFs, their unique role in globalization, and the concerns that are the basis for the current regulatory moment. Part III discusses, also in necessarily general terms, the regulatory responses engendered by SWFs on the national and global levels. Much of the preceding will be familiar to many readers, but is provided in the interest of clarity and continuity. Part IV discusses some of the tax policy considerations relevant to determining tax's place in the overall regulatory response to SWFs.

## II. BACKGROUND

### a. The Sovereign Wealth Fund Phenomenon

In 2005, before the term "sovereign wealth fund" existed in the popular parlance,[4] the global aggregate total of assets under management by government-owned investment funds was slightly less than $1 trillion,[5] approximately the same size as the hedge fund sector (which had been attracting much scrutiny in global finance, and tax, circles). Since then, U.S. hedge funds have grown 50% in size to approximately $1.5 trillion in assets under management,[6] while the size of the SWF sector has more than tripled in size to well over $3 trillion.[7]

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[4] The term appears to have been coined by Andrew Rozanov in 2005. Andrew Rozanov, *Who Holds the Wealth of Nations?*, Central Banking Journal, Vol. 15, no. 4 (2005), at 52-57. What we now call SWFs have existed since the mid-1950s when Kuwait and Kiribati first established their funds.

[5] Unless otherwise indicated, monetary amounts are given in United States dollars.

[6] $1.7 trillion, according to the IMF in February 2008. International Monetary Fund, Monetary and Capital Markets Policy Development and Review Departments, "Sovereign Wealth Funds – A Work Agenda" 6 (Feb. 29, 2008) [hereinafter "IMF Work Agenda"], *available at* http://www.imf.org/external/np/pp/eng/2008/022908.pdf. $1.4 trillion, according to Scott G. Alvarez, two months later. Scott G. Alvarez, testimony before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate (April 24, 2008), *available at* http://www.federalreserve.gov/newsevents/testimony/alvarez20080424a.htm [hereinafter "Alvarez Testimony"].

[7] In February 2008 the International Monetary Fund estimated that SWFs had between $2.1 trillion and $3.0 trillion of total assets under management. IMF Work Agenda at 7. In May 2008 JP Morgan Chase Bank estimated that SWFs managed between $3.0 trillion and $3.7 trillion worldwide as of the end of 2007. David G. Fernandez & Bernard Eschweiler, JP Morgan Research, "Sovereign Wealth Funds: A Bottom-Up Primer" 7 (May 22, 2008) [hereinafter "JP Morgan Report"].

Although currently a relatively small fraction of overall global financial assets,[8] analysts have projected that SWFs will continue to grow rapidly in size. The IMF has projected that foreign assets under SWF management could rise to between $6 trillion and $10 trillion by 2013,[9] while other projections put SWF assets at well over $10 trillion in the next decade.[10] But even should these projections turn out to be as sensational as much of the popular coverage given to SWFs recently, and should SWFs continue to claim only 1-2% of the global financial pie, their *individual* sizes alone warrant some amount of attention. At average sizes into the tens and even hundreds of billions of dollars,[11] each fund has the potential to wield an amount of market influence that is indeed befitting of a sovereign nation-state.

A mix of government, capitalism, and politics, SWFs come in a variety of shapes and (usually large) sizes. Variously categorized and defined, at the most broad level SWFs are simply government-owned investment funds.[12] Many SWFs are funded by wealth derived from commodities (usually oil), for example in the Gulf states, Norway, and Alaska; others are funded with non-commodity-derived foreign exchange reserves, for example in Singapore, China, and Australia. In terms of their purposes and

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[8] The International Monetary Fund estimated that global bonds, equities, and bank assets amounted to $241 trillion in 2007. International Monetary Fund, "Global Financial Stability Report" 177 (April 2009), *available at* http://www.imf.org/External/Pubs/FT/GFSR/2009/01/pdf/text.pdf.

[9] IMF Work Agenda at 6. The JP Morgan Report, at 11, makes similar projections (from $5.0 trillion to $9.3 trillion in 2012).

[10] *See, e.g.*, Stephen Jen, Morgan Stanley Research Global, "Currencies: How Big Could the Sovereign Wealth Funds Be by 2015?" (May 3, 2007) *available at*: http://www.morganstanley.com/view/perspectives/files/soverign_2.pdf; Gerard Lyons, "State Capitalism: the Rise of Sovereign Wealth Funds" (Oct. 15, 2007), *available at*: http://www.banking.senate.gov/public/_files/111407_Lyons.pdf.

[11] According to the Alvarez Testimony, approximately 40 SWFs collectively manage $3.6 trillion ($90 billion average). The top ten SWFs collectively manage nearly $2.8 trillion ($280 billion average). Anna L. Paulson, "Raising capital: The role of sovereign wealth funds," Chicago Fed Letter, January 2009 (No. 258) (citations omitted: Chhaochharia and Laeven, SWF Inst.). By contrast, the single-most capitalized hedge fund in the world has less than $40 billion, and the top ten largest hedge funds in the world amount to just over $280 billion *total*. Institutional Investor, "2009 Hedge Fund 100," *available at* http://www.iimagazine.com/Rankings/RankingsHeFu100RGlobal09.aspx (click on 'Rankings' tab).

[12] *See, e.g.*, Joint Committee on Taxation, Economic and U.S. Income Tax Issues Raised by Sovereign Wealth Fund Investment in the United States (JCX-49-08), June 17, 2008 [hereinafter "JCT Report"], at 21, *available at* http://www.house.gov/jct/x-49-08.pdf ("actively managed, government-owned pools of capital originating in foreign exchange assets); U.S. Department of Treasury, Office of International Affairs, *Semiannual Report to Congress on International Economic and Exchange Rate Policies* (June 2007), Appendix 3: Sovereign Wealth Funds ("Government investment vehicles that are funded by foreign exchange assets and that are managed separately from official reserves."); IMF Work Agenda at 5 ("government-owned investment funds established for a variety of purposes and funded by foreign exchange assets.").

objectives, SWFs fall into one of three broad general types: (i) stabilization and reserve investment funds (i.e., funds that pursue macroeconomic goals), (ii) savings and pension funds (i.e., funds that directly address citizen welfare), and (iii) development funds (i.e. funds from developing countries that use sovereign wealth as an alternative means of pursuing economic development). Definitional and categorization issues are at the forefront of the policy debate surrounding SWFs; the diversity exhibited by SWFs complicates the regulatory landscape considerably. Moreover, few of these issues are static.

There is a robust and variegated flow of sovereign capital to all over the world, increasingly from all over the world. Currently, the flow of sovereign capital is largely from the Middle East and Asia to North America, Europe, and Asia (in roughly equal amounts). Much of the sovereign investment in Asia is intra-regional, and a large amount of inter-regional investment is flowing from the Middle East to traditional capital markets in the U.S. and Europe.[13] As existing SWFs look to further diversify and mature, and new SWFs (particularly from emerging markets) enter the fray, the only safe prediction is that these patterns will continue to change with the evolving geopolitical landscape.

SWFs have historically invested passively – in part in response to regulatory thresholds and in part due to internal domestic political and financial concerns. Their recent appetite for more active, larger, and sometimes controversial equity investments indicates another phase in the maturation of SWFs as investors. During the current financial meltdown that started in late 2007, SWFs have made headlines by acquiring large ownership interests in some giant financial institutions that are intricately linked with national economies.[14]

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[13] The aforementioned lack of transparency on the part of many SWFs means that comprehensive data is unavailable; at any rate, because the bulk of sovereign investments have been made in the last two years, aggregate historical data is not particularly meaningful. The characterization of sovereign wealth flows is thus necessarily tentative and broad. Steffen Kern, Deutsche Bank Research, "SWFs and foreign investment policies – an update" 4-9 (October 22, 2008).

[14] In late 2007, Swiss bank UBS received a $9.7 billion investment from the Government of Singapore Investment Corporation; Morgan Stanley notoriously received $5 billion from the China Investment Corporation; Citibank sold a 4.9% equity stake to the Abu Dhabi Investment Corporation, and Merrill Lynch received $5 billion from Temasek Holdings (Singapore). In early 2008, Citigroup got $12.5 billion from a group of investors including SWFs from Singapore and Kuwait; and Merrill Lynch received $6.6 billion from a group that includes Kuwaiti and Korean SWFs. SWFs also draw attention for their high-profile real estate investments.

The debate surrounding sovereign wealth is illustrative of the challenges presented by globalization generally and raises many important issues with far-reaching implications: the relationship between traditional economic powers and emerging markets, the role of the state in the economy, global capital flows, and international investment and ownership of assets are but some of the issues thrown into relief by SWFs.

Like any phenomenon complex enough to be interesting, SWFs embody some contradictions: they are funded by public money, but are to act as though they are private actors when it comes to investment decisions; they are huge in size, but are not to move markets (except, of course, when we need them to in a crisis);[15] they are operated by governments, whose business is to govern, but who refrain from or are prevented from actively participating in the control of their investments. SWFs' diversity of origin, strategy, and tactics make coordination and one-size-fits-all policy responses difficult.[16]

**b. Policy Concerns**

The United States and the European Union in particular have raised broad but interrelated policy concerns regarding the SWF phenomenon. These concerns persist despite the recognition that SWFs can play a useful role in the global economy (for example, by stabilizing financial markets on the brink of chaos).[17] The main concern is that SWFs will invest based upon political or non-commercial motivations (and hide such motivations through their notorious lack of transparency), thereby causing costly market distortions and threatening recipient country domestic and foreign policy interests.[18]

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[15] Fairly or not, some have identified SWFs as the international financial system's lenders of last resort.
[16] For a discussion of how SWF diversity affects the evaluation of tax policy with respect thereto, *see* Michael S. Knoll, *Taxation and the Competitiveness of Sovereign Wealth Funds: Do Taxes Encourage Sovereign Wealth Funds to Invest in the United States?*, 82 S. Cal. L. Rev. __ (forthcoming 2009), at 48, *available at* http://ssrn.com/abstract=1342510.
[17] *See, e.g.*, JCT Report. For an overview of the spectrum of recipient country, *see* Marchick & Slaughter, note 1, at 7-12.
[18] *See, e.g.*, Victor Fleischer, *A Theory of Taxing Sovereign Wealth*, 84 N.Y.U. L. REV. 440, 485-94 (2009); Victor Fleischer, *How Should We Tax Sovereign Wealth Funds?*, 118 YALE L.J. POCKET PART 93 (2008) ("Allowing sovereign wealth funds to own equity stakes in American companies encroaches on the autonomy of U.S. industrial and foreign policy in a way that private investment does not."), *available at* http://thepocketpart.org/2008/11/17/fleischer.html; Lawrence Summers, *Sovereign Funds Shake the Logic of Capitalism*, FIN. TIMES, July 30, 2007, at 11.

More urgent commentators envision SWFs encroaching on the autonomy of recipient country enterprise, stealing industrial technology, increasing the influence and soft-power of foreign sovereigns, and supporting unsavory regimes.

Even absent such negative effects, policymakers have expressed concern that SWFs as a class are immature, inexperienced investors who have yet to adopt professional norms and who could potentially (i) invest in an inefficient or disruptive manner, (ii) compete unfairly with private actors, (iii) negatively affect corporate governance of portfolio companies, and (iv) create undesirable macroeconomic effects.[19] Furthermore, the mere fact of their lack of transparency (whether or not they are "hiding" anything) can bring about a contagion effect and engender suspicion and distrust (which is distortionary when unwarranted).

By the same token, because of their nature and size, SWFs can positively implement monetary policy when needed, and are "well-positioned to increase stability in financial markets, particularly in times of market stress."[20] Sovereign wealth investment is also thought to lower the cost of capital in recipient countries, enjoy a generally longer-term horizon, and lead to mutually beneficially economic interdependence.[21] To the extent that SWFs deviate from purely short-term economic considerations when making decisions, that can be construed as a good thing in certain circumstances. And, to be sure, private investors (such as corporations wherever located) are equally capable of investing in ways that are not properly motivated or that are contrary to recipient country interests. SWFs, on the other hand, face considerable non-regulatory pressure from constituents and the international community alike to invest responsibly. Putting theory

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[19] JCT Report at 31.

[20] *Id.* As mentioned above, SWFs provided a much-needed new source of capital for financial institutions weathering the recent economic crisis.

[21] *See, e.g.*, Ruth Mason, *Efficient Management of the Wealth of Nations*, 120 TAX NOTES 1321, 1321-22 (September 29, 2008) (economic interdependence "bring[s] people and governments closer together and therefore aid[s] peace and prosperity rather than undermining it."); Richard Posner's December 10, 2007 post on The Becker-Posner Blog, entitled "Sovereign Wealth Funds – Posner's Comment," *available at* http://www.becker-posner-blog.com/archives/2007/12/ ("It does not undermine our national security just because the purchaser [of a domestic company] a foreign government, but on the contrary enhances our security because the investment is a hostage. It's as if to guarantee China's good behavior the president of China sent his family to live in the United States."). Professor Mason points out that, in fact, it is precisely when SWFs invest abroad that are most likely to behave in a purely commercial manner ("if governments must invest in capital markets, perhaps it is best that they do so abroad").

aside, it is worth noting that there is very little evidence of SWF investments actually being pursued for non-financial goals.[22]

## III. Regulation of SWFs

The general academic prescription is for minimal regulation of SWFs.[23] The American legal academy's view, at least, seems to be that existing laws of general applicability (such national security laws, securities regulations, rules pertaining to regulated industries, antitrust laws, etc.) are sufficient to address whatever political and economic risks are presented by SWF investment.[24]

Nonetheless, in response to these concerns, a number of U.S. Congressional hearings on SWF investment have been held in the last 18 months, and both the IMF and the OECD have undertaken significant policy initiatives. In recognition of the significant barriers to wide-ranging multilateral agreements, the emerging consensus approach to SWF regulation is the "best practices" model, the successful implementation of which is intended to lead to a state of normality with SWFs considered more or less like other "regular" investors.

In March 2008, the United States, Abu Dhabi, and Singapore agreed on a set of policy principles for SWF self-governance as well as for national regulation of SWFs by countries receiving SWF investment.[25] The principles that emerged with respect to SWF

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[22] Christopher Balding, *A Portfolio Analysis of Sovereign Wealth Funds*, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1141531.

[23] *See, e.g.,* Richard A. Epstein & Amanda M. Rose, *The Regulation of Sovereign Wealth Funds: The Virtues of Going Slow*, *available at*: http://ssrn.com/abstract=1394370; Mark Plotkin, *Foreign Direct Investment by Sovereign Wealth Funds: Using the Market and the Committee on Foreign Investment in the United States Together To Make the United States More Secure*, 118 YALE L.J. POCKET PART 88 (2008), *available at*: http://thepocketpart.org/2008/11/17/plotkin.html; Paul Rose, *Sovereigns as Shareholders*, 87 N.C. L. Rev. 83 (2008) (arguing that existing regulatory scheme is sufficient and that existing economic and political factors mitigate risks posed by SWF investment); Ronald J. Gilson & Curtis J. Milhaupt, *Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism*, 60 STAN. L. REV. 1345 (2008) (proposing vote suspension of SWF equity positions so as to minimize risk of inefficient meddling).

[24] For example, in the United States, certain foreign direct investments are subjected to a stringent national security review under the auspices of the Committee on Foreign Investment in the United States ("CFIUS"). The Foreign Investment and National Security Act of 2007, Pub. L. No. 110-49, July 26, 2007, significantly strengthened the CFIUS review process.

[25] Press Release HP-881, U.S. Department of Treasury, "Treasury Reaches Agreement on Principles for Sovereign Wealth Fund Investment with Singapore and Abu Dhabi," March 20, 2008, *available at* http://www.treas.gov/press/releases/hp881.htm.

self-regulation were also the basis for the so-called Santiago Principles, or Generally Accepted Principles and Practices ("GAPP"): investment decisions based purely on commercial grounds; transparent operations; rigorous governance structures; and fair competition with the private sector.[26] The trilateral agreement also yielded policy principles for recipient countries: no protectionist barriers to foreign investment, clear and consistent regulation, no discrimination between like-situated investors, and proportional national security measures.[27] These policies served as a preview for the OECD efforts.

Despite being dominated by the developed nations, the OECD is the leading source for international investment norms. In April 2008, as part of its Freedom of Investment initiative, the OECD's Investment Committee released a report highlighting the economic benefits for home and recipient countries of SWF investment, and announced principles of non-discrimination, transparency and predictability, and regulatory proportionality for recipient country regulatory policies toward SWFs.[28] In October 2008, the OECD culminated its investigation with the OECD Declaration.[29] Reflecting the OECD's commitment to an open international investment climate, the policy principles are that:

- Recipient countries should *not erect protectionist barriers* to foreign investment.
- Recipient countries should *not discriminate among investors in like circumstances.* Any additional investment restrictions in recipient countries should only be considered when policies of general application to both foreign and domestic investors are inadequate to address legitimate national security concerns.

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[26] Perhaps because of mounting scrutiny of SWFs, the GAPP represents a proactive response from the international community to address the concerns raised by this relatively new investment phenomenon. The IMF efforts enjoyed broad participation from the relevant players and by all accounts the process was conclusive and the results broadly acceptable.

[27] Press Release HP-881, note 25.

[28] Organisation for Economic Co-operation and Development, Report by the OECD Investment Committee, "Sovereign Wealth Funds and Recipient Country Policies," (April 2008), *available at* http://www.oecd.org/dataoecd/34/9/40408735.pdf.

[29] Although the Declaration is non-binding, it nevertheless increases the principles' weight as a source of international investment law.

- Where such national security concerns do arise, investment safeguards by recipient countries should be: transparent and predictable, proportional to clearly-identified national security risks, and subject to accountability in their application.[30]

The italicized language is the most relevant regarding tax treatment, but the OECD guidance overall raises as many questions as it answers regarding the appropriate tax policy. Clearly, open investment is the key objective of the OECD Declaration. As a general matter, the OECD's uncontroversial position is that a liberal investment environment is about creating growth opportunities in the private sector. Caution is therefore required, as laws and regulation aimed at SWFs could have significant spillover effects.[31]

The admonition against protectionist barriers raises the question of whether any distinction should be made between foreign and domestic investors at all. The anti-discrimination principle (followed up by language referencing "policies of general application") is a further generalization of the general OECD investment principle to treat foreign investors "not less favorably than *domestic* investors in like situations."[32] While the general point is clear, the devil, as the following discussion illustrates, is in the details.

## IV. Tax Treatment of SWFs

### a. Tax as Regulation

Aside from revenue collection (of course), promoting efficiency is a fundamental default goal of the tax system. But it is also a cornerstone of tax policy analysis that tax is used, often extensively, in the real world as a weapon in a state's regulatory arsenal. There are a number of reasons why the tax system is used for various regulatory purposes, in spite of institutional competency concerns, and revenue collection, if any,

[30] OECD Declaration, at 2 (emphasis added).
[31] *See, e.g.*, Epstein & Rose, note 23, at 111 ("It is not hyperbolic to suggest the future of private equity – including the going private phenomenon – and the future of SWFs are inescapably intertwined.").
[32] OECD Declaration at 3.

can be merely a side effect of a tax policy designed to encourage or deter particular behavior.

The conventional wisdom is that tax is the appropriate tool for implementing regulatory policy in narrowly tailored sets of circumstances. According to the prevalent theory of the tax system's suitability for regulatory action, the question of which government agency implements which policy is largely one of institutional competence and design.[33]

Whether the tax system is the appropriate regulatory tool in any given case is a difficult question and obviously depends upon the purpose to be served and the benefits of coordinating the activity with the tax system.[34] In the case of SWFs, the purpose to be served is difficult to ascertain owing, in part, to the diversity of SWFs. Tax analyses to date have been agnostic regarding the non-tax policy concerns raised by SWFs.[35] This is largely because to the extent SWFs present negative externalities, they are non-uniform. It has therefore been argued that it would be difficult to draft tax legislation finely tuned enough to regulate bad SWFs without unduly burdening good ones, and that tax administration, personnel, and lawyers cannot fairly be expected to have the required competency to implement foreign policy.[36] Calls for non-discriminatory investment policies suggest that tax could best complement the regulatory mix by simply "getting out of the way" and promoting efficiency.

As a matter of current practice, we observe differential treatment of SWFs, presumably based on a policy other than the baseline of promoting efficiency. As a

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[33] David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955, 964, 966 (2004).
[34] *Id.* at 959.
[35] Both the JCT Report and a report by the New York State Bar Association Tax Section declined to discuss non-tax policy concerns. N.Y. State Bar Ass'n Tax Section, Report on the Tax Exemption for Foreign Sovereigns Under Section 892 of the Internal Revenue Code (June 2008) [hereinafter "NYSBA Report"], *available at* http://www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1157rpt.pdf.
[36] *See* Fleischer, *Theory*, note 18, at 446 ("Tax policy may not be the optimal regulatory tool to address the disparate risks created by each fund, particularly as those funds evolve over time.") and at 450 (concluding that, in the U.S. context, "it is unlikely that our existing domestic political institutions are well-suited" to account for SWF variation); Mihir A. Desai & Dhammika Dharmapala, *Taxing the Bandit Kings*, 118 YALE L.J. POCKET PART 98, 102 (2008), *available at* http://thepocketpart.org/2008/11/17/desaidharmapala.html, ("The use of tax policy to address these concerns would preclude the United States' ability to discriminate across industries and countries, leading to a rather blunt and imprecise approach to addressing such non-pecuniary motivations.").

matter of theory, asking the tax system to simply promote efficiency (by being as non-distortionary as possible) is not as simple as it may first appear.

### b. Tax Treatment of SWFs

A bottom-up consensus of sorts has formed (at least among many of the larger advanced economies) regarding the tax treatment of inbound foreign (including SWF) investment, even without the benefit of a coordinated international effort. International tax law generally taxes income from commercial activity in the source country, and passive investment income in the taxpayer's country of residence.[37] The rationale for the international tax norm relating to passive foreign investment is complicated in the case of sovereign wealth (a special subset of foreign investment).

As far as sovereign wealth is concerned, the basis for exempting from tax the income of foreign governments is the idea of sovereign immunity.[38] From the inception of the U.S. income tax, for example, foreign governments enjoyed sovereign immunity from taxation.[39] But by about the time sovereign wealth funds came into existence, the U.S. (in response to the commercial activities of Soviet bloc governments in the U.S.) had moved to a more restricted concept of sovereign immunity generally, limiting a sovereign's immunity from being subjected to the laws of a foreign jurisdiction to only those acts performed in *its role as a sovereign* and denying immunity for "commercial" activity.[40]

Under U.S. tax law as it relates to SWFs, commercial activity is broadly defined as activity that is ordinarily conducted "with a view towards the current or future

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[37] Reuven Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1316-33 (1996). Tax systems differ in how they implement this emergent norm.

[38] NYSBA Report, at 3. Before the time when governments engaged in commercial activity on such a scale, the jurisdictional doctrine of sovereign immunity's application to tax law made sense.

[39] *See, e.g.*, Section 213(b)(5) of The Revenue Act of 1918, Pub. L. No. 254, 40 Stat. 1057 (1919) (exempting from income tax foreign governments' income from stocks, bonds, securities, deposits, or "any other source within the United States").

[40] The non-commerciality requirement was codified in 1976 by the Foreign Sovereign Immunities Act (28 U.S.C. §§1602-1611), which provides sovereign immunity from the application of foreign law except when waived or when the application of law is based upon the "commercial activity" of the foreign state. 28 U.S.C. §1605. Shortly thereafter, Treasury promulgated regulations pursuant to Section 892, which clarified that income from commercial activity did not qualify for that section's exemption from tax. 43 Fed. Reg. 36111 (August 15, 1978).

production of income or gain;" specific carve-outs from this definition are then provided (for a selection of passive investments).[41] What matters in determining commerciality is the nature of the activity in the U.S., not the underlying governmental purposes generally.[42] Thus, even though portfolio investments are "commercial" in the common sense of the word, they are not considered "commercial" for tax purposes.

This distinction between commercial activity on the one hand and core governmental activity or passive activity on the other hand has been implemented in a variety of ways by taxing jurisdictions. U.S. tax law is an example of a legislative approach (rather than administrative or diplomatic), and a little background in this regard is illustrative of the difficulty in formulating the proper tax response to SWF investment more generally.

Section 892 of the U.S. Internal Revenue Code is the current provision that provides special rules for the taxation of "foreign governments," which, for these purposes, include (i) the integral parts of a foreign government, and (ii) certain, but not all, entities controlled by a foreign government.[43]

Generally, for SWFs qualifying under Section 892, income from investments in stocks, bonds, or other U.S. securities is exempt from income tax; as is, in most circumstances, gain from the sale of minority interests in real estate companies.[44] Section 892 does not protect income from commercial activity,[45] investment income

[41] Treas. Reg. §1.892-4T(b). Carve-outs are in Treas. Reg. §1.892–4T(c).
[42] Fleischer, *Theory*, note 18, at 459.
[43] Treas. Reg. §1.892-2T(a)(2). The regulation also attempts to distinguish between ownership by a foreign government and ownership by a ruler in the ruler's individual capacity. Section 892 and the regulations promulgated thereunder do not use the term "sovereign wealth fund," and not all such funds qualify for treatment under Section 892.
[44] *But see, e.g.*, IRS Notice 2007-55, involving certain distributions from non-controlled REITs that will not qualify for the exemption under Section 892 and will be taxed under FIRPTA (Foreign Investment in Real Property Tax Act of 1980, which applies to the sale by foreign corporations of interests in real property located in the U.S.).
[45] Section 892(a)(2) of the Internal Revenue Code. Unless indicated otherwise, 'Section' references are to the U.S. Internal Revenue Code.

from a "controlled commercial entity,"[46] or gain from the sale of real estate[47] or a majority interest in a real estate company.[48]

Whether or not they qualify for treatment under Section 892, SWFs might also qualify for particularized treatment under other tax and legal provisions, such as the exemption enjoyed by foreign taxpayers generally for most capital gains on stock and interest derived from portfolio debt. At the end of the day, the differences between U.S. taxation of foreign taxable investors and SWFs are limited in practice.[49]

Most Commonwealth countries (i.e., Australia, Canada, the UK) and Japan also exempt passive income of foreign governments, but they do so by administrative practice rather than through legislation. For example, in Australia sovereign immunity from taxation can be claimed when the investor is a government or agency thereof, the invested funds will remain the government's, and the income is derived from non-commercial activity.[50] Many other countries have no specific tax law on point (such as Germany), or simply treat governments like other investors (such as Norway, Poland, and Switzerland), and rely on treaties for specific bilateral exemptions.[51]

### c. Tax Policy

#### 1. Standard

The identification of commerciality as the main tax policy consideration implicated by SWFs is rooted in concerns regarding the possibility of SWFs competing

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[46] *Id.* If an integral part of government earns income from commercial activity, that income does not qualify for the exemption. If, however, a controlled entity has even $1 of income from commercial activity *anywhere in the world*, it is consider a "controlled commercial entity." Section 892(a)(2)(A)(iii). This has been labeled a trap for the unwary.

[47] Treas. Reg. §1.892-3T(a)(1).

[48] Section 892(a)(2)(B)(2); Treas. Reg. §1.892-5T(b)(1).

[49] SWFs are only nominally favored over foreign corporations when Section 892 provides an exemption otherwise unavailable to foreign corporations; for example, in the case of portfolio dividends, interest from certain noncontrolled commercial entities, and gain from sale of certain noncontrolled real estate companies.

[50] Matt Weerden, *the King and I: advising on transactions involving Sovereign Wealth Funds*, TAXATION IN AUSTRALIA, Vol. 43, No. 7 (February 2009), at 414-18. An ATO interpretive decision (ATO ID 2002/45: Sovereign immunity) characterized commercial activity as concerned with the trading of goods and services, such as buying, selling, bartering, and transportation, and includes the carrying on of a business. *Id.* at 415.

[51] JCT Report at 77.

unfairly with taxable entities and otherwise creating market distortions. The OECD Declaration (calling for equal treatment of similarly situated taxpayers) is concerned with preventing policies that are unnecessary restrictive or protective, but presumably is meant to apply to *more* favorable treatment as well. Thus, in tax policy terms, the essential policy consideration with respect to inbound SWF investment is efficiency: the minimization of deviations from market decisions that would obtain in the absence of tax considerations. In the absence of a strong policy reason to offer SWFs different incentives than other investors, a tax system should strive to preserve the theoretical conditions necessary for utility maximization.

Traditionally, international tax policy, developed in an era when foreign direct investment was the main concern, has used worldwide utility maximization as the measure of efficiency.[52] There are, however, both theoretical and practical reasons to anchor international tax policy analysis on notions of national welfare.[53] In the instant case, it might be argued that utilizing the worldwide welfare standard might be more appropriate when evaluating the effects of tax policy on the direct investment behavior of multinational corporations, but such a standard makes less sense when applied to sovereign wealth funds whose behavior can be assumed to be undertaken for the explicit purpose of increasing some measure of its own national welfare. Also, as a practical matter, it is likely asking too much of any nation's tax system to unilaterally consider worldwide utility as opposed to national utility.

A more than cursory discussion of the appropriate standard for evaluating tax policy is beyond the scope of this paper, but it is worth noting that the selection of standard will effect the interpretation of what is meant by the policy prescription to "treat

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[52] Under this rubric, commentators have developed a plethora of evaluative efficiency standards. *See, e.g.*, Daniel Shaviro, *Why Worldwide Welfare as a Normative Standard in U.S. Tax Policy?*, 60 TAX L. REV. 155 (2007); Mitchell A. Kane, *Ownership Neutrality, Ownership Distortions, and International Tax Welfare Benchmarks*, 26 VA. TAX REV. 53 (2006).

[53] Shaviro, note 52. *See also* Michael Graetz, *Taxing International Income: Inadequate Policies, Outdated Concepts, and Unsatisfactory Policies*, The David R. Tillinghast Lecture, NYU School of Law, in 54 TAX L. REV. 261, 281 (2001) ("this nation's international tax policy [should] be fashioned to advance the interests of the American people…"). Professors Desai and Dharmapala have thus proposed a principle of taxing foreign passive investment ("global portfolio neutrality") that "explicitly addresses national welfare maximization". Mihir A. Desai and Dhammika Dharmapala, *Investor Taxation in Open Economies, available at* http://www.law.nyu.edu/academics/colloquia/taxpolicy/index.htm. "Global portfolio neutrality" seeks to account for the fact that, due to risk-aversion, investors will suboptimally allocate their investments when faced with differential tax treatment of foreign and domestic investment. Global portfolio neutrality calls for each investor to face the same tax rate whether she invests at home or abroad.

similarly situated taxpayers in a like manner." The issue then becomes what types of investors are "similarly situated" to SWFs? And what does it mean to treat them equally?

### 2. Similarly Situated Taxpayers

Tax policy discussions have been resistant to the idea that SWFs are unique creatures requiring specialized treatment. The discussions have assumed, then, that a suitable similarly situated investor exists and that SWFs should received the same treatment. It is not clear that such an investor exists, but the appeal of finding one is obvious.

The candidate that most readily suggests itself is private foreign investors.[54] In terms of the host of issues raised by globalization and cross-border investment, the commonality of foreignness between sovereigns and private investors would appear to be the most salient category. The bulk of U.S. tax scholarship regarding the treatment of SWFs has taken foreign private investors as the relevant benchmark. There are, however, other possibilities.

The OECD's relevant general investment principle is to treat foreign investors "not less favorably than *domestic* investors in like situations." A textualist reading (admittedly of non-binding non-tax authority) can be used to support the proposition that domestic sovereigns (in the case of the U.S., for example, State and tribal governments) are appropriately "similarly situated." A belief in the strong version of sovereign immunity might lead one to compare foreign and domestic sovereigns. Sovereigns, after all, are analytically similarly situated in terms of purposes and objectives.

Another interpretation is that SWFs should be treated like private domestic investors.[55] This position would be hard to maintain without also advocating that foreign

[54] Thus, Professor Fleischer advocates treating SWF investment income "no better and no worse than foreign private investors' income." Fleischer, *Theory*, note 18, at 446.

[55] In February 2008, Treasurer of Australia Wayne Swan announced a set of principles to guide Australia's open-ended foreign investment review process, including whether or not an investment may impact on government revenue of policies, "for example, investments by foreign government entities must be taxed on the same basis as operations by other commercial entities." Principles Guiding Consideration of Foreign Government Related Investment in Australia, Media Release No. 009, Government Improves Transparency of Foreign Investment Screening Process, Treasurer of the Commonwealth of Australia (February 17, 2008), *available at*

and domestic private investors are also treated similarly. In other words, using private domestic investors as the benchmark is an implicit call for the type of fulsome tax harmonization that does not seem realistically possible at this point.

Finally, tax exempt entities might also provide for a useful comparison to foreign sovereigns in the sense that they are organized for non-commercial purposes but are frequent market participants.[56] Policy makers might be particularly interested in transparency, information sharing, and strong governance with respect to both sorts of entities. And, at least in the U.S., there is already in place a tax mechanism to govern such "mixed motive" entities.

### 3. Equal Treatment

Even assuming that private foreign investors are the correct comparison for SWFs, the picture is further complicated when we take a more nuanced look at what "equal tax treatment" entails. Adhering to the spirit of the OECD Declaration, Professor Fleischer has suggested a starting point of "sovereign tax neutrality" between private foreign investors and sovereigns because it "comports with widely shared beliefs of equity and fairness and…it protects against unintended subsidies or penalties in the capital markets that could distort the allocation of economic resources."[57]

But Professor Fleischer also notes that "What counts as neutral in this context is a complex question that requires consideration of how both sovereign and private investors are taxed on different types of investments."[58] Professor Knoll has offered a more blunt

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http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/009.htm&pageID=003&min=wms&Year=2008&DocType=0.

[56] There is somewhat of a divergence between the treatment of tax-exempts and foreign governments with respect to commercial activity – even though both raise concerns related to unfair competition. Organizations exempt from tax under Section 501(a) enjoy a broader exemption from tax than do foreign governments under Section 892. Tax-exempt entities' income is generally exempt, but Section 501(b) imposes a tax (at rates applicable to U.S. corporations) on income derived from a trade or business unrelated to the tax-exempt entity's purpose. But this tax does not apply to dividends (even from controlled entities) or to gain from the sale or disposition of real property, and the controlled entities of tax exempts are not subject to the cliff effect of disqualifying for the exemption based on $1 of income from commercial activity. On other hand, tax exempts cannot reap the benefit of tax-advantaged treatment of debt-financed property.

[57] Fleischer, *Theory*, note 18, at 468. Professor Fleischer notes that the EU baseline is sovereign tax neutrality. *Id.*

[58] *Id.*, at note 104. For a thorough attempt at answering this question, *see* Knoll, note 16, at 48.

outlook: "[D]esigning a tax system that is neutral among domestic investors, private foreign investors and SWFs is…made harder (and might be impossible) because investment capital comes from many different countries with different tax systems."[59]

It is tempting to equate one jurisdiction's equal tax rates between, say, foreign private investors and SWFs with non-distortionary "tax equality." Simply put, however, what matters is comparative and not absolute advantage.[60] The fact that foreign sovereigns might be more lightly taxed than private foreign investors (for example, with respect to dividends sourced in the recipient country) does not necessarily mean that they are in a tax-advantaged position that will result in distortion. Differential taxation by recipient countries of SWFs and private foreign taxpayers

> does not distort the pattern of investment as long as each investor faces the same tax rate wherever it invests. Indeed, as long as a given investor faces the same tax rate across all investments, her choices will be undistorted relative to a no-tax equilibrium, which is the classic benchmark for assessing efficiency.[61]

Bringing about such a non-distortionary state of affairs is of course much easier said than done. The tax literature, as briefly noted above, has yielded a variety of theories for best achieving efficiency with respect to the taxation of SWFs and no easy answer has presented itself. The theories require either treating each investor, including SWFs, differently (depending on, for example, their rate of taxation at home), or, on the other hand, harmonizing worldwide tax rates to an extent not likely to be possible.[62] At any rate, the point here is not to thoroughly explain and critique these analyses, but rather

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[59] Professor Knoll continues, "[T]here is no single and simple answer to the question do taxes provide SWFs with a competitive advantage when they invest in the United States. The answer to that question depends upon to whom the comparison is being made, what is the asset in question, the correlation among rates of return across asset classes and countries, and the tax laws of other countries." *Id.* at 53.

[60] Wei Cui, *Is Section 892 the Right Place to Look for a Response to Sovereign Wealth Funds?*, *available at* http://ssrn.com/abstract=1413137, at 2 ("[I]nvestors measure their tax advantage with respect to a particular investment relative to their other investment options."). *See also* Knoll, note 16, at n. 104 and accompanying text.

[61] Desai & Dharmapala, note 36, at 103. Despite facially different treatment, In practice, it is not clear that foreign private investors are disadvantaged vis-à-vis SWFs under U.S. law. Professor Cui points out this is particularly true given the failure to consider that i) places that generate most investment to US tend to have worldwide taxation systems, and ii) SWFs are often taxed at home. Cui, note 60, at 3. While this may be true and relevant for certain SWFs, the point of SWF investment generally requires foreign investment.

[62] Mitchell A. Kane, *Strategy and Cooperation in National Responses to International Tax Arbitrage*, 53 EMORY L.J. 89, 93 (2004) ("[E]limination of rate differentials across jurisdictions is not a policy goal that any jurisdiction seriously advances at this time.").

to demonstrate the complexity of the tax policy issues presented by the task of treating SWFs equal to similarly situated taxpayers.

### 2. Implementation

Even if there were agreement as to the tax policy recommendation, there is still the issue of tax policy implementation. The GAPP and OECD Declaration are substantial steps in the direction of full-fledged international coordination, but multilateral agreements regarding foreign investment look to continue to be hard to come by, particularly with regard to tax issues.[63] A consummated international agreement would still require further implementation at the national level.

In the absence of a thorough multilateral agreement, Professor Desai notes that "unilaterally optimal policies provide the benchmark" against which multilateral action is measured.[64] Further, the OECD's general investment policy principles call for unilateral liberalization ("avoidance of reciprocity is an important OECD policy tradition") based on the belief that liberalization benefits all, but especially the actor.[65] In practice, countries are understandably hesitant to unilaterally act, given the nature of the prisoner's dilemma with respect to tax harmonization.

With multilateral and unilateral solutions at the two ends of the spectrum, much practice and theory appears to be focused on a middle position: reciprocity.[66] The thousands of bilateral tax treaties are testament to the allures of reciprocity.[67] While treaties are a useful tool for finely tuned international relations efforts, promote cross-border investment, and work to avoid double taxation, they are problematic in the SWF context. For one thing, they are unwieldy instruments – individually and collectively –

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[63] *See* Paul Rose, note 23, at 148-49 ("The difficulty in setting up a multilateral agreement for SWFs, however, is demonstrated by the number of unsuccessful attempts that have been made in the recent past to develop a multilateral framework for foreign direct investment generally.") *But see* Shaviro, note 52, at 164-66 (discussing possibility of basing taxation on cooperative tax norms among OECD countries).
[64] Desai & Dharmapala, note 53, at 5.
[65] OECD Declaration, at 3.
[66] Professor Fleischer argues that preferential treatment for SWFs should only be offered for countries that offer reciprocal treatment. Fleischer, *Theory*, note 18, at 447.
[67] Section 892(a)(3) treats governments as corporate residents of that country. Many bilateral tax treaties have begun to explicitly define particular SWFs as corporate residents of their countries as well.

and take a long time to negotiate and come into force. The problem they are principally designed to resolve, double taxation, is not as big a problem for SWFs. Treaty negotiations, or the lack thereof, are also subject to the same political winds that are said to plague SWFs themselves. The U.S., for example does not have tax treaties with the Gulf states, and the treaty mechanism favors those with good relationships, perhaps to the detriment or small and developing nations. Perhaps most importantly for the framework of this discussion, unless undertaken consistently and thoughtfully, their inefficient effects are magnified by the small number but large size of the players.

A compromise position, conditioning neutral tax treatment (however defined) on adherence to some version of best practices principles, could take many forms, including well-constructed legislation.[68] Essentially, the idea is to tax SWFs as financial investors if they act as such.[69] The many countries that grant tax exemption to SWFs based on administrative decision do just this. The appeal of such an approach is that it moves towards the efficient outcome while avoiding some of the practical problems associated with multilateral or unilateral action.

At the end of the day, the choice of implementation tool will depend upon the extent to which there is harmony regarding the appropriate role of tax in the overall regulatory mix, particularities of the enacting country and its tax system, and the nature of the underlying tax policy. One tentative conclusion to be drawn from this discussion is that a harmonized tax response may not necessarily take the form of a coordinated effort. To the extent nations conclude that promoting efficiency is in their national interest, the challenge will lie more in defining a policy that treats SWFs equally than in implementing it.

## V. CONCLUSION

Even the most conservative rendering of tax law's role in the international regulatory scheme for SWFs indicates the challenges presented to the tax system by this new creature. Taxing SWFs in a way that does not distort investment decisions requires

[68] Fleischer, *How Should We Tax Sovereign Wealth Funds?*, note 18, at 96 (If funds "comply with best practices…then perhaps they should be taxed at a lower rate similar to private investors.").
[69] Fleischer, *Theory*, note 18, at 505.

complicated analyses of what type of investor is most similar to SWFs and how to ensure equality of tax treatment between such investors and SWFs. As SWFs continue to normalize, and as the international community refines its regulatory response, policy makers and academics alike would do well to consider how best to integrate tax policy considerations into their overall evaluation of the SWF phenomenon.