ECONOMIC AND U.S. INCOME TAX ISSUES RAISED BY SOVEREIGN WEALTH FUND INVESTMENT IN THE UNITED STATES

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

June 17, 2008
JCX-49-08

CONTENTS

INTRODUCTION

This document,[1] prepared by the Staff of the Joint Committee on Taxation, describes the economic and U.S. income tax issues raised by sovereign wealth fund ("SWF") investment in the United States.

The United States has been a net importer of goods and services since 1982. Whenever a country imports more than it exports, the currency that its residents use to purchase those imports must ultimately return to that country, either as payment for that country's exports or to purchase that country's assets. Because the United States has been a net importer of goods and services for the last quarter century, this economic principle means that U.S. dollars that are used to purchase foreign goods and services (net of payments received for exports) must return to the United States to purchase U.S. assets. In fact, the relative share of U.S. assets owned by foreign investors has steadily increased during the last 25 years, indicating not only that dollars paid for net imports have been recycled into purchases of U.S. assets, but also that the rate of investment in the U.S. economy by foreign investors has grown in relation to the rate of investment by domestic investors.

Recently, attention has focused on a particular source of cross-border investment in the United States—SWFs. In general, SWFs are actively managed, government-owned pools of capital originating in foreign exchange assets. SWFs are currently estimated to manage total assets of $3 trillion or more, with significant growth anticipated in the next five to 10 years. The largest SWFs are controlled by countries with substantial commodity exports or large current account surpluses.

The increasing prominence of SWFs in global finance has raised some policy concerns, such as their perceived lack of transparency and the possibility that they may have political objectives. At the same time, SWFs are generally recognized as playing a useful role in the world economy. International organizations in which the United States participates are developing "best practices" guidelines for both SWFs and countries that are the recipients of SWF investments.

In the United States, SWFs may benefit from a long-standing exemption from U.S. income tax that applies to certain passive income received by foreign governments. This exemption does not apply to income related to commercial activity. The exemption is not specifically directed at SWFs, and, in fact, first became part of the U.S. income tax laws in 1917, long before the first SWFs were created.

In addition to existing law's statutory (and, in respect of some sovereigns, treaty) exemption for passive income earned by foreign governments, the United States also exempts from income tax, or taxes at reduced rates, many important types of income earned by nongovernmental foreign investors. To the extent that a foreign government recognizes income

[1] This document may be cited as follows: 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. This document can also be found on the internet at www.jct.gov.

that is not exempt from U.S. income tax under the exception for passive income received by foreign sovereigns, the foreign government is treated as a corporate resident of its own country.

As a result, the U.S. income tax treatment of foreign governments in many cases is similar to the U.S. income tax treatment of foreign persons generally. In each case, for example, portfolio interest income paid by U.S. obligors generally is exempt from U.S. income tax. Both foreign sovereigns and foreign private investors are subject to U.S. net income tax on commercial activities conducted directly in the United States. Moreover, the exception for passive income earned by foreign sovereigns is not available to a foreign government with respect to income that it derives from a controlled subsidiary conducting a commercial business in the United States. In that case, the foreign government must rely on the same statutory and treaty rules as would apply to a private foreign investor holding the same investment. In practice, some of the most important statutory U.S. income tax advantages that a foreign sovereign investor enjoys over a foreign private investor are: exemption from U.S. withholding tax on all U.S. source dividends paid by noncontrolled corporations; exemption from U.S. withholding tax on interest paid by a corporation where the foreign sovereign owns at least 10 percent (so the general "portfolio interest" exemption is not available) but less than 50 percent (so the payor is not "controlled" by the foreign sovereign) of the payor; and exemption from U.S. tax on certain gains from real estate transactions.

The economic analysis presented here suggests that investment in the United States by foreign sovereigns, like that of investment by foreign private investors, is a necessary and desirable consequence of the long-term trade deficit position of the United States. As noted earlier, investments by SWFs or foreign governments more generally raise nontax policy concerns, but these fall largely outside the expertise of the Staff of the Joint Committee on Taxation. Tax policy considerations addressed in this document include consistency between a foreign government's exemption from U.S. income tax and a foreign country's immunity from the jurisdiction of U.S. courts, the scope of the difference in the U.S. income tax treatment between foreign governments and other investors in the United States, and certain issues specific to the technical terms of the U.S. income tax exemption for foreign governments.

I. U.S. CROSS-BORDER TRANSACTIONS AND INVESTMENTS

SWFs purchase U.S. assets (including stock of U.S. corporations) and make loans to U.S. owners of assets. They also may purchase U.S. government bonds. Each of these activities is a form of foreign investment in the United States. Such cross-border investment cannot be examined without also examining cross-border trade in goods and services and the domestic savings rate, as these economic activities are all interrelated. This section discusses the economic relationship between trade deficits, capital inflows, investment, and savings in the economy. In doing so, it also presents background data relating to the scope of the international trade sector in the United States economy, and briefly reviews trends in both the current account (the trade surplus or deficit) and the financial account (U.S. investment abroad and foreign investment in the United States).[2]

A. Trade Deficits and Cross-Border Capital Flows

National income accounting

In popular discussion of trade issues, much attention is given to the trade deficit or surplus, that is, the difference between the economy's exports and imports. In the late 1980s, just as at present, there was also attention given to inflows of capital from abroad. Capital inflows can take the form of foreign purchases of domestic physical (or "real") assets, or of domestic financial assets, such as equity interests or debt instruments.

These two phenomena, trade balances and capital inflows, are related to each other. More generally, trade deficits, capital inflows, investment, savings, and income are all connected in the economy. The connection among these economic variables can be examined through the "national income and product accounts," which measure the flow of goods and services and income in the economy.[3]

---

[2] Prior to 1999, the U.S. Department of Commerce, Bureau of Economic Analysis reported and described international transactions by reference to the "current account" and the "capital account." Beginning in June 1999 the Bureau of Economic Analysis adopted a three-group classification to make U.S. data reporting more closely aligned with international guidelines. The three groups are labeled: current account; capital account; and financial account. Under this regrouping, the "financial account" encompasses all transactions that used to fall into the old "capital account," that is, the financial account measures U.S. investment abroad and foreign investment in the United States. Under the new system, the "current account" is redefined by removing a small part of the old measure of unilateral transfers and including it in the newly defined "capital account." The capital account consists of capital transfers and the acquisition and disposal of non-produced, non-financial assets. For example, the capital account includes such transactions as forgiveness of foreign debt, migrants' transfers of goods and financial assets when entering or leaving the country, transfers of title to fixed assets, and the acquisition and disposal of non-produced assets such as natural resource rights, patents, copyrights, and leases. In practice, the Bureau of Economic Analysis believes that "capital account" transactions will be small in comparison to the current account and financial account.

[3] The national income and product accounts measure the flow of goods and services (product) and income in the economy. The most commonly reported measure of national economic income is gross

The value of an economy's total output must be either consumed domestically (by private individuals and government), invested domestically, or exported abroad. If an economy consumes and invests more than it produces, it must be a net importer of goods and services. If the imports are all consumption goods, in order to pay for those imports, the country must either sell some of its assets or borrow from foreigners. If the imports are investment goods, foreign persons must be the owners or lend money to the owners of these investments. Thus, an economy that runs a trade deficit must experience foreign capital inflows, as foreign persons purchase domestic assets, make equity investments, or lend funds (purchase debt instruments).

In other words, if the economy is a net importer, it must attract capital inflows to pay for those imports. If the economy is a net exporter, it must have capital outflows to dispose of the payments it receives for its exports. For example, when the United States imports more than it exports, the United States pays for the imports with dollars. If foreigners are not buying U.S. goods or services with the dollars, then they will use the dollars to purchase U.S. assets. (Another way of viewing these relationships is that dollars flowing out of the U.S. economy in order to purchase goods or to service foreign debt must ultimately return to the economy as payment for exports or as capital inflows.)

The connection between capital flows and the goods and services in the economy can also be understood by concentrating on the sources of funds for investment. Investment in the United States must come either from domestic saving (that is saving by U.S. persons) or from foreign investors. If domestic saving is less than investment in the United States, that difference must be attributable to net capital inflows from foreign persons. In government reporting, such net capital inflows from foreign persons are termed "net foreign borrowing" even though the capital inflows may take the form of either equity investments or loans.

---

domestic product ("GDP"). Related to GDP is gross national product ("GNP"). GDP can be understood as the total annual value of goods and service produced by the U.S. economy, regardless of the nationality of the owners of the factors of production (land, labor, and capital) that are required to produce the goods and services. GNP, by contrast is the total annual value of goods and services produced anywhere in the world where the relevant factors of production are owned by U.S. persons. Thus, wages earned by a U.S. resident from temporary work abroad, or dividends received by a U.S. person from an investment in a foreign corporation, constitutes part of GNP but not GDP.

Relation of Trade Deficits to Cross-Border Capital Flow

In formal terms, the connection between trade deficits and cross-border capital flows is as follows. In the following it is useful to use GNP, which includes cross border returns to investment, rather than the more commonly reported GDP concept.

One way to measure GNP is by expenditures on final product. By this measure,

(1) GNP = C + I + G + (X-M) + NI.

Equation (1) is an accounting identity which states that gross national product for a period equals the sum of private consumption expenditures (C), private investment expenditures on plant, equipment, inventory, and residential construction (I), government purchases of goods and services (G), net exports (exports less imports of goods and services and net interest payments to foreigners, or X-M), plus net investment income (the excess of investment income of U.S. persons received from abroad over investment income paid to foreign persons from investments located in the United States), denoted "NI" in equation (1).

An alternative is to measure GNP by the manner in which income is spent. By this measure,

(2) GNP = C + S + T.

Equation (2) is another accounting identity which states that gross national product for a period equals the sum of private consumption expenditures (C), saving by consumers and businesses (S), and net tax payments to the government (T) (net tax payments are total tax receipts less transfer, interest, and subsidy payments made by all levels of government).

Because both measures of GNP are simple accounting identities, the right hand side of equation (1) must equal the right hand side of equation (2). From this observation can be derived an additional national income accounting identity:

(3) I = S + (T - G) + (M - X) - NI

Equation (3) states that private investment equals private saving (S), plus public saving (T-G) and net imports (M - X), less net investment income. An intuitive interpretation of equation (3) is that it requires dollars to make investments in the United States and equation (3) identifies the sources of investment dollars. Equation (3) identifies private saving by U.S. persons, S, as one source of dollars and government saving, T - G, as another source of dollars. The next two terms in equation (3) identify dollars that result from cross-border transactions as yet additional sources of potential investment dollars. If imports, M, exceed exports, X, then, on net, dollars are in the hands of foreign persons and available for investment in the United States. If the earnings of foreign persons from their investments in the United States exceeds the earning of U.S. persons on their investments abroad, then NI is negative and, on net, dollars are in the hands of foreign person and available for investment in the United States. If the opposite is the case, NI is positive, there are not additional dollars available for investment. (If net investment income is reinvested in the economy then that reinvestment of course is reflected as savings, S.)

These relationships can be summarized as follows (the equation ignores relatively small unilateral transfers such as foreign aid and assumes, without loss of generality, that the government budget is balanced):

Net Foreign Borrowing = Investment - Saving

Net Foreign Borrowing = (Imports - Exports) - Net Investment Income

For this purpose, imports and exports include both goods and services, and net investment income is equal to the excess of investment income received from abroad over investment income sent abroad.[4] The excess of imports over exports is called the "trade deficit" in goods and services. Net investment income can be viewed as payments received on previously-acquired foreign assets (foreign investments) less payments made to service previous net foreign borrowing.

If the investment in an economy is larger than that country's domestic saving, the country must be running a trade deficit, or the country must be increasing foreign borrowing, or both. Similarly, a country cannot run a trade surplus without also exporting capital, either by increasing its foreign investments, or by paying down (or reacquiring) previously acquired domestic assets or financial claims against the domestic economy held by foreign investors. Because the level of net investment income in any year is fixed by the level of previous foreign investment (except for changes in interest rates), changes in investment or saving that are associated with capital inflows will have a negative impact on a country's trade balance.

Economic implications of trade deficits

A trade deficit is not necessarily undesirable; what is important is the present and future consumption possibilities of the economy. Those consumption possibilities depend in part on whether the trade deficit is financing consumption or investment.

For example, if a country uncovers profitable investment opportunities, then it will be in that country's interest to obtain funds from abroad to invest in these profitable projects.[5] If the economy currently does not have enough domestic savings to invest in these projects, it could reduce its consumption (generating more domestic saving) or look to foreign sources of funds (thus allowing investment without reducing current consumption).

For example, suppose new oil reserves that could be profitably recovered through increased investment are discovered in the United States. The investment may be financed by foreigners. In order to invest in U.S. assets, foreigners will have to buy dollars, thus increasing the value of the dollar. This dollar appreciation makes U.S. goods more expensive to foreigners, thereby reducing their demand for U.S. exports. At the same time, the dollar appreciation makes foreign goods cheaper for U.S. residents, increasing the demand for imports and resulting in a trade deficit. Eventually, the flow of capital will be reversed, as the U.S. demand for new investment falls, and foreigners receive interest and dividend payments on their previous investments.

---

[4] This equation in the text can be derived from equation (3) in the text box on page 3 above if the government budget is assumed to be balanced, that is, if $G = T$. It follows that if the government runs a deficit, that is, if $G>T$, for a given level of investment, saving, and net investment income, net foreign borrowing must be greater.

[5] This scenario describes the experience of the United States in the mid to late 1800s, when foreign capital inflows financed much of the investment in railroads and other assets.

The borrowing from foreign investors in the above example was used to finance investment. This borrowing did not reduce the living standards of current or future U.S. residents, because the interest and dividends that were paid to foreigners came from the return from the new investment. The increased capital investment led to increases in labor productivity, resulting in higher wages both at that time and in the future.

If, by contrast, foreign borrowing finances consumption instead of investment, there are no new assets created to generate a return that can support the borrowing. When the debt eventually is repaid, the repayments will come at the expense of future consumption.

For instance, consider a situation in which the domestic supply of funds for investment decreases because domestic saving rates fall. Foreign borrowing in this case is not associated with increased investment, but instead is devoted to investment that was previously financed with domestic savings. Because the foreign borrowing is not associated with increased investment, future output does not increase, and interest and dividends on the investment will be paid to foreign persons at the expense of future domestic consumption. In this case, there may be an increase in the standard of living for current U.S. residents at the expense of a decrease in the standard of living of future residents.

The difference between the case where foreign investors fund incremental investment in the United States on top of domestic saving and the case where foreign investment simply replaces current domestic saving (which instead are currently consumed) can be summarized as follows. In the first case, the economy grows faster over time than it would without the incremental foreign investment and both U.S. and foreign persons share in that growth. In the second case, the economy continues to grow (but not as quickly as the first case) but all the future returns to the foreign investment belong to foreign persons. U.S. persons enjoy the immediate boost to their standard of living that comes from consuming money that they formerly saved, but future residents will not enjoy the returns from the money their predecessors consumed rather than saved.

During the period that foreign borrowing finances U.S. consumption, the United States runs a trade deficit. Although the United States could service its growing foreign debt by increased borrowing, and thereby generating larger trade deficits, in the long run trade deficits cannot keep growing. In fact, the United States must eventually run a trade surplus. If the United States imported more goods than it exported every year, there also would be an inflow of foreign capital every year. As the capital inflow grew from year to year, so would costs of servicing the claims held by foreign investors (e.g., interest on U.S. debt instruments). Eventually, foreigners would be unwilling to continue investing in the United States, and the value of the dollar would fall. The fall in the dollar would eliminate the trade deficit, and the United States would eventually run a trade surplus, so that the current account deficit (the sum of the trade deficit in goods and services and the net interest on foreign obligations) would be small enough for foreigners to be willing to lend again to the United States.[6]

---

[6] An alternative adjustment would require U.S. interest rates to rise to make it more attractive for foreigners to invest in the United States. The rise in interest rates could also encourage increased

Even when foreign investment finances domestic consumption, trade deficits and capital inflows themselves should not necessarily be viewed as undesirable, because the foreign capital inflows help to keep investment in the domestic economy, and hence labor productivity, from falling. (As noted in the preceding paragraph, however, this pattern cannot continue indefinitely.) For instance, the large inflow of foreign capital to the United States in the 1980s is widely viewed to have been a result of low U.S. saving rates. If the mobility of foreign capital had been restricted (through capital or import controls, for example), then the low saving rate could have led to higher domestic interest rates and lower rates of investment. That decreased investment would have led to decreases in future living standards because the lower growth rate of the capital stock would have resulted in lower growth rates of U.S. labor productivity. In this instance, the fact that foreign capital was not restricted and did finance U.S. investment helped mitigate some of the negative effects on economic growth of low domestic saving.

The above observations support the argument that the trade deficit does not in itself provide a useful measure of international competitiveness, since trade deficits and trade surpluses can be either good or bad for the United States. The oil discovery example discussed above shows that even increases in a country's stock of exportable goods can have ambiguous effects on the trade deficit. If the discovery of oil also increases the demand for investment, then the trade deficit may actually increase in the short run. Increases in natural resources, advances in technology, increases in worker efficiency, and other wealth-enhancing innovations have ambiguous effects on the trade deficit in the short and medium run. Because these innovations increase the productivity of U.S. workers and lower production costs, they increase the attractiveness of U.S. goods, and may result in increased exports. To the extent these innovations increase the demand for investment, however, they can have the opposite effect on the trade deficit. Nonetheless, each of these innovations increases the output of the economy, and hence the incomes of U.S. residents.

The balance of payments accounts, presented in Table 1, are analogous to a sources and uses of funds statement of the United States with the rest of the world. As demonstrated above, the current account balance, which consists primarily of the trade balance, should be exactly offset by the capital account and financial account balances, which measure the net inflow or outflow of capital to or from the United States. The difference between the current account surplus or deficit and the capital and financial accounts deficit or surplus is recorded as a statistical discrepancy. Problems of measurement, which have been large in some years, cause the accounts to be somewhat mismatched in practice, but basic patterns are unlikely to be significantly distorted by these problems. The subsequent sections examine trends in the current account and financial account in more detail.

domestic savings, helping to reduce the need for foreign investment funds. Some combination of dollar devaluation and rising interest rates is also possible.

Table 1.–International Transactions of the United States, Selected Years, 1975-2007
(Dollars in Billions Nominal)

	1975	1985	1995	2000	2005	2007[1]
Current Account Balance	18.1	-118.2	-109.9	-444.7	-791.5	-738.6
Exports of Goods and Services	157.9	387.6	1,005.9	1,418.6	1,749.9	2,410.6
Merchandise	107.1	215.9	575.2	772.2	894.6	1,149.2
Services	25.5	73.2	219.2	293.5	380.6	479.2
Receipts from U.S. assets abroad	25.4	98.5	211.5	352.9	474.6	782.2
Imports of Goods and Services	132.7	483.8	1,081.8	1,809.1	2,455.3	3,044.8
Merchandise	98.2	338.1	749.4	1,224.4	1,677.4	1,964.6
Services	22.0	72.9	141.4	217.0	314.6	372.3
Payments on foreign-owned U.S. assets	12.6	72.8	191.0	367.7	463.4	707.9
Unilateral Transfers	7.1	22.0	34.1	54.1	86.1	104.4
Financial Account Balance	**-22.5**	**101.3**	**113.3**	**443.2**	**785.4**	**657.4**
Foreign Investment in the United States	17.2	146.1	465.7	1,024.2	1,212.3	1,863.7
Direct Investment	2.6	19.7	57.8	287.7	109.8	204.4
Private non-direct investment	7.5	127.5	298.0	700.2	903.0	1,246.6
Official	7.0	-1.1	109.9	37.6	199.5	412.7
U.S. Investment Abroad	39.7	44.8	352.4	581.0	426.8	1,206.3
Direct Investment	14.2	18.9	98.8	152.4	9.1	335.4
Private non-direct investment	21.1	19.1	242.9	427.3	437.4	847.9
Increase in government assets	4.3	6.7	10.7	1.2	-19.6	22.9
Capital Account Transactions, net	**n.a.**	**0.3**	**0.4**	**0.7**	**4.4**	**2.3**
Statistical Discrepancy	**4.4**	**16.5**	**3.8**	**0.7**	**10.4**	**83.6**

Source: Christopher L. Bach, "U.S. International Transactions in 2007," *Survey of Current Business*, 88, April 2008, and earlier editions from the *Survey of Current Business*.

n.a. - not applicable.
[1] Preliminary Figures for 2007.

B. Trends in the U.S. Balance of Payments

<u>Overview of U.S. balance of payments (current account)</u>

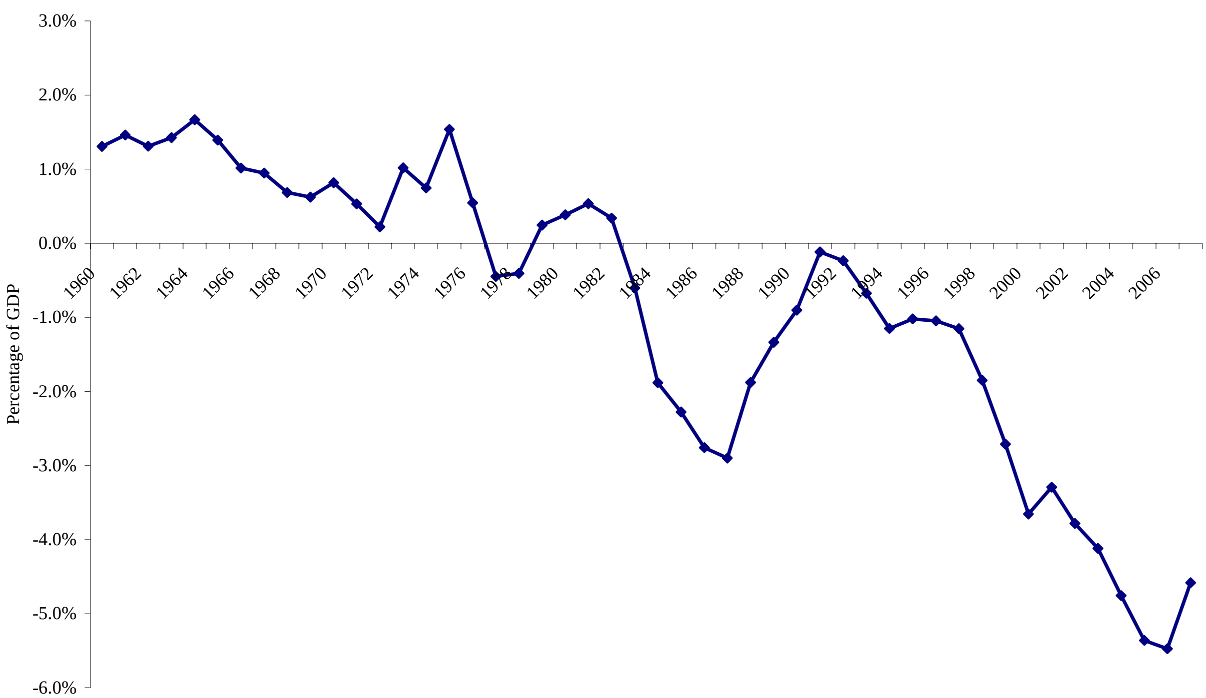
Foreign trade has become increasingly important to the United States economy. Figure 1 presents the value of exports from the United States and imports into the United States as a percentage of GDP for the period 1960-2007. As depicted in Figure 1, exports and imports each have risen from less than six percent of GDP in 1960 to more than 16 percent in 2007. Imports have consistently exceeded 15 percent of U.S. GDP since 1997. Figure 1 also shows that the United States generally was a net exporter of goods and services prior to 1982. Since that time, the United States has been a net importer of goods and services.

Figure 1.–Exports and Imports as a Percentage of United States GDP, 1960-2007

Source: Department of Commerce, Bureau of Economic Analysis.

The net trade position of a country is commonly summarized by its current account. The U.S. current account as a whole, which compares exports of goods and services and income earned by U.S. persons on foreign investments to imports of goods and services and income earned by foreign persons on their investments in the United States (plus unilateral remittances), generally was positive from 1960 through 1981, but generally has been in deficit since 1982. Figure 2 reports the current account balance of the United States for the period 1960 through 2007 as a percentage of GDP to eliminate the effect of inflation on reported nominal figures. Figure 2 reflects a substantial reduction in the current account deficit for 1992. In that year, the United States received substantial payments from abroad related to the Persian Gulf War.

Figure 2.–United States Current Account as a Percentage of GDP, 1960-2007



Source: Department of Commerce, Bureau of Economic Analysis.

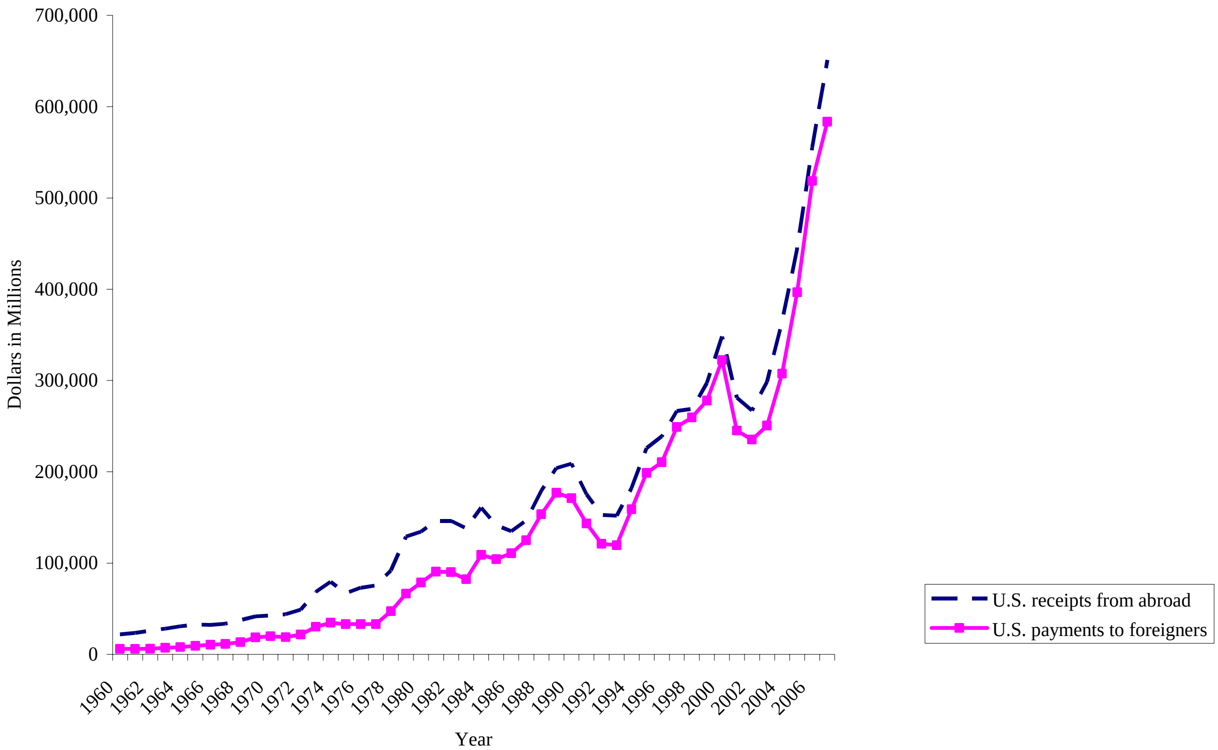
Components of the current account

Merchandise trade, trade in services, and income from investments

The aggregate data reported in Figure 1 and Figure 2 mask differences in the trade position of various sectors of the economy. As explained above, the current account compares exports of goods and services and payments of income earned by U.S. persons on foreign investments to imports of goods and services and payments of income earned by foreign persons on their investments in the United States.

Several different trends are embedded within the data. Measuring the trade deficit in real, inflation adjusted year 2000 dollars, as has been widely reported, the merchandise (goods only) trade deficit has been over $400 billion per year since 2000 and over $650 billion per year the last three years. On the other hand, the United States has been a net exporter of services since the 1970s. This surplus in trade in services has averaged more than $60 billion per year (real, 2000 dollars) since 2002. Also, throughout the entire period covered in Figure 2, U.S. receipts of income on investments abroad have exceeded payments of income to foreign persons on their U.S. investments (see Figure 3, below).

Figure 3.–Receipts of Income from Investments Abroad and U.S. Payments to Foreign Persons on Investments in the U.S., 1960-2007
(Millions of Real 2000 Dollars)



Source: Department of Commerce, Bureau of Economic Analysis.

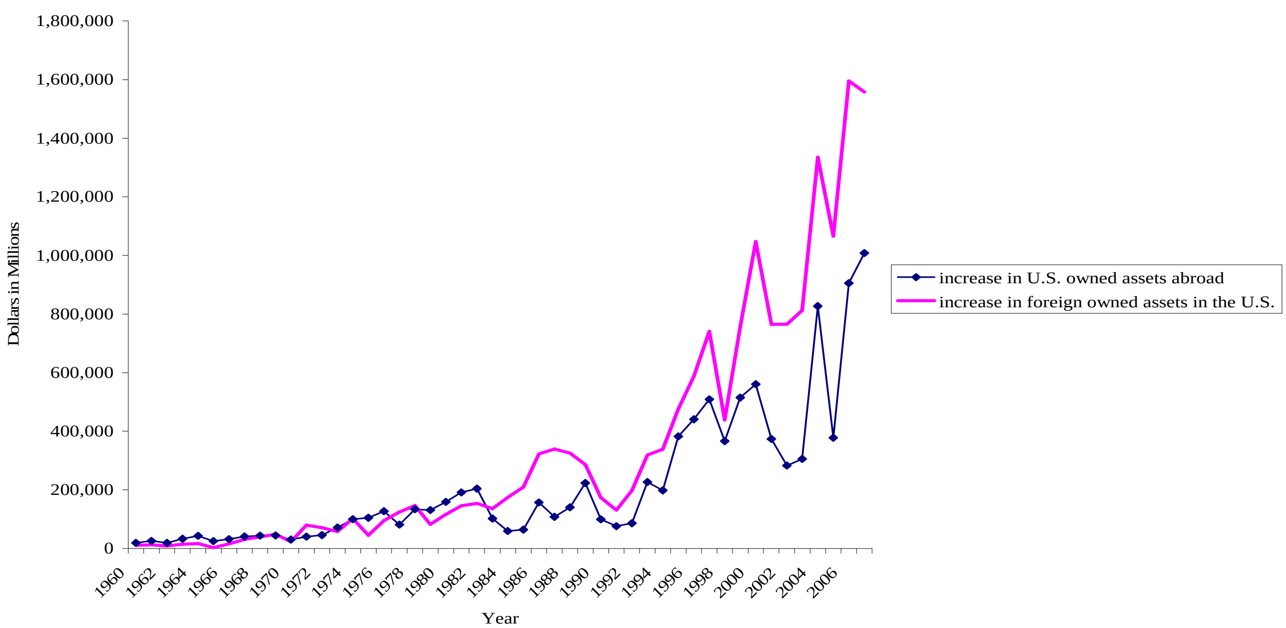
C. Trends in the U.S. Financial Account

Overview of the United States' financial account

As explained above, when the United States imports more than it exports, the dollars the United States uses to buy the imports must ultimately return to the United States as payment for U.S. exports or to purchase U.S. assets. As Figure 2 and Table 1 document, the U.S. current account has been in deficit since the early 1980s. As a direct result, the United States changed from being a modest exporter of capital in relation to GDP to being a large importer of capital. In addition, the domestic saving rate has declined. As a consequence of both of these trends, net foreign investment has become a larger proportion of the economy and a more significant proportion of total domestic investment than in the past. In 2007, gross investment in the United States was $2.59 trillion and net foreign investment was $712 billion, or 27.5 percent of gross domestic investment. In 1993, net foreign investment comprised 6.1 percent of gross domestic investment.

Net foreign investment in the United States is measured by the U.S. financial account. The financial account measures the increase in U.S. assets abroad compared to the increase in foreign assets in the United States. Figure 4 plots the annual increase of U.S. assets abroad and of foreign assets in the United States in constant dollars for the period 1960-2007 in constant 2000 dollars. Foreign assets in the United States increased by $1.20 trillion in 2005, $1.86 trillion in 2006, and $1.86 trillion in 2007 in nominal dollars. At the same time, foreign assets owned by U.S. persons increased by $427 billion in 2005, $1.06 trillion in 2006, and $1.21 trillion in 2007 (nominal dollars).

Figure 4.–Annual Increase in U.S. Assets Abroad and in Foreign Assets in U.S., 1960-2007, in Constant 2000 Dollars



Source: Department of Commerce, Bureau of Economic Analysis.

Growth in foreign-owned assets in the United States and U.S.-owned assets abroad

Overview

Measured in nominal dollars, the amount of foreign-owned assets in the United States grew at an annual rate of more than 13 percent per year between 1981 and 2006. The total amount of foreign-owned assets in the United States exceeded $16 trillion by the end of 2006.[7] The recorded value of U.S.-owned assets abroad grew less rapidly during the same period. The Department of Commerce reports that in 1976 the amount of U.S.-owned assets abroad exceeded foreign-owned assets in the United States by $165 billion. By the mid-1980s, however, the situation had reversed, so that the amount of foreign-owned assets in the United States exceeded U.S.-owned assets abroad. By 2006, the amount of foreign-owned assets in the United States exceeded U.S.-owned assets abroad by $2.5 trillion.[8] The value of investments abroad by private U.S. persons has grown from $693 billion in 1980 to $12.23 trillion in 2006.[9] The rate of growth of private U.S. investment abroad has not been as rapid as the rate of growth in the value of investments by foreign persons in the United States. Foreign non-official holdings of U.S. assets has grown from $393 billion in 1980 to $12.35 trillion in 2006.

These investments are measured at their so-called "current cost."[10] Some argue that the market value of U.S.-owned assets abroad is similar to, or greater than, the market value of foreign-owned assets in the United States, if market values were measured accurately.[11] Figure 5 and Figure 6 display the value of U.S.-owned assets abroad and foreign-owned assets in the United States for selected years measured in constant dollars under both current cost and based on estimates of current market values. Regardless of whether this argument is correct with respect to the current net investment position, it is clear that foreign-owned U.S. assets are growing more rapidly than U.S.-owned assets abroad, as depicted in Figure 6.

---

[7] U.S. Department of Commerce, Bureau of Economic Analysis, "International Investment Position of the United States at Year-End, 1976-2006."

[8] *Ibid*.

[9] This figure values the direct investment at current cost. Both the 1980 and 2006 values are reported in nominal dollars.

[10] The Bureau of Economic Analysis estimates the values of U.S. foreign direct investment abroad and foreign direct investment in the United States using three different bases: historical cost, current cost, and market value. Using the historical cost base, assets are measured according to values carried on taxpayers' books. Thus, investments reflect the price level of the year in which the asset was acquired. Under the current cost measure, a parent's share of its affiliates' tangible assets (property, plant, and equipment and inventories) is revalued from historical cost to replacement cost. Under the market value measure, an owner's equity in foreign assets is revalued to current market value using indexes of stock prices.

[11] The distinction between book valuation and market valuation is only relevant for the category of investment labeled "direct investment," not for "portfolio investment." The distinction between direct and portfolio investment is explained in the text below.

Figure 5.–International Investment Position of the United States, 1982, 1994, and 2006 in Constant 2000 Dollars (Direct Investment at Current Cost)

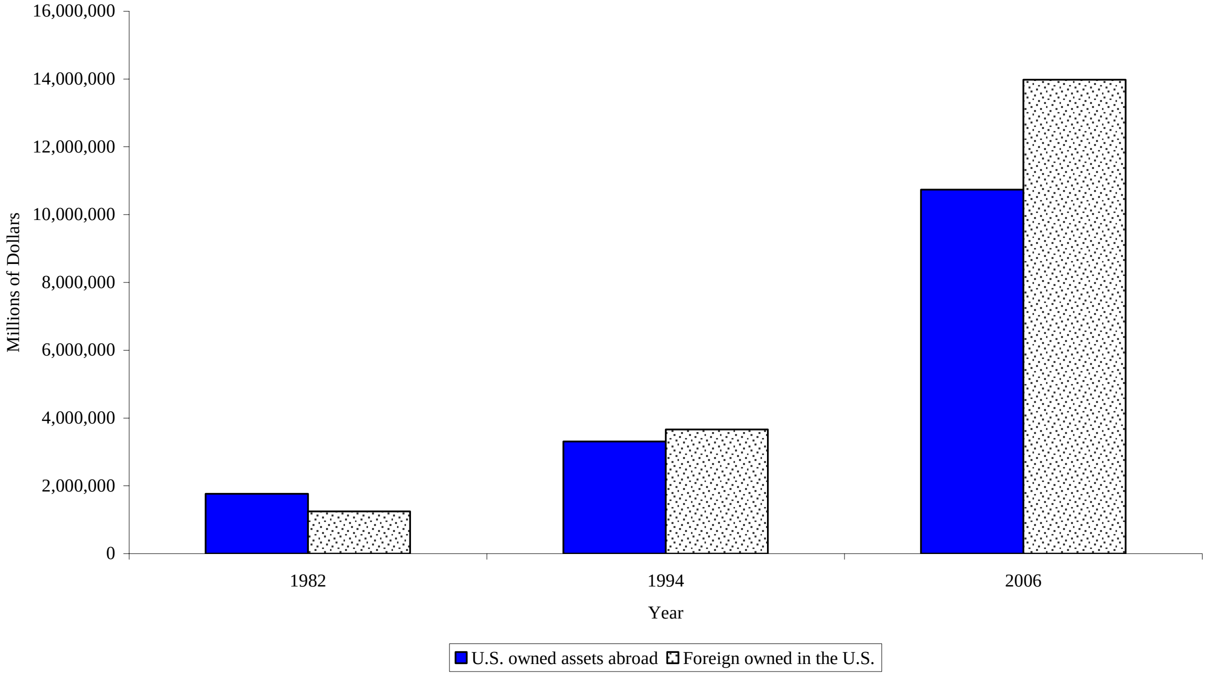
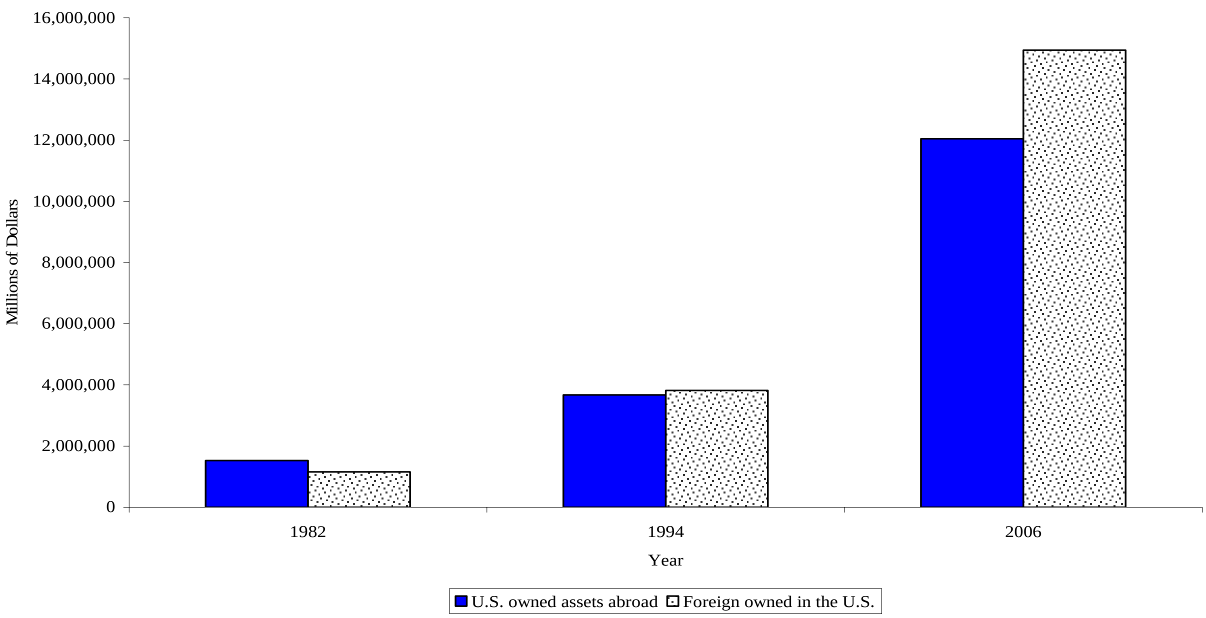


Figure 6.–International Investment Position of the United States, 1982, 1994, 2006 in Constant 2000 Dollars (Direct Investment at Market Value)



Source: Department of Commerce, Bureau of Economic Analysis.

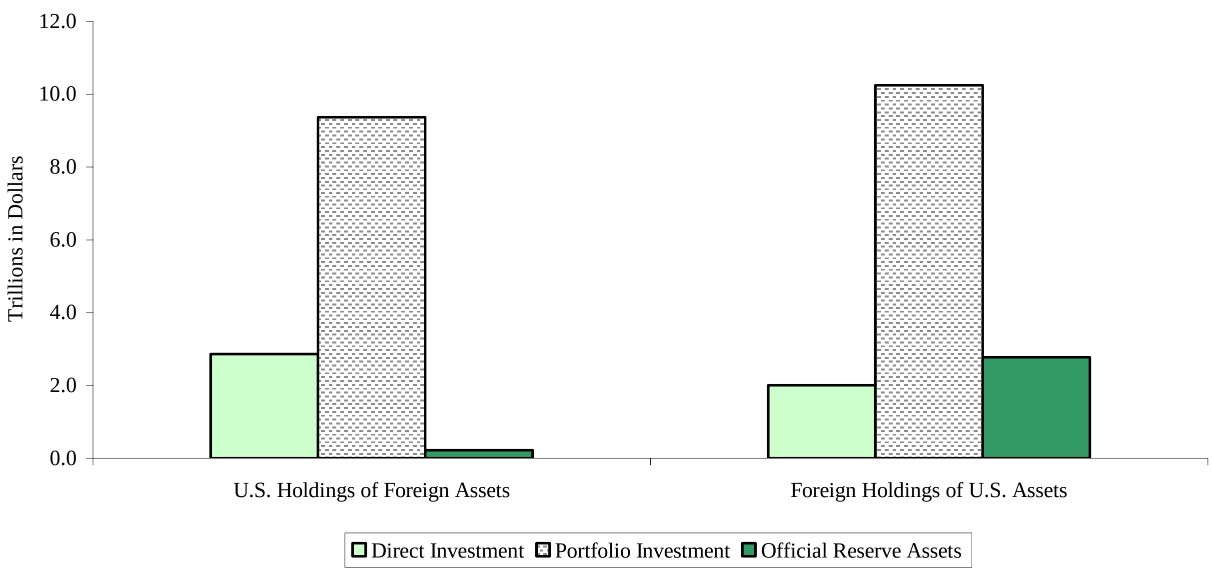
Direct investment, non-direct (portfolio) investment, and official investment

Foreign-owned assets in the United States (and U.S.-owned assets abroad) can be categorized as direct investment, non-direct investment, and official assets. Direct investment constitutes assets over which the owner has direct control. The Department of Commerce defines an investment as direct when a single person owns or controls, directly or indirectly, at least 10 percent of the voting securities of a corporate enterprise or the equivalent interests in an unincorporated business.

The largest category of outbound and inbound investment is non-direct investment held by private (non-governmental) foreign investors, commonly referred to as portfolio investment. For most of the past decade, foreign portfolio investment annually has exceeded foreign direct investment, making portfolio investment responsible for the majority of growth in foreign ownership of U.S. assets. Foreign portfolio investment consists mostly of holdings of corporate equities, corporate and government bonds, and bank deposits. The portfolio investor generally does not have control over the assets that underlie the financial claims. Foreign investment in bonds, corporate equities, and bank deposits, like other types of financial investment, provide a source of funds for investment in the United States but also represent a claim on future U.S. resources.

The final category of foreign-owned U.S. assets or U.S.-owned foreign assets is official assets: in the former case, for example, U.S. assets held by governments, central banking systems, and certain international organizations. The foreign currency reserves of other governments and banking systems, for example, are treated as official assets. Figure 7, below reports the value of these different categories as estimated for the close of 2006.

Figure 7.–International Investment Position by Type of Investment
Trillions of Dollars
2006



Source: Department of Commerce, Bureau of Economic Analysis.

Foreign persons held direct investments of $2.1 trillion in the United States in 2006, having grown from $127 billion in 1980.[12] In 2006, portfolio assets of foreign persons in the United States were more than four times the recorded value of direct investment, $10.2 trillion compared to $2.1 trillion, respectively. Bank deposits account for nearly one-third of this total ($3.3 trillion), and reflect, in part, the increasingly global nature of banking activities. Levels of foreign-held official assets have grown substantially since 2002. In 2002, foreign official assets were estimated to be $1.25 trillion. In 2006, foreign official assets were estimated to be $2.77 trillion.

As has been the case for foreign investors in U.S. assets, over the past decade U.S. investors' portfolio holdings of foreign assets has increased more rapidly than U.S. foreign direct investment. At year-end 2006, U.S. foreign direct investment constituted approximately one-quarter of U.S. ownership of foreign assets, with foreign direct investment valued at $2.89 trillion and portfolio investment valued at $9.34 trillion (with direct investment measured at current cost). Measured at current cost, the value of U.S. direct investment abroad has remained above the value of foreign direct investment in the United States. (See Figure 8.) Measured at market value, the value of foreign direct investment in the United States and the value of U.S. direct investment abroad were estimated to have been comparable for 1998-2002, but recent preliminary estimates place the value of U.S. owned foreign direct investment in excess of foreign owned direct investments in the United States. (See Figure 9.)

[12] This values the direct investment at current cost. The Bureau of Economic Analysis estimate for 2006, when valued at market value, is $3.2 trillion.

Figure 8.–Year-End Value of Foreign Direct Investment in the United States and U.S. Direct Investment Abroad, 1982-2006

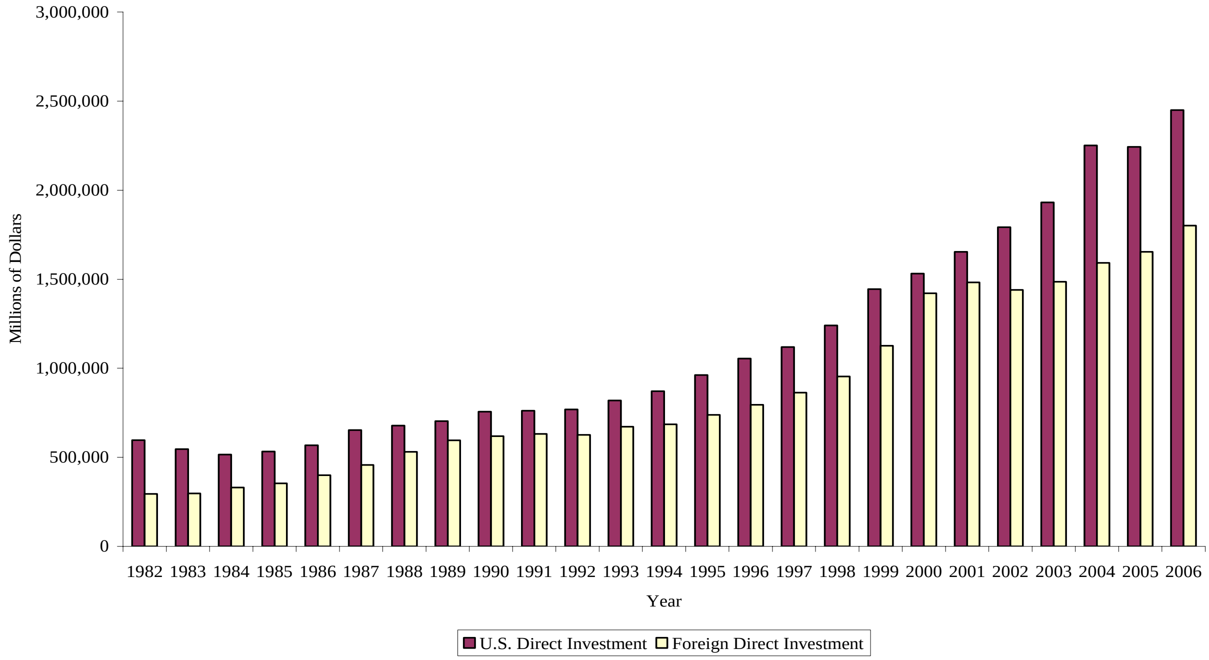
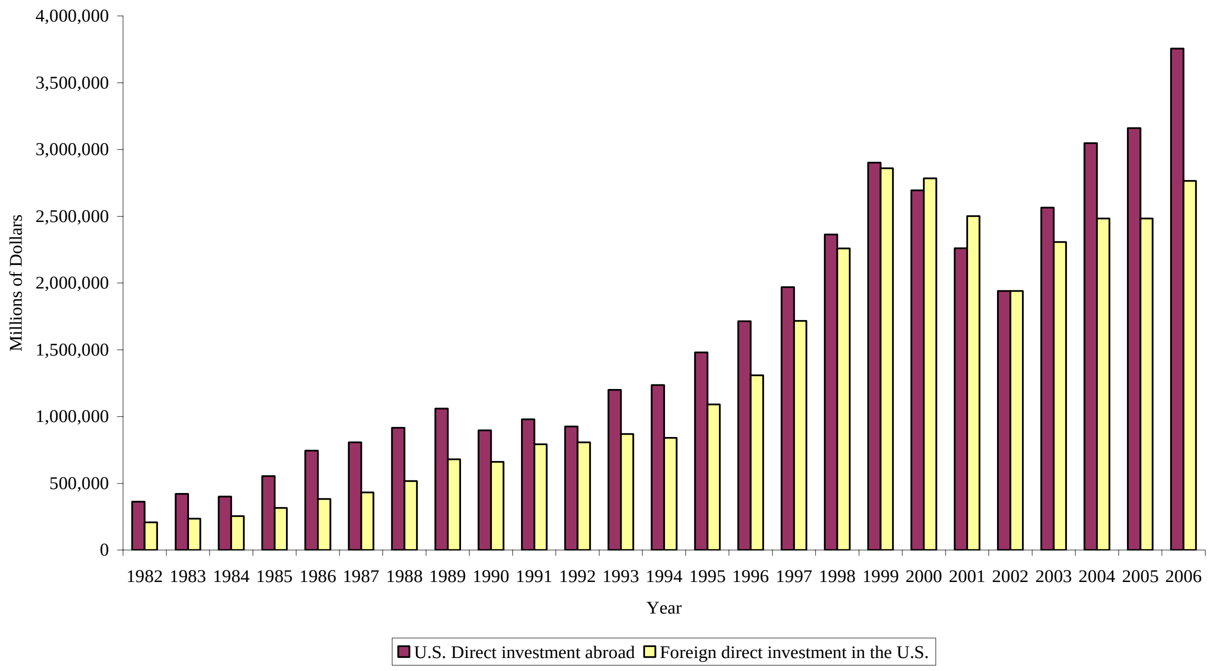


Figure 9.–Year-End Value of Foreign Direct Investment in the United States and U.S. Direct Investment Aborad, 1982-2006
(Millions of Real 2000 Dollars at Maket Value)

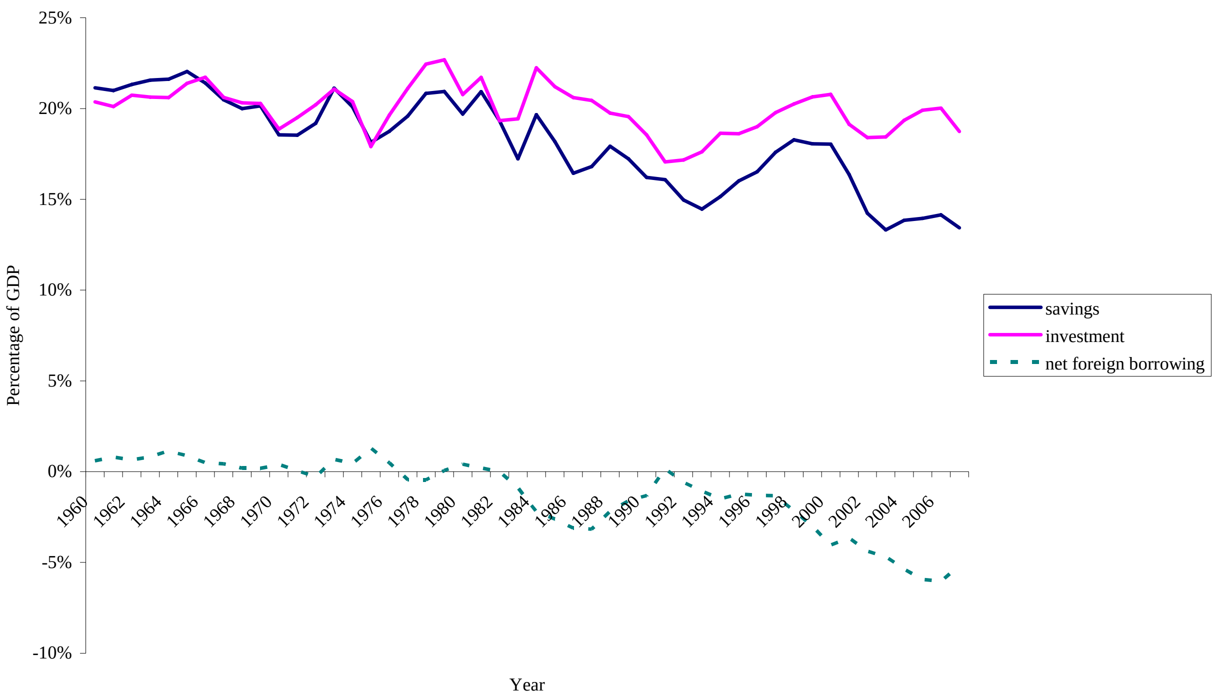


Source: Department of Commerce, Bureau of Economic Analysis.

D. Summary and Implications for Discussion of SWFs

As explained in Section I.A, above, when domestic saving is less than investment in the United States, investment dollars flow into the United States from abroad. Between 1960 and the present, the rate of investment in the United States has ranged from 17.1 percent to 22.7 percent of GDP, and has exceeded 18.4 percent for the past decade. Over the same period, the domestic saving rate, which was never less than 20 percent of GDP in the 1960s, has not exceed 14.5 percent of GDP since 2002. The result, as documented in Figure 10, below, has been an increase in the country's annual net foreign borrowing to finance investment in the United States. (In this regard, remember that the term "annual net foreign borrowing" includes equity investments.)

Figure 10.–Saving, Investment, and Net Foreign Borrowing as a Percentage of U.S. GDP 1960-2007



Source: U.S. Department of Commerce, Bureau of Economic Analysis, "Saving and Investment 2007."

As must be the case, and as documented in Figure 2, an increasing current account (trade) deficit has accompanied the increases in net foreign borrowing, thereby supplying foreign persons with dollars that are returned to the United States as investment dollars. In short, the declining domestic saving rate and increasing trade deficit dictate that the dollar depreciate or foreign investment in the United States increase, or both.

SWFs are one source of foreign investment dollars, but this observation does not mean that the declining U.S. saving rate or large annual U.S. trade deficits necessarily cause SWFs to acquire U.S. assets. Even if the U.S. did not have a trade deficit and the U.S. were a net foreign investor (as was the case prior to 1982), rather than a net foreign borrower, SWFs, like other foreign investors, might well acquire U.S. assets for multiple economic reasons, such as global diversification of investment risk. The current economic climate does, however, require that dollars held abroad by foreigners return to the United States as capital inflows.

The data presented above document that foreign persons are increasing their ownership of U.S.-based assets more rapidly that U.S. persons are increasing ownership of foreign assets. These ownership claims by foreigners take the form of directly controlled assets and portfolio assets, with portfolio assets the dominant share. As discussed in Section II, SWFs make portfolio and directly controlled investments. In this respect, SWFs are making investment choices similar to other private foreign investors in U.S. assets.

II. SOVEREIGN WEALTH FUNDS

A. Background Information

This section provides background information on SWFs, including common definitions of a SWF, the largest SWFs, the size of SWF assets in relation to other major sources of investment capital, and the principal non-tax policy concerns raised by SWF investment. The staff of the Joint Committee on Taxation has consulted multiple publicly available sources of data about SWFs but has not conducted independent research to verify the accuracy of the data presented below.

During the second half of 2007 and in early 2008, SWFs based in Asian and Middle Eastern countries made a series of significant investments in United States financial institutions. These investments have attracted considerable attention, both in the financial and mainstream media and among policymakers in Congress and the Administration. The Senate Committee on Banking, Housing, and Urban Affairs ("Senate Banking Committee") has held two hearings on SWF investment in the United States, one in November 2007 and one in April 2008.[13] In February 2008 the Joint Economic Committee held a hearing on the same topic.[14] More recently, the Senate Committee on Foreign Relations convened a hearing on foreign relations issues related to SWF activities.[15] At the request of Senator Richard Shelby, ranking member of the Senate Banking Committee, the Government Accountability Office is conducting an investigation into the size and scope of SWFs, whether SWF investment in the United States is effectively monitored, and the application of existing U.S. law to that investment.[16] The International Monetary Fund ("IMF") and Organisation of Economic Co-operation and Development ("OECD") have also undertaken significant policy initiatives in response to the rapid growth of SWFs in recent years.

SWF defined

There is no single, widely agreed upon definition of a SWF. Broadly speaking, however, SWFs are actively managed, government-owned pools of capital originating in foreign exchange

[13] U.S. Senate Committee on Banking, Housing, and Urban Affairs, "Sovereign Wealth Fund Acquisitions and Other Foreign Government Investment in the U.S.: Assessing the Economic and National Security Implications," Nov. 14, 2007; "Turmoil in U.S. Credit Markets: Examining the U.S. Regulatory Framework for Assessing Sovereign Investments," Apr. 24, 2008.

[14] U.S. Congress, Joint Economic Committee, "Do Sovereign Wealth Funds Make the U.S. Economy Stronger or Pose National Security Risks," Feb. 13, 2008.

[15] U.S. Senate Committee on Foreign Relations, "Sovereign Wealth Funds: Foreign Policy Consequences in an Era of New Money," June 11, 2008.

[16] See "Proliferation of Multibillion-Dollar Foreign Investments in US Banks Raises Concerns," International Herald Tribune, Jan. 15, 2008.

assets. Two more specific definitions developed by the U.S. Department of the Treasury and the IMF focus, respectively, on the sources and objectives of SWF investment.

The Treasury Department has described SWFs as government investment vehicles that are funded by foreign exchange assets and that are managed separately from official reserves.[17] The Treasury Department divides SWFs into two categories based on the source of a fund's foreign exchange assets. One category is composed of commodity funds, and the other category is composed of non-commodity funds. A commodity fund's assets are generated by exports of commodities owned or taxed by the government (for example, state-owned crude oil). A non-commodity fund's assets are produced by transfers from the government's official foreign exchange reserves. These transfers have been made possible by large current account surpluses in non-commodity exporting countries, Asian countries in particular. A distinction between SWFs and traditional reserve assets, according to the Treasury Department, is that SWFs typically are invested in assets that have higher expected rates of return than are the traditional reserves.

Like the Treasury Department, the IMF defines SWFs as government-owned investment funds established for a variety of purposes and funded by foreign exchange assets. The IMF, however, distinguishes among SWFs based on the funds' objectives.[18] The IMF has identified five categories of SWFs. Stabilization funds are intended to insulate an economy against commodity price changes. Savings funds invest capital from nonrenewable commodity assets in diversified portfolios designed to benefit future generations. Reserve investment corporations are funded by assets that are counted as official reserve assets, and those assets are invested in a manner intended to increase returns above ordinary returns on reserves. Development funds are established to promote socio-economic projects or industrial policies intended to increase a country's economic growth. Contingent pension reserve funds are organized to satisfy contingent government pension liabilities (from sources other than individual pension contributions).[19]

---

[17] U.S. Department of the Treasury, Office of International Affairs, Semiannual Report on International Economic and Exchange Rate Policies, June 2007, Appendix 3: Sovereign Wealth Funds.

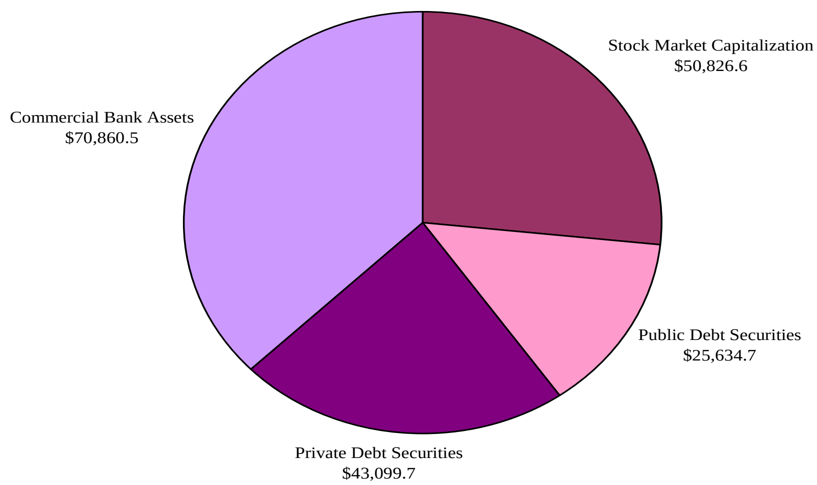
[18] International Monetary Fund, Monetary and Capital Markets Policy Development and Review Departments, "Sovereign Wealth Funds – A Work Agenda" 4-6 (Feb. 29, 2008) [hereinafter IMF Work Agenda].

[19] Observers classify some but not all government pension funds as SWFs. A report published by the OECD divides government pension funds (which it refers to as "public pension reserve funds" or "PPRFs" rather than as contingent pension reserve funds) into two categories, social security reserve funds ("SSRFs") and sovereign pension reserve funds ("SPRFs"). In this categorization, an SSRF is part of a government's overall social security system and is funded by payroll taxes, and an SPRF is established by the government but is completely apart from the government's social security system and instead is funded by direct fiscal transfers by the government. Unlike SSRFs, SPRFs are organized to finance public pension expenditures at a designated future date and in some cases are not permitted to make payouts for decades. SPRFs established for future pension expenditures may, in this view, be considered SWFs. A prominent example of an SPRF that is widely considered to be an SWF is Norway's

Existing SWFs

According to various publicly available data sources, the size of SWF holdings is large in absolute terms and in comparison with the size of global hedge fund and private equity fund holdings but is small relative to the amount of assets managed by private institutional investors and relative to the amount of financial assets worldwide. Based on information available as of February 2008, the IMF has estimated that the amount of total assets under management by SWFs ranges from $2.093 trillion to $2.968 trillion.[20] A more recent study by analysts at JP Morgan Chase Bank estimates SWF assets under management at the end of 2007 as in the range of $3.0 trillion to $3.7 trillion.[21] By comparison, global financial assets (bonds, equities, and bank assets) in 2006 amounted to $190 trillion.[22] The chart below shows the composition of these financial assets.

Figure 11.–Global Capital Markets, 2006
U.S. Dollars in Billions



Source: International Monetary Fund, "Global Financial Stability Report" 139 (Oct. 2007).

Government Pension Fund - Global. Adrian Blundell-Wignall, Yu-Wei Hu, & Juan Yermo, "Sovereign Wealth Fund and Pension Issues," Financial Market Trends, OECD (2008).

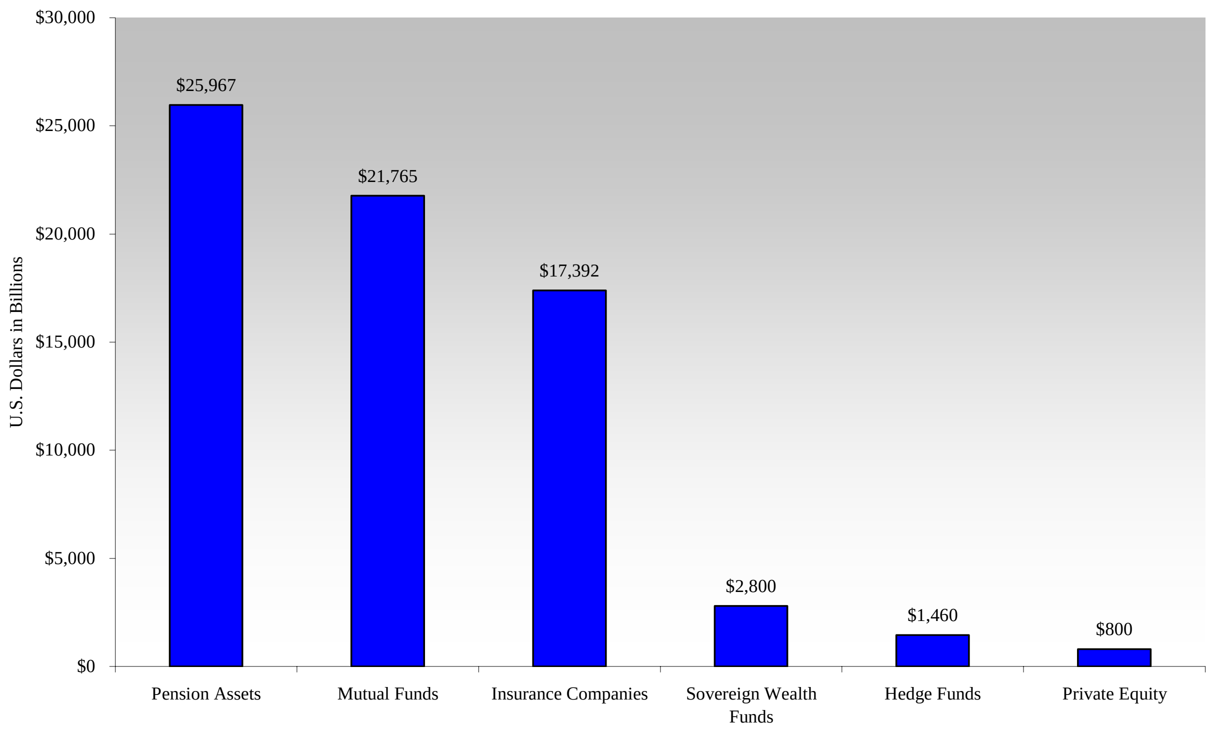
[20] IMF Work Agenda at 7.

[21] David G. Fernandez & Bernhard Eschweiler, JP Morgan Research, "Sovereign Wealth Funds: A Bottom-Up Primer" 7 (May 22, 2008) [hereinafter JP Morgan Report].

[22] International Monetary Fund, "Global Financial Stability Report" 139 (Oct. 2007).

The amount of SWF assets is dwarfed by the amount of assets held in insurance, mutual funds, and pensions, but is greater than the amount of assets managed by private equity firms and hedge funds. The chart below provides a comparison.[23]

Figure 12.–Global Assets Under Management, 2006



Source: International Financial Services, London. The $800 billion estimate for private equity is as of 2007, not 2006.

Although SWFs are small relative to overall global financial assets and in comparison with certain classes of assets, commentators have projected that SWF assets will grow rapidly. According to the IMF, foreign assets under SWF management could increase to $6 trillion to $10 trillion by 2013.[24] The recent JP Morgan study mentioned previously makes roughly similar

[23] The data in the chart are from the following reports of International Financial Services, London: Pension Markets 2008, Jan. 2008, available at http://www.ifsl.org.uk/upload/PB_Pension_markets_2008.pdf; Fund Management 2007, Oct. 2007, available at http://www.ifsl.org.uk/upload/CBS_Fund_Management_2007.pdf; Sovereign Wealth Funds 2008, Mar. 2008, available at http://www.ifsl.org.uk/upload/CBS_Sovereign_Wealth_Funds_2008.pdf; and Hedge Funds 2007, Apr. 2007, available at http://www.ifsl.org.uk/upload/CBS_Hedge_Funds_2007.pdf.

[24] IMF Work Agenda at 6.

projections, ranging from $5.0 trillion to $9.3 trillion in 2012.[25] The chief currency economist at Morgan Stanley has forecast that SWF assets could reach $12 trillion by 2015 and could surpass the amount of official foreign currency reserves by 2011.[26] A Standard Chartered Bank projection has found that SWF assets could total $13.4 trillion within the next decade.[27]

With limited exceptions, the largest SWFs are held by commodity exporting countries and by Asian countries with large current account surpluses. The following table shows the largest SWFs and estimates of the amount of assets managed by the funds.[28] This table is based on publicly-available data the accuracy of which has not been independently verified by the staff of the Joint Committee on Taxation.

---

[25] JP Morgan Report at 11.

[26] Stephen Jen, Morgan Stanley Global Economic Forum, "How Big Could Sovereign Wealth Funds Be By 2015," available at http://www.morganstanley.com/views/gef/archive/2007/20070504-Fri.html#anchor4840.

[27] Gerard Lyons, Standard Chartered Bank, "State Capitalism: the Rise of Sovereign Wealth Funds" 5 (Oct. 15, 2007).

[28] No Latin American country appears in the table. According to the IMF, Venezuela has a SWF, the Macroeconomic Stabilization Fund, with $800 million in assets, and Chile has two SWFs, the Economic and Social Stabilization Fund and the Pension Reserve Fund, with $14.9 billion and $1.5 billion in assets, respectively. IMF Work Agenda at 7. A recent news article reports that the government of Brazil intends to organize a SWF with assets generated by newly discovered coastal oil reserves in the South Atlantic Ocean. The fund could have as much as $200 billion to $300 billion in three to five years and is intended to limit inflation and to prevent the Brazilian currency from becoming overvalued. Jonathan Wheatley & Richard Lapper, "Brazil in $200bn Sovereign Fund Plan," Financial Times, June 9, 2008, at 6.

Table 2.–Largest SWFs

FUND	Assets (Dollars in Billions)
Abu Dhabi Investment Authority	$650 - $700[1]
Norway Government Pension Fund Global	$382[2]
Saudi Arabia Public Investment Fund	$289 - $380[3]
Singapore Government Investment Corporation	$100 - $330[4]
Kuwait Reserve Fund for Future Generations/General Reserve Fund	$225[5]
China Investment Corporation	$200[6]
Russia Reserve Fund/National Wealth Fund	$162[7]
Singapore Temasek Holdings	$108[8]
Australian Future Fund	$57[9]
Libyan Investment Corporation	$50[10]
Algeria Reserve Fund/Revenue Regulation Fund	$43[11]
Qatar State Reserve Fund/Stabilization Fund	$30 - $50[12]
Alaska Permanent Fund	$37[13]

1 Landon Thomas Jr., "Cash-Rich, Publicity-Shy, Abu Dhabi Fund Draws Scrutiny," New York Times, Feb. 28, 2008, at C1 (citing bankers, former employees, and analysts familiar with the fund). A widely cited estimate is that the Abu Dhabi Investment Authority may have as much as $875 billion in assets under management. See Stephen Jen, Morgan Stanley Research, "Sovereign Wealth Funds" 8 (Mar. 2008) [hereinafter Morgan Stanley SWF Estimates]. Jen called this figure and figures for other funds his "guesstimates as of February 2008."

2 Norges Bank, available at http://www.norges-bank.no/Pages/Article____41397.aspx?print=true. The $382 billion amount was the size of the fund on March 31, 2008 based on the U.S. dollar-Norwegian krone exchange rate on that day. The Norwegian government's revised national budget for 2007 forecasts that the fund will grow to $484 billion by January 1, 2009 (based on the March 31, 2007 exchange rate). *Id.*

3 The Saudi Arabian capital consists of the government's official foreign exchange reserves and therefore is considered under some definitions (such as the Treasury Department's) not to be a SWF. The $289 billion figure is from IMF Work Agenda at 7. The $380 billion number is from Andrew England, "Saudis to Launch $5.3 Billion Sovereign Fund," Financial Times, Apr. 28, 2008. England notes that the Public Investment Fund is forming a SWF that will be managed separately from the government's official reserves and will make portfolio investments similar to those undertaken by other SWFs.

4 The web site of the Government Investment Corporation states that the company manages "well above US$100 billion." See http://www.gic.com.sg/aboutus.htm. The $330 billion estimate is from Morgan Stanley SWF Estimates.

5 Reuters, Factbox, "Kuwait's KIA: History, Holdings, and Strategy," Jan. 15, 2008, available at http://www.reuters.com/articlePrint?articleID=USL1517206420080115.

6 "China Launches US$200 Billion Government Investment Fund," International Herald Tribune, Sept. 28, 2007.

7 Gregory L. White, Bob Davis, and Marcus Walker, "Russian Fund Rattles West," Wall Street Journal, May 7, 2008, at A1.

8 Temasek Holdings, http://www.temasek.com.sg. The $108 billion amount is as of March 31, 2007 and is calculated using the Singapore dollar-U.S. dollar exchange rate on that day.

9 Australian Government Future Fund, http://www.futurefund.gov.au. The $57 billion amount is as of April 30, 2008 and is calculated using the Australian dollar-U.S. dollar exchange rate on that day.

10 IMF Work Agenda at 7.

11 *Id.*

12 *Id.*

13 Alaska Permanent Fund, http://www.apfc.org.

B. Recent Prominent SWF Investments in the United States

In the midst of a weak economy, a serious downturn in the housing market, and severe credit market problems, U.S. firms received a large volume of investments from abroad in 2007, in significant part from SWFs.[29] According to news reports, foreign investors invested $414 billion in 2007 in U.S. companies, including both private deals and purchases of publicly-traded stock.[30] SWFs accounted for at least $21.5 billion of that investment.

Much of this SWF investment was in U.S. financial institutions, and a large portion of that financial institution investment occurred in a series of high-profile transactions announced in November and December 2007.[31] Two large transactions also were announced in January 2008. On November 26, Citigroup Inc. announced that Abu Dhabi Investment Authority was investing $7.5 billion for a 4.9 percent stake in the company.[32] On December 19, Morgan Stanley announced that the China Investment Corporation would pay $5 billion for a 9.9 percent share of the company.[33]

Five days later, Merrill Lynch & Co. Inc., Inc. announced it was selling up to $6.2 billion in stock to Singapore's Temasek Holdings and Davis Selected Advisers.[34] Temasek's share of the deal was a $4.4 billion initial stock purchase plus an option to buy $600 million in additional stock by March 28.[35]

---

[29] Peter S. Goodman & Louise Story, "Overseas Investors Buy Aggressively in U.S.," New York Times, Jan. 20, 2008, at A1.

[30] *Id.*

[31] Non-U.S. financial firms also received SWF investment. The largest announced transaction was a $9.7 billion investment in Swiss bank UBS AG by the Government of Singapore Investment Corporation. Mark Landler & Julia Werdigier, "UBS Records a Big Write-Down and Sells a Stake," New York Times, Dec. 11, 2007, at C1. The $9.7 billion investment represented a nine percent stake in UBS. An unnamed Middle Eastern investor also made a $1.8 billion investment in the bank.

[32] See Citigroup Inc., Current Report on Form 8-K, filed with the Securities Exchange Commission on November 27, 2007, available at http://www.sec.gov/Archives/edgar/data/831001/000114420407064349/v095633_ex99-1.htm.

[33] See Morgan Stanley, Current Report on Form 8-K, filed with the Securities Exchange Commission on December 27, 2007, available at http://www.sec.gov/Archives/edgar/data/895421/000115752307012287/a5568797ex991.htm.

[34] See Merrill Lynch & Co. Inc., Current Report on Form 8-K, filed with the Securities Exchange Commission on December 27, 2008, available at http://www.sec.gov/Archives/edgar/data/65100/000095012307017127/y45445exv99w1.htm.

[35] *Id.*

On January 15, 2008, two large deals were announced: Citigroup Inc. announced that it would receive $12.5 billion from a group of investors including the Government of Singapore Investment Corporation Pte. Ltd. and the Kuwait Investment Authority, and Merrill Lynch & Co., Inc. received $6.6 billion from a group that includes the Kuwait Investment Authority and the Korean Investment Corporation.[36]

The structures of the recent SWF investments in U.S. financial institutions, and their U.S. federal income tax consequences, are described in Section IV below.

One recent analysis identified 420 publicly-reported equity investments made by SWFs since 2000, totaling $114 billion.[37] Of these investments, 87 percent involved purchasing equity interests of 10 percent or greater in the target company. Both this recent analysis and other news reports emphasize, however, that SWF equity investments in the United States may involve less visible stakes. Some recent news reports, for example, have concluded that SWFs, fearing losses on financial institution investments and concerned about political backlash in recipient countries, have been reluctant to make highly publicized investments and have instead engaged in lower-profile activity such as investment through private equity funds.[38] The lower-profile activity has included equity investment in a fund that bought distressed mortgage debt from UBS; acquisitions of stakes in U.S. real estate investment trusts; and possible direct investment in U.S. real estate by the Kuwait Investment Authority, the Qatar Investment Authority and other SWFs.[39] In this vein, the recent JP Morgan report referred to above forecasts that SWFs will allocate increasingly large amounts of capital to alternative investment vehicles such as private equity funds and hedge funds and by the end of 2012 could account for as much as 17 percent of

---

[36] See Citigroup Inc., Current Report on Form 8-K, filed with the Securities Exchange Commission on January 15, 2008, available at http://www.sec.gov/Archives/edgar/data/831001/000110465908002663/a08-1948_1ex99d1.htm; Merrill Lynch & Co., Inc., Current Report on Form 8-K, filed with the Securities Exchange Commission on January 15, 2008, available at http://www.sec.gov/Archives/edgar/data/65100/000095012308000429/y46693exv99w1.htm.

[37] William Miracky *et al*, Monitor Group, "Assessing the Risks: The Behaviors of Sovereign Wealth Funds in the Global Economy" (June 2008). See also Bob Davis, "Sovereign-Wealth Funds Seek Control," Wall Street Journal, June 6, 2008, at C2.

[38] Henny Sender, "Sovereign Funds Fuel Black Rock's UBS Deal," Financial Times, May 31, 2008, at 1 [hereinafter FT, Black Rock]; Henny Sender, "Temasek Refused to Rescue Bear Days Before its Sale to Morgan," Financial Times, June 5, 2008, at 1.

[39] FT, Black Rock. A very recent article reports on negotiations over a higher profile real estate acquisition – the possible $800 million purchase of a 90-percent stake in the Chrysler Building in New York by the Abu Dhabi Investment Corporation. See Daniel Pimlott, "Abu Dhabi Fund Sets Sights on Chrysler Building," Financial Times, June 12, 2008, at 19. In May, real estate developer Harry Macklowe agreed to sell the General Motors Building and three other New York buildings for $3.95 billion to Boston Properties and investors that were expected to include the Kuwait Investment Authority and the Qatar Investment Authority. See Daniel Pimlott & Justin Baer, "Macklowe Sells GM Building," Financial Times, May 25, 2008.

the amount of capital in those alternatives.[40] A very recent example of this investment is the reported agreement by China's State Administration of Foreign Exchange (which oversees most of China's $1.6 trillion in official foreign exchange reserves) to invest more than $2.5 billion in a fund sponsored by the private investment firm Texas Pacific Group, Inc.[41]

---

[40] JP Morgan Report at 16.

[41] Henny Sender, "$2.5bn China Investment in TPG Could Be Private Equity Landmark," Financial Times, June 11, 2008, at 1.

C. Non-Tax Policy Concerns Raised by SWFs

SWFs have emerged as prominent participants in global finance. Some of the funds provide little information to the public about their holdings, investment strategy and performance, management, or size, while others are more transparent.[42] The prominence of SWFs and their lack of uniform information disclosure have caused policymakers to express three related concerns about the effects of SWF investment in the United States and in other countries that receive SWF investment. These concerns are described below.[43]

Political objectives

The lack of transparency regarding SWF investment activities has given rise to a concern that the funds may pursue objectives that are not strictly commercial. Although SWFs have stated investment goals – for example, fiscal stabilization or saving for future generations – because they are instruments of sovereign nations, it is possible that they will consider foreign policy goals as well when making foreign investments. Governments might see opportunities to use large pools of capital managed by SWFs to secure access to strategic assets such as natural resources or defense-related technologies. Policymakers therefore have stated that SWFs might pose perceived or actual problems for national security in the United States and other countries that receive SWF investment.[44]

---

[42] See IMF Work Agenda at 8. The Norway Government Pension Fund Global is widely seen as very transparent, while the Abu Dhabi Investment Authority is considered opaque. For an evaluation of how much information various SWFs provide, see Gerard Lyons, Standard Chartered Bank, "State Capitalism: the Rise of Sovereign Wealth Funds" 7-8 (Oct. 15, 2007). The president and chief investment officer of the China Investment Corporation, which has been viewed as secretive, has indicated that the corporation is attempting to become more transparent. John Thornhill, "Chinese Fund Tries to Calm West's Fears," Financial Times, June 4, 2008.

[43] Reports in the mainstream media also have described private and official expressions of concern. See, e.g., "The World's Most Expensive Club," The Economist, May 26, 2007, at 40; "Sovereign Wealth Funds: Asset-Backed Insecurity," The Economist, Jan. 17, 2008, at; Gregory L. White, Bob Davis, & Marcus Walker, "Russian Wealth Fund Rattles West," Wall Street Journal, May 7, 2008, at A1.

[44] See, e.g., Under Secretary for International Affairs David H. McCormick, testimony before the Joint Economic Committee, Feb. 13, 2008, press release HP-823, available at http://www.treas.gov/press/releases/hp823.htm [hereinafter McCormick JEC Testimony]; U.S. Department of the Treasury, Office of International Affairs, Semiannual Report on International Economic and Exchange Rate Policies, Dec. 2007, Appendix 2: Sovereign Wealth Funds, at 2 [hereinafter Treasury Seminannual Report]; Organisation for Economic Co-operation and Development, Investment Committee Report, "Sovereign Wealth Funds and Recipient Country Policies" 2-3 (Apr. 4, 2008) [hereinafter OECD Recipient Country Report]; IMF Work Agenda at14-15.

Effects on markets and governance

SWFs have large amounts of capital, often seek long-term rather than short-run returns, and, by contrast with hedge funds and other private investment vehicles, to date have not relied on extensive leverage. Consequently, they are well-positioned to increase stability in financial markets, particularly in times of market stress. Policymakers have recognized this stabilizing role,[45] a role evident in connection with the significant SWF investments in U.S. financial institutions made in late 2007 and early 2008 (described in Section II.C. above) at a time when credit concerns were acute.

Although SWFs recently have helped stabilize markets, policymakers have expressed concern that because of their sheer size, SWFs could invest in ways that cause volatility in markets and disruptions in economies.[46] Even rumors of SWF transactions could cause market volatility as other participants react to news.[47] Policymakers also have argued that SWFs might be able to use their status as instrumentalities of governments to compete unfairly with private actors, perhaps through explicit or perceived government guarantees of their financial commitments.[48] There has, however, been little or no evidence that SWFs have caused market volatility or economic disruptions or have gained unfair competitive advantages.[49]

The form of SWF investments also has raised concerns relating to corporate governance. Where SWFs take large but purely passive stakes in portfolio companies, and, perhaps because of concern about hostile responses to perceived SWF activism, choose not to exercise voting right or other mechanisms of shareholder control, governance of the portfolio companies could be weakened.[50]

Finally, SWF investment activities may have global macroeconomic effects involving monetary conditions, balance of payments, and stability of current and capital accounts. These effects have been described elsewhere.[51]

---

[45] McCormick JEC Testimony; Treasury Semiannual Report, at 2; IMF Work Agenda, at 12-13.

[46] See, e.g., McCormick JEC Testimony; Treasury Semiannual Report, at 2-3; IMF Work Agenda, at 13.

[47] *Id.*

[48] See IMF Work Agenda at 15.

[49] But see news reports about the Norway Government Pension Fund Global selling short Icelandic bank bonds and causing protest in Iceland. "Sovereign Wealth Funds: Asset-Backed Insecurity," The Economist, Jan. 17, 2008, at 12.

[50] IMF Work Agenda, at 15.

[51] *Id.* at 10-12.

Protectionist reactions

SWFs' perceived or actual strategic behavior and their potential effects on markets has prompted concern among policymakers that the United States and other countries that receive SWF investments might consider adopting broad protectionist financial markets policies.[52] Restrictions on foreign investment in the United States could have harmful effects on the economy and foreign relations.

Economic harm would be possible because the United States relies on foreign capital.[53] As described in Section I, the United States is a net importer of goods and services. It must pay for those goods and services by attracting foreign capital. This foreign capital either finances consumption or is used for investment in the United States. Restrictions on foreign capital could result in decreased current or future living standards in the United States. Living standards could be reduced if, among other possible scenarios, a continued low U.S. savings rate and reductions in foreign investment resulted in less total investment in the United States and a reduction in the rate of growth of U.S. productivity.

Restrictions on foreign capital could damage foreign relations as well as the U.S. economy. Restrictions could prompt U.S. trading partners to adopt their own protectionist policies. These protectionist policies would exacerbate economic and political harms.

[52] See, e.g., McCormick JEC Testimony; Treasury Semiannual Report, at 2; OECD Recipient Country Report.

[53] Economic harm could occur even if the United States were a net capital exporter. Retaliation by foreign governments in the form of investment restrictions could reduce income growth in the United States if otherwise available foreign investment opportunities were foreclosed.

D. Non-Tax Policy Responses

Countries that receive SWF investments and countries that have SWFs in recent months have extensively discussed the non-tax policy issues related to SWF investment. Although few countries have adopted rules that specifically address the treatment of foreign government investment,[54] there have been numerous unilateral expressions of policy views.[55] In addition, the OECD has recently developed guidance on recipient country policies toward SWF investment, and the IMF has undertaken a project to develop guidance on best practices for SWFs. These efforts are described below. First, existing U.S. rules and recent U.S. policy responses are summarized.

U.S. rules and recent activity

In the United States, rules of general application in various substantive areas may apply to investments by SWFs. These rules include securities regulations; rules applicable to regulated financial industries such as banking and insurance; antitrust laws; and market structure and behavior rules in strategic industries such as defense, energy, media, and telecommunications.[56]

More targeted rules apply to U.S. investment by foreign persons. In particular, the Committee on Foreign Investment in the United States ("CFIUS"), which is chaired by the Treasury Department, reviews certain foreign direct investments in the United States, including investment by SWFs, that raise national security issues. CFIUS review has been made more stringent by the Foreign Investment and National Security Act of 2007 ("FINSA").[57] Among other changes, FINSA (1) formally establishes CFIUS by statute (whereas previously, CFIUS had existed only by executive order) and specifies certain high-ranking government officials (such as the Attorney General and the Secretaries of Homeland Security, Commerce, Defense,

[54] The OECD has found that four of the 30 OECD members have laws restricting foreign government controlled investment. Several member countries have broad investment review procedures that may consider foreign government control as a relevant factor. Two member countries specifically list this control as a criterion in investment review procedures. One member country considers foreign government control to be a relevant factor in antitrust reviews of proposed mergers. OECD Recipient Country Report, p. 4. For a general discussion of the rules in selected jurisdictions governing foreign investment, including an overview of the U.S. rules, see U.S. Government Accountability Office, Report to the Honorable Richard Shelby, Ranking Member, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, "Foreign Investment: Laws and Policies Regulating Foreign Investment in 10 Countries (GAO-08-320), Feb. 2008.

[55] For a summary of recent policy expressions by American and European officials, see Martin A. Weiss, "Sovereign Wealth Funds: Background and Policy Issues for Congress," CRS Report for Congress, Mar. 26, 2008, at 15-18.

[56] See Alan W. Granwell & Akemi Kawano, "Sovereign Wealth Funds: Tell Me More . . . and More" (slide presentation), American Bar Association Section of Taxation, May Meeting, Washington, DC, May 9, 2008.

[57] Pub. L. No. 110-49, July 26, 2007.

State, and Energy) as members of CFIUS; (2) formalizes a CFIUS national security review process for any transaction that might result in foreign control of persons engaged in interstate commerce in the United States; (3) provides, as part of the formal review process, a 30-day CFIUS review of any covered transaction to determine the effects of the transaction on national security and to address any threat to national security; (4) subject to certain exceptions, requires an additional 45-day investigation in certain cases, including when a transaction involves a foreign government controlled company or would result in foreign control over critical infrastructure; (5) requires that certain high-level officials certify to Congress that for any transaction for which CFIUS has completed a review, CFIUS has determined there are no unresolved national security concerns; (6) adds to the list of factors that CFIUS should consider in its reviews and investigations the potential effect a transaction could have on critical infrastructure, energy assets, or critical technologies; and (7) requires annual reporting to Congress on the activities of CFIUS, including information about the transactions that have been reviewed during the preceding 12 months. In April 2008 the Treasury Department issued proposed rules to implement FINSA.[58] Among other rules, these regulations define control in functional terms as the ability to exercise certain powers over important matters affecting a business, and they provide that a foreign person does not control an entity if it owns 10 percent or less of the voting interest in the entity and holds the interest solely for the purpose of investment.

On March 19, 2008 the Treasury Department reached an agreement with the governments of Singapore and Abu Dhabi on policy principles for SWFs and for countries receiving SWF investment.[59] These principles are intended to support the OECD and IMF initiatives described below. For SWFs, the principles include basing investment decisions only on commercial grounds; greater information disclosure; strong governance structures; fair competition with the private sector; and respect for host-country rules. For recipient countries, the principles include avoidance of protectionist barriers to portfolio or direct investment; predictable investment frameworks; nondiscrimination among investors; lack of intrusion into investor decisions; and a narrow scope for restrictions based on national security concerns.

In public statements, Treasury Department and other government officials have emphasized the general importance of keeping the United States open to foreign investment and, more specifically, the receptiveness of the United States to SWF investment.[60]

---

[58] Regulations Pertaining to Mergers, Acquisitions, and Takeovers by Foreign Persons, 73 Fed. Reg. 21861-02 (Apr. 23, 2008).

[59] See "Treasury Reaches Agreement on Principles for Sovereign Wealth Fund Investment with Singapore and Abu Dhabi," press release HP-881, Mar. 20, 2008, available at http://www.treas.gov/press/releases/hp881.htm. See also U.S. Department of the Treasury, Office of International Affairs, "Semiannual Report on International Economic and Exchange Rate Policies," May 2008, Appendix: Sovereign Wealth Funds.

[60] E.g., McCormick JEC Testimony. In a Treasury Department press release announcing the agreement with the Abu Dhabi and Singapore governments, Treasury Secretary Henry M. Paulson, Jr. is quoted as saying, "The U.S. welcomes sovereign wealth fund investment."

OECD guidance on recipient country policies

In the fall of 2007 the G7 Finance ministers and the other OECD member countries asked the OECD to develop guidance for recipient countries' policies toward SWF investment. The OECD has responded to this request by undertaking work through the OECD Investment Committee's ongoing project entitled, "Freedom of Investment, National Security, and 'Strategic' Industries." Discussions under the Freedom of Investment project occur three times a year. One of the discussions in the next year will include a session on government-controlled investors.

In April, the Investment Committee issued a report that describes agreed principles for recipient countries' treatment of SWF investment.[61] The report acknowledges recipient countries' concerns about national security, but it catalogs the potential economic benefits of SWFs for home and recipient countries. The agreed principles for the treatment of SWF investment are based on established and more broadly applicable OECD investment policy principles. In brief, the principles are the following:

- Non-discrimination: This principle calls on governments to provide measures of general application that treat similarly situated investors in a similar manner. Any measures taken to address national security concerns raised by individual investments should be narrowly tailored.

- Transparency and predictability: Regulatory goals and practices should be as open as possible so that outcomes are predictable. Transparency includes, among other features, codification and easy accessibility of rules and regulations; public notice of intended changes in investment policies; consultation with interested parties when governments are considering policy changes; time limits on review of foreign investments; and public disclosure of investment policy actions.

- Regulatory proportionality: Investment restrictions and conditions on transactions should be no broader than necessary to protect national security and should be avoided when other measures can address security concerns.

IMF work on SWF best practices

In October 2007, the IMF's International Monetary and Financial Committee ("IMFC") asked the IMF to establish a dialogue on identifying a set of best practices for the management of SWFs.[62] The IMF has since taken several steps toward the goal of producing best practices guidelines. In November 2007 the IMF convened a "Roundtable of Sovereign Asset and

---

[61] OECD Recipient Country Report. The existing principles are embodied in two OECD investment documents, the OECD Code of Liberalisation of Capital Markets (1961) and the OECD Declaration on International Investment and Multinational Enterprises (1976, revised 2000).

[62] Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund, Oct. 20, 2007.

Reserve Managers" that was attended by representatives of central banks, finance ministries, and SWFs from 28 countries. The roundtable included a discussion of policy, institutional, and operational issues related to SWFs. A February 2008 IMF paper sets forth an agenda for developing best practices.[63] At a March meeting the IMF Executive Board conducted its first policy discussion of SWFs and approved the agenda.[64] The agenda calls for the establishment of an international working group of SWFs and an April 2008 roundtable to start technical discussions and drafting work related to best practices guidelines. This international working group (the "IWG") was organized, and the roundtable was held on April 30 and May 1, 2008. The IWG is comprised of representatives from 25 IMF member countries, and one of the co-chairmen is an official with the Abu Dhabi Investment Authority.[65] According to the agenda approved in March, a draft of best practices could be prepared by August 2008 for discussion over the following two months and could be submitted to the Executive Board for discussion in advance of the IMF's 2008 annual meeting.

[63] IMF Work Agenda.

[64] IMF Survey Magazine: In the News, "IMF Board Endorses Work Agenda on Sovereign Funds," Mar. 21, 2008, available at http://www.imf.org/external/pubs/ft/survey/so/2008/NEW032108A.htm.

[65] International Monetary Fund, "International Working Group of Sovereign Wealth Funds is Established to Facilitate Work on Voluntary Principles," Press Release No. 08/97, May 1, 2008, available at http://www.imf.org/external/np/sec/pr/2008/pr0897.htm.

III. CURRENT U.S. INCOME TAX RULES

A. U.S. Income Taxation of Foreign Persons

U.S. persons (i.e., citizens and residents) generally are subject to U.S income taxation on their worldwide income, without regard to whether the income is U.S. or foreign source. In contrast, foreign persons (i.e., nonresident alien individuals or foreign corporations) are taxable only on (i) U.S.-source income and limited categories of foreign-source income that is effectively connected with the conduct of a U.S. trade or business and (ii) other U.S.-source income that is fixed or determinable annual or periodic ("FDAP") income.

The Code provides rules for determining the source of income.[66] For example, interest and dividends paid by a U.S. citizen or resident or by a U.S. corporation generally are considered U.S.-source income. Conversely, dividends and interest paid by a foreign corporation generally are treated as foreign-source income. Special rules apply to treat as foreign-source income (in whole or in part) interest paid by certain domestic corporations with foreign businesses and to treat as U.S.-source income (in whole or in part) dividends paid by certain foreign corporations with U.S. businesses. Rents and royalties paid for the use of property in the United States are considered U.S.-source income.

<u>Income effectively connected with a U.S. trade or business</u>

Income of a foreign person that is effectively connected with the conduct of a trade or business in the United States[67] generally is subject to U.S. tax in the same manner and at the same rates as income of a U.S. person.[68] Deductions are allowed to the extent that they are related to effectively connected income.[69] Generally, only U.S.-source income is treated as effectively connected with the conduct of a U.S. trade or business. However, certain limited categories of foreign-source income are treated as effectively connected if the income is attributable to an office or other fixed place of business maintained by the foreign person in the United States.[70]

---

[66] Secs. 861-863, 865. Unless otherwise provided, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

[67] Partners in a partnership and beneficiaries of an estate or trust are treated as engaged in the conduct of a trade or business within the United States if the partnership, estate, or trust is so engaged. Sec. 875. In addition, the activities of a foreign person's agents may be imputed to the foreign person such that the foreign person will be treated as engaged in a U.S. trade or business. See, e.g., *Lewenhaupt v. Commissioner*, 20 T.C. 151 (1951), *aff'd per curiam*, 221 F.2d 227 (9th Cir. 1955). Whether an agent's activities are imputed to a principal for this purpose depends, to a large extent, on the degree of control the principal exercises over the agent.

[68] Secs. 871(b)(1), 882(a)(1).

[69] Secs. 873(a), 882(c)(1)(A).

[70] Sec. 864(c)(4).

The Code includes provisions intended to ensure that a foreign corporation operating a U.S. trade or business in branch form is subject to two levels of U.S. income tax, just as a foreign corporation operating a U.S. trade or business as a domestic subsidiary would be. Thus, a foreign corporation is subject to a flat 30-percent branch profits tax on its "dividend equivalent amount," which is a measure of the effectively connected earnings and profits of the corporation that are removed in any year from the conduct of its U.S. trade or business.[71] In addition, a foreign corporation is subject to a flat 30-percent branch-level excess interest tax on the excess of the amount of interest that is deducted by the foreign corporation in computing its effectively connected income over the amount of interest that is paid by its U.S. trade or business.[72]

The question whether a foreign person is engaged in a U.S. trade or business has generated a significant body of case law. Basic issues involved in the determination include whether the activity constitutes business rather than investing, whether sufficient activities in connection with the business are conducted in the United States, and whether the relationship between the foreign person and persons performing functions in the United States with respect to the business is sufficient to attribute those functions to the foreign person.

Income from disposition of U.S. real property interests

Special U.S. tax rules apply to gains and losses of foreign persons attributable to dispositions of interests in U.S. real property.[73] For this purpose, U.S. real property includes both (a) an interest in real property located in the United States or the Virgin Islands and (b) an interest in a U.S. real property holding corporation ("USRPHC").[74] An interest in a USRPHC is an interest in a domestic corporation in which the value of its U.S. real property interests is equal to at least 50 percent of the value of the sum of its worldwide real property interests and its other assets used or held for use in its trade or business.

In effect, the FIRPTA rules treat the ownership of U.S. real property interests as a U.S. trade or business. Thus, these rules generally provide that gain or loss of a foreign person from the disposition of a U.S. real property interest is taken into account for U.S. tax purposes as if such gain or loss were effectively connected with a U.S. trade or business during the taxable year.[75] Accordingly, foreign persons generally are subject to U.S. tax on any gain from a

---

[71] Sec. 884(a).

[72] Sec. 884(f).

[73] The rules governing the imposition and collection of tax on such dispositions are contained in a series of provisions that were enacted in 1980 and that are collectively referred to as the Foreign Investment in Real Property Tax Act ("FIRPTA"). Secs. 897, 1445, 6039C, 6652(f). Prior to the enactment of the FIRPTA provisions, foreign persons could invest in U.S. real property without being subject to U.S. income tax upon the eventual disposition of such property.

[74] Sec. 897(c)(1).

[75] Sec. 897(a).

disposition of a U.S. real property interest at the same rates that apply to similar income received by U.S. persons.[76]

Interests in certain real estate investment trusts ("REITs"), which would otherwise constitute USRPHCs, are excluded from the definition of U.S. real property interest.[77] This exception applies if a REIT is domestically controlled (i.e., less than 50 percent of the value of its outstanding stock is held (directly or indirectly) by foreign persons during the relevant testing period—typically, the five-year period ending on the date of the transaction at issue). The consequence of this exclusion is that sales of the REIT interests by foreign persons generally are not subject to U.S. income tax.

A look-through rule provides that any distribution by a qualified investment entity ("QIE"), including a REIT, to a nonresident alien individual, foreign corporation, or other QIE shall, to the extent attributable to gain from sales or exchanges by the QIE of U.S. real property interests, be treated as gain recognized by such nonresident alien individual, foreign corporation, or other QIE from the sale or exchange of a U.S. real property interest.[78] This rule does not apply to any distribution to a nonresident alien individual or a foreign corporation with respect to any class of stock that is regularly traded on an established U.S. securities market if such individual or corporation owns no more than five percent of such class of stock at any time during the one-year period ending on the date of such distribution.

As a general rule, nonrecognition provisions apply under the FIRPTA provisions only in the case of an exchange of a U.S. real property interest for an interest the sale of which would be taxable under the Code (for example, another U.S. real property interest). The Code generally imposes a withholding obligation on the transferee when a U.S. real property interest is acquired from a foreign person.[79]

<u>Income not effectively connected with a U.S. trade or business</u>

A foreign person's FDAP income (including, for example, interest, dividends, rents, royalties, salaries, and annuities) that is not effectively connected with the conduct of a U.S. trade or business is subject to U.S. tax at a rate of 30 percent of the gross amount paid.[80] These rules generally do not apply to gain from the sale, exchange, or other disposition of property.[81]

---

[76] In the case of foreign corporations, the gain from a disposition of a U.S. real property interest may also be subject to the branch profits tax at a 30-percent rate (or a lower treaty rate).

[77] Sec. 897(h)(2).

[78] Sec. 897(h)(1)

[79] Sec. 1445.

[80] Secs. 871(a), 881(a).

[81] See T.D. 8734, 1997-2 C.B. 109, 128 (stating that the "only clear exception" from FDAP is for gain from the disposition of property); see also Treas. Reg. sec. 1.1441-2(b)(2)(i) (excepting such gains

The tax on FDAP income generally is collected by means of withholding by the person making the payment to the foreign person receiving the income.[82] A foreign person's foreign-source income and non-FDAP income, not effectively connected with the conduct of a U.S. trade or business, are not subject to U.S. tax.

Specific statutory exemptions from the 30-percent withholding tax on FDAP income are provided. The most significant of these is the exemption for certain interest paid on portfolio obligations.[83] Portfolio interest generally is defined as any U.S.-source interest (including original issue discount), not effectively connected with the conduct of a U.S. trade or business, (1) on an obligation that satisfies certain registration requirements or specified exceptions thereto, and (2) that is not received by a 10-percent shareholder. This exception is not available for any interest received either by a bank on a loan extended in the ordinary course of its business (except in the case of interest paid on an obligation of the United States), or by a controlled foreign corporation from a related person. Moreover, this exception is not available for certain contingent interest payments.

In addition to the portfolio interest exemption, certain original issue discount and certain interest on deposits with banks or savings institutions are exempt from the 30-percent withholding tax.[84] Original issue discount on obligations maturing in six months or less is also exempt.[85]

An income tax treaty between the United States and a foreign country may reduce or eliminate the 30-percent gross-basis withholding tax on certain payments, including certain dividends and interest. A tax treaty also may permit the United States to tax a foreign person's income from business operations only to the extent the income is attributable to that person's permanent establishment in the United States.

---

from the withholding rules). As noted above, however, gains from the disposition of interests in U.S. real property generally are taxed as effectively connected with the conduct of a U.S. trade or business.

[82] Secs. 1441, 1442.

[83] Secs. 871(h), 881(c).

[84] Secs. 871(i)(2)(A), 881(d).

[85] Sec. 871(g)(1)(B)(i).

B. U.S. Income Taxation of Foreign Governments

The Code exempts from U.S. income tax certain income of foreign governments under section 892 and foreign central banks of issue under section 895. Longstanding regulations provide additional guidance with respect to the scope of these exemptions. U.S. income tax treaties provide additional relief from U.S. income tax in certain circumstances.

<u>History of the exemption</u>

<u>Sovereign immunity principle</u>

It is a well-established principle of international law that one country is immune from the jurisdiction of the courts of another country.[86] The scope of that immunity evolved in the twentieth century from an absolute theory of immunity to a restrictive theory of immunity. Under an absolute theory of immunity, a country enjoys immunity in all cases; under a restrictive theory of immunity, a country is denied immunity in certain cases, such as those arising out of the commercial activities of that country. This evolution in the theory of immunity reflected the fact that governments were increasingly engaging in commercial activities.

The U.S. Supreme Court recognized the principle of sovereign immunity as early as 1812.[87] In *The Schooner Exchange*, the Court stated that each nation has exclusive and absolute jurisdiction within its own territory and that all exceptions thereto must derive from the consent, either express or implied, of that nation. The Court further stated that:

> One sovereign being in no respect amenable to another; and being bound . . . not to degrade the dignity of his nation, by placing himself or its sovereign rights within the jurisdiction of another, can be supposed to enter a foreign territory only under an express license, or in the confidence that the immunities belonging to his independent sovereign station, though not expressly stipulated, are reserved by implication, and will be extended to him.[88]

Throughout the remainder of the nineteenth century and into the twentieth century, U.S. courts generally applied an absolute theory of immunity. In the 1940s, the Supreme Court stated that it was a guiding principle for courts, in determining whether to exercise or surrender

---

[86] See *Restatement (Third) of the Foreign Relations Law of the United States* 390 (1987). This immunity from jurisdiction is not the same as immunity from local law. "In general, unless otherwise provided by special agreement, activities of a foreign state, whether they are 'governmental' or 'commercial' in character, are subject to local law, though as to the former the foreign state is immune from enforcement of that law by domestic courts, administrative bodies, or police action." *Id.* at 439. As a practical matter, immunity from jurisdiction may make it difficult for one state to enforce its local law with respect to another state. However, a state may still give effect to its laws by certain nonjudicial measures, the most widespread of which is withholding of tax. *Id.* at 440; see also *id.* at 325.

[87] *The Schooner Exchange v. McFaddon*, 11 U.S. (7 Cranch) 116 (1812).

[88] *Id.* at 137.

jurisdiction in a case involving a foreign country, that the courts should not act in a way that would embarrass the executive branch in its conduct of foreign affairs.[89] "It is therefore not for the courts to deny an immunity which our government has seen fit to allow, or to allow an immunity on new grounds which the government has not seen fit to recognize."[90]

In 1952, the U.S. Department of State announced that it would follow a restrictive theory of immunity.[91] The Department of State acknowledged that a shift in the policy of the executive branch could not control the judicial branch, but stated that it was the Department's belief "that the courts are less likely to allow a plea of sovereign immunity where the executive has declined to do so."[92] From that point forward, and consistent with the Supreme Court's recognized deference to executive branch authority in this area, a restrictive theory of immunity prevailed in the United States.

The United States statutorily adopted a restrictive theory of immunity with the enactment of the Foreign Sovereign Immunities Act of 1976 ("FSIA").[93] FSIA generally provides that: "Subject to existing international agreements to which the United States is a party at the time of enactment of this Act a foreign state shall be immune from the jurisdiction of the courts of the United States and of the States."[94] Consistent with a restrictive theory of immunity, FSIA further provides that immunity does not apply to a foreign state in any case in which the action is based (i) upon a commercial activity carried on in the United States by the foreign state; (ii) upon an act performed in the United States in connection with a commercial activity of the foreign state elsewhere; or (iii) upon an act outside the territory of the United States in connection with a commercial activity of the foreign state elsewhere and the act causes a direct effect in the United States.[95] Certain other exceptions to immunity are provided, including any case in which rights to immovable property situated in the United States are in issue.[96]

---

[89] *Mexico v. Hoffman*, 324 U.S. 30, 35 (1945); see also *Ex parte Peru*, 318 U.S. 578, 587-88 (1943).

[90] *Mexico*, 324 U.S. at 35.

[91] Letter from Jack B. Tate, Acting Legal Adviser, U.S. Department of State, to Philip B. Perlman, Acting Attorney General, *in* 26 Dep't St. Bull. 984 (1952). The Department of State noted three reasons for this decision: with limited exception, few countries were continuing to follow an absolute theory of immunity; it was inconsistent for the United States to subject itself to suit in U.S. courts while granting immunity to foreign governments; and, as governments increasingly engaged in commercial activities, people doing business with them should be able to utilize the courts to determine their rights.

[92] *Id.* at 985.

[93] Pub. L. No. 94-583, 90 Stat. 2891.

[94] 28 U.S.C. sec. 1604.

[95] *Id.* sec. 1605(a)(2).

[96] *Id.* secs. 1605, 1607.

U.S. income tax provisions

An exemption from U.S. income tax for certain income received by foreign governments first appeared in the War Revenue Act of 1917.[97] That Act exempted from tax "the income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments, or from interest on deposits in banks in the United States of moneys belonging to foreign governments."[98] The provision was modified in 1918 to provide that gross income did not include "[t]he income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments, or from interest on deposits in banks in the United States of moneys belonging to such foreign governments, or from any other source within the United States."[99]

The next change occurred in 1945, when the scope of the exemption was expanded to include international organizations in addition to foreign governments.[100] In 1954, the provision was recodified as section 892 without further change.[101]

In 1957, regulations were first adopted under section 892.[102] The regulations provided that the exemption was available to both foreign governments and their political subdivisions, but was not available with respect to income from investments loaned to, but not actually owned by, foreign governments.

In response to uncertainty over the status of separately incorporated foreign central banks under section 892, Congress enacted section 895 in 1961.[103] The provision provided that income

---

[97] This exemption followed a 1916 Treasury Decision that concluded that certain passive, U.S.-source income received by foreign governments was subject to U.S. income tax. T.D. 2425, 18 Treas. Dec. Int. Rev. 276 (1917).

[98] War Revenue Act of 1917, Pub. L. No. 65-50, sec. 1211, 40 Stat. 300, 337.

[99] Revenue Act of 1918, Pub. L. No. 65-254, sec. 213(b)(5), 40 Stat. , 1057, 1066. The provision was recodified in 1928, but otherwise remained unchanged. Revenue Act of 1928, Pub. L. No. 70-562, sec. 116(c), 45 Stat. 791, 823.

[100] International Organizations Immunities Act, Pub. L. No. 79-291, sec. 4, 59 Stat 669, 670-71 (1945). For this purpose, "international organizations" are public international organizations in which the United States participates with the sanction of Congress and that are designated by the President as entitled to enjoy the privileges, exemptions, and immunities provided in the International Organizations Immunities Act.

[101] Internal Revenue Code of 1954, Pub. L. No. 83-591, sec. 892, 68A Stat. 1, 284.

[102] T.D. 6258, 1957-2 C.B. 368, 413-14.

[103] Pub. L. No. 87-29, 75 Stat. 64. In 1920, the Bureau of Internal Revenue (the predecessor to the Internal Revenue Service (the "IRS")) ruled that the Commonwealth Bank of Australia, an Australian corporation wholly owned by the Australian government, was nevertheless entitled to the exemption from

earned by a foreign central bank of issue from obligations of the United States was exempt from U.S. income tax unless those obligations related to the conduct of commercial activities.[104] Section 895 was amended for the first and only time in 1966 to allow additional income to qualify for the exemption.[105] Current section 895 is discussed in more detail below.

In 1980, the section 892 regulations were amended in a manner that generally narrowed the scope of the exemption.[106] As amended, the regulations defined foreign government to include only integral parts and controlled entities of a foreign government and provided that the exemption did not apply with respect to income derived from commercial activities in the United States.[107]

The Tax Reform Act of 1986 (the "1986 Act") made significant revisions to section 892, particularly with respect to the treatment of income derived from commercial activities.[108] The 1980 regulations had specified that certain income from commercial activities did not qualify as investment income and therefore was not exempt from U.S. income tax. Congress identified

---

U.S. income tax under the predecessor to section 892. O.D. 628, 3 C.B. 124 (1920). That decision was revoked in 1946. I.T. 3789, 19461-1 C.B. 100. The revocation was a response to the objection of the staff of the Joint Committee on Internal Revenue Taxation (later renamed the Joint Committee on Taxation) to an income tax refund filed by a New York corporation wholly owned by a foreign government and engaged in commercial activities in the United States. S. Rep. No. 87-163 (1961). In 1950, however, the Tax Court held that a corporation wholly owned by a foreign government might nevertheless constitute part of the foreign government for U.S. income tax purposes. *Louis Vial*, 15 T.C. 403 (1950), *acq.* 1952-1 C.B. 4. In 1955, the IRS again ruled that the Commonwealth Bank of Australia was entitled to exemption under section 892. The staff of the Joint Committee on Internal Revenue Taxation objected to the bank's refund claim and recommended that the claim be rejected. S. Rep. No. 87-163 (1961). The IRS revoked its 1955 ruling. However, due to concerns over anticipated financial repercussions from foreign central banks shifting their investments, the ruling revocation was suspended to the extent a foreign central bank was not engaged in commercial activities. *Id.*

In 1966, the IRS issued a Revenue Ruling stating its position that an organization separate in form and wholly owned by a foreign government would qualify for the section 892 exemption in certain circumstances. Rev. Rul. 66-73, 1966-1 C.B. 174. In 1975, the IRS issued a Revenue Ruling that refined its position on this issue and revoked the 1966 ruling. Rev. Rul. 75-298, 1975-2 C.B. 290, *obsoleted by* Rev. Rul. 2003-99, 2003-2 C.B. 388.

[104] Regulations under section 895 were adopted in 1963. T.D. 6636, 1963-1 C.B. 122.

[105] Pub. L. No. 89-809, sec. 102(a)(4)(A), 80 Stat. 1539, 1543. The regulations were amended in 1975 to reflect the statutory changes. T.D. 7378, 1975-2 C.B. 272.

[106] T.D. 7707, 1980-2 C.B. 213 (deleted by T.D. 8211, 1988-2 C.B. 214).

[107] By excluding income earned from commercial activities from the exemption, the regulations paralleled the limitations on sovereign immunity statutorily adopted in the FSIA.

[108] Pub. L. No. 99-514, sec. 1247, 100 Stat. 2085, 2583-84. A detailed discussion of section 892, as revised in 1986 and 1988, is found below.

several problems with the existing exemption.[109] First, nationalized industries were favored over privately owned industries because certain investment income earned by wholly government-owned entities was exempt (even if the corporations were engaged in commercial activities). Second, Congress found inappropriate that under the law, interest and dividend income received by foreign governments that controlled U.S. businesses was exempt from shareholder-level tax. Third, Congress intended to make clear that the exemption applied only to specific income items, despite the fact that a literal reading of the existing statutory language suggested a broader scope to the exemption.

The Technical and Miscellaneous Revenue Act of 1988 (the "1988 Act") made further changes to section 892.[110] Those changes provided that the exemption did not apply to the disposition of any interest in a controlled commercial entity or to any income received indirectly from a controlled commercial entity. In addition, the 1988 Act provided that, for purposes of the Code, a foreign government is treated as a corporate resident of its country and that, for income tax treaty purposes, a foreign government is treated as a corporate resident of its country if such government grants equivalent treatment to the U.S. government.

In 1988, the prior section 892 regulations were deleted and temporary regulations were issued.[111] Those regulations are described in conjunction with the more detailed description of current section 892 provided below.

Current section 892

In its current form, section 892 exempts from U.S. income tax certain income of foreign governments. In addition, section 892 provides that, for purposes of Title 26, a foreign government is treated as a corporate resident of its country. Furthermore, a foreign government is treated as a corporate resident of its country for income tax treaty purposes if such government grants equivalent treatment to the U.S. government.

Definition of foreign government

For purposes of section 892, a foreign government is the integral parts and controlled entities of a foreign sovereign.[112] "Integral part" is broadly defined and includes, inter alia, any person, body of persons, organization, agency, bureau, or fund that constitutes a governing

[109] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), at 1058-59, May 4, 1987; see also S. Rep. No. 99-313, at 416 (1986).

[110] Pub. L. No.100-647, sec. 1012(t), 102 Stat. 3342, 3527-28.

[111] T.D. 8211, 1988-2 C.B. 214. In 2002, the regulations were revised to provide that a partnership may be a controlled commercial entity and to reflect other minor changes. T.D. 9012, 2002-2 C.B. 389.

[112] Temp. Treas. Reg. sec. 1.892-2T(a)(1). The rules that apply to a foreign sovereign also apply to the political subdivisions of a foreign country and to transnational entities. Temp. Treas. Reg. sec. 1.892-2T(d).

authority of a foreign country, but does not include any individual who is acting in a private or personal capacity. Moreover, no portion of the earnings of the governing authority may inure to the benefit of any private person.[113]

A "controlled entity" is any entity separate in form from a foreign sovereign that satisfies four requirements.[114] The separate entity must (1) be wholly owned and controlled (directly or indirectly) by the foreign sovereign; (2) be organized under the laws of the foreign sovereign by which it is owned; (3) have its net earnings credited to its own account or to the accounts of the foreign sovereign, with no portion inuring to the benefit of any private person; and (4) have its assets vest in the foreign sovereign upon dissolution.[115]

A separately organized pension trust qualifies as a controlled entity if it satisfies four requirements. The pension trust must (1) be established exclusively for the benefit of current or former employees of a government or for current or former nongovernmental employees who perform or performed governmental or social services; (2) have its funds managed by people who are employees of, or appointed by, the foreign government; (3) provide for retirement, disability, or death benefits in consideration of prior services rendered; and (4) have its income satisfy the obligations of the foreign government to participants under the plan.

As discussed above, there is no single, generally accepted definition of what constitutes a SWF. Absent unusual circumstances, however, SWFs will generally constitute either an integral part or a controlled entity of a foreign sovereign for purposes of section 892.

Scope of exemption

In general, section 892(a)(1) provides that the income of foreign governments received from (1) investments in the United States in stocks, bonds, or other securities owned by such foreign governments, (2) investments in the United States in financial instruments held in the execution of governmental financial or monetary policy, or (3) interest on deposits in banks in

---

[113] Income does not inure to the benefit of a private person if such person is the intended beneficiary of a government program that is carried on by the foreign sovereign and the activities of which constitute governmental functions. Temp. Treas. Reg. sec. 1.892-2T(b). This rule also applies for purposes of the definition of "controlled entity" described below.

Not specifically addressed by the regulations, however, is whether there is impermissible private inurement when, for example, a SWF compensates a private investment manager, who is providing advisory services to the SWF, based on the investment performance of the SWF.

[114] Temp. Treas. Reg. sec. 1.892-2T(a)(3). Some taxpayers may take the position that an entity separate in form from a foreign sovereign is nevertheless an integral part of the foreign sovereign.

[115] Under the entity-classification regulations (i.e., the "check-the-box rules"), any business entity wholly owned by a foreign government (including its integral parts or controlled entities) is a per se corporation, and is thus ineligible to elect to be treated as a disregarded entity. Treas. Reg. sec. 301.7701-2(b)(6).

the United States of moneys belonging to such foreign governments, is exempt from U.S. tax.[116] For this purpose, the term "other securities" includes any note or other evidence of indebtedness (e.g., an annuity contract or a mortgage); the term generally does not include commodity forward or future contracts, commodity options, trust interests, or partnership interests (with the exception of interests in publicly traded partnerships as defined in section 7704).[117] Income from investments in stocks, bonds, or other securities includes gain from their disposition and income from engaging in securities lending transactions described in section 1058.[118]

As discussed in more detail above, the Code contains special rules addressing the taxation of interests in U.S. real property (including direct ownership and interests in USRPHCs). Income from an interest in a USRPHC that a foreign sovereign does not control is generally exempt from U.S. tax under section 892 as income from an investment in a U.S. security; however, section 892 does not apply to exempt income from interests in other U.S. real property (i.e., direct ownership).[119] The section 892 regulations do not specifically address how the section 892 exemption interacts with the FIRPTA look-through rule that treats certain distributions as gain from the disposition of a U.S. real property interest. The IRS has stated that Treasury and the IRS will clarify this interaction in regulations.[120]

Importantly, the section 892 exemption does not apply to income (1) derived from conducting any commercial activity (whether within or outside the United States), (2) received by or from (directly or indirectly) a controlled commercial entity, or (3) derived from the disposition of any interest in a controlled commercial entity. A "controlled commercial entity" is any entity engaged in commercial activities (whether within or outside the United States) in which a foreign government (1) holds (directly or indirectly) any interest that (by vote or value) is 50 percent or more of the total interests in such entity, or (2) holds (directly or indirectly) any

---

[116] Section 892(c) provides a similar exemption from U.S. tax for income of international organizations. In addition, section 893 provides an exemption from U.S. tax for certain compensation of qualifying employees of foreign governments and international organizations.

[117] Treas. Reg. sec. 1.892-3T(a)(3).

[118] Because trust and partnership interests (other than publicly traded partnerships) are not treated as other securities, gain from their disposition is not exempt under section 892.

[119] Temp. Treas. Reg. sec. 1.892-3T(a)(1), -3T(b) Example 1.

[120] Notice 2007-55, 2007-27 I.R.B. 13. In Notice 2007-55 the IRS also stated its intention to challenge, as inconsistent with relevant statutory and regulatory language, assertions regarding the application of section 892 made by some foreign governments with respect to certain investments they made in privately held, domestically controlled REITs. In the investments at issue, the foreign government took the position that distributions received from a domestically controlled REIT (including liquidating distributions) attributable to gain realized by the REIT from an actual or deemed sale or exchange of an interest in real property located in the United States were exempt under section 892. Although the statutory analysis is complex, in effect, the issue presented by Notice 2007-55 is whether a foreign government's exemption under section 892 should shelter gain realized by the REIT, rather than gain realized by the foreign government from a direct sale of its interest in the REIT.

other interest in such entity that provides the foreign government with effective control of the entity. A central bank of issue is treated as a controlled commercial entity only if it is engaged in commercial activities in the United States.

"Commercial activity" generally means all activity, whether conducted within or outside the United States, that is ordinarily conducted by the taxpayer or other persons with a view towards the current or future production of income.[121] USRPHCs, and foreign corporations that would be USRPHCs if they were domestic corporations, are treated as engaged in commercial activity.[122] Five types of activities are specifically identified as not constituting commercial activities. Those five types of activities are (1) investments in stocks, bonds, and other securities; loans; investments in financial instruments held in the execution of governmental financial or monetary policy; the holding of net leases on real property or land that is not producing income; the holding of bank deposits in banks; and trading for a foreign government's own account; (2) certain amateur athletic and cultural events; (3) activities that are not customarily attributed to or carried on by private enterprise for profit; (4) governmental functions; and (5) the mere purchasing of goods for the use of a foreign government.[123]

Commercial activities engaged in by one entity may be attributed to related controlled entities for purposes of section 892.[124] Commercial activities of a partnership (other than a publicly traded partnership) are attributed to its (limited and general) partners. In addition, commercial activities of a parent controlled entity are attributed to that entity's subsidiaries. However, no attribution is made of commercial activities from a controlled entity to that entity's parent. Similarly, no attribution is made of commercial activities from a controlled entity to that entity's other brother-sister related entities.

Partnerships

When a foreign government invests in an entity that is treated for U.S. income tax purposes as a partnership, the partnership is treated as a mere conduit in determining the character of the partnership income received by the foreign government partner.[125] Thus, the foreign government partner's distributive share of the partnership's income is exempt from tax under section 892 to the same extent that the partnership's income would have been exempt if received directly by the foreign government partner. If a partnership engages in commercial activity, some or all of the foreign government partner's distributive share of the partnership

[121] Temp. Treas. Reg. sec. 1.892-4T(b). Activity may constitute commercial activity even if it does not constitute the conduct of a trade or business in the United States under section 864(b). *Id.*

[122] Temp. Treas. Reg. sec. 1.892-5T(b)(1).

[123] Temp. Treas. Reg. sec. 1.892-4T(c).

[124] Temp. Treas. Reg. sec. 1.892-5T(d).

[125] Secs. 702-703; Treas. Reg. sec. 1.702-1(a)(8)(ii).

income will not be exempt from tax under section 892.[126] If the partner is the foreign sovereign itself, or an integral part of the foreign sovereign, then the partnership's commercial activities do not taint the partnership's other income (i.e., the income that would otherwise be exempt from tax under section 892 continues to be exempt from tax), although the partnership's income from the commercial activities is not exempt from tax under section 892. If, by contrast, the partner is a controlled entity, then the partnership's commercial activities are attributable to the controlled entity, and the controlled entity becomes a controlled commercial entity. At that point, the partner's entire share of partnership income is tainted (i.e., no portion of the income is exempt from tax under section 892), and any other income received by the partner (i.e., any nonpartnership income) is similarly tainted by the attributed commercial activities.

Tax treatment if not exempt

Income that is not exempt under section 892 is treated in the same manner as such income would be treated if received by a foreign corporation. The U.S. tax treatment of foreign corporations is described in more detail above. In general terms, however, certain income that is exempt under section 892 would also be exempt under the Code if received by a foreign corporation—for example, portfolio interest and gains from the sale of stock. Nevertheless, there are certain differences. For example, dividends and income from stock in a USRPHC are generally exempt under section 892 but are subject to tax when received by a foreign corporation. Finally, there are certain categories of income that are neither exempt under section 892 nor escape U.S. taxation when received by a foreign corporation. For example, U.S.-source royalty income is generally subject to U.S. tax whether it is received by a foreign government or a foreign corporation. Similarly, income that is effectively connected with the conduct of a U.S. trade or business generally is subject to U.S. tax in the same manner and at the same rates as income of a U.S. person, without regard to whether that income is earned by a foreign government or a foreign corporation.

As discussed in more detail below, U.S. income tax treaties may reduce or eliminate residual U.S. taxation of income received by foreign governments and/or foreign corporations in certain cases.

Foreign central banks of issue (section 895)

In addition to the exemption available under section 892, section 895 provides a special rule that exempts from U.S. tax certain income derived by a foreign central bank of issue from U.S. government obligations or from interest on deposits with persons carrying on the banking business.[127] For purposes of section 895, a foreign central bank of issue is a bank, which by law or government sanction, is the principal authority, other than the government itself, issuing

[126] See, e.g., Treas. Reg. sec. 1.892-5T(d)(4) Example 4(a)-(b).

[127] An entity that qualifies for the section 895 exemption from U.S. income tax might also qualify for the broader section 892 exemption.

instruments intended to circulate as currency.[128] The exemption applies to an instrumentality that is separate from a foreign government, whether or not owned in whole or in part by a foreign government.[129]

The exemption does not apply (1) if the foreign central bank of issue does not own the obligations or bank deposits, or (2) if the obligations or deposits are held for, or used in connection with, the conduct of commercial banking functions or other commercial activities.

Withholding and reporting

Sections 1441 and 1442 generally impose withholding requirements on the payors (or other withholding agents) of certain types of income, although no withholding is required if the income is exempt under section 892 or 895.[130] To establish that no withholding is required, a foreign government claiming exemption from tax under section 892 or a foreign central bank of issue claiming exemption from tax under section 895 may file, under penalties of perjury, a Form W8-EXP with the payor (or other withholding agent).[131] A payor who relies on such a claim of exemption, absent actual knowledge or other reason to know that it is inaccurate, is excused from any potential liability for failure to withhold. A Form W8-EXP provided by a person claiming to be a foreign government, an integral part of a foreign government, or a foreign central bank of issue remains valid indefinitely (unless there is a change of circumstance that makes any of the information on the form incorrect); if the person claims to be a controlled entity of a foreign government for section 892 purposes, then the form remains valid for three calendar years (unless there is a change of circumstance that makes any of the information on the form incorrect).[132] Payors (or other withholding agents) are required to report on Forms 1042 and 1042-S all payments made to foreign governments, even if not subject to withholding, to the same extent as if paid to a nongovernment foreign person.[133]

---

[128] Treas. Reg. sec. 1.895-1(b)(1). The Bank for International Settlements is treated as though it were a foreign central bank of issue for purposes of obtaining the section 895 exemption. Sec. 895; Treas. Reg. sec. 1.895-1(b)(3).

[129] In contrast, section 892 does not apply to an entity separate from the foreign sovereign unless the foreign sovereign wholly owns and controls the entity. Temp. Treas. Reg. sec. 1.892-2T(a)(3)(i).

[130] Temp. Treas. Reg. sec. 1.892-7T(e); Treas. Reg. sec. 1.1441-8(a), (c). Section 1445 generally imposes a withholding obligation on the buyer of a USRPI (which serves to satisfy the seller's tax liability under FIRPTA). However, no withholding is required if, as discussed above, the seller is exempt from tax on the transaction under section 892 and furnishes the buyer with a notice of nonrecognition treatment. Temp. Treas. Reg. sec. 1.1445-10T(b)(1).

[131] Treas. Reg. sec. 1.1441-8(b), (c); Instructions for Form W8-EXP.

[132] Treas. Reg. sec. 1.1441-1(e)(4)(ii).

[133] Treas. Reg. sec. 1.1461-1(b), (c).

Comparison to the U.S. income tax treatment of other persons

Foreign corporations

There are only limited differences between the U.S. income tax treatment of income derived by foreign governments from U.S. investments and income derived by other foreign investors from U.S. investments. As discussed above, section 892 exempts only certain income earned by foreign governments from U.S. income tax; income that is not exempt under section 892 is subject to U.S. income tax in the same manner, and to the same extent, as that income would be if earned by a foreign corporation. Thus, the only possible difference in tax treatment of foreign governments and foreign corporations arises from situations in which section 892 provides an exemption to a foreign government and another provision of the Code does not provide a similar exemption to a foreign corporation.[134]

There are three principal categories of income for which foreign governments receive better U.S. income tax treatment than foreign corporations: portfolio dividends; interest income from noncontrolled, but at least 10 percent owned, commercial entities; and income from the disposition of interests in certain noncontrolled USRPHCs.[135] In each instance, the income is generally exempt under section 892 when received by a foreign government but taxable when received by a foreign corporation.

As discussed in more detail above, U.S.-source dividends not effectively connected with the conduct of a U.S. trade or business are FDAP income subject to a 30 percent tax when received by a foreign person.[136] In contrast, section 892 generally exempts dividends, other than those from controlled commercial entities, from U.S. income tax.

U.S.-source interest not effectively connected with the conduct of a U.S. trade or business is FDAP income subject to a 30 percent tax when received by a foreign person. However, there is an important exemption for portfolio interest (generally, interest paid on an obligation that satisfies certain registration requirements, or exceptions thereto, and is received by someone who owns less than 10 percent of the payor). In contrast, section 892 generally exempts interest income from U.S. income tax; this exemption is not available if the interest is received from a

[134] As discussed below, U.S. income tax treaties might also provide favorable tax treatment to foreign governments and foreign corporations with respect to certain income, although, as a general matter, foreign corporations will fare at least as well as foreign governments under such treaties.

[135] Other categories of income may also result in this same outcome. For example, the contract payments received as part of certain mandatory convertible securities transactions, such as those discussed in Section IV, may be subject to U.S. income tax if received by a foreign corporation but exempt from tax if received by a foreign government.

[136] In certain cases, a foreign person may be able to avoid U.S. taxation by structuring its investment as an equity swap. For a discussion of equity swaps and related tax considerations, see Joint Committee on Taxation, *Present Law and Analysis Relating to the Tax Treatment of Derivatives* (JCX-21-08), Mar. 4, 2008.

controlled commercial entity (i.e., an entity engaged in commercial activity in which the foreign government owns at least 50 percent of the total interests, or a lesser percentage if the foreign government effectively controls the entity). The U.S. income tax treatment of foreign corporations and foreign governments resulting from the interaction of these rules is best understood by dividing the possible payors of interest into three categories: (1) neither a foreign corporation nor a foreign government is subject to U.S. income tax on interest received from payors in which they own less than 10 percent of the interests; (2) a foreign government, but not a foreign corporation, is exempt from U.S. income tax on interest received from an entity in which it owns at least 10 percent of the interests, but less than 50 percent; and (3) both a foreign corporation and a foreign government are subject to U.S. income tax on interest received from a commercial entity in which they own at least 50 percent of the interests.[137]

Under the FIRPTA rules, a foreign corporation generally will not be subject to U.S. income tax on any gain from the disposition of interests in domestically controlled REITs. However, a foreign corporation's gain from the disposition of an interest in any other USRPHC, including a REIT that is not domestically controlled, will be subject to U.S. income tax. In contrast, section 892 generally exempts all such income from U.S. income tax when derived by a foreign government, so long as the foreign government does not control the USRPHC whose interests are sold. (If the USRPHC is controlled by the foreign government, the USRPHC is a controlled commercial entity, with the consequence that the section 892 exemption is unavailable and any gain that results from the foreign government's disposition of interests in the USRPHC is subject to U.S. income tax to the same extent as if derived by a foreign corporation.)

Nonfederal U.S. sovereigns

The limited U.S. income tax exception afforded foreign governments and foreign central banks of issue under sections 892 and 895 is significantly less favorable than the U.S. income tax treatment afforded nonfederal sovereigns, specifically U.S. States and Indian tribes. States are not subject to U.S. income tax on any income that they earn directly, even if from commercial activities.[138] Moreover, States are specifically exempt under the Code from tax on certain

[137] A fourth possible category of payor is a noncommercial entity in which a foreign corporation or foreign government owns at least 50 percent of the interests. In such a case, a foreign government, but not a foreign corporation, is exempt from U.S. income tax on interest received from the entity. This fourth category, however, is unlikely to be significant in practice.

[138] The Code does not specifically address the question of whether States and their political subdivisions are subject to U.S. income tax on income that they earn directly. However, the IRS has long taken the position that States and political subdivisions are not subject to U.S. income tax on such income. See, e.g., Rev. Rul. 87-2, 1987-1 C.B. 18 (providing that income earned by a lawyer trust account fund created and controlled by a State Supreme Court is not taxable); Rev. Rul. 71-132, 1971-1 C.B. 29 (providing that income derived by a State from the operation of liquor stores is not taxable); Rev. Rul. 71-131, 1971-1 C.B. 28 (same); G.C.M. 14,407, XIV-1 C.B. 103 (1935) (same), *superseded by* Rev. Rul. 71-131. At least one Circuit Court of Appeals, relying on Supreme Court precedents, has also addressed this specific issue and arrived at the same conclusion as the IRS. *State of Michigan v. United States*, 40 F.3d 817 (6th Cir. 1994).

income that they earn indirectly, if the income is derived from a public utility or the exercise of an essential governmental function.[139] This exemption may apply to income derived from commercial activities.

Indian tribes and wholly owned tribal corporations chartered under Federal law are similarly not subject to U.S. income tax, even if the income is from commercial activities and even if the activity is conducted off the tribe's reservation. No specific Code provision governs the U.S. income tax liability of Indian tribes. However, the IRS has long taken the position that Indian tribes and wholly owned tribal corporations chartered under Federal law are not taxable entities for U.S. income tax purposes.[140]

Tax-exempt organizations

There are certain differences in the U.S. income tax treatment of tax-exempt organizations and foreign governments that sometimes favor tax-exempt organizations and other times favor foreign governments. Since the inception of the U.S. income tax, Congress has exempted certain types of entities from income taxation. The main exemption provision of the Code, section 501(a), generally provides a tax exemption for qualified pension, profit-sharing, and stock bonus plans described in section 401(a), religious and apostolic organizations described in section 501(d), and organizations described in section 501(c).[141] Section 501(c) lists 28 different types of organizations, including groups as diverse as charitable organizations, social welfare organizations, title holding companies, fraternal organizations, small insurance companies, credit unions, cooperative organizations, and cemetery companies.[142] In addition, other subsections treat certain organizations as described in section 501(c).[143]

Notwithstanding the general tax exemption available to these organizations, the Code imposes a tax, at ordinary corporate rates, on the income that a tax-exempt organization obtains

[139] Sec. 115.

[140] See, e.g., Rev. Rul. 94-65, 1994-2 C.B. 14; Rev. Rul. 94-16, 1994-1 C.B. 19; Rev. Rul. 81-295, 1981-2 C.B. 15; Rev. Rul. 67-284, 1967-2 C.B. 55.

[141] In addition to the tax exemption provided in section 501, other Code provisions provide tax exemption. See, e.g., secs. 220 (Archer MSAs), 223 (health savings accounts), 408(e) (individual retirement accounts), 457(g) (deferred compensation plans of state and local governments and tax-exempt organizations), 521 (farmers' cooperatives), 526 (shipowners' protection and indemnity associations), 527 (political organizations), 528 (certain homeowners associations), 529 (qualified tuition programs), and 530 (Coverdell education savings accounts).

[142] Section 501(c) has 28 subsections, although the exemption provided for section 501(c)(20) organizations (qualified group legal plan organizations or trusts) expired for taxable years beginning after June 30, 1992. Sec. 120(e).

[143] Secs. 501(e) (cooperative hospital service organizations), 501(f) (cooperative service organizations of operating educational organizations), 501(k) (certain child care organizations), and 501(n) (charitable risk pools).

from an "unrelated trade or business . . . regularly carried on by it."[144] Most exempt organizations are subject to the tax with respect to at least a portion of their income.[145] Passive income, such as dividends, interest, royalties, certain rents, and certain gains and losses from the sale or exchange of property, is exempt from the unrelated business income tax.[146] In general, the exemption for such passive income applies unless the income is derived from debt-financed property[147] or is in the form of certain payments from certain 50-percent controlled subsidiaries.[148] Organizations liable for tax on unrelated business taxable income may be liable for alternative minimum tax determined after taking into account adjustments and tax preference items.

The tax exemption afforded tax-exempt organizations is narrower in some respects and broader in others than the tax exemption afforded foreign governments. For example, the exemption afforded tax-exempt organizations is somewhat broader in that tax-exempt organizations generally may derive income from commercial activities that are related to the organization's tax-exempt purpose without that income being subject to U.S. income tax; the exemption provided to foreign governments under section 892 does not include any income derived from a commercial activity. On the other hand, tax-exempt organizations lose their tax exemption with respect to passive income derived from debt-financed property; the exemption

---

[144] Secs. 512(a)(1), 511(a)(1). Generally, "unrelated trade or business" is "any trade or business the conduct of which is not substantially related . . . to the exercise or performance by such organization of its charitable, educational, or other purpose." Sec. 513(a).

[145] Organizations subject to the unrelated business income tax include all organizations described in section 501(c) (except for U.S. instrumentalities and certain charitable trusts), religious and apostolic organizations described in section 501(d), qualified pension, profit-sharing, and stock bonus plans described in section 401(a), and certain State colleges and universities. Sec. 511(a)(2).

[146] Sec. 512(b)(1)-(3), (5). Other exemptions from the unrelated business income tax are provided for activities in which substantially all the work is performed by volunteers, for income from the sale of donated goods, and for certain activities carried on for the convenience of members, students, patients, officers, or employees of a charitable organization. Sec. 513(a)(1)-(3). In addition, special unrelated business income tax provisions exempt from tax certain activities of trade shows and State fairs, income from bingo games, and income from the distribution of certain low-cost items incidental to the solicitation of charitable contributions. Sec. 513(d), (f), (h).

[147] In general, income produced by debt-financed property is treated as unrelated business income in proportion to the acquisition indebtedness on the income-producing property. Secs. 512(b)(4), 514(a). Acquisition indebtedness generally means the amount of unpaid indebtedness incurred by an organization to acquire or improve the property and indebtedness that would not have been incurred but for the acquisition or improvement of the property. Sec. 514(c).

[148] Sec. 512(b)(13).

provided to foreign governments under section 892 is available without regard to whether it is derived from debt-financed property.[149]

[149] In practice, however, a foreign government, and, in particular, a SWF, may not have any income derived from what would be debt-financed property for purposes of the unrelated business income tax. Thus, the ability to derive tax-exempt income from debt-financed property may not represent a meaningful tax benefit for foreign governments when compared to tax-exempt organizations.

C. Application of Income Tax Treaties to Foreign Governments and SWFs

Applicability of tax treaties to SWFs in general

In general, a foreign person may obtain benefits from the United States under a U.S. tax treaty with a foreign country if the foreign person (i) is a "resident" of the foreign country, as defined in such treaty, (ii) meets the requirements contained in any limitation-on-benefits provision of such treaty, and (iii) meets any other requirements for the particular benefit specified in the treaty. The question whether the United States will provide tax treaty benefits to a foreign government or a SWF with respect to particular income arises only if section 892 does not provide complete relief with respect to such income. This result may occur where the recipient of the income does not meet the statutory or regulatory requirements for the section 892 exemption. Treaties may be relevant, for example, where section 892 does not apply due to the nature of the payor, such as in the case of dividends or interest received from a U.S. controlled commercial entity. Treaty protection might also be relevant to items of income paid to an entity that is owned by a foreign government, but is not a "controlled entity" under the Treasury Regulations because it is not organized under the laws of the foreign government that owns it, or because it is an entity that is engaged in commercial activities.[150]

Finally, the availability of a tax treaty may be relevant if the both the payor and recipient of the income are not disqualified under section 892, but the general type of income is not exempt under section 892. Examples include noncommercial income, such as royalties from a patent held for investment by a controlled entity, or income earned through a U.S. trade or business conducted directly by the foreign sovereign that does not have a permanent establishment in the United States.

Foreign governments and SWFs as residents for treaty purposes

In sum, it would appear that it is the official view of the Treasury Department that the condition of section 892(a)(3) relating to treaties is satisfied (i) in the case of a tax treaty that follows the reciprocal language of the United States Model Income Tax Convention of September 20, 1996 ("1996 Model treaty") or its equivalent, (ii) with the possible caveat noted below with respect to controlled entities, in the case of a tax treaty that follows the language of the United States Model Income Tax Convention of November 15, 2006 ("2006 Model treaty") or its equivalent, and (iii) under the general authority of the language of the Department of the Treasury Technical Explanation to the 1996 Model treaty, in the case of a tax treaty between the United States and another country (particularly an OECD country) that does not follow the language of either of those U.S. Model treaties, unless that other country has announced a contrary interpretation of such treaty provision (or has such an overriding contrary interpretation in its domestic law). The next several pages explain the basis for these conclusions.

---

[150] Temp. Treas. Reg. sec. 1.892-2T(a)(1) provides that "the term 'foreign government' means only the integral parts or controlled entities of a foreign sovereign." Temp. Treas. Reg. sec. 1.892-2T(a)(3) defines the term "controlled entity."

Effect of section 892(a)(3)

As discussed above, there is no single, generally accepted definition of what constitutes a SWF. Absent unusual circumstances, however, a SWF generally will constitute either an integral part or a controlled entity of a foreign sovereign for purposes of section 892. Section 892(a)(3), enacted in 1988,[151] provides that "[f]or purposes of this title, a foreign government shall be treated as a corporate resident of its country. A foreign government shall be so treated for purposes of any income tax treaty obligation of the United States if such government grants equivalent treatment to the Government of the United States."

The legislative history indicates that section 892(a)(3) was an attempt to clarify the law by plugging a technical gap in many treaties existing at the time of its enactment. That legislative history illustrates the two key principles that whether the United States allows tax treaty benefits to a foreign government depends on whether the foreign government does the same, and that a foreign government should be treated no worse (but may be treated better) than comparable private investors resident in the country of that foreign government.[152] In order to determine whether a foreign government is treated as a resident of its country for purposes of its treaty with the United States, therefore, one must look (i) first to see whether the treaty includes language expressly granting such reciprocal residency status or, (ii) if there is no such express language, to the foreign government's interpretation of the treaty, with due regard to the foreign government's domestic tax law. As discussed below, however, the Department of the Treasury appears to interpret treaties which include no such express language, such as the United States Model Income Tax Conventions of May 17, 1977 and June 16, 1981, as including such language.

Residency of foreign sovereigns under treaties that follow the 2006 Model treaty

The 2006 Model treaty represents the current official U.S. treaty policy. The 2006 Model treaty expressly provides that a resident of a treaty country includes that treaty country as well as any political subdivision or local authority of that country.[153] A resident of a country also includes a "pension fund" (whether public or private) established in that country.[154] Under the 2006 Model treaty, a pension fund is any person established in a treaty country that is generally tax exempt in that country and which operates, *inter alia*, to provide pension or retirement benefits.[155] That definition appears to be sufficiently broad to cover both foreign governments'

---

[151] The actual statutory provision was added as a technical correction to the Tax Reform Act of 1986 by the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, sec. 1012(t)(3), generally effective for amounts received on or after July 1, 1986.

[152] S. Rep. No. 99-313, at 416-17 (1986) (Senate Finance Committee Report on Tax Reform Act of 1986); see also S. Rep. No. 100-445, at 306-07 (1988) (Senate Finance Committee Report on Technical Corrections Act of 1988).

[153] 2006 Model treaty, art. 4, par. 1.

[154] 2006 Model treaty, art. 4, par. 2.

[155] 2006 Model treaty, art. 3, par. 1(k).

pension funds and pension trusts, as defined under the section 892 regulations.[156] U.S. income tax treaties that follow the 2006 Model treaty reciprocally treat the integral parts of governments of the two treaty partners as residents of their respective countries, including SWFs that are integral parts.

Residency under treaties that preceded the 1996 Model treaty, or that follow the language of the 1996 Model treaty

It appears from the 1986 legislative history quoted above that many of the bilateral income tax treaties in force in the 1980s did not expressly provide that the treaty countries were residents of their respective countries for treaty purposes. The 1996 Model treaty, which was superseded by the 2006 Model treaty described above, remedied this omission for subsequent treaties and clarified the effect of the omission in earlier treaties. The 1996 Model treaty provides that a "qualified governmental entity is to be treated as a resident of the Contracting State where it is established."[157] A "qualified governmental entity" is defined in the 1996 Model treaty as:

> (i) any person or body of persons that constitutes a governing body of a Contracting State, or of a political subdivision or local authority of a Contracting State;
>
> (ii) a person that is wholly owned, directly or indirectly, by a Contracting State or a political subdivision or local authority of a Contracting State, provided (A) it is organized under the laws of the Contracting State, (B) its earnings are credited to its own account with no portion of its income inuring to the benefit of any private person, and (C) its assets vest in the Contracting State, political subdivision or local authority upon dissolution; and
>
> (iii) a pension trust or fund of a person described in subparagraph (i) or (ii) that is constituted and operated exclusively to administer or provide pension benefits described in Article 19;
>
> provided that an entity described in subparagraph (ii) or (iii) does not carry on commercial activities.[158]

Thus, the language of the 1996 Model treaty generally tracks the definitional rules of the section 892 Temporary Treasury Regulations relating to integral parts of foreign sovereigns (in the case of clause (i)), controlled entities (in the case of clause (ii)), and pension trusts.[159]

---

[156] Temp. Treas. Reg. sec. 1.892-2T(c).

[157] 1996 Model treaty, art. 4, par. 1(c).

[158] 1996 Model treaty, art. 3, par. 1(i).

[159] Temp. Treas. Reg. sec. 1.892-2T(a). Compare Temp. Treas. Reg. sec. 1.892-2T(c), which provides that a separate pension trust (but not a pension fund that is an integral part or controlled entity of

Therefore, SWFs of foreign countries with U.S. treaties that include the concept of qualified governmental entities will be treated as foreign corporations resident in the treaty country.

The Department of the Treasury Technical Explanation of the 1996 Model treaty states that "[a]lthough this [i.e., the qualified governmental entities] provision is not contained in previous U.S. Models, it is generally understood that such entities are to be treated as residents under all of those Model treaties. The purpose of including the rule in the Model is to make this understanding explicit." The Technical Explanation to the 1996 Model treaty also observes that article 4 of the Organisation for Economic Co-operation and Development Model Tax Convention on Income and Capital ("OECD Model treaty") was amended in 1995 to adopt a similar approach.[160] Thus, the Department of the Treasury would deem this language to be part of the earlier U.S. Model treaties, and therefore, would generally consider the exemption to be reciprocal under these treaties. The underlying assumption in this case appears to be that the deemed language would override any contrary rule of the domestic law of the treaty partner. In the unlikely event that the treaty partner announced a contrary interpretation of the treaty provision, or had a contrary rule in its domestic law that overrode the deemed treaty language, there would be no reciprocity, and the foreign government presumably would be denied U.S. residency under the principles of section 893(a)(3). However, these would be extraordinary circumstances.

Although due to their noncontemporaneous nature the above-quoted statements in the Technical Explanation may not be controlling authority regarding those pre-1996 treaties that are silent regarding the residency of these entities, the Technical Explanation implies that, absent the extraordinary circumstances described above, the Treasury Department will continue to treat such entities as treaty residents under those in-force treaties that follow the language of the pre-1996 Model treaties.

Treatment of controlled entities under treaties that follow the 2006 Model treaty

At least on their face, the technical rules of the 2006 Model treaty are different than those of the 1996 Model treaty. The general category of "qualified governmental entity" in the 1996

---

a foreign sovereign) is subject to the rules of section 1.892-5T(b)(3) regarding controlled commercial entities. Although a pension trust or fund that carries on commercial activities would not be a qualified governmental entity under a treaty that follows the language of the 1996 Model treaty quoted above, such a trust or fund might qualify as a resident of the foreign country under the more general pension provision in article 4, paragraph 1(b)(ii), which provides that "[a] legal person organized under the laws of a Contracting State and that is generally exempt from tax in that State and is established and maintained in that State…(ii) to provide pensions or other similar benefits to employees pursuant to a plan is to be treated for purposes of this paragraph as a resident of that Contracting State."

[160] Paragraph 8.1 of the commentary on article 4 of the OECD Model treaty states that "[i]t has been the general understanding of most Member countries that the government of each State, as well as any political subdivision or local authority thereof, is a resident of that State for purposes of the Convention. Before 1995, the Model did not explicitly state this; in 1995, article 4 was amended to conform the test of the Model to this understanding."

Model treaty that corresponds to a controlled entity does not appear in the 2006 Model treaty.[161] Thus, although the Department of the Treasury has not issued any pronouncement or comment on this change, it appears that the 2006 Model treaty may have narrowed this exemption.[162] If the exemption has, in fact, been narrowed, some of a controlled entity's income, of a type not within the scope of section 892, that would have qualified for treaty benefits as income of a qualified governmental entity under a treaty with language similar to that of the 1996 Model treaty may not qualify for benefits under a treaty with language similar to that of the 2006 Model treaty.

For example, if a controlled entity receives U.S.-source royalties that are not from commercial activities (for example, from a patent purchased for investment purposes) and the controlled entity satisfies the other applicable requirements of the 1996 Model treaty language, the controlled entity would be entitled to benefits under a treaty similar to the 1996 Model treaty, i.e., a zero rate of U.S. income tax withholding under article 12. Under the language of the 2006 Model treaty, however, it appears that the controlled entity would qualify as a resident of its foreign country only if the term "State and any political subdivision or local authority" is interpreted by both the United States and the treaty country as including a controlled entity.[163] In general, where the treaty in question is silent regarding the resident status of a controlled entity, the question arising under section 892(a)(3) is whether the domestic tax law of foreign treaty partner would recognize for treaty purposes a U.S.-owned controlled entity as a resident of the United States.

Assuming that the controlled entity is tax-exempt in its home country,[164] it appears unlikely that the controlled entity would be considered a resident of the foreign country for treaty purposes as if it were a private corporation organized in that foreign country. The general definition of resident of a country under paragraph 1 of article 4 of the 2006 Model treaty and

[161] The language of the 1996 Model treaty, art. 3, par. 1(i)(ii) (that does not appear in the 2006 Model treaty) relates to that one type of qualified governmental entity, and closely tracks the language of Temp. Treas. Reg. sec. 1.892-2T(a)(3), which defines the term "controlled entity."

[162] The issue arises only with respect to a controlled entity's income that, although not within the scope of section 892, is of a type that would be eligible for treaty benefits if earned by a resident of the treaty country.

[163] This quoted language, where appearing in a limitation-on-benefits article of a particular treaty, but not in the residence article, may evidence the treaty partners' intent to treat the treaty country governments as residents of their respective countries. Such a rationale may apply to treaties such as the U.S.-Australia treaty. It is less clear, however, how that same rationale might be easily applied to controlled entities.

[164] This appears to be a reasonable assumption. In any event, section 892(a)(3) rejects the view that residence should turn on home-country taxation of the SWF. The legislative history to section 892(a)(3) states that "whether a foreign government is liable to pay tax to itself on its income seems to be a meaningless question. It does not appear that U.S. tax exemption to a foreign government that is a treaty partner should depend, for instance, on its internal sovereign immunity laws." S. Rep. No. 99-313, at 416-17 (1986) (Senate Finance Committee Report on Tax Reform Act of 1986).

other treaties requires that the person is "liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature." Moreover, the literal language of paragraph 2 of article 4 of the 2006 Model treaty requires that a tax-exempt organization (that is not a pension fund) must be established and maintained in that country exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes. A controlled entity would not meet any of these purposes. Therefore, outside the pension area, a controlled entity may not rely on a treaty's general tax-exempt residency provision.

Classification of certain treaties relevant to present-day SWFs

A number of foreign countries that have SWFs have entered into income tax treaties with the United States.[165] Of those U.S. income tax treaties, those with Japan, Canada and France provide language in their residence article that is similar to that provided in the 2006 Model treaty, i.e., "State, political subdivision, or local authority." In addition, the U.S.-Canada and U.S.-France treaties provides language that expressly includes "any agency or instrumentality" of the treaty country, political subdivision, or local authority. That additional language appears to encompass controlled entities. At the present time, Japan has a pension fund that is covered by the U.S.-Japan treaty and does not have a SWF. Therefore, these present-day foreign investment funds appear to qualify as treaty country residents even if they are controlled entities.

The language of the residence article of the U.S.-Ireland treaty follows that of the 1996 Model treaty. Therefore, the Irish SWF appears to be a resident of Ireland under the U.S.-Ireland treaty.

The following U.S. income tax treaties, which mostly entered into force prior to 1996, include no language regarding the governments' status as a resident under the respective treaty: U.S.-Australia, U.S.-China, U.S.-Kazakhstan, U.S.-Korea, U.S.-Mexico, U.S.-Netherlands, U.S.-New Zealand, U.S.-Norway, U.S.-Russia, and U.S.-Venezuela. The Chinese SWF, China Investment Corporation, the Korean SWF, Korea Investment Corporation, and two Australian SWFs, Queensland Investment Corporation and Victorian Funds Management Corporation, are denoted as corporations and, therefore, are probably controlled entities.[166] The Kazakhstan SWF, the National Oil Fund, is reportedly not a legal entity.[167] We have not been able to determine definitively whether the SWFs in Mexico, the Netherlands, New Zealand, Norway, Russia and Venezuela, and the Future Fund in Australia are controlled entities or instead integral

[165] The information provided in this section relates to countries that have entered into tax treaties with the United States and also have SWFs that are listed in JP Morgan Report; Congressional Research Service, *Sovereign Wealth Funds: Background and Policy Issues for Congress*, at 11, RL34336 (Jan. 31, 2008) (citing as its source the Peterson Institute for International Economics); and Peterson Institute for International Economics, *A Blueprint for Sovereign Wealth Fund Best Practices* (Apr. 2008).

[166] JP Morgan Report at 31 (China), 58 (Korea), 39 (Queensland, Australia), and 49 (Victoria, Australia).

[167] JP Morgan Report at 56.

parts of their respective foreign governments.[168] We also have not been able to determine at the present time whether any of these foreign countries would treat a SWF of the United States Government as a resident of the United States for tax treaty purposes.

Limitation-on-benefits provisions and treaty shopping

Limitation-on-benefits provisions in treaties are intended to deny treaty benefits in certain cases of treaty shopping engaged in by third-country residents. Many, but not all, of the U.S. income tax treaties have a limitation-on-benefits article. Generally, under a limitation-on-benefits provision of a treaty, a resident of either treaty country is entitled to the benefits under the treaty if the resident is a "qualified person," that is, a resident that meets one of a list of additional requirements that demonstrate a significant nexus with the treaty country. Most tax treaties include the treaty country or a political subdivision or local authority thereof as a qualified person.[169]

Treaty shopping is of limited relevance to SWFs. In general, a third-country resident may engage in treaty shopping by, for example, organizing in a treaty country a corporation that is entitled to the benefits of the treaty. A SWF organized in a nontreaty country could engage in treaty shopping in a treaty country to the same extent as a private company organized in that nontreaty country.[170] Similarly, a SWF organized in a treaty country could engage in treaty shopping in a country with a more beneficial tax treaty to the same extent as a private company organized in the SWF's country. For treaty-shopping purposes, therefore, being a SWF conveys no advantages over being a foreign corporation.[171]

[168] Although these funds are generally described as owned by their respective foreign governments, the information we have available does not state whether these funds are separate entities. JP Morgan Report at 80 (Mexico), 70 (New Zealand), 24 (Norway), 37 (Russia), 60 (Venezuela), and 41 (Australia Future Fund).

[169] A SWF that is a controlled entity of a foreign government would also generally be treated as a qualified person because it meets the "ownership and base erosion test," that is, it is owned by a qualified person and does not pay out more than 50 percent of its gross income to persons other than that sovereign. If the ownership and base erosion test is not met in a particular case, the controlled entity would probably be granted qualified person status by the U.S competent authority under a standard treaty provision that grants the competent authority discretion to allow benefits to a resident of the other country if it determines that the establishment, acquisition, or maintenance of such person and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the treaty. 2006 Model treaty, art. 22, par. 4; 1996 Model treaty, art. 22, par. 4.

[170] In contrast, a company organized in a country other than that of the foreign sovereign would not qualify as a controlled entity under section 892 and Temp. Treas. Reg. sec. 1.892-2T(a)(3).

[171] While it is hypothetically possible that a third-country resident could be permitted to invest in a SWF of a treaty country in order to avail itself of the SWF's treaty benefits, there is no evidence, anecdotal or otherwise, that any SWFs have or would permit any foreign investors.

IV. TECHNIQUES USED BY SWFs TO INVEST IN UNITED STATES

As described previously, SWFs made a series of five high-profile investments in U.S. financial institutions at the end of 2007 and the beginning of 2008. This section describes the structures of these investments and their likely tax treatment under present law, including the possible relevance of section 892. In addition, this section describes certain other techniques commonly employed by SWFs for investing in the United States.

A. Mandatory Convertible Securities

ADIA-Citigroup investment

On November 26, 2007, Citigroup Inc. announced that the Abu Dhabi Investment Authority had agreed to purchase $7.5 billion of "Upper DECS Equity Units" in Citigroup (the "ADIA-Citigroup investment").[172] Each equity unit is a mandatory convertible security consisting of a forward contract to purchase Citigroup common stock on four settlement dates[173] and an undivided beneficial interest in each of four trust preferred securities. The trust preferred securities are pledged as collateral under the forward contract. The forward contract provides a maximum purchase price which may be reset in the event that Citigroup issues certain types of equity or equity-linked securities in excess of $5 billion before December 3, 2008. Each trust preferred security represents an interest in a separate trust sponsored by Citigroup.[174] Each trust holds a junior subordinated deferrable interest debenture issued by Citigroup. The Series A and Series B trusts hold debentures that mature on different dates in 2041 and bear interest at 6.320 percent and 6.455 percent, respectively. The Series C and Series D trusts hold debentures that mature at different dates in 2042 and bear interest at 6.700 percent and 6.935 percent, respectively. The trust preferred securities each provide for quarterly payments equal to the amount of interest paid on the underlying Citigroup debenture. Citigroup Inc. holds the common interests in each trust.

Each equity unit held by ADIA provides for quarterly payments at an 11 percent fixed annual rate. These payments consist of the payments on the trust preferred securities (i.e., the passthrough of the interest paid on the underlying Citigroup debentures) and quarterly "contract

---

[172] See Citigroup Inc., Current Report on Form 8-K, filed with the Securities Exchange Commission on November 27, 2007, available on the internet at http://www.sec.gov/Archives/edgar/data/831001/000114420407064349/v095633_ex99-1.htm. The acronym "DECS" stands for Debt Exchangeable for Common Stock.

[173] These settlement dates are March 15, 2010 (the "series A stock purchase date"), September 15, 2010 (the "series B stock purchase date"), March 15, 2011 (the "series C stock purchase date") and September 15, 2011 (the "series D stock purchase date"). Each settlement date is subject to an extension of up to one year.

[174] These trusts are the Citigroup Capital XXIX trust (the "Series A trust"), the Citigroup Capital XXX trust (the "Series B trust"), the Citigroup Capital XXXI trust (the "Series C trust"), and the Citigroup Capital XXXII trust (the "Series D trust").

payments" on the forward purchase contract. The contract payments are made at four different rates on the portion of the stated amount of the purchase contract that corresponds to each stock purchase date. Thus, with respect to the portion of the purchase contract corresponding to the series A stock purchase date, the quarterly contract payments are made at a rate of 4.680 percent (which, when added to the 6.320 percent payment on the Series A trust preferred security, equals 11.000 percent). The quarterly contract payments corresponding to the series B, series C and series D stock purchase dates are 4.545 percent, 4.300 percent, and 4.065 percent, respectively. According to the press release issued by Citigroup on November 26, 2007 announcing the ADIA investment, the 11.000 percent rate "reflects market terms based on the conversion premium as well as Citi's current dividend yield."[175]

Approximately three months prior to each stock purchase date, the trust preferred securities corresponding to that stock purchase date will be remarketed to new investors on market terms (unless ADIA elects not to participate in the remarketing). The proceeds of the remarketing will be applied to settlement of the forward purchase contract on the corresponding stock purchase date. The equity units also provide, however, that the holder may separate the trust preferred securities from the forward purchase contract (thereby creating "Stripped DECS") at any time other than certain limited periods surrounding a remarketing or a payment date. In order to separate the trust preferred securities (for example, in order to sell them separately), the holder must substitute qualifying Treasury securities with a corresponding principal amount to serve as collateral for its obligation under the forward purchase contract. The holder may also subsequently recreate "Normal DECS" by replacing the appropriate series of trust preferred securities for the Treasury securities.

Additional terms of the ADIA-Citigroup investment include the following. ADIA may not transfer, sell, or hedge the equity units or its exposure to the underlying common stock until at least December 3, 2009. After December 3, 2009 and until three years after the final stock purchase date, ADIA will be subject to certain manner-of-sale restrictions for its common stock. ADIA's aggregate ownership of Citigroup's common stock, including shares bought under the forward purchase contract, may not exceed 4.9 percent of Citigroup's total outstanding common stock, and ADIA will have no special rights of ownership or control and no role in the management or governance of Citigroup. In particular, ADIA will have no right to designate a member of the Citigroup board of directors.

CIC-Morgan Stanley investment

On December 19, 2007, the China Investment Corporation agreed to purchase approximately $5.6 billion of equity units called PEPS issued by Morgan Stanley (the "CIC-Morgan Stanley investment").[176] The PEPS units in the CIC-Morgan Stanley investment are

---

[175] "Citi to Sell $7.5 Billion of Equity Units to the Abu Dhabi Investment Authority," available at http://www.citigroup.com/citigroup/press/2007/071126j.htm.

[176] See Morgan Stanley, Current Report on Form 8-K, filed with the Securities Exchange Commission on December 27, 2007, available at http://www.sec.gov/Archives/edgar/data/895421/000115752307012287/a5568797ex991.htm. The acronym "PEPS" stands for Premium Equity Participating Security.

similar in structure to the Upper DECS equity units in the ADIA-Citigroup investment and, like ADIA, CIC is a passive portfolio investor in Morgan Stanley with no special ownership or management rights.

Each PEPS unit is a mandatory convertible security consisting of a forward contract to purchase Morgan Stanley common stock on a stock purchase date[177] and an undivided beneficial interest in a trust preferred security. The trust preferred security is pledged as collateral under the forward contract. The trust preferred security represents an interest in a trust sponsored by Morgan Stanley[178] that holds a junior subordinated debenture issued by Morgan Stanley. The junior subordinated debenture matures in 2042 and bears interest at an annual rate of 6.00 percent. The trust preferred securities each provide for quarterly payments equal to the amount of interest paid on the underlying Morgan Stanley debenture.

Each PEPS unit held by CIC provides for quarterly payments at a 9 percent fixed annual rate. These payments consist of the payments on the trust preferred security (i.e., the passthrough of the interest paid on the underlying Morgan Stanley debenture) and quarterly "contract payments" on the forward purchase contract at an annual rate of 3 percent. The PEPS units provide for remarketing of the trust preferred securities shortly prior to the stock purchase date in a manner similar to the remarketing of the Citigroup Upper DECS units and for the proceeds of the remarketing to be applied to settlement of the forward purchase contract. The PEPS units also provide that the holder may separate the trust preferred securities from the forward purchase contract by substituting qualifying Treasury securities to serve as collateral for its obligation under the forward purchase contract (creating "Treasury Units"). The holder may also subsequently recreate "Corporate Units" by replacing the appropriate series of trust preferred securities for the Treasury securities.

Tax treatment

The mandatory convertible securities issued in the ADIA-Citigroup and CIC-Morgan Stanley investments provide significant tax and regulatory benefits to the issuers. However, it is not clear that the structure of these securities provides ADIA or CIC with a significant tax benefit that would not have been available to a nongovernmental foreign investor.

More specifically, the terms of the securities purchased by ADIA and CIC are substantially similar to the terms of the instruments described in IRS Revenue Ruling 2003-97.[179]

---

[177] The stock purchase date is expected to be August 17, 2010, subject to an extension of up to one year.

[178] The PEPS were issued in three series, each representing an interest in a trust preferred security issued by one of three separate trusts; each of these trusts in turn held one of three series of Morgan Stanley debentures with identical terms.

[179] 2003-2 C.B. 380.

Each of these are variants of mandatory convertible securities.[180] The instruments described in the revenue ruling consist of a note and a forward contract to purchase common stock of the issuer (together referred to in the revenue ruling as the "Purchase-Contract/Note unit"). The note is pledged as collateral under the forward contract. The notes in the Purchase-Contract/Note units provide quarterly payments of amounts denominated as interest at a fixed rate. The notes are required to be remarketed before the forward contract's settlement date, and the proceeds of the remarketing are applied to settle the forward contract. A holder of a Purchase-Contract/Note unit may separate the note from the forward contract but is not required to do so. If the holder does "strip" out the note, the holder must substitute qualifying Treasury securities to serve as collateral for its obligation under the forward contract.

The Upper DECS equity units and PEPS units acquired by ADIA and CIC, respectively, are similar to those described in Revenue Ruling 2003-97, except that they include trust preferred securities rather than notes. Each trust preferred security represents, however, a beneficial interest in an underlying debenture held by the issuing trust. It appears that the issuing trusts were structured in such a manner that they are treated as grantor trusts for U.S. federal income tax purposes, so that each holder of a trust preferred security (and thus each holder of an equity unit) is treated for federal income tax purposes as holding a proportionate interest in the underlying debenture.[181]

In Revenue Ruling 2003-97, the IRS addressed the questions of whether (a) the note in the Purchase Contract/Note unit could be treated as a separate debt instrument during the period prior to the remarketing (or instead as a prepayment on the forward contract with the actual notes being issued only upon a conversion, a settlement for separate cash or a successful remarketing) and (b) if so, whether section 163(l) would prevent the issuer from deducting interest on the note.[182] The IRS concluded that the note in the Purchase-Contract/Note unit could be treated separately from the forward contract at all times and, further, that section 163(l) did not apply to disallow a deduction for interest accruing on the note. Because the terms of the Upper DECS equity units and the PEPS units are substantially similar to the terms of the Purchase-Contract/Note unit, it can be expected that Citigroup and Morgan Stanley are relying on the revenue ruling to take the position that they are allowed interest deductions for amounts accruing on the debentures underlying the trust preferred securities. This interest deduction provides a significant tax benefit to the issuers that would have been unavailable if they had instead issued

---

[180] Investment banks have developed proprietary versions of these securities. Citigroup's version has the trade name DECS, Morgan Stanley's product is called PEPS, and Merrill Lynch's instrument is called Feline PRIDES. The acronym PRIDES stands for preferred redeemable increased dividend equity securities.

[181] See Internal Revenue Service Technical Advice Memorandum 199910046 (Nov. 16, 1998), addressing the treatment of an earlier version of the trust preferred security issued by a foreign limited liability company.

[182] Section 163(l) disallows a deduction for any interest paid or accrued on a "disqualified debt instrument," defined as indebtedness of a corporation that is payable in equity of the issuer or a related party.

common or preferred stock directly. According to one commentator, the annual tax values of the interest deductions to Citigroup and Morgan Stanley approximate $175 million and $100 million, respectively.[183]

In addition, the choice of mandatory convertible securities appears to have been influenced by regulatory considerations. In particular, it was important that the capital raised by Citibank and Morgan Stanley be counted toward "Tier 1" capital requirements for bank regulatory purposes.[184] The equity units acquired by ADIA and CIC qualified as Tier 1 capital, whereas the issuance of a debt security alone would not have so qualified. Moreover, at least one analyst has argued that the use of mandatory convertible securities allowed ADIA's and CIC's percentages of ownership in Citigroup and Morgan Stanley to remain below ownership and control thresholds that would have subjected the transactions to CFIUS review.[185]

It is less clear that the U.S. tax treatment of ADIA and CIC (and the availability of section 892 in particular) influenced the structure of these investments. Assuming, as seems likely, that ADIA and CIC are integral parts or controlled entities of the Abu Dhabi and Chinese governments, they generally should qualify under section 892 for exemption from U.S. tax on income eligible for the exemption. Income from the ADIA-Citigroup investment and the CIC-Morgan Stanley investment should be eligible for the exemption, because the investments are in "stocks, bonds, or other securities," and because the commercial activity and controlled commercial entity exceptions would seem not to apply.

A nongovernmental foreign investor would have enjoyed most, but not all, of the U.S. tax benefits obtained by ADIA and CIC. In particular, in the hands of a nongovernmental foreign investor, the portion of the return attributable to interest paid on the debentures underlying the trust preferred securities generally would have been eligible for the portfolio interest exemption of section 871(h) or 882(c) from U.S. withholding tax,[186] and any capital gains realized on a sale

---

[183] David D. Stewart, "Sovereign Wealth Funds Take Advantage of IRS Ruling," Tax Notes International, Mar. 10, 2008, at 830. In the ADIA-Citigroup investment, interest at 6.5 percent (the amount treated as interest) on $7.5 billion is $487.5 million, and the resulting tax savings computed at a 35 percent corporate tax rate is $170.625 million. In the CIC-Morgan Stanley investment, interest at 6 percent (the amount treated as interest on $5 billion is $300 million, and the resulting tax savings computed at a 35 percent corporate tax rate is $105 million.

[184] See, e.g., Liz Moyer, "Abu Dhabi Pumping $7.5B into Citi," Forbes.com, Nov. 11, 2007, available at http://www.forbes.com/markets/2007/11/26/citi-abudhabi-stake-markets-equity-cx_lm_1126markets44.html; "Morgan Stanley F4Q07 (Qtr End 11/30/07) Earnings Call Transcript," available at http://seekingalpha.com/article/57886-morgan-stanley-f4q07-qtr-end-11-30-07-earnings-call-transcript?page=-1.

[185] See David D. Stewart, "Sovereign Wealth Funds Take Advantage of IRS Ruling," Tax Notes International, Mar. 10, 2008, at 831 (citing New America Foundation official Douglas Rediker).

[186] The portfolio interest exemption would not be available to a foreign investor that was a 10-percent (or greater) shareholder of Citigroup or Morgan Stanley, as applicable. Secs. 871(h)(3)(B), 881(c)(3)(B). The Citigroup Upper DECS acquired by ADIA, and the Morgan Stanley PEPS acquired by

of the investments or the stock received on maturity of the forward contracts would have been exempt under section 871 or section 881.

The only potential U.S. tax advantage obtained by ADIA and CIC, when compared to a nongovernmental foreign investor in identical equity units, relates to the portion of the return attributable to the quarterly contract payments. In the case of a nongovernmental foreign investor, those payments might be characterized as "fixed and determinable annual or periodic income," in which case the payments would be subject to withholding tax at a 30-percent rate unless the investor were eligible for an exemption or reduced rate under an income tax treaty.[187] By contrast, regardless of the proper characterization of such contract payments, ADIA and CIC probably would be exempt from taxation on the contract payments by virtue of Section 892.

A foreign investor eligible for section 892 also obtains a U.S. tax benefit when compared to a nongovernmental foreign investor, in respect of dividends received on the stock delivered under the forward contract portion of the equity units. For a nongovernmental foreign investor, dividends are generally subject to withholding tax at a 30 percent rate, unless reduced by an income tax treaty.

CIC, represented less than 10-percent ownership interests in the issuers, taking into account the stock to be delivered on maturity.

[187] The proper characterization of contract payments in arrangements similar to that described in Revenue Ruling 2003-97 is uncertain, and the revenue ruling does not address that case. One plausible interpretation is that those contract payments constitute a miscellaneous fee paid by the issuer to induce the investor to make the relevant investment. Another possible interpretation is that the contract payments represent net option premium paid by the issuer to the investor on a periodic basis (which in turn is not the norm for option premium payments). Other interpretations also could be developed.

B. Common and Convertible Preferred Stock

On December 24, 2007, Merrill Lynch & Co., Inc. ("Merrill Lynch") announced that it would sell up to $6.2 billion in common stock to Temasek Holdings[188] and Davis Selected Advisors, L.P. Temasek Holding's share of the transaction was a $4.4 billion initial stock purchase, with an option to purchase an additional $600 million in common stock by March 28, 2008.[189]

On January 15, 2008, Merrill Lynch announced that it would issue $6.6 billion of nonvoting mandatory convertible non-cumulative preferred stock to a group of investors that included the Kuwait Investment Authority ("KIA"), the Korean Investment Corporation ("KIC") and Mizuho Bank.[190] The preferred stock pays a dividend of 9 percent per annum and has a maturity of 2¾ years, at which point it mandatorily converts into Merrill Lynch common stock.

On January 23, 2008, Citigroup Inc. sold $12.5 billion in convertible preferred stock to a group of investors that included the Singapore Government Investment Corporation Pte Ltd. ("GIC"),[191] KIA, the New Jersey Investment Division and a number of private investors including nongovernmental foreign investors.[192] The preferred stock is perpetual and pays a dividend of 7 percent per annum. The holder may convert the preferred stock into common stock of Citigroup at any time, and Citigroup may convert the stock into common stock at any time on or after February 15, 2015. The preferred stock is also redeemable for cash on or after February 15, 2015 subject to certain limitations. The preferred stock conveys no governance rights, subject to the customary right of preferred stockholders to elect two members to the board of directors upon nonpayment of dividends for six dividend periods.

For the SWF investors in each of these transactions, section 892 would exempt any dividend payments on the common or preferred stock. In the case of the two convertible preferred stock issuances, however, the stock was sold on the same terms to a group of investors that included both SWFs and other nongovernmental foreign investors (who would be subject to

[188] Temasek Holdings is a Singapore corporation that is wholly owned by the Singapore Ministry of Finance. It holds and manages investments for the Government of Singapore.

[189] See Merrill Lynch & Co., Inc., Current Report on Form 8-K, filed with the Securities Exchange Commission on December 27, 2007, available at http://www.sec.gov/Archives/edgar/data/65100/000095012307017127/y45445exv99w1.htm. This transaction settled on December 28, 2007 (60 percent) and January 11, 2008 (40 percent).

[190] See Merrill Lynch & Co., Inc., Current Report on Form 8-K, filed with the Securities Exchange Commission on January 15, 2008, available at http://www.sec.gov/Archives/edgar/data/65100/000095012308000429/y46693exv99w1.htm.

[191] GIC acquired $6.88 billion of the preferred stock.

[192] See Citigroup Inc., Current Report on Form 8-K, filed with the Securities Exchange Commission on January 15, 2008, available on the internet at http://www.sec.gov/Archives/edgar/data/831001/000110465908002663/a08-1948_1ex99d1.htm.

U.S. withholding tax on dividend payments). This suggests that the availability of an exemption under section 892 was not a significant consideration in the choice of convertible preferred securities. A more significant concern may have been the qualification of the preferred stock as Tier 1 capital for bank regulatory purposes.

C. Other Investment Strategies

Due to the risk that tax-exempt income may become tainted, a foreign government considering investing in a partnership through a controlled entity typically will seek to avoid any situation that might result in the attribution of any commercial activity (occurring anywhere in the world) to its controlled entity. One method by which a foreign government could minimize the risk of tainting its otherwise tax-exempt income under section 892 in this circumstance is by having its controlled entity ("Corp A") create (at least) two subsidiary brother-sister corporations ("Sub B" and "Sub C"). Corp A would then function solely as a holding company for Sub B and Sub C, making no investments itself. Sub B would make all non-U.S. investments (including any investments in non-U.S. partnerships). Sub C would invest solely in the U.S., and would not invest directly in any partnership. If Sub C desired to invest in a U.S. partnership, such as a U.S. hedge fund or private equity fund, it would do so only by investing in a corporate entity (i.e., a blocker company) that it would not control, such as the foreign feeder corporation commonly found in many U.S. hedge fund or private equity fund structures.[193] With such a structure, it is irrelevant whether Sub B engages in, or is treated as engaging in, any commercial activities, as all of its investments are outside the United States, and thus not subject to U.S. tax. As brother-sister corporations, any Sub B commercial activities would not taint Sub C. Sub C's income would not be tainted because it would not engage in any commercial activities itself and would have no commercial activities attributed to it as a result of any investment in a U.S. hedge fund or private equity fund because the foreign feeder corporation would block any potential attribution.

In certain cases, a SWF might also invest in an investment fund organized as a partnership, not only as a limited partner but also as a member of the general partner managing the fund assets (typically itself organized as a passthrough entity, such as a partnership or limited liability company). As a member of the general partner, the SWF would share in both fee income derived by the general partner and the so-called "carried interest," generally a partnership profits interest under which the general partner has a right to receive a percentage of partnership profits but has no obligation to contribute capital and no right to partnership assets on liquidation.[194] Because the character of a partnership's income passes through to its partners, the general partner's share of income has the same character as the income has when it is realized by the underlying investment fund. Accordingly, under present law income from a carried interest may be reported as long-term capital gain to the extent that the income is attributable to gains

[193] For a description of a common fund structure that employs a foreign feeder corporation, as well as an explanation of some of the possible tax advantages of such a structure, see Joint Committee on Taxation, *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part II* (JCX-63-07), at 2-5, Sept. 4, 2007.

[194] For a comprehensive discussion of partnership carried interests and their tax treatment, see Joint Committee on Taxation, *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part I* (JCX-62-07) and *Part II* (JCX-63-07), Sept. 4, 2007.

realized by the investment fund from capital assets held for more than one year.[195] In the case of a SWF, the investment management activities of the general partner might be treated as a commercial activity that would be attributed to the SWF.[196] If so, section 892 would not be available with respect to income derived by the SWF through its interest in the general partner. However, any portion of the carried interest treated as capital gains would normally be exempt in any event under the rules generally applicable to foreign investors; other income, such as dividends, would likewise receive the same treatment as in the hands of a private foreign investor. Moreover, the use of a special purpose "blocker" company, as described above, could prevent the commercial activity attributed to the SWF from tainting other income earned by the SWF, including its income earned as a limited partner in the investment fund.[197]

[195] Section 1201 of the Tax Reduction and Reform Act of 2007, H.R. 3970, 110th Cong., introduced on October 25, 2007, would generally treat income from a carried interest as ordinary income.

[196] Temp. Treas. Reg. sec. 1.892-5T(d)(3).

[197] An alternative, and perhaps simpler, way for a SWF to invest in an investment fund manager and share in the carried interest would be to acquire stock in one of the publicly traded fund managers, such as The Blackstone Group L.P. or Fortress Investment Group LLC. Both dividends and capital gains realized from such an investment presumably would be exempt under section 892.

V. POLICY CONSIDERATIONS REGARDING THE CURRENT TAX TREATMENT OF U.S. INVESTMENT BY FOREIGN GOVERNMENTS

As discussed above, the U.S. income tax treatment afforded U.S. investments by foreign governments is generally similar to, but somewhat better than, the tax treatment afforded similar investments by foreign corporations. We have set out below a number of factors that should be considered in evaluating the merits of this differential. As a preliminary matter, however, we note that it is difficult to conceive of any reasonable justification for modifying the existing rules to treat SWFs, or foreign governments more generally, less favorably than foreign corporations.

A. Economic Policy Considerations

Economic theory generally argues that unencumbered trade in goods and services and cross border investment creates the greatest opportunity for growth both in the United States and abroad. Policies that impede cross border investment can lead to inefficient investment decisions and potentially reduced aggregate investment. Reduced aggregate investment and an inefficient allocation of investment dollars reduces future growth compared to that achievable in the absence of restrictions. Reduced growth means that per capita income will be lower in the future than it might otherwise be. This analysis would argue that restrictions on investments by SWFs cannot improve economic well being in the United States. On the other hand, as documented above, investment by SWFs is small relative to aggregate U.S. investment and even smaller relative to aggregate worldwide investment. If SWFs are not the marginal investor in the United States, that is if investments made by SWFs would be readily substituted by other funds at little or no change in the cost of capital, restrictions on the investments of SWFs would have little or no effect on future economic growth in the United States. However, restrictions on some foreign investors may be interpreted by other potential investors as an indication that the United States is inhospitable to foreign investors. Such a perception could make foreign investment funds more expensive and reduce aggregate investment.

B. Tax Policy Considerations

<u>Sovereign immunity</u>

As discussed in more detail above, the exemption from U.S. income tax afforded foreign governments with respect to certain income has a long history that is consistent with the development of the concept of sovereign immunity under U.S. law. When first added to the U.S. income tax laws in 1917, the predecessor to the exemption now found in section 892 was consistent with the then-prevailing absolute theory of sovereign immunity, under which one country was absolutely immune from the jurisdiction of the courts of another country. The broad exemption from U.S. income tax that Congress provided to foreign countries was a natural extension of this immunity from U.S. courts.

The income tax exemption evolved with the passage of time in such a way as to reflect sovereign immunity developments and an increase in the scope of activities engaged in by foreign countries. In the 1950s, the United States moved from following an absolute theory of immunity to following a restrictive theory of immunity. With the enactment of FSIA in 1976, the United States statutorily adopted a restrictive theory of immunity. FSIA broadly provides foreign countries immunity from the jurisdiction of U.S. courts, except in certain cases involving, inter alia, commercial activities. In 1980, regulations under section 892 were adopted that narrowed the scope of the tax exemption by stating that it was not available with respect to income derived from commercial activities in the United States. In 1986, section 892 was amended to specifically include a commercial activities exception to the exemption. As amended and applied, section 892 is generally consistent with FSIA in that it provides exemption from the U.S. income tax laws for certain types of investment income, but does not provide exemption for income derived from commercial activities. In light of this background, any consideration of the proper scope of section 892 should take into account, and reflect the scope of, the immunity provided under FSIA.

Differences in U.S. tax treatment of various investors in the United States

Another consideration is that the difference between the U.S. income tax treatment of foreign governments and foreign corporations is limited as a practical matter. That difference is described in more detail above. In brief, however, there are three principal differences: portfolio dividends, interest income from certain noncontrolled commercial entities, and income from the disposition of interests in noncontrolled USRPHCs that are not domestically controlled REITs. In each instance, the income is generally exempt under section 892 when received by a foreign government but is taxable when received by a foreign corporation. However, the differential U.S. income tax treatment with respect to the first two categories of income may be reduced or eliminated in cases in which U.S. income tax treaties apply to provide foreign persons relief from U.S. income tax on dividends and interest. With respect to the third category, U.S. income tax treaties generally preserve the United States ability to impose U.S. income tax on dispositions of interests in USRPHCs by foreign persons, so the differential tax treatment will generally continue to exist in that case.

Given these limited differences in the U.S. income tax treatment between foreign governments and foreign corporations, achieved through different Code provisions and the application of U.S. income tax treaties, one might consider whether the tax exemption in section 892 provides much meaningful benefit to foreign governments. If one concludes that it does not, that conclusion might suggest, on the one hand, that narrowing or eliminating the specific tax exemption in section 892 might be of little practical consequence; on the other hand, that conclusion might suggest that there is limited justification for altering the specific tax exemption in section 892 (particularly in light of the risk that foreign countries might choose to respond to any narrowing of section 892 with changes in their own laws that could disadvantage U.S. investors).

A further consideration is that the income tax treatment afforded foreign governments (including their political subdivisions) under section 892, although somewhat better than the treatment afforded foreign corporations, is significantly less favorable than the U.S. income tax treatment afforded nonfederal sovereigns, specifically U.S. States and Indian tribes. As discussed above, States are not subject to U.S. income tax on any income that they earn directly, even if from commercial activities. Moreover, States are specifically exempt under the Code from tax on certain income that they earn indirectly, if the income is derived from a public utility or the exercise of an essential governmental function. This exemption may apply to income derived from commercial activities. As also discussed above, Indian tribes and wholly owned tribal corporations chartered under Federal law are similarly not subject to U.S. income tax, even if the income is from commercial activities and even if the activity is conducted off the tribe's reservation. One might suggest that this disparity in the existing treatment between foreign sovereigns and nonfederal sovereigns demonstrates that section 892 already provides too narrow of an exemption or, conversely, that the exemption provided to nonfederal sovereigns is too broad.

Select section 892 considerations

Section 892 contains a fairly broad definition of foreign government, which includes certain controlled entities. One could imagine utilizing a narrower definition for this purpose, but any such effort might present difficult line-drawing issues. For example, if one were to consider limiting the definition of foreign government to foreign sovereigns and their integral parts (i.e., the definition would not include controlled entities), it would be necessary to consider whether there is any type of controlled entity that should nevertheless qualify (e.g., a separately organized pension trust). One would also need to consider whether investments that are currently made through controlled entities might instead be made through integral parts, such as bureaus or departments that might be established specifically to make those investments.

A related issue arises with respect to the different outcome under section 892 if an integral part or a controlled entity engages in commercial activity. If an integral part engages in commercial activity, the income from that activity does not qualify for the section 892 tax exemption, but any other income received by the integral part that would otherwise qualify for the exemption continues to qualify for the exemption (i.e., the commercial activity does not taint the other income). However, if a controlled entity engages in commercial activity, neither the income from that activity nor any other income received by the controlled entity qualifies for the section 892 tax exemption (i.e., the commercial activity taints all of the income). In effect, this disparity in outcome elevates form over substance, in that in either case the source of the funds for the investment that generated the noncommercial income is the same—the funds belong to the foreign sovereign—and the only difference is the form the foreign sovereign chooses to utilize to make the investment. On the one hand, it is true that the foreign sovereign is generally free to choose the form of its investment and, in so doing, accepts the consequences. More importantly, however, the disparate impact of commercial activities on integral parts and controlled entities creates a potential trap for the unwary—a controlled entity that engages in any commercial activity, no matter how minimal, anywhere in the world, taints all of that controlled entity's income. Although structural solutions are available, one might consider whether it is appropriate to employ a rule with such consequences in a case in which the Code generally provides U.S. income tax exemption. Other approaches, such as a de minimis rule or an examination of the activities of the controlled entity as a whole, may be more appropriate.

An additional issue is the nature of the interaction between the section 892 exemption and the look-through rule of section 897(h)(1) for distributions from QIEs, including REITs. This issue is discussed in Notice 2007-55, which is described in more detail above. In brief, the Notice indicates the IRS's view that the look-through rule applies to REIT distributions (including liquidating distributions) to foreign governments, such that the section 892 exemption does not apply to a distribution to the extent it is attributable to gains from the sale or exchange by the REIT of interests in real property located in the United States or the Virgin Islands. In addition, the Notice states that the Treasury Department and the IRS will clarify the interaction of these provisions in regulations. As noted earlier, the issue presented by the Notice is whether a foreign government's exemption under section 892 should shelter gain realized by the REIT. In this regard, one might consider whether a foreign government that receives a distribution from a REIT should be exempt from U.S. income tax to the extent that the distribution is from the REIT's sale of property that, if sold by the foreign government directly, would be subject to tax. On the other hand, section 892 exempts from U.S. income tax a foreign government's gain from the sale of an interest in a noncontrolled USRPHC, including a REIT. This treatment may suggest that a foreign government that receives a REIT distribution attributable to gains from the sale or exchange by the REIT of interests in U.S. real property should be exempt from U.S. income tax under the general rule of section 892 that dividends from noncontrolled commercial entities, including REIT distributions, are exempt.

VI. COMPARISON WITH FOREIGN LAW

Appendix One hereto contains a report prepared by the Directorate of Legal Research for International, Comparative, and Foreign Law of The Law Library of Congress entitled *Taxation of the Passive Income of Foreign Governments and Sovereign Wealth Funds in Selected Foreign Countries*. These countries are Australia, Canada, Germany, Japan, Norway, Poland, Switzerland and the United Kingdom. For purposes of the analysis in the report, passive income is defined as interest, dividends and capital gains.

As the report illustrates, four of those countries have adopted a general policy that is broadly similar to that of the United States in that they exempt foreign governments unilaterally from taxation of passive income, based on a principle of sovereign immunity. Each of these countries, however, has implemented that policy in a manner different from the United States, including with respect to SWFs. The remaining countries either do not exempt foreign governments from taxation or do so only bilaterally through income tax treaties (in which case SWFs may or may not benefit from the exemption, depending on the treaty).

Japan and the Commonwealth countries of Australia, Canada and the United Kingdom have each adopted a general policy of exemption for foreign governments from taxation on passive income. In Australia and Canada, that policy is implemented administratively and on an individual government-by-government basis. In both cases, exemptions are granted to SWFs in only limited circumstances. Thus, in Australia, a foreign government or its agency may obtain an exemption for funds that will remain governmental by applying for a private ruling that usually is granted for portfolio investments (with 10 percent or less equity ownership being a guidepost for defining a noncommercial activity). A SWF may obtain an exemption only by establishing that the passive investment income that will be eligible for the exemption results from the performance of a governmental function in Australia. In Canada, the government or a central bank of a foreign country may obtain an exemption from withholding taxes for Canadian source portfolio investments that serve a truly governmental function, and not a commercial activity, provided that there is reciprocity. For this purpose, SWFs appear to have been evaluated based on whether their purpose is public/humanitarian, or commercial.

Japan apparently exempts foreign governments from taxation on interest and dividends by administrative practice, while capital gains are exempt by law. SWFs do not benefit, however, from the administrative exemption for interest and dividends. Instead, they are taxable in the same manner as a foreign corporation, except to the extent that an income tax treaty may grant relief for a SWF based in the treaty country. The United Kingdom also exempts foreign governments from taxation on passive income by administrative practice; SWFs benefit fully from this exemption (assuming the SWFs are integral parts of the governments of their respective countries).

Germany, Norway, Poland, and Switzerland do not apply the doctrine of sovereign immunity to exempt foreign governments from taxation. Germany taxes foreign governments, including SWFs, in the same manner as foreign corporations, and its income tax treaties also do not provide any specific exemption for foreign governments. However, Germany’s tax laws provide a general exemption for both interest and non-substantial-participation capital gains derived by nonresidents; a 95-percent exemption is also provided for dividends and substantial participation capital gains. Thus, all nonresidents, including foreign governments, bear relatively little tax on passive income from German sources.

Norway's tax laws do not appear to include any special provision for foreign governments or SWFs. However, Norway does not tax interest income earned by nonresidents. Norway also provides an exemption for dividend income and capital gains attributable to ownership of stock in Norwegian companies by corporate shareholders in EEA countries; dividends paid to corporate shareholders outside the EEA are subject to a 25-percent withholding tax, unless reduced by treaty. Certain of Norway's income tax treaties also appear to provide for reciprocal government exemptions.

Like Norway, Poland's tax laws do not provide an exemption for foreign governments or SWFs. In fact, Poland's tax laws do not distinguish between residents and nonresidents; all income of corporations originating in Poland is subject to a flat 19 percent corporate tax, regardless of the residence of the corporation. Certain income tax treaties entered into by Poland do provide reduced dividend withholding rates for nonresidents and, in some cases (such as Kuwait) an exemption for the other country's government.

Switzerland also does not exempt foreign governments from taxation by law. It does, however, provide exemptions on a reciprocal basis through its income tax treaties.

The Law Library of Congress

REPORT FOR CONGRESS

May 2008

Directorate of Legal Research
LL File No. 2008-00763

TAXATION OF THE PASSIVE INCOME OF FOREIGN GOVERNMENTS AND SOVEREIGN WEALTH FUNDS IN SELECTED FOREIGN COUNTRIES

Australia, Canada, Germany, Japan, Norway, Poland, Switzerland, and the United Kingdom.

.

Directorate of Legal Research for International, Comparative, and Foreign Law
James Madison Memorial Building; 101 Independence Avenue, S.E.; Room LM 240; Washington, DC 20540-3200
Reception: (202) 707-5065 – FAX: (202) 315-3654
www.loc.gov/law/congress

2008-00763

LAW LIBRARY OF CONGRESS

TAXATION OF THE PASSIVE INCOME OF FOREIGN GOVERNMENTS AND SOVEREIGN WEALTH FUNDS IN SELECTED FOREIGN COUNTRIES

COMPARATIVE SUMMARY

Executive Summary

On the basis of the principle of sovereign immunity, Australia, Canada, Japan, and the United Kingdom exempt foreign governments and their instrumentalities from taxation of their source country passive investments through administrative acts or practices, and to a limited extent, sovereign wealth funds may also benefit from these regimes. Germany, Norway, Poland, and Switzerland do not apply the doctrine of sovereign immunity to grant foreign governments general exemptions from taxation on their source country income. However, the Norway-Russia double taxation treaty exempts interest earned by the other government and its central bank while the Kuwait-Poland treaty exempts source dividends earned by the other county's governments and their funds. Germany appears to have no such exemptions in its double taxation treaties, while the Swiss double taxation treaties allow for much discretion and flexibility on the basis of informal agreements between the Contracting States.

In their domestic legislation, Canada, Germany, Norway, and the United Kingdom do not tax source country interest of non-residents, whereas Australia, Japan, Poland, and Switzerland withhold tax on such interest at varying rates. Source country dividends are exempted for non-residents in the United Kingdom, and for corporate non-residents they are totally exempted in Norway and 95 percent exempted in Germany. Australia taxes only the dividends from untaxed corporate profits, whereas Canada, Japan, Poland, and Switzerland withhold taxes on source country dividends at varying rates.

I. Scope of the Project

This report consists of individual reports for Australia, Canada, Germany, Japan, Norway, Poland, Switzerland, and the United Kingdom. All these countries are members of the Model Tax Convention of the Organization for Economic Co-operation and Development [OECD Model Tax Convention][1] and for each of these countries the report surveys the country's domestic legislation, policy, or practice on the taxation of passive income (interest, dividends, and capital gains) earned by foreign governments or their instrumentalities and by foreign sovereign wealth funds. To assess the significance of any tax exemptions for foreign governments and their funds, this report also reviews the domestic laws on taxing source country income from interest, dividends, and capital gains that is earned by non-resident corporations in general. In addition, to provide a sampling of the applicable double taxation treaties, each country report examines at least one double taxation treaty with another country that has a prominent sovereign wealth fund.

[1] Organization for Economic Co-operation and Development, Model Tax Convention on Income and on Capital, Electronic Version, Feb. 1, 2005, available by subscription from the official Web-site http://www.oecd.org/document/17/0,3343,es_2649_33747_35035793_1_1_1_1,00.html.

II. Taxation of Foreign Governments

In comparing the domestic laws and policies on the taxation of foreign governments and their entities, a difference between Japan and the Commonwealth countries of Australia, Canada, and the United Kingdom on the one hand and Continental Europe on the other becomes apparent. Whereas Japan and the surveyed Commonwealth countries base their practice of exempting foreign governments and their agencies from taxation of their passive source income on the international law concept of sovereign immunity, this theory is not used to generally exempt governments from taxation in continental Europe.[2] In the domestic laws of Germany, Norway, Poland, and Switzerland, foreign governments are deemed to be treated like other foreign entities, and if exemptions are made, they are most likely to be found in double taxation treaties or the practice resulting from them.

Australia and Canada exempt foreign governments from taxation on their passive source income; they implement this principle through individual administrative acts.

- In Australia, a foreign government or its agency may obtain an exemption for funds that will remain governmental by applying for a private binding ruling that usually will be granted for portfolio investments, with 10 percent equity or less being the guidepost for defining a non-commercial activity.
- In Canada, the government or a central bank of a foreign country may obtain an exemption from withholding taxes for Canadian source portfolio investments that serve a truly governmental function and not a commercial activity, provided that there is reciprocity.

Japan and the United Kingdom exempt foreign governments from taxation on their passive source income through their administrative practice, which in the case of Japan has found expression in the exemption of the foreign governments from having to report source income to the authorities, on the grounds that it would not be taxed in any event.

In addition to these unilateral or reciprocity-based practices, these above described countries may allow for further exceptions on the basis of their double taxation treaties.

Among the surveyed continental European countries that do not subscribe to the sovereign immunity concept for the taxation of foreign government's passive investments, Germany stands out by adhering to the principle of taxing foreign governments like any other foreign company, not only in its domestic legislation but also in its treaty practice. The German double taxation treaties follow the spirit of article 4, paragraph 1 of the OECD Model Tax Convention by treating the governments of the treaty states as residents, and therefore as taxpayers, and by not making exceptions from this principle.

Norway and Poland, while adhering to the principle that foreign governments should be taxpayers, nevertheless make some treaty exceptions to this principle. The double taxation treaty between Norway and Russia, for instance, exempts passive income from taxation at the source if it is beneficially owned by the other Contracting State or its subdivisions or instrumentalities, central banks, certain named financial institutions for foreign trade, and similar institutions designated by mutual agreement.

Poland has double taxation treaties with China, Kuwait, Russia, and Singapore. Of these, the only exemption from the taxation of a foreign government is found in the treaty with Kuwait. It provides that dividends earned in the source country by the government of the other state are exempt from taxation.

[2] All the surveyed countries are members of the Convention on Diplomatic Relations, Apr. 18, 1961, 23 UST 3227; TIAS 7502; 500 UNTS 95 and of the Convention on Consular Relations, Apr. 24, 1963, 21 UST 77; 596 UNTS 261, and it can be safely assumed that they observe these conventions by exempting diplomatic and consular staff from taxation, as well as exempting foreign governments for mission-related purposes. These Conventions are not further discussed in this report.

Switzerland has no domestic legislation exempting foreign governments from taxation of their passive Swiss-source income. It also appears that the double taxation treaties do not specify such exemptions. The actual practice, however, cannot be deduced from a reading of the relevant double taxation treaties, because they contain many discretionary clauses that should allow the contracting states to make exceptions from the otherwise governing regimes for dividends and interest. This, at least, was found in the double taxation treaties with Norway and Kuwait.

III. Taxation of Sovereign Wealth Funds

In exempting foreign governments from taxation of their passive source income, Australia, Canada, and the United Kingdom may extend this principle to sovereign wealth funds on the basis of individual decisions that examine the governmental nature and purpose of the fund.

- In Australia, a sovereign wealth fund may be exempted from the dividend or interest withholding tax, if the fund establishes that the generated passive investment income results from the performance of a governmental function within Australia.
- In Canada, the scrutiny of the sovereign wealth fund appears to focus on the public/humanitarian or commercial purpose of the fund: Chinese banks have been denied exempt status, whereas the New Zealand Earthquake Relief Fund qualified.
- In the United Kingdom, a sovereign wealth fund will be exempted from passive investment income if it is an integral part of the government of a foreign sovereign state, but the exemption will be denied if the fund is an entity that is separate from the government, even though the government may own its shares.

Germany, Japan, Norway, Poland, and Switzerland have no unilateral or reciprocity-based rules on exempting sovereign wealth funds, thus allowing only for treaty provisions to exempt sovereign wealth funds from the taxation of their passive source-country income. German treaties appear to contain no such provisions, whereas the flexibility found in the Swiss double taxation treaties is not helpful in revealing the actual practice.

The treaty between Japan and Singapore exempts the taxation of interest earned not only by the Contracting State's governments, their local authorities, and central banks, but also of any institution wholly owned by that government. The Canada-Norway double taxation treaty contains a similar provision, thus exempting Canadian and Norwegian sovereign wealth funds from taxation of dividend and interest income in the other country. The treaty between Poland and Kuwait exempts dividend income earned by a company owned by the government of the other country.

IV. Domestic Tax Rates for Passive Investment Income Earned by Foreign Corporations

Interest

Canada, Germany, Norway and the United Kingdom exempt interest from taxation to a considerable extent, if the interest is earned by a non-resident portfolio investor. In Germany, the only types of interest that are taxable for non-residents are mortgage interest and interest derived from certain hybrid debt instruments that are similar to shares. Interest from German bank accounts is not taxed if earned by a foreign resident. In Canada, interest is exempt if earned by a foreign resident through an arm's length transaction, and in the United Kingdom, interest earned from bank accounts is exempt for foreign residents. Norway generally exempts interest earned by non-residents.

Australia, Japan, Poland, and Switzerland tax non-residents on source country interest, usually by applying the general withholding tax from which relief can only be obtained through an applicable double taxation treaty. Australia taxes interest at the general rate of 10 percent; the Japanese tax rate for interest earned by passive investments is 15 percent; Poland taxes non-resident corporations on their Polish-source interest at the flat corporate rate of 19 percent; and Switzerland generally withholds at the rate of 35 percent, with certain exceptions applying to affiliated enterprises within the European Union.

Dividends

Norway exempts foreign corporations from being taxed on their source country dividends on the theory that this avoids inter-corporate taxation. Norway, however, taxes non-resident portfolio dividends of non-residents from outside the European Economic Area and also dividends earned by residents of tax havens. Such dividends are taxed at the generally applicable rate of 25 percent.

The German provisions and their underlying philosophies are similar, yet Germany exempts from taxation only 95 percent of the dividends earned by resident and non-resident corporations. The remaining 5 percent, as well as dividends earned by individual non-resident shareholders, are taxed at the rate of 26.38 percent. The United Kingdom, on the other hand, generally exempts from taxation the dividends earned by non-residents.

Australia, Canada, Japan, Poland, and Switzerland tax non-residents on their source country dividends, usually at the rates that also apply to residents. Australia, however, distinguishes between franked and unfranked dividends and imposes the 30 percent tax rate only on dividends from profits for which the corporation has not been taxed.

Canada generally withholds at the rate of 25 percent, aside from various exceptions; the Japanese withholding rate for passive income dividends earned by non-residents is 20 percent; Poland withholds dividends earned by non-resident business entities at the flat corporate rate of 19 percent; and Switzerland applies the withholding rate of 35 percent to portfolio holdings while granting a participation exemption to substantial holdings by Swiss and European investors.

Capital gains

Capital gains from passive investments of non-residents are not taxed in Japan and the United Kingdom. Norway exempts capital gains from the sale of stock if earned by a non-resident corporation under the principles that are applied to dividend income. In Germany, non-resident corporate entities pay capital gains tax at the rate of 26.38 percent on only 5 percent of the gain from on the sale of substantial participations (one percent of shares held during five years).

Capital gains from passive investments that are earned by non-residents are generally taxed in Australia, Canada, Poland, and Switzerland. Australia applies the marginal tax rate, Canada withholds at 25 percent, Poland applies the 19 percent corporate tax rate to business entities, and Switzerland applies the federal income tax rate of 8.5 percent.

IV. Tax Rates in Sample Double Taxation Treaties

In this very limited sampling of double taxation treaties,[3] the bilateral treaties between Norway on the one hand and Australia, Canada, Germany, Japan, and Switzerland, on the other, have been reviewed because the Norwegian Pension Fund is one of the oldest and most prominent sovereign wealth funds.[4]

Of these, the treaty with Canada exempts dividends and interest earned by the governments of the contracting states. The treaty with Switzerland exempts the Swiss dividends earned by the Norwegian Government, Central Bank, and Oil Fund, and no corresponding provision for interest is needed because

[3] For a more comprehensive treatment of several double taxation treaties between Australia and countries that have sovereign wealth funds, see the country report on Australia.

[4] For more information, see the country report on Norway.

it is generally not taxed at the source. The treaty with Poland exempts dividends earned by the Kuwaiti government or a company owned by it, but does not provide a corresponding provision for interest? Does this last sentence refer to a Norwegian treaty?

The treaties with Australia, Germany, and Japan contain no specific exemption of Norway's government or its funds.

The treaty with Australia taxes source country interest at a rate of up to 15 percent, portfolio dividends at up to 15 percent, and dividends from participations at 0 to 5 percent. The treaty with Germany taxes source country interest with a rate of 0 percent, portfolio dividends at up to 15 percent, and dividends from participations at up to 5 percent. The treaty with Japan does not tax Japanese interest and dividends earned by Norwegian residents.

Prepared by Edith Palmer
Senior Foreign Law Specialist
May 2008

2008-00763

LAW LIBRARY OF CONGRESS

TAXTION OF THE PASSIVE INCOME EARNED BY FOREIGN GOVERNMENTS AND SOVEREIGN WEALTH FUNDS

AUSTRALIA

Australia does not grant a complete immunity from Australian taxation to foreign sovereigns. Rather Australia distinguishes between commercial and non-commercial investments and permits non-commercial passive investments to apply for and be granted an exemption from taxation on the basis of sovereign immunity. Australia's foreign policy and domestic legislation permits commercial investments by foreign sovereigns to be taxed.

Australia has signed a number of taxation agreements that may reduce the rate of Australian taxation payable by any foreign resident. In some recent taxation agreements the term resident is defined to include the governments of the contracting parties.

Introduction

Within Australia taxation is primarily levied in accordance with the Income Tax Assessment Act 1936 (Cth) and the Income Tax Assessment Act 1997 (Cth). Rulings and interpretations on application of income tax law may be made by the Australian Taxation Office.[1]

International tax agreements are governed by the text of the relevant treaty and the International Tax Agreements Act 1953 (Cth). Direct foreign investment is regulated via the Foreign Acquisitions and Takeovers Act 1975 (Cth) and overseen by the Foreign Investment Review Board.[2]

Immunities granted to foreign states are governed by the Foreign States Immunities Act 1985 (Cth) and the public international law doctrine of sovereign immunity.

I. Tax Status of Foreign Governments

General Position

Generally, a non-resident is liable for Australian taxation on income that is sourced in Australia and is not liable for Australian taxation on foreign sourced income.[3] In accordance with the International

[1] See the Australian Taxation Office Web site at: http://www.ato.gov.au/default.asp?menu=4244 (last visited May 2, 2008). Income Tax Assessment Act 19997 (Cth) §§ 6-5(3), 6-10(5), available from the official Web site of the Australian government, Attorney-General's Department, http://www.comlaw.gov.au.

[2] See the Foreign Investment Review Board's website at http://www.firb.gov.au/content/default.asp (last visited May 2, 2008). Legislation available from the official Web site of the Australian government, Attorney-General's Department, http://www.comlaw.gov.au.

[3] *Income Tax Assessment Act 1997* (Cth) §§ 6-5(3), 6-10(5), available from the official Web site of the Australian government, Attorney-General's Department, http://www.comlaw.gov.au.

Tax Agreements Act 1953 (Cth) and taxation treaties, rates of taxation for some situations are agreed and recorded within the relevant treaty. These treaties become schedules to the International Tax Agreements Act 1953 (Cth).

Australia's policy on commercial investments by foreign governments is, as articulated by the Foreign Investment Review Board, to require "...commercial investments by foreign governments or their agencies to be structured in a manner that enables all normal taxes and charges to be levied, and avoids questions of sovereign immunity arising".[4]

Further § 20 of the Foreign States Immunities Act 1985 (Cth) provides that:

> A foreign State is not immune in a proceeding in so far as the proceeding concerns an obligation imposed on it by or under a provision of a law of Australia with respect to taxation, being a provision that is prescribed,[5] or is included in a class of provisions that is prescribed, for the purposes of this section.

Exemption for Foreign Governments

In general foreign governments (and their agencies) that hold "passive investments" may be exempt from withholding tax on interest or dividends provided they meet the following conditions:

- the investment is made by a foreign government (or agency of a foreign government);
- the funds invested are and will remain government funds; and
- the income is derived from a "non-commercial activity."[6]

An exemption may be obtained by the foreign government seeking a binding private ruling from the Australian Taxation Office (ATO). In general a holding of 10 percent or less equity in a company (i.e. a portfolio holding) will be considered "non-commercial activity.[7]

The basis for this exemption is the doctrine of sovereign immunity, and while there is no legislation establishing this exemption, it is a long-standing practice and has been detailed in an Australian Taxation Office interpretive decision.[8]

On November 4, 2005, the then Australian Treasurer announced that new legislation would be introduced to clarify and codify the existing practice,[9] however, to date such legislation has not been

[4] *See also* Foreign Investment Review Board, ANNUAL REPORT 2005-2006: CHAPTER 3 OVERVIEW OF THE *FOREIGN ACQUISITIONS AND TAKEOVERS ACT 1975*, *available at* http://www.firb.gov.au/content/Publications/AnnualReports/2005-2006/Chapter3.asp.

[5] By virtue of regulation 3 and the schedule to the Foreign States Immunities Regulations 1987 (Cth), prescribed legislation includes the Income Tax Assessment Act 1936 (Cth) and the International Tax Agreements Act 1953 (Cth). All legislation available from the official Web site of the Australian government, Attorney-General's Department, http://www.comlaw.gov.au

[6] Australian Taxation Office Interpretative Decision, ATO ID 2002/45, available from the Australian Taxation Office Web site, http://law.ato.gov.au/atolaw/view.htm?dbwidetocone=05%3AATO%20Interpretative%20Decisions%3ABy%20Year%3A2002%3A1-99%3A%230045%23ATO%20ID%202002%2F45%20-%20Sovereign%20Immunity%3B (official source, last visited May 2, 2008).

[7] *Id.*

[8] ATO ID 2002/45, *id.*

[9] Press Release, Australian Government, 094/2005: Clarifying The Taxation Of Foreign Government Investments (Nov. 4, 2005), *available at* http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2005/094.htm&pageID=&min=phc&Year=2005&DocType=0.

introduced.

II. Tax Status of Sovereign Wealth Funds

Unless an exemption applies, dividends, interest, and royalties derived by sovereign wealth funds are subject to a final withholding tax at the time of payment.[10] Currently the general rates of taxation are:[11]

- unfranked dividends[12] – 30 percent;
- interest – 10 percent; and
- royalties – 30 percent.

These rates may be reduced due to the operation of a tax treaty or agreement (also known as double taxation avoidance agreements) between foreign governments and Australia.[13] For example, an agreement between Australia and China prescribes the following rates for tax on income: 15 percent for unfranked dividends; 10 percent for interest; and 10 percent for royalties.[14]

Sovereign wealth funds that are beneficiaries of Australian trusts (including beneficiaries that are trustees) are taxed upon distribution.[15] Where the sovereign wealth fund is a beneficiary of an Australian managed investment trust, the fund is taxed via a non-final withholding tax rate of 30 percent[16] (this rate may be reduced as the result of a tax treaty).

Where a sovereign wealth fund has direct ownership of real property, any associated rental income will be taxed at the general tax rate, and, the property may be subject to capital gains tax on disposal.[17]

Similar to a foreign government, where a sovereign wealth fund establishes that income generated results from the performance of a governmental function within Australia and that the income is from a

---

[10] Income Tax Assessment Act 1936 (Cth) §§ 128B(1), (2) and (2B), available from the official Web site of the Australian government, Attorney-General's Department, http://www.comlaw.gov.au.

[11] Current rates of tax are available from the Australian Taxation Office Web site at http://www.ato.gov.au/. (last visited April 10, 2008).

[12] Unfranked dividends are dividends paid from profits on which Australian tax has not been paid. Franked dividends do not attract dividend withholding tax.

[13] Australia has entered into tax agreements with over 40 countries. *See* Australian Taxation Office Web site, PAYG *Withholding From Interest, Dividends And Royalties To Non-Residents*, AUSTRALIAN TAX AGREEMENTS, http://www.ato.gov. au businesses/content.asp?doc=/Content/50240.htm&page=15&H15 (last visited April 10, 2008). Details of each agreement, and the domestic legislation implementing each agreement, are available from the Australian Government, Treasury Web site at http://www.treasury.gov.au/documents/625/XLS/Australian_Tax_Treaty_Table_April_2008.xls (last visited April 10, 2008).

[14] Agreement between the Government of Australia and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion [1990] ATS 45, arts. 10-12, [1990] Australian Treaty Series (ATS) 45 (official source). A copy of the treaty is available from the AustLII Australian Treaty Series Web site, http://www.austlii.edu.au/au/other/dfat/treaties/1990/45.html (unofficial source, last visited May 2, 2008).

[15] The trustee of the Australian trust is assessed on behalf of the Sovereign Wealth Fund.

[16] Taxation Administration Act 1953 (Cth), Schedule 1, Division 12, §§ 12-375 – 12-40, available from the official Web site of the Australian government, Attorney-General's Department, http://www.comlaw.gov.au. *Also see* Australian Taxation Office, WITHHOLDING ARRANGEMENTS FOR MANAGED FUND DISTRIBUTIONS TO FOREIGN RESIDENTS, http://www.ato.gov.au/taxprofessionals/content.asp?doc=/content/78088.htm&pc=001/005/054/002/014&mnu=24612&mfp=001&st=&cy=1 (last visited Apr. 10, 2008). The current company tax rate is available from the Australian Taxation Office Web site at: http://www.ato.gov.au/businesses/content.asp?doc=/content/44266.htm (last visited Apr. 10, 2008).

[17] Advice from the Australian Embassy, Washington DC, to author, dated April 10, 2008.

"passive investment," the fund may be exempted from dividend or interest withholding tax.[18]

However, where a sovereign wealth fund carries on a business in Australia, either through a resident subsidiary or a branch, the fund will be taxed on the same basis as an Australian resident company and generally will not be able to claim any sovereign immunity exemption for any subsequent passive income through that entity.[19]

III. Domestic Law

Section 995-1 of the Income Tax Assessment Act 1997 (Cth) defines a foreign resident as "a person who is not a resident of Australia for the purposes of the Income Tax Assessment Act 1936" (person is defined to include a company).

Section 44(1)(b) of the Income Tax Assessment Act 1936 (Cth) provides that the assessable income of a foreign resident shareholder in a company (whether the company is resident in Australia or not) includes:

> (i) dividends (other than non-share dividends) paid to the shareholder by the company to the extent to which they are paid out of profits derived by it from sources in Australia; and
> (ii) non-share dividends paid to the shareholder by the company to the extent to which they are derived from sources in Australia; and
> (c) if the shareholder is a non-resident carrying on business in Australia at or through a permanent establishment of the shareholder in Australia, and the company is a resident:
> (i) dividends (other than non-share dividends) that are paid to the shareholder by the company and are attributable to the permanent establishment, to the extent to which they are paid out of profits derived by the company from sources outside Australia; and
> (ii) non-share dividends that are paid to the shareholder by the company and are attributable to the permanent establishment, to the extent to which they are derived from sources outside Australia.

Section 855 of the Income Tax Assessment Act 1997 (Cth) provides that a foreign resident is subject to capital gains tax where a capital gains tax event[20] occurs in relation to specified assets.

---

[18] In accordance with ATO ID 2002/45, *supra* note 6.

[19] *Id.*

[20] Section 104-5 of the Income Tax Assessment Act 1997 (Cth) describes a capital gains tax event as: "Disposal of a capital gains tax asset; Use and enjoyment before title passes; Loss or destruction of a capital gains tax asset; Cancellation, surrender and similar endings; End of option to acquire shares etc; Creating contractual or other rights; Granting an option; Granting a right to income from mining; Entering into a conservation covenant; Creating a trust over a capital gains tax asset; Transferring a capital gains tax asset to a trust; Converting a trust to a unit trust; Capital payment for trust interest; Beneficiary becoming entitled to a trust asset; Disposal to beneficiary to end income right; Disposal to beneficiary to end capital interest; Disposal by beneficiary of capital interest; Creating a trust over future property; Granting a lease; Granting a long term lease; Lessor pays lessee to get lease changed; Lessee receives payment for changing lease; Lessor receives payment for changing lease; Capital payment for shares; Liquidator or administrator declares shares or financial instruments worthless; Forfeiture of a deposit; Receipt for event relating to a capital gains tax asset; Individual or company stops being an Australian resident; Trust stops being a resident trust; Company stops being member of wholly-owned group after roll-over less that market value; Change in relation to replacement asset or improved asset after a roll-over under Subdivision 152-E; Trust fails to cease to exist after a roll-over under Subdivision 124-N; Failure to acquire replacement asset and to incur fourth element expenditure after a roll-over under Subdivision 152-E; Cost of acquisition of replacement asset or amount of fourth element expenditure, or both, not sufficient to cover disregarded capital gain; Bankrupt pays amount in relation to debt; Asset passing to tax-advantaged entity; capital gains tax asset starts being trading stock; Special capital loss from collectable that has fallen in market value; Pre- capital gains tax shares or trust interest; Balancing adjustment occurs for a depreciating asset that you used for purposes other than taxable purposes; Direct value shifts affecting your equity or loan interests in a company or trust; Entitlement to receive payment of a carried interest; You make a FOREX realisation gain covered by item 1 of the table in subsection 775-70(1); You make a FOREX realisation loss covered by item 1 of the table in subsection 775-75(1); Foreign hybrid loss exposure adjustment section 705-57 in tax cost setting amount of assets of entity becoming subsidiary member of consolidated group or MEC group; Amount

In relation to capital gains tax events occurring on or after December 12, 2006, the specified assets are taxable Australian property (i.e. direct or indirect interests in Australian real property and an Australian permanent establishment's business assets (other than real property)) (§ 855-20).[21]

On the basis of Australia law (and in the absence of a relevant double taxation treaty or Sovereign exemption from taxation ruling)[22] a non-resident corporations is subject to a final withholding tax at the time of payment[23] and is subject to capital gains tax.

Currently the general rates of taxation are:[24]

- unfranked dividends[25] – 30 percent;
- interest – 10 percent; and
- royalties – 30 percent.

Capital gains are taxed at the gain at marginal tax rate[26] (capital losses may be carried forward).

Australia considers Australian real property owned by non-residents (whether owned directly or via an entity) as eligible for taxation and that income (or gains) from the alienation of property may also

---

remaining after step 3A etc. of joining allocable cost amount is negative; Tax cost setting amounts for retained cost base assets exceed joining allocable cost amount; No reset cost base assets against which to apply excess of net allocable cost amount on joining; Amount remaining after step 4 of leaving allocable cost amount is negative; Error in calculation of tax cost setting amount for joining entity's assets; Discharged amount of liability differs from amount for allocable cost amount purposes; and Reduction in tax cost setting amount for reset cost base assets on joining cannot be allocated." Available from the official Web site of the Australian government, Attorney-General's Department, http://www.comlaw.gov.au.

[21] AUSTRALIAN MASTER TAX GUIDE, 2007 ¶ 13-720 (41st ed, CCH, Sydney, 2007). There are three methods that may be used to establish the capital gains tax payable. *See*: The Australian Tax Office, CALCULATORS – CAPITAL GAINS – THREE METHODS OF CALCULATING CAPITAL GAINS, Sept. 2007, *available at* http://www.ato.gov.au/businesses/content.asp?doc=/content/33748.htm&pc=001/003/019/002/007&mnu=601&mfp=001/003&st=&cy=1.

[22] Details of reduce taxation rates resulting from taxation agreements may be viewed on the Australian Taxation Office website at http://www.ato.gov.au/businesses/content.asp?doc=/Content/50240.htm&page=15&H15 (last visited May 2, 2008).

[23] Income Tax Assessment Act 1936 (Cth) §§ 128B(1), (2) and (2B), available from the official Web site of the Australian government, Attorney-General's Department, http://www.comlaw.gov.au.

[24] Current rates of tax are available from the Australian Taxation Office Web site at http://www.ato.gov.au/ (last visited Apr. 10, 2008).

[25] Unfranked dividends are dividends paid from profits on which Australian tax has not been paid. Franked dividends do not attract dividend withholding tax.

[26] Non-resident individual tax rates for 2007-2008 are:

Taxable income	Tax on this income
$0 – $30,000	29c for each $1
$30,001 – $75,000	$8,700 plus 30c for each $1 over $30,000
$75,001 – $150,000	$22,200 plus 40c for each $1 over $75,000
$150,001 and over	$52,200 plus 45c for each $1 over $150,000

Non-resident companies are taxed at the same marginal rate as Australian companies. The current income tax rate for companies is 30% (with some superannuation and non-profit companies being eligible for a 15% tax rate). *See* Australian Tax Office, COMPANY TAX RATES, TAX RATES 2006-2007, Jan. 2008, available at http://www.ato.gov.au/businesses/content.asp?doc=/content/44266.htm&pc=001/003/019/001/006&mnu=601&mfp=001/003&st=&cy=1.

be taxed.[27]

IV. Treaties on Double Taxation

Australia has double taxation agreements with several nations that have significant Sovereign wealth funds, including China; Norway, Russia, and Singapore. The taxation rates set in those agreements are:

Country	**Withholding taxes (% rate limits)**[28]			
	Dividends	**Interest**	**Royalties**	**Application dates**
China[29]	15	10	10	July 1, 1991
Norway[30] (1983 and 2006 Convention)	0/5/15	0/15	5/10	July 1, 1983 and January 1, 2008 (respectively)
Russia[31]	5/15/30	10	10/30	July 1, 2003
Singapore[32]	0/15	10	10	July 1, 1969

[27] AUSTRALIA MASTER TAX GUIDE, *supra* note 21, at 1204.

[28] *See* Australian Government, Treasury Web site, http://www.treasury.gov.au/documents/625/XLS/Australian_Tax_Treaty_Table_April_2008.xls (last visited May 2, 2008) and *PAYG Withholding From Interest, Dividends And Royalties To Non-Residents*, *supra* note 13.

[29] Agreement between the Government of Australia and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, 1990 ATS 45 (official source). A copy of the treaty is available from the AustLII Australian Treaty Series Web site, http://www.austlii.edu.au/au/other/dfat/treaties/1990/45.html (unofficial source, last visited May 6, 2008).

[30] Convention with the Kingdom of Norway for the Avoidance of Double Taxation with Respect to Taxes on Income and the Prevention of Fiscal Evasion, 2007 ATS 32 (official source); Convention between Australia and the Kingdom of Norway for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital, and Protocol, 1983 ATS 19 (official source). Copies of the treaties are available from the AustLII Australian Treaty Series Web site, http://www.austlii.edu.au/au/other/dfat/treaties/2007/32.html & http://www.austlii.edu.au/ au/other/dfat/treaties/1983/19.html, respectively (unofficial source, last visited May 6, 2008).

[31] These rates do not apply where the "dividend, royalty or interest income is preferentially taxed and information related to that dividend, royalty or interest income is given confidential treatment," *see PAYG Withholding From Interest, Dividends And Royalties To Non-Residents*, *supra* note 13. Thus the effect of Article 23 of the treaty (Limitation of Benefits) is to deny treaty benefits for highly mobile income where the income is preferentially taxed and information concerning that income is not readily exchanged between the two countries, meaning that dividends, interest, and royalties falling into this category are subject to withholding tax at the Australian domestic law rates. For this reason there are three possible withholding tax rates for Russian-bound dividends (5%, 15% and 30%) and two royalty withholding tax rates (10% and 30%).

[32] Agreement between the Government of the Commonwealth of Australia and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, 1969 ATS 14 (official source); Protocol amending the Agreement with the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, 1990 ATS 3 (official source). Copies of the treaty and protocol are available from the AustLII Australian Treaty Series Web site, http://www.austlii.edu.au/au/other/dfat/ treaties/1969/14.html and http://www.austlii.edu.au/au/other/dfat/treaties/1990/3.html, respectively (unofficial source, last visited May 6, 2008).

Capital Gains Tax Provisions

Australia introduced a capital gains tax regime in 1985 and has several "pre-capital gains tax" treaties, some of which have been amended by subsequent protocols or re-negotiations to include provisions dealing comprehensively with capital gains (eg. Malaysia (1999),[33] New Zealand (1995), [34] and Singapore (1989)[35]).

However, it should be noted that Australia's Commissioner of Taxation has released a public ruling that "Australia's right to tax gains taxable in Australia exclusively under the capital gains tax regime … is not limited by pre-CGT treaties.. because: (a) from Australia's perspective these treaties do not distribute taxing rights over capital gains; and (b) …Australia's tax on capital gains is not a tax to which pre-CGT treaties apply."[36]

Australia's treaty provisions in relation to pre and post introduction of capital gains tax may be represented as:[37]

	Pre-Capital Gains Tax	**Post-Capital Gains Tax**
Heading	Alienation of Property	Alienation of Property
Activities	No article in pre-OECD treaties (ie. negotiated before Australia's membership of the OECD) and later pre-capital gains tax treaties did not deal with alienation of property comprehensively, thus often only real property alienations is addressed.	Comprehensively deals with capital gains.

---

[33] Agreement between the Government of Australia and the Government of Malaysia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income (Canberra, 20 August 1980) [1981] ATS 15 (official source), amended by Protocol Amending the Agreement between the Government of Australia and the Government of Malaysia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income of 20 August 1980 (Sydney, 2 August 1999), [2000] ATS 25 (official source) & by Second Protocol And Exchange Of Letters, Amending The Agreement Between The Government Of Australia And The Government Of Malaysia For The Avoidance Of Double Taxation And The Prevention Of Fiscal Evasion With Respect To Taxes On Income Of 20 August 1980, a amended by the First Protocol of 2 August 1999, (Genting Highlands, 28 July 2002), [2004] ATS 1 (official source).

[34] Agreement between the Government of Australia and the Government of New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (Melbourne, 27 January 1995) [1997] ATS 23 (official source), amended by Protocol Amending the Agreement between the Government of Australia and the Government of New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Melbourne, 15 November 2005, [2007] ATS 5 (official source).

[35] Agreement between the Government of the Commonwealth of Australia and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (Canberra, 11 February 1969) [1969] ATS 14 (official source), amended by Protocol amending the Agreement between the Government of the Commonwealth of Australia and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income of 11 February 1969 (Canberra, 16 October 1989) [1990] ATS 3 (official source).

[36] Australian Tax Office, TAXATION RULING TR 2001/12 available at the ATO Web site, http://law.ato.gov.au/atolaw/print.htm?DocNum=0000540667&Life=20011219000001-99991231235959&DB=full&printTitle=Rulings~Taxation~TR%202001%2F12~Income%20tax%20and%20capital%20gains%20tax%3A%20capital%20gains%20in%20pre-CGT%20tax%20treaties%20-%20Overview%20(As%20at%2019%20December%202001) (official source, last visited Apr. 30, 2008).

[37] Table abbreviated version of that found in Australian Tax Office, *id*.

	Pre-Capital Gains Tax	**Post-Capital Gains Tax**
Characterization	Generally expressed to deal only with income from alienation of property.	Income, profits, and gains.
Source Rules	Income	Income, profits, and gains.
Entry into force provisions in treaties address	Income	Income, profits, and gains.
Force of law provisions	Give treaty force of law in relation to 'income'	General formula introduced: provisions of the treaty have force of law 'according to their tenor' (i.e., dealing with income, profits, or gains).

Capital gains tax provisions are addressed in the treaties between Australia and China, Norway, Russia and Singapore and in recent agreements between Australia and Canada[38] and Australia and Finland.[39] The intention of the Australian government is to more closely align the treaty provisions addressing capital gains tax to those in the model OECD treaty.[40]

Status of Contracting States' Governments

The 2006 Convention with Norway[41] specifically includes the government of the contracting states within the resident provision (art. 4, para. 1): "The Government of a Contracting State or a political subdivision or local authority of that State is also a resident of that State for the purposes of the Convention."

Agreements with China, Singapore and Russia do not include this provision; however, it is included in the agreements with the United Kingdom,[42] Japan (not yet in force),[43] and South Africa (not

[38] Protocol Amending the Convention between Australia and Canada for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Canberra, 23 January 2002, [2002] ATS 26 (official source). Available from the Australian Treaty Database on Austlii, http://www.austlii.edu.au/cgi-bin/sinodisp/au/other/dfat/treaties/2002/26.html?&nocontext=1 (unofficial source, last visited May 1, 2008).

[39] Agreement between the Government of Australia and the Government of Finland for the Avoidance of Double Taxation with Respect to Taxes on Income and the Prevention of Fiscal Evasion, Melbourne, 20 November 2006, [2007] ATS 36 (official source). Available from the Australian Treaty Database on Austlii, http://www.austlii.edu.au/cgi-bin/sinodisp/au/other/dfat/treaties/2007/36.html?&nocontext=1 (unofficial source, last visited May 1, 2008).

[40] *See* Hon. Peter Costello, Press Release, New Australia-Finland Taxation Treaty Signed, No. 126 (Nov. 2006), *available at* http://www.treasurer.gov.au/DisplayDocs.aspx?pageID=&doc=pressreleases/2006/126.htm&min=phc.

[41] Convention Between Australia and the Kingdom of Norway for the Avoidance of Double Taxation with Respect to Taxes on Income and the Prevention of Fiscal Evasion, Canberra, 8 August 2006, [2007] ATS 32 (official source). Available form the Australian Treaty Database on Austlii, http://www.austlii.edu.au/cgi-bin/sinodisp/au/other/dfat/treaties/2007/32.html?&nocontext=1 (unofficial source, last visited May 1, 2008).

[42] Convention between the Government of Australia and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, Canberra, 21 August 2003**,** 2003 ATS 22 (in force) (official source). Available from the Australian Treaty Database on Austlii, http://www.austlii.edu.au/cgi-bin/sinodisp/au/other/dfat/treaties/2003/22. html?&nocontext=1 (unofficial source, last visited May 1, 2008).

[43] Convention between Australia and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Protocol, and Exchange of Notes,Tokyo, January 31, 2008, [2008] AUSTRALIAN TREATIES NOT IN FORCE, (ATNIF) 1 (not yet in force) (official source). Available from the Australian Treaty Database on Austlii, http://www.austlii.edu.au/au/other/dfat/treaties/notinforce/2008/1.html (unofficial source, last visited May 6, 2008).

yet in force).[44]

Sample text from some of Australia's taxation treaties addressing the definition of resident and the implementation of capital gains tax is detailed in Annex A.

V. Foreign Investment Approval

All direct investments by foreign governments (or their agencies) are subject to the Foreign Acquisitions and Takeovers Act 1975 (Cth)[45] and the Australian Government's foreign investment policy; as such, direct investments require prior notification to, and prior approval from, the Australian government.

Direct investment includes investments made via an entity that is 15 percent or more owned by a foreign government.[46] However, these are distinguished from non-controlling investments where the investing party is not in a position to determine the policy of the business.[47] In accordance with the Foreign Acquisitions and Takeovers Act 1975 (Cth) and the Government's foreign investment policy, the Australian government may block proposals (subject to the Act) where it determines that the proposal is contrary to Australia's national interest.[48]

In determining "national interest," the Australian Government will have regard to the six issues[49] including "whether the investment may impact on Australian Government revenue or other policies." Thus "investments by foreign government entities must be taxed on the same basis as operations by other commercial entities."[50]

VI. Australia's Sovereign Funds

Australia has two sovereign wealth funds. The Australian Future Fund (derived from privatization of national government assets (eg. Telstra), budget contributions and taxation revenue) is intended to fund public sector superannuation payments.[51] The Australian Future Fund is established

---

[44] Protocol Amending the Agreement between the Government of Australia and the Government of the Republic of South Africa for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income of 1999, Pretoria, 31 March 2008 [2008] ATNIF 2 (not yet in force) (official soruce). Available from the Australian Treaty Database on Austlii, http://www.austlii.edu.au/cgi-bin/sinodisp/au/other/dfat/treaties/notinforce/2008/2.html?&nocontext=1 (unofficial source, last visited May 1, 2008).

[45] Foreign Acquisitions and Takeovers Act 1975 (Cth), available from the official Web site of the Australian government, Attorney-General's Department, http://www.comlaw.gov.au.

[46] *Id.*, § 17F.

[47] *Id.*, § 19(7), *id*.

[48] *Id.*, § 17F. *Also see* Australian government, the Treasury, *Summary of Australia's Foreign Investment Policy,* Mar. 2008, available at http://www.firb.gov.au/content/_downloads/General_Policy_Summary%20march%202008%20-%20including%20guidelines%20and%20electronic%20lodgement.rtf.

[49] The other five issues are: 1. Whether an investor's operations are independent from the relevant foreign government. 2. Whether an investor is subject to and adheres to the law and observes common standards of business behavior. 3. Whether an investment may hinder competition or lead to undue concentration or control in the industry or sectors concerned. 4. Whether an investment may impact on Australia's national security. 5. Whether an investment may impact on the operations and directions of an Australian business, as well as its contribution to the Australian economy and broader community.

[50] *See* Attachment A: The Treasury, *Summary of Australia's Foreign Investment Policy*, *supra* note 48.

[51] Australian Government Future Fund Web site, http://www.futurefund.gov.au/ (last visited April 9, 2008).

under the Future Fund Act 2006 (Cth)[52] and operates separately and independently from the Australian government.

The Higher Education Endowment Fund (established via the Higher Education Endowment Fund Act 2007 (Cth))[53] is managed by the Future Fund Board of Guardians under a specific investment mandate. The Higher Education Endowment Fund provides funding for education sector capital works and research projects (as decided by the Minister for Education, Employment and Workplace Relations and the Minister for Industry, Innovation, Science and Research).[54]

Prepared by Lisa White
Foreign Law Specialist
May 2008

---

[52] Available from the official Web site of the Australian government, Attorney-General's Department, http://www.comlaw.gov.au.

[53] *Id.*

[54] For further information on the Higher Education Endowment Fund, see Australian government, Department Education, Employment and Workplace Relations' website at: http://www.heef.dest.gov.au/default.htm (last visited May 6, 2008).

I. Annex A

Country[55]	**Capital Gains Tax**
China Agreement between the Government of Australia and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income 1990 ATS 45	Article 4 Resident 1. For the purpose of this Agreement, the term "resident", in relation to a Contracting State, means a person who is fully liable to tax therein by reason of being a resident of that State under the tax law of that State. 2. A person is not a resident of a Contracting State for the purposes of this Agreement if the person is liable to tax in that State in respect only of income from sources in that State. 3. Where by reason of the preceding provisions of this Article a person, being an individual, is a resident of both Contracting States, then the status of the person shall be determined in accordance with the following rules: (a) the person shall be deemed to be a resident solely of the Contracting State in which a permanent home is available to the person; (b) if a permanent home is available to the person in both Contracting States, or in neither of them, the person shall be deemed to be a resident solely of the Contracting State with which the person's economic and personal relations are the closer. 4. Where by reason of the provisions of paragraph (1) a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident solely of the Contracting State in which its place of effective management or head office is situated. However, where such a person has its place of effective management in a Contracting State and its head office in the other Contracting State, the person shall be deemed to be a resident solely of that other State. 5. If a company has become a resident of a Contracting State for the principal purpose of enjoying benefits under this Agreement, that company shall not be entitled to any of the benefits of Articles 10, 11 and 12.

[55] See Australian government, Treasury Web site at, http://www.treasury.gov.au/documents/625/XLS/Australian_Tax_Treaty_Table_April_2008.xls (last visited Apr. 30, 2008) for links to the Australian Treaty Database on Austlii. A copy of the treaty is available from the Austlii Australian Treaty Serie, http://www.austlii.edu.au/cgi-bin/sinodisp/au/other/dfat/treaties/2007/36.html?&nocontext=1(last visited May 1, 2008).

Country[55]	Capital Gains Tax
	6. Where by reason of the provisions of paragraph (1) a company is a resident of Australia and, under a tax agreement between China and a third country, is also a resident of that third country, the company shall not be considered to be a resident of Australia for the purposes of enjoying benefits under this Agreement. Article 13 Alienation of property 1. Income or gains derived by a resident of a Contracting State from the alienation of real property referred to in Article 6 and, as provided in that Article, situated in the other Contracting State may be taxed in that other State. 2. Income or gains from the alienation of property, other than real property referred to in Article 6, that forms part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or pertains to a fixed base available to a resident of the first-mentioned State in that other State for the purpose of performing independent personal services, including income or gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such a fixed base, may be taxed in that other State. 3. Income or gains from the alienation of ships or aircraft operated in international traffic, or of property other than real property referred to in Article 6 pertaining to the operation of those ships or aircraft, shall be taxable only in the Contracting State of which the enterprise which operated those ships or aircraft is a resident. 4. Income or gains derived by a resident of a Contracting State from the alienation of shares or comparable interests in a company, the assets of which consist wholly or principally of real property in the other Contracting State of a kind referred to in Article 6, may be taxed in that other State. 5. Nothing in this Agreement affects the application of a law of a Contracting State relating to the taxation of gains of a capital nature derived from the alienation of property other than that to which any of paragraphs (1), (2), (3) and (4) apply.

Country[55]	**Capital Gains Tax**
Singapore Protocol amending the Agreement with the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 1990 ATS 3.	Article 10A (1) Income or gains derived by a resident of one of the Contracting States from the alienation of real property referred to in Article 4A and, as provided in that Article, situated in the other Contracting State may be taxed in that other State. (2) Income or gains from the alienation of property, other than real property referred to in Article 4A, that forms part of the business property of a permanent establishment which an enterprise of one of the Contracting States has in the other Contracting State or pertains to a fixed base available to a resident of the first-mentioned State in that other State for the purpose of performing independent personal services, including income or gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such a fixed base, may be taxed in that other State. (3) Income or gains from the alienation of ships or aircraft operated in international traffic, or of property (other than real property referred to in Article 4A) pertaining to the operation of those ships or aircraft, shall be taxable only in the Contracting State of which the enterprise which operated those ships or aircraft is a resident. (4) Income or gains derived by a resident of one of the Contracting States from the alienation of shares or comparable interests in a company, the assets of which consist wholly or principally of real property in the other Contracting State of a kind referred to in Article 4A and, as provided in that Article, situated in that other State, may be taxed in that other State. (5) Nothing in this Agreement affects the application of a law of a Contracting State relating to the taxation of gains of a capital nature derived from the alienation of property other than that to which any of paragraphs (1), (2), (3) and (4) apply.".
Russia Agreement between the Government of Australia and the Government of the Russian Federation for the avoidance of Double Taxation and	Article 4 Residence 1 For the purposes of this Agreement, a person is a resident of a Contracting State if the person is a resident of that State under the law of that State relating to its tax. 2 A person is not a resident of a Contracting State for the purposes of this Agreement if the person is liable to tax in that State in respect only of income

Country[55]	**Capital Gains Tax**
the prevention of Fiscal Evasion with respect to Taxes on income, and Protocol 2003 ATS 23	from sources in that State. 3 Where by reason of the preceding provisions of this Article a person, being an individual, is a resident of both Contracting States, then the person shall be deemed to be a resident solely of the Contracting State in which a permanent home is available to the person, or if a permanent home is available to the person in both Contracting States, or in neither of them, the person shall be deemed to be a resident solely of the Contracting State with which the person's personal and economic relations are closer. For the purpose of this paragraph, an individual's citizenship of one of the Contracting States shall be a factor in determining the degree of the individual's personal and economic relations with that Contracting State. 4 Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident solely of the State in which its place of effective management is situated. Article 13 Income from alienation of property 1 Income or profits derived by a resident of a Contracting State from the alienation of real property situated in the other Contracting State may be taxed in that other State. The meaning of the term "real property", and its situation, shall be determined in accordance with Article 6. 2 Income or profits from the alienation of property, other than real property, that forms part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or pertains to a fixed base available in that other State to a resident of the first mentioned State for the purpose of performing independent personal services, including income or profits from the alienation of that permanent establishment (alone or with the whole enterprise) or of that fixed base, may be taxed in that other State. 3 Income or profits from the alienation of ships or aircraft operated by an enterprise of a Contracting State in international traffic, or of property (other than real property) pertaining to the operation of those ships or aircraft, shall be taxable only in that State. 4 Income or profits derived by a resident of a Contracting State from the

Country[55]	**Capital Gains Tax**
	alienation of any shares or other interests in a company, or of an interest of any kind in a partnership, trust or other entity, where the value of the assets of such entity, whether they are held directly or indirectly (including through one or more interposed entities, such as, for example, through a chain of companies), is principally attributable to real property, situated in the other Contracting State, may be taxed in that other State. 5 Nothing in this Agreement affects the application of a law of a Contracting State relating to the taxation of capital gains derived from the alienation of any property other than that to which any of the preceding paragraphs of this Article apply.
Norway Convention Between Australia and the Kingdom of Norway for the Avoidance of Double Taxation with Respect to Taxes on Income and the Prevention of Fiscal Evasion 2007 ATS 32 (2006 Convention)	Article 4 Residence 1 For the purposes of this Convention, the term "resident of a Contracting State " means: (a) in the case of Australia , a person who is a resident of Australia for the purposes of Australian tax; and (b) in the case of Norway, a person who is liable to tax therein by reason of domicile, residence, place of management or any other criterion of a similar nature. The Government of a Contracting State or a political subdivision or local authority of that State is also a resident of that State for the purposes of the Convention. 2 A person is not a resident of a Contracting State for the purposes of this Convention if the person is liable to tax in that State in respect only of income from sources in that State. 3 Where by reason of the preceding provisions of this Article a person, being an individual, is a resident of both Contracting States, then the person's status shall be determined as follows: (a) the individual shall be deemed to be a resident only of the State in which a permanent home is available to that individual; but if a permanent home is available in both States, or in neither of them, that individual shall be deemed to be a resident only of the State with which the individual's personal and

Country[55]	**Capital Gains Tax**
	economic relations are closer (centre of vital interests); (b) if the State in which the centre of vital interests is situated cannot be determined, the individual shall be deemed to be a resident only of the State of which that individual is a national; (c) if the individual is a national of both States or of neither of them, the competent authorities of the Contracting States shall endeavour to resolve the question by mutual agreement. 4 Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated. 5 Where under this Convention any income, profits or gains are relieved from tax in a Contracting State and, under the law in force in the other Contracting State, an individual in respect of that income or those profits or gains is exempt from tax by virtue of being a temporary resident of the other State within the meaning of the applicable tax laws of that other State, then the relief to be allowed under this Convention in the first-mentioned State shall not apply to the extent that that income or those profits or gains are exempt from tax in the other State. Article 13 Alienation of Property 1 Income, profits or gains derived by a resident of a Contracting State from the alienation of real property referred to in Article 6 and situated in the other Contracting State may be taxed in that other State. 2 Income, profits or gains from the alienation of property, other than real property, that forms part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, including income, profits or gains from the alienation of that permanent establishment (alone or with the whole enterprise), may be taxed in that other State. 3 Income, profits or gains of an enterprise of a Contracting State from the

Country[55]	**Capital Gains Tax**
	alienation of ships or aircraft operated by that enterprise in international traffic, or of property (other than real property) pertaining to the operation of those ships or aircraft, shall be taxable only in that State. 4 Income, profits or gains derived by a resident of a Contracting State from the alienation of any shares or comparable interests deriving more than 50 per cent of their value directly or indirectly from real property situated in the other Contracting State, may be taxed in that other State. 5 Gains of a capital nature from the alienation of any property, other than that referred to in the preceding paragraphs shall be taxable only in the Contracting State of which the alienator is a resident.
Norway Convention between Australia and the Kingdom of Norway for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital, and Protocol 1983 ATS 19 (1983 Convention)	Article 4 Residence (1) For the purposes of this Convention, a person is a resident of one of the Contracting States- (a) in the case of Australia, subject to the provisions of paragraph (2), if the person is a resident of Australia for the purposes of Australia tax; and (b) in the case of Norway, if the person is liable to tax therein by reason of his domicile, residence, place of incorporation or any other criterion of a similar nature but not if he is liable to tax in Norway in respect only of income from sources therein. (2) In relation to income from sources in Norway, a person who is subject to Australian tax on income which is from sources in Australia shall not be treated as a resident of Australia unless the income from sources in Norway is subject to Australian tax or, if that income is exempt from Australian tax, it is so exempt solely because it is subject to Norwegian tax. (3) Where by reason of the preceding provisions of this Article an individual is a resident of both Contracting States, then his status shall be determined in accordance with the following rules: (a) he shall be deemed to be a resident solely of the Contracting State in which he has a permanent home available to him; (b) if he has a permanent home available to him in both Contracting States, or

Country[55]	**Capital Gains Tax**
	if he does not have a permanent home available to him in either of them, he shall be deemed to be a resident solely of the Contracting State with which his personal and economic relations are the closer. (4) For the purposes of the last preceding paragraph, an individual's citizenship or nationality of a Contracting State as well as his habitual abode shall be factors in determining the degree of his personal and economic relations with that Contracting State. (5) Where by reason of the provisions of paragraph (1), a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident solely of the Contracting State in which its place of effective management is situated. Article 13 Alienation of property (1) Income or gains from the alienation of real property or of an interest in or over land or of a right to exploit, or to explore for, a natural resource may be taxed in the Contracting State in which the real property, the land or the natural resource is situated. (2) For the purposes of this Article, shares or comparable interests in a company, the assets of which consist wholly or principally of real property or of interests in or over land in one of the Contracting States or of rights to exploit, or to explore for, natural resources in one of the Contracting States, shall be deemed to be real property situated in the Contracting State in which the land or the natural resources are situated or in which the exploration may take place. (3) Subject to the provisions of paragraph (1), income from the alienation of capital assets of an enterprise of one of the Contracting States or of capital assets available to a resident of one of the Contracting States for the purpose of performing professional services or other independent activities shall be taxable only in that State, but, where those assets form part of the business property of a permanent establishment or fixed based situated in the other Contracting State, such income may be taxed in that other State. (4) Gains from the alienation of shares in a company the capital of which is wholly or partly divided into shares and which is a resident of Norway for the purposes of Norwegian tax, derived by an individual who is a resident of

Country[55]	**Capital Gains Tax**
	Australia, may be taxed in Norway. (5) Gains from the alienation of ships or aircraft operated in international traffic, or movable property pertaining to the operation of such ships or aircraft shall be taxable only in the Contracting State of which the alienator is a resident.

2008-00763

LAW LIBRARY OF CONGRESS

TAXATION OF PASSIVE INCOME EARNED BY FOREIGN GOVERNMENTS AND SOVEREIGN WEALTH FUNDS

CANADA

Executive Summary

Canada does not have a specific law on the subject, but it does have a written departmental policy of granting qualified sovereign immunity to the passive income earned by foreign governments or their agencies through non-commercial activities. Applications for exemptions are filed with the Revenue Canada Agency. Canada also has provisions exempting certain types of income earned by foreign governments in its many tax treaties. These provisions vary from country to country.

I. Tax Status of Foreign Governments

Are they exempt from taxation on their passive income (interest, dividends, capital gains) on the basis of legislation?

Canada's Income Tax Act[1] and its supporting regulations do not contain a provision specifically exempting passive income earned by foreign governments or their agencies from taxation.

Is there a practice of exempting them?

Canada recognizes a qualified principle of sovereign immunity to exempt most income earned by foreign governments and their agencies from Canadian income tax. The Revenue Canada agency has published an Information Circular in which it outlines this principle in the following terms:

> Sovereign Immunity
>
> 50. Under the Doctrine of Sovereign Immunity, the Government of Canada may grant exemption from tax on certain Canadian-source investment income paid or credited to the government or central bank of a foreign country. Written authorization not to withhold tax is given to the Canadian resident payer upon request after substantiation that such investment income (other than that already exempt under the Act and Regulations) is the property of the government or central bank of a foreign country. The written authorization will have an expiry date at which time the Canadian payer would be required to re-apply for further authorization not to withhold. A request for authorization not to withhold should be forwarded to: Revenue Canada, Taxation 875 Heron Road Ottawa, Ontario K1A 0L8 Attention: Provincial and International Relations Division Investment income of a foreign government or its agency is exempt only if (a) the other country would provide a reciprocal exemption to the Canadian Government or its agencies; (b) the income is derived by the foreign government or agency in the course of exercising a function of a governmental nature and is not income arising in the course of an industrial or commercial activity carried on by the foreign authority; and (c) it is interest on an arm's length debt or portfolio dividends on listed company shares. Income such as rentals, royalties or direct dividends from a

[1] R.S.C. c. 1 (5th Supp. 1989), as amended, (official source), also *available at* http://lois.justice.gc.ca/ en/showtdm/cs/I-3.3?noCookie (unofficial source, last visited May 2, 2008).

company in which the foreign government has a substantial or controlling equity interest does not qualify for exemption.[2]

The above paragraph does not specifically mention capital gains. However, it appears that Revenue Canada would apply the same basic rules in deciding whether the capital gain was taxable as a commercial activity or would be exempt under the principle of sovereign immunity.[3]

Is that practice based on the country's understanding of international customary law?

Revenue Canada officials believe that the principle of sovereign immunity has been recognized for many years and may well be based upon Canada's understanding of international customary law. However, there are no legislative provisions in which sovereign immunity is specifically recognized, even though observation of it has long been the practice of Canadian tax authorities. Therefore, there is no supporting legislative history or commentary.[4]

If there is no legislation or practice, does that mean that they are taxed as ordinary foreign taxpayers?

Canada does recognize sovereign immunity and has included relevant and supporting provisions in most of its tax treaties. It should be noted that foreign governments are non-residents and thus the immunity they generally enjoy is from withholding taxes, rather than from the income taxes paid by Canadian residents. The general rate of withholding tax on dividends and capital gains is 25 percent, but this is usually reduced or eliminated by tax treaties. Canada has recently exempted interest income earned at arm's length by non-residents from withholding tax.[5]

Is their tax treatment brought about by treaties?

Canada has over eighty tax treaties. Many of these treaties contain provisions exempting interest income earned by foreign governments. Such a provision is contained in article 11(3) of the Canada-United States Income Tax Convention of 1980.[6] There are no comparable provisions for dividends or capital gains in the treaty with the United States, but as has already been pointed out, applications for the exemption of these types of passive income may be filed with the Revenue Canada Agency.

II. Tax Status of Sovereign Wealth Funds

Revenue Canada authorities indicate that Canada does not have any special rules for sovereign wealth funds. Interest earned by these funds would generally be exempt from Canadian withholding tax under the Income Tax Act and under Canada's tax treaties. Applications for sovereign immunity for dividends and capital gains would have to be filed with Revenue Canada. Passive income from commercial activities would normally be taxable. Revenue Canada authorities cited Chinese banks as an example of government-owned enterprises that had been denied sovereign immunity. Investments by New Zealand's Earthquake Commission were cited as an example of a foreign government agency that

---

[2] Revenue Canada Agency, IC77-16R4, s. 50, http://www.cra-arc.gc.ca/E/pub/tp/ic77-16r4/ic77-16r4-e.html (last visited May 3, 2008).

[3] *Id.*

[4] Information obtained by telephone from the Revenue Canada Agency on May 2, 2008.

[5] 2007 S.C. c. 35, § 59 (official source).

[6] 1984 S.C. c. 20, Part I (official source), also *available at* http://www.lexum.umontreal.ca/ca_us/cgi-bin/disp.pl/en/cts.1984.15.1.en.html?query=%22tax%22&langue=en&selection=&database=en&method=all&retour=/ca_us/cgi-bin/srch.pl?numhits=25~~language=en~~method=all~~query=tax~~database=en (unofficial source).

had been granted sovereign immunity and is not taxed on its Canadian earnings.[7]

III. Domestic Law

Non-resident interest paid at arm's length is currently not taxable in Canada. Interest that is not paid at arm's length is taxed at the 25 percent withholding rate. Dividends and capital gains are also generally subject to the 25 percent withholding rate, although there are a number of complicated exceptions.[8]

IV. Treaties on Double Taxation

Canada has a tax treaty with the Kingdom of Norway. Like the Canada-United States Tax Treaty, this treaty exempts interest income earned in one country and paid to the government or a political subdivision of the other from tax in the country in which it is earned. However, unlike the Canada-United States Tax Treaty, the Canada-Norway treaty contains a virtually identical provision respecting dividends. Thus, dividends earned by Norway's SWF or the Province of Alberta's Heritage Fund are not taxable in the country in which they are earned. This means that Norway's SWF does not have to apply for sovereign immunity, as a SWF founded in a country that does not have a similar provision in its tax treaty with Canada would.

Under the Canada-Norway tax treaty, dividends may be taxed in the country in which they are earned at the rate of 5 percent, if the recipient holds at least 10 percent of the voting power of the payer, and 15 percent in other cases. The treaty also provides that capital gains from transactions involving real property are subject to withholding tax.[9]

Prepared by Stephen F. Clarke
Senior Foreign Law Specialist
May 2008

[7] Information obtained by telephone from the Revenue Canada Agency on May 6, 2008.

[8] C.C.H. Canada, CANADIAN TAX REPORTER, para. 26,105 (2008).

[9] Canada-Norway Income Tax Convention 2002, 2002 S.C. c. 24. (official source), also *available at* C.C.H. Canada, *id.*, para 31,903.

2008-00763

LAW LIBRARY OF CONGRESS

TAXATION OF PASSIVE INCOME EARNED BY FOREIGN GOVERNMENTS AND SOVEREIGN WEALTH FUNDS

GERMANY

Executive Summary

Germany taxes foreign governments and sovereign wealth funds on their passive investments in the same manner as any other foreign corporate entity. There is no exemption on the basis of statutory law or deemed customary international law or practice, nor do German double taxation treaties exempt foreign governments or their entities.

Nevertheless, the tax burden of foreign governmental entities on their passive income from German sources is light, because domestic law generally exempts from taxation most German-source interest that is earned by foreign residents, and it also exempts from taxation 95 percent of the dividends from German corporations that are earned by foreign corporate entities. Capital gains are not taxed at all, unless they amount to a participation, in which case they also enjoy the 95 percent corporate exemption.

I. Tax Status of Foreign Governments

Germany does not exempt foreign governments from taxation on their passive German-source income.[1] Instead, foreign governments are deemed to be foreign corporate entities that are taxed on their passive German source income.[2] Although section 5 of the German Corporation Tax Code[3] exempts certain specifically named German governmental units from taxation, there are no corresponding provisions for foreign governments, and consequently, the general provision of section 2 of the Corporation Tax Code applies to them. It provides that foreign entities are subjected to limited tax liability, which means that they are taxed on their German-source income as provided by law.[4]

German authorities are not under the impression that foreign governments should be exempted from taxation by virtue of international customary law.[5] Instead, exemptions of governmental institutions are provided only on the basis of bilateral and multilateral treaties, for the specific purposes listed in these treaties,[6] and these treaties do not include any general immunity of foreign governments, central banks, or

[1] This information has been obtained from officials of the German Federal Ministry of Finance.

[2] D. Gosch, Körperschaftsteuergesetz 111 (München, 2005).

[3] Körperschaftsteuergesetz [KStG], repromulgated Oct. 15, 2002, BUNDESGESETZBLATT [BGBl, official law gazette of the Federal Republic of Germany] I at 4210, as amended.

[4] KStG, § 2 subjects foreign entities to "limited tax liability"; Einkommensteuergesetz [EStG], repromulgated Oct. 19, 2002, BGBl I at 4210, as amended; § 49 lists the taxes that are imposed on limited taxpayers.

[5] Information obtained from officials of the German Federal Ministry of Finance.

[6] The Ministry of Finance periodically publishes a list of tax-exempting treaties for the benefit of the decentralized tax authorities. The latest of this list is Bundesministerium der Finanzen, Vorschrift VV DEU BMF 2007-08-20 IV B 3 –S 1311/07/0039, Aug. 20, 2007, *available at* the official Web-site http://www.bundesfinanzministerium.de/nn_58004/DE/BMF__Startseite/Aktuelles/BMF__Schreiben/Veroffentlichungen__zu__Steuerarten/einkommensteuer/055.html. The listings contained therein are limited to multilateral treaties such as the Vienna Conventions and very specific bilateral treaties exempting specifically named governmental institutions in the host country, such as, for instance, cultural institutions.

sovereign wealth funds. Moreover, the German philosophy is strongly influenced by article 4, paragraph 1 of the OECD Model Treaty,[7] according to which a foreign government and its subdivisions are residents (and therefore taxpayers) in the other treaty country.

Despite this seemingly categorical approach to taxing foreign governments, the tax burden imposed on their passive investments in Germany is light due to a tax policy that aims to attract foreign investments (see below, section III).[8]

II. Tax Status of Sovereign Wealth Funds

Germany taxes sovereign wealth funds like any other foreign corporate taxpayer.[9] Since, as explained above, Germany does not exempt foreign governments from taxation on their passive income, there is no occasion in German law to distinguish between types of sovereign wealth funds according to their degree of governmental management or purpose. Yet, as is explained below (section III), the tax burden on these funds is light.

III. Domestic Law on the Taxation of Passive Income Earned by Foreign Residents

Interest

Aside from a few exceptions, Germany does not tax foreign taxpayers on their German interest earnings. This is provided in section 49 of the Income Tax Code.[10] This provision contains a complete listing of the circumstances under which foreign individuals or corporations are taxed on their German source income.[11] The only types of interest that are listed in this section as taxable to non-residents are interest derived from loans secured by mortgages and interest derived from convertible bonds, non-voting preferred stock, and profit-sharing bonds. For a non-resident, the interest on these specified types of debt instruments is withheld at the rate of 25 percent. [12]

Dividends

Ninety-five percent of the dividends from German corporate entities are exempted from taxation if they are earned by a corporate shareholder. This is provided in section 8b, paragraph 1 of the Corporation Tax Act, and this rule applies to domestic corporations and foreign corporations alike.[13] This exemption of corporate dividend income became applicable in 2003 and is the result of a reform of the German corporation tax that was designed to avoid inter-corporate double taxation. Under this system, the domestic dividend-distributing corporation is taxed at a 25 percent tax rate on its earned income (whether distributed or not), and ultimately the domestic private shareholder is taxed on his dividend

[7] Organization for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital*, version of January 2003, promulgated in German translation in the official administrative gazette BUNDESSTEUERBLATT 2007 I at 656.

[8] GERMAN TAX AND BUSINESS LAW GUIDE ¶ 131,000 (Sweet & Maxwell, London, 2002-).

[9] This information has been obtained from officials of the German Federal Finance Ministry.

[10] EStG, *supra* note 3.

[11] W. Bächle & T. Rupp, Internationales Steuerrecht 461 (Stuttgart, 2002).

[12] EStG § 43 20 1 and EStG § 43 a ¶ 1. Added to this withholding is a 5.5% surcharge [Solidaritätszuschlaggesetz, repromulgated Oct. 15, 2002, BGBl I at 4130, as amended], thus amounting to 26.38%.

[13] Gosch, *supra* note 2, at 802.

income.[14] In between these two stages, dividends are generally not taxed. Foreign corporations are included in this exemption from taxation, in order to grant them equal treatment.[15]

There are some exceptions from this principle that make dividends taxable if the shares are owned by banks, life insurers, or pension funds. These exceptions, however, only affect corporate shareholders who reside in Germany, in the member states of the European Union (EU), or in Switzerland[16] and do not apply to residents of other countries.[17]

The actual exemption of only 95 percent of dividend income results from section 8 b, paragraph 5, which provides for the taxation of 5 percent of the dividend income on the grounds that this percentage is deemed to be attributed to expenses related to this income that the corporation may be able to deduct in its general income computation. The result of this complex rule is a definitive limitation of the tax exemption of dividends to 95 percent.[18]

Capital Gains

Capital gains realized by a non-resident corporate entity from the sale of shares in German companies are taxed only if they amount to the sale of a participation,[19] which is defined as the ownership of at least 1 percent of the shares of the company over the five years preceding the sale.[20] Capital gains of such substantial participations are taxed according to the same principles as dividends from foreign companies:[21] section 8 b, paragraphs 2 and 3 of the Corporation Tax Act exempt 95 percent of the capital gains from a participation in a German corporation if the gains are realized by a foreign or domestic corporation. The remaining 5 percent of the gains are taxed.[22]

IV. Treaties on Double Taxation

In General

German double taxation treaties are to a large extent irrelevant for the taxation of passive German-source income earned by foreign residents because, aside from certain exceptions, the exemption of 95 percent of corporate dividends and of capital gains from participations also applies to foreign corporations residing in countries that have a double taxation treaty with Germany.[23] In addition, it appears that the non-taxability of German-source interest for foreign residents also should override any less favorable treaty provisions, because there is no tax liability generated for such income to which a

---

[14] Individual taxpayers, both foreign and domestic, who have portfolio holdings of shares in German companies are subject to a withholding tax of 25%, [EStG § 20 ¶ 1, in conjunction with EStG § 43, 43 a, and § 49 ¶ 5 (a)], plus a 5.5% surcharge [Solidaritätszuschlaggesetz, repromulgated Oct. 15, 2002, BGBl I at 4130, as amended], thus amounting to 26.38%.

[15] Gosch, *supra* note 2, at 791.

[16] KStG, § 8b ¶ 7 & 8.

[17] Gosch, *supra* note 2, at 894

[18] *Id.*, at 874.

[19] Gains derived from the sale of substantial participations, German permanent establishment, and ships or real property are the only types of gains that are listed in ESTG § 49 as creating a tax liability for taxpayers with a limited tax liability.

[20] As defined by EStG § 17.

[21] Bächle, *supra* note 11 at 469; C. Bourseaux, *Germany* in TAXATION OF COMPANIES IN EUROPE at 8.4.2.3 (Amsterdam, 2004).

[22] KStG § 2 no. 1, in conjunction with EStG § 49 ¶ 1 no. 2 (e).

[23] Gosch *supra* note 2, at 790 & 823.

treaty could apply. These features of German law may also reduce scope of application of the EU Parent-Subsidiary Directive[24] and the EU Savings Directive.[25]

Generally, the newer German double taxation treaties follow the Model Tax Convention of the Organization for Economic cooperation and Development [OECD][26] by considering the governments of the treaty states as residents and therefore taxpayers.

The OECD Model Convention's philosophy of limiting the source country taxation of interest, dividends, and capital gains from passive investment is also observed in these treaties.[27] It is often stated that the focus on taxing passive source income less at the source and more in the country of residence of the transnational taxpayer favors the European countries when they export capital.[28] On the other hand, this distribution of the taxes on passive income may benefit the European member states of the OECD by allowing them to compete for investments through lower source-country tax rates.[29]

Kuwait

The double taxation treaty between Germany and Kuwait[30] defines the governments of the treaty states and their governmental institutions as residents, which appears to imply that they are deemed to be taxpayers.

Interest is not taxed in the source country, and portfolio dividends may be taxed in the source country with a rate of up to 15 percent while dividends of substantial holdings (at least 10 percent of the share capital) may be taxed in the source country with a rate of up to 5 percent. Capital gains from passive investments are not taxed at all in the source country.

Norway

The double taxation treaty between Germany and Norway[31] contains no provisions on the taxation of each other's governments or their agencies or funds, other than the confirmation of diplomatic immunities as provided by treaty or customary international law.

According to this agreement, source country interest earned by residents of the other country is not taxed in the source country; source country dividends earned from portfolio investments of a resident of the other country may be taxed by the source country with a rate of up to 15 percent, while dividends earned from a substantial participation (of at least 25 percent of the shares) in a source country corporation may not be taxed at all by the source country. Capital gains from the sale of shares or

---

[24] Council Directive 90/435/EEC of 23 July 1990, on the common system of taxation applicable in the case of parent companies and subsidiaries of different member states, 1990 OFFICIAL JOURNAL OF THE EUROPEAN COMMUNITIES [O. J., official source] (L225) 6.

[25] Council Directive 2003/48/ECof 3 June 2003, on taxation of savings income in the form of interest payments, 2003 O. J. (L 157) 38.

[26] *Model Tax Convention on Income and on Capital, supra* note 7, at 656.

[27] K. VOGEL, DOPPELBESTEUERUNGSABKOMMEN 772, 962, & 1087 (München, 1986).

[28] OBERSON & H. Hull, Switzerland in International Tax Law 77 (Amsterdam, 2006).

[29] W. SCHÖN, TAX COMPETITION IN EUROPE 3 (Amsterdam, 2003).

[30] Abkommen zwischen der Bundesrepublik Deutschland und dem Staat Kuwait zur Vermeidung der Doppelbesteuerung auf dem Gebiet der Steuern vom Einkommen und vom Vermögen und zur Belebung der wirtschaftlichen Beziehung, May 18, 1999, BGBl 2000 II at 390.

[31] Abkommen zwischen der Bundesrepublik Deutschland und dem Königreich Norwegen zur Vermeidung der Doppelbesteuerung und über gegenseitige Amtshilfe auf dem Gebiet der Steuern vom Einkommen und vom Vermögen, Oct. 4, 1991, BGBl 1993 II at 969.

participations in a source country company are not taxable in the source country, if the seller of the shares or participations is a corporation that resides in the other country.

Prepared by Edith Palmer
Senior Foreign Law Specialist
May 2008

2008-00763

LAW LIBRARY OF CONGRESS

JAPAN

TAXATION OF PASSIVE INCOME EARNED BY FOREIGN GOVERNMENTS AND SOVEREIGN WEALTH FUNDS

Executive Summary

Though there is no explicit provision to exempt foreign governments from tax on passive income, they are, in fact, exempted from tax on interests on deposits and dividends. There is no provision for taxation on sovereign wealth funds either. They are taxed the same way as other funds. The Japan-Singapore Tax Treaty and the Japan-Norway Tax Convention have provisions to exempt the Singapore government and Singapore's sovereign wealth fund from taxation on interest.

I. Tax Status of Foreign Governments

Though the Corporation Tax Law and the Income Tax Law do not have provisions to exempt the foreign government from taxation, passive income earned in Japan by foreign governments are exempted from taxation.

By reading the Corporation Tax Law,[1] it appears that foreign governments are liable to pay tax on domestic source income. Under the definitions of the Corporation Tax Law, a foreign government is classified as a foreign corporation. A foreign corporation must pay corporation tax if it has domestic source income unless it is a public corporation. A foreign government is not a public corporation because foreign governments are not listed as public corporations in the Schedule No. 1 of the Corporation Tax Law. In comparison, local governments are listed in the Schedule though they are domestic corporations.

> Article 2
>
> (iii) Domestic corporation: a corporation maintaining its head office or main office within the country.
>
> (iv) Foreign corporation: a corporation other than domestic corporations.
>
> (v) Public corporation: the corporations listed in Schedule No. 1.[2]
>
> Article 4
>
> (2) Foreign corporations shall be liable to pay corporation tax pursuant to this Act in cases where they have domestic source income defined in Article 138 (Domestic source income) (with respect to public interest corporations, etc. or non-juridical organizations, etc. that are foreign corporations, they are liable to

[1] Hōjinzei hō [Corporation Tax Law], Law No. 34 of 1965, *as amended by* Law No. 100 of 2007, *available at* http://law.e-gov.go.jp/htmldata/S40/S40HO034.html (a government Web site, unofficial source).

[2] Translation from YUJI GOMI and TASUKU HONJO, WA-EI TAIYAKU HŌJINZEI HŌ [CORPORATION TAX ACT OF JAPAN], 2 (2007) (unofficial translation).

> pay corporation tax only if they have such domestic source income derived from profit-making activities), where they undertake a corporate taxation trust, or where they carry out operations for retirement fund, etc. defined in Article 145-3 (Computation of amount of retirement pension fund as to foreign corporations).
>
> (3) Notwithstanding the preceding two paragraphs, public corporations shall not be liable to pay corporation tax.[3]

Domestic source income includes interests on national government bonds or municipal bonds or certain credits issued by domestic corporations and interest on deposits and savings in Japan.[4] Also included in domestic source income are: dividends of surplus or profits, distribution of surplus or funds from a domestic corporation, or distribution of profits of investment trusts (excluding bond investment trusts and investment trusts on employment of publicly issued bonds) or specified beneficiary certificate issuance trusts that have been entrusted to business places in Japan.[5]

In addition to the Corporation Tax Law, the Income Tax Law states that foreign corporations are obligated to pay income tax when they receive payment that is classified as "foreign corporation taxable income" or that derives from certain trustee activities.[6] "Foreign corporation taxable income" includes interests and dividends.[7]

Based on these provisions, it looks foreign governments must pay tax on interests on bonds and savings, and dividends of profit. However, interests accrued in bank deposits in Japan for a foreign government are not taxed in Japan.[8] It is explained that such treatment is an international custom based on international law of sovereign immunity.[9] This treatment is not based on explicit provisions of laws in Japan. For tax on dividends, it appears foreign governments are also exempted from them though documents that directly so state were not located. Corporations have to submit notices before they receive interests or dividends to the payer of those under article 224 of the Income Tax Law.[10] Foreign

---

[3] *Id.* at 51.

[4] Corporation Tax Law, Law No. 34 of 1965, *as amended by* Law No. 100 of 2007, art. 138, item 4.

[5] *Id.* art. 138, item 5.

[6] Income Tax Law, Law No. 33 of 1965, *as amended by* Law No. 100 of 2007, art. 5, para. 4, *available at* http://law.e-gov.go.jp/htmldata/S40/S40HO033.html (a government Web site, unofficial source).

[7] "Foreign corporation taxable income" means incomes prescribed in article 161, item 1-2 through item 7 and item 9 through item 12 of the Income Tax Law. *Id.* art. 5, para. 2. Article 61, items 4 and 5 of the Income Tax Law lists interests and dividends.

[8] Yasunori Chikaishi , *Gaikoku seifu · gaikoku taishikan tō no gensen chōshū gimu oyobi nōzei gimu [Obligation of foreign governments and foreign embassies to withhold and pay tax],* ZEIDAI RONSHU 45, 79, 104-5 (2004), *available at* http://www.nta.go.jp/ntc/kenkyu/ronsou/45/chikaishi/ronsou.pdf; and KONOSUKE KIMURA, KOKUSAI ZEIHŌ [INTERNATIONAL TAX LAW], 151 (2000).

[9] Chikaishi, *supra* note 8 at 104-105; and KIMURA, *supra* note 8, at 151.

[10] Article 224 of the Income Tax Law, Law No. 30 of 1965, *as amended by* Law No. 100 of 2007.

> A person (excluding corporations mentioned in the Attached List No. 1 (Table of public corporations) of the Corporation Tax Law and others prescribed by Cabinet Order; …) who in this country receives payment of interest, etc. or dividend, etc. (excluding interest of ordinary deposits and others prescribed by Cabinet Order; …) provided for in Article 23 paragraph 1 (Interest Income) or Article 24 paragraph 1 (Dividend income) shall, as prescribed by Cabinet Order, not later than the date such payment becomes definite, give notice of his name or title and address (…) to a person (…) who makes payment of that interest, etc. or dividend, etc. …. (translated by author.)

governments, however, are exempted from this notice requirement. It is explained that there is little reason to get notices from corporations that do not have to pay these tax.[11] Therefore, it is assumed that foreign governments are not paying tax on dividends. Presumably, this exemption was also based on sovereign immunity though no documents stated so.

Capital gains on stocks are not listed as taxable income of foreign corporations in the Corporation Tax Law and the Income Tax Law.

II. Tax Status of Sovereign Wealth Funds

Sovereign Wealth Funds are not treated differently from other funds.[12] They are taxed in accordance with Japanese tax law and tax treaties.

In a case of Singapore's fund, a Sovereign Wealth Fund is exempted from tax in Japan based on the Agreement between the Government of the Republic of Singapore and the Government of Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income.[13] Article 11, paragraph 3 of the Agreement reads:

> 3. Notwithstanding the provisions of paragraph 2, interest arising in a Contracting State and derived by the Government of the other Contracting State, a local authority there of, the central bank of that other Contracting State or any institution wholly owned by that Government, or by any resident of the other Contracting State with respect to debt-claims guaranteed, insured or indirectly financed by the Government of that other Contracting State, a local authority thereof, the central bank of that other Contracting State or any institution wholly owned by that Government shall be exempt from tax in the first-mentioned Contracting State.

The Japan-Norway Tax Convention also has a similar provision.[14]

III. Domestic Law

Tax rates for foreign corporations on domestic source interests and dividends depend on their size, business, or other factors. Also, temporary treatment to reduce such tax would be applied. There may be exceptions to the general rule on specific items. The following are the general rules. The general tax rate for a foreign corporation is thirty percent of income as of 2008.[15]

Article 355, paragraph 2 of the Income Tax Law Enforcement Order lists foreign governments and foreign local governments as "others" who are excluded from the notice requirement of the Income Tax Law Article 224, paragraph 1.

[11] Masasuke Takeda, DHC konmentaru shotokuzei hō [DHC Income Tax Law Commentary], 8895 (1983), *cited by* Chikaishi, *supra* note 8, at 150.

[12] Confirmed by an e-mail from a National Tax Agency official, to Sayuri Umeda, Senior Foreign Law Specialist, Law Library of Congress (Apr. 3, 2008) (on file with the author).

[13] Agreement between the Government of the Republic of Singapore and the Government of Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Treaty No. 8 of 1995, *available at* http://www.iras.gov.sg/ESVPortal/resources/singaporejapandta.pdf (unofficial source).

[14] Convention between Japan and The Kingdom of Norway for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Treaty No. 8 of 1992, art. 11, para. 3. Ministry of Foreign Affairs, Nikokukan jōyaku shū [Treaties between two countries] 1992, 1857 (1994) (unofficial source).

[15] Corporation Tax Law, Law No. 34 of 1965, *as amended by* Law No. 100 of 2007, art. 143, para. 1.

Interest

In general, fifteen percent of interest is withheld at the source.[16] If a foreign corporation has a permanent establishment in Japan, interest income should be included in taxable income when it pays tax by self assessment.[17] The amount of tax withheld is credited to the corporation tax to be paid.

Dividends

In general, twenty percent of dividend is withheld at the source.[18] If a foreign corporation has a permanent establishment in Japan, dividend income should be included in taxable income when it pays tax by self assessment.[19] The amount of tax withheld is credited to the corporation tax to be paid.

Capital Gain from Shares

As stated in section I, a foreign company's capital gain from shares is generally not taxed in Japan.

IV. Treaties on Double Taxation

Japan has treaties on double taxation with fifty-five countries, including China, Singapore, and Sweden, but not Kuwait.[20] In the Japan–Singapore Tax Agreement,[21] there is no provision on whether governments and their subdivisions are considered taxpayers or not. Though there are more details, the general rules of taxation and rates on interest, dividends, and capital gains in Japan for a Singapore resident are as follows.

Interest

It is not taxed (taxed in Singapore).[22] The beneficial owner of the interest is taxed up to ten percent of the gross amount of interest.[23]

Dividends

They are not taxed (taxed in Singapore).[24] The beneficial owner of the dividends is taxed fifteen percent of the gross amount of the interest.[25] The tax rate is five percent if the beneficial owner is a

---

[16] Income Tax Law, Law No. 33 of 1965, *as amended by* Law No. 100 of 2007, art. 179, item 3 and art. 212, para. 1.

[17] Corporation Tax Law, Law No. 34 of 1965, *as amended by* Law No. 100 of 2007, art. 141, item 1.

[18] Income Tax Law, Law No. 33 of 1965, *as amended by* Law No. 100 of 2007, art. 179, item 1 and art. 212, para. 1.

[19] Corporation Tax Law, Law No. 34 of 1965, *as amended by* Law No. 100 of 2007, art. 141, item 1.

[20] KAZUO KINOSHITA AND HIROSHI KANEKO EDS., KOKUSAI KAZEI NO RIRON TO KADAI [THEORIES AND TASKS OF INTERNATIONAL TAXATION], 36-7 (2005).

[21] Agreement between the Government of the Republic of Singapore and the Government of Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Treaty No. 8 of 1995.

[22] *Id*. art. 11, para. 1.

[23] *Id*. art. 11, para. 2.

[24] *Id*. art. 10, para. 1.

[25] *Id*. art. 10, para. 2 (b).

company which owns twenty five percent or more of the voting shares of the company in Japan for six months.[26]

Capital Gains

A nonresident's capital gains from shares are basically not taxed in Japan. They may be taxed in the following cases:

> (a) gains from the alienation of shares of a company not traded regularly at a recognized stock exchange, or of an interest in a partnership, a trust or an estate, the property of which consists principally of immovable property situated in a Contracting State, may be taxed in that Contracting State.
>
> (b) gains derived by a resident of a Contracting State from the alienation of shares of a company being a resident of the other Contracting State may be taxed in that other Contracting State, if:
>
> (i) shares held or owned by the alienator (together with such shares held or owned by any other related persons as may be aggregated therewith) amount to at least 25 per cent of the entire share capital of such company at any time during the taxable year or the basis period for the year of assessment; and
>
> (ii) the total of the shares alienated by the alienator and such related persons during that taxable year or the basis period for that year of assessment amounts to at least 5 per cent of the entire share capital of such company.[27]

In the Japan-Norway Tax Convention, there are almost identical provisions concerning interest and dividends.[28] There is, however, no provision similar to the above paragraph in the Convention.[29] Nonresident's capital gains from shares are basically not taxed in Japan.

Prepared by Sayuri Umeda
Senior Foreign Law Specialist
April 2008

---

[26] *Id*. art. 10, para. 2 (a). More specifically, six months period should be "immediately before the end of the accounting period for which the distribution of profits takes place."

[27] *Id*. art 13, paragraph 4.

[28] Convention between Japan and The Kingdom of Norway for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Treaty No. 8 of 1992, arts. 10 and 11.

[29] *Id*. art. 13.

2008-00763

LAW LIBRARY OF CONGRESS

TAXATION OF PASSIVE INCOME EARNED BY FOREIGN GOVERNMENTS AND SOVEREIGN WEALTH FUNDS

NORWAY

Executive Summary

Norway has ratified the Vienna Convention on Diplomatic Relations and the Vienna Convention on Consular Relations, which govern the status of foreign government personnel in Norway. Norway applies a tax exemption on companies' income from shares. This exemption applies to both private and state-owned companies, as well as to foreign companies within the European Economic Area. No provisions specifically concerning the taxation of sovereign wealth funds in Norway were located. Norway has a large sovereign wealth fund called the Government Pension Fund which manages Norway's substantial petroleum revenues to meet the needs of the increasing public pension expenditures.

I. Tax Status of Foreign Governments

Chapter 2 of the Norwegian Tax Act contains provisions regarding limitations on taxation and tax exemptions for certain persons and organizations.[1] According to the Tax Act, the Norwegian state is exempt from paying taxes, which includes government institutions, government establishments, and government funds.[2] No similar provisions have been found for foreign states.

The status of foreign government agencies and personnel, consular officers, and representatives of international organizations in Norway is governed by the provisions of the Vienna Convention on Diplomatic Relations (1961),[3] and the Vienna Convention on Consular Relations (1963).[4] Foreign government personnel are exempt from municipal wealth and income taxes.[5]

II. Tax Status of Sovereign Wealth Funds

No information was found with regards to the taxation of foreign sovereign wealth funds in Norway during the preparation of this report. As discussed under section III below, Norway applies a tax exemption on companies' incomes from shares. The tax exemption also applies to state-owned foreign companies within the European Economic Area (EEA), but not to companies outside the EEA (which are still taxed at a rate of 25 percent).

---

[1] Skatteloven (Act No. 14, Mar.28, 1999) [in Norwegian], *available at* http://www.lovdata.no/all/hl-19990326-014.html (official source).

[2] *Id.*, ch. 2 § 30.

[3] Vienna Convention on Diplomatic Relations, Apr.18, 1961, 500 UNITED NATIONS TREATY SERIES (UNTS, official source) 95, *available at* http://untreaty.un.org/ilc/texts/instruments/english/ conventions/9_1_1961.pdf.

[4] Vienna Convention on Consular Relations, Apr. 24, 1963, 596 UNTS 261, *available at* http://untreaty.un.org/ ilc/texts/instruments/english/conventions/9_2_1963.pdf.

[5] Ministry of Foreign Affairs, *Diplomat in Norway*, June 21, 2006, *available at* http://www.regjeringen.no/ en/dep/ud/Documents/veiledninger/2006/Diplomat-in-Norway.html?id=419528 (offficial Web site of the Norwegian Ministry of Foreign Affairs).

III. Domestic Law

Interest

Interest earned directly by non-residents from Norwegian sources is not taxable in Norway.[6]

Capital Gains

In the information available from the Norwegian government, share income constitutes both dividends and capital gains. Please see text below under "Dividends."[7]

Dividends

Since 2004, Norway has granted a tax exemption on companies' income from shares. The tax exemption model was adopted to avoid chain taxation when shares are owned by companies in multi-tier corporate structures. The tax exemption applies to Norwegian private and public limited companies and other companies of the same standing for tax purposes. It also applies to associations, institutions, Norwegian stock investment funds, estates in bankruptcy, and municipal and state-owned companies. The tax exemption model also applies to foreign companies and entities within the EEA that correspond to the Norwegian companies.[8] According to the Ministry of Finance, the tax exemption generally applies to domestic and cross-border income on shares.[9] In order to prevent tax avoidance, the tax exemption is not applicable to investments in foreign countries outside the EEA with low corporate taxation or to portfolio investments outside the EEA.[10]

The withholding tax regime on dividends from Norwegian companies to corporate shareholders outside the EEA has not changed. These corporate shareholders are still subject to a withholding tax of 25 percent or a reduced rate if there is an applicable double tax convention.[11]

IV. Treaties on Double Taxation

On the Norwegian Government's official Web site, a list of the countries with which Norway has double-taxation treaties, with links to the relevant treaties, is available.[12] As an example, Norway and Russia entered into a double taxation treaty in 1996, which came into force in 2002. The treaty applies to persons who are residents in either Norway or Russia, or both.[13] The term "persons" means individuals,

---

[6] *Norway*, THE TAXATION OF PATENT ROYALTIES, DIVIDENDS, INTEREST IN EUROPE 11 (IBFD Amsterdam, 2002-).

[7] Ministry of Finance, *The Corporate Tax System and Taxation of Capital Income*, http://www.regjeringen.no/nb/dep/fin/tema/Norsk_okonomi/topics/The-corporate-tax-system-and-taxation-of-capital-income.html?id=418058 (official Web site of the Norwegian Ministry of Finance, last visited May 5, 2008).

[8] *Id.*

[9] *Id.*.

[10] *Id.*, & Elisabeth A. Landmark, *Kildeskatt på Aksjeutbytte til Utenlandske Aksjonærer – Fritaksmetoden*, SKATTEDIREKTORATET, Mar. 2, 2005, *available at* http://www.nordea.no/sitemod/upload/root/www_nordea_no/Text/Corporate/issuer_services_05-05457_informasjon_kildeskatt-fritaksmetodenb-020305-el.pdf.

[11] Landmark, *id.*

[12] Ministry of Finance, *General Tax Conventions between Norway and Other States*, Oct. 9, 2007, *available at* http://www.regjeringen.no/en/dep/fin/Selected-topics/Taxes-and-Duties/skatteavtaler/tax-treaties-between-norway-and-other-st-2.html?id=450647.

[13] Convention between The Kingdom of Norway and The Russian Federation for the avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes and Income on Capital, art. 1, Ministry of Finance Web site, May 17,

companies, or other bodies of persons.[14] According to article 4 of the OECD model tax convention, the term "resident" includes States, political subdivisions, and local authorities thereof.[15] Article 4 of the tax treaty between Norway and Russia, which also defines the term "resident," does not include States. The first paragraph of this article states:

> For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of registration, place of management or any other criterion of a similar nature. But this term does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

With regard to dividends, article 10, first paragraph, of the tax treaty between Norway and Russia follows the OECD model convention, stating: "Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State."[16]

The second paragraph differs from the OECD Model Convention and states that dividends may also be taxed in the Contracting State where the company paying the dividends is a resident, according to the laws of that State, but if the recipient is the beneficial owner of the dividends, the tax shall not exceed 10 percent of the gross amount of the dividends.[17]

Interest arising in a Contracting State that is paid to a resident of the other State may be taxed in that other State.[18] This is the same rule as in the OECD Model Convention. The second paragraph of article 11 differs, and in the Norway-Russia tax treaty it states:

> However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the recipient is the beneficial owner of the interest the tax so charged shall not exceed 10 per cent of the gross amount of the interest.

The third paragraph of article 11 contains a provision which exempts interest from tax in cases where the interest is beneficially owned by the Norwegian or Russian state, a regional or local authority thereof, or by an instrumentality of Norway or Russia which is not subject to tax within the state. The paragraph states:

> Notwithstanding the provisions of paragraph 2, interest shall be exempt from tax in the Contracting State in which it arises if:
> a) the interest is beneficially owned by a Contracting State, a regional or local authority thereof or by an instrumentality of that State which is not subject to tax therein;
> b) the interest is beneficially owned by: the Central Bank of Norway, the Norwegian Guarantee Institute for Export Credits, A/S Eksportfinans; the Central Bank of Russia, Foreign Trade Bank of Russia; or any other institution similar to the above-mentioned institutions, as may be agreed from time to time between the competent authorities of the Contracting States;

2001, *available at* http://www.regjeringen.no/en/dep/fin/Selected-topics/Taxes-and-Duties/skatteavtaler/Skatteatale-Norge-Russland-vedlegg2.html?id=107028.

[14] *Id.*, art. 3, point d.

[15] Articles of the Model Convention with Respect to Taxes on Income and on Captial, OECD, July 15, 2005, *available at* http://www.oecd.org/dataoecd/50/49/35363840.pdf.

[16] Convention between The Kingdom of Norway and The Russian Federation for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes and Income on Capital, art. 10, Ministry of Finance Web site, May 17, 2001, *available at* http://www.regjeringen.no/en/dep/fin/Selected-topics/Taxes-and-Duties/skatteavtaler/Skatteatale-Norge-Russland-vedlegg2.html?id=107028.

[17] *Id.*

[18] *Id.*, art. 11.

> c) the interest is paid by a purchaser to a seller in connection with a commercial credit resulting from deferred payments for goods, merchandise, equipment or services. [19]

The general rule for capital gains is the same in the tax treaty between Norway and Russia as in the OECD model convention and states that "gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in that other State."[20] Paragraph 5 of article 13 of the tax treaty between Norway and Russia differs from the OECD Model Convention and regulates gains derived from the alienation of shares and other corporate rights. It states:

> Gains derived by an individual of a Contracting State from the alienation of shares or the other corporate rights in an entity which is a resident of the other Contracting State, and gains from the alienation of any other security which are subjected in that other State to the same taxation treatment as gains from the alienation of such shares or other rights may be taxed in that other Contracting State, but only if:
> a) the alienator has been a resident of that other Contracting State at any time during the five years immediately preceding the alienation of the shares, rights or security; and
> b) the alienator was the beneficial owner of the abovementioned shares or rights while a resident of that other State.[21]

V. Other Information

Norway is unique among the Nordic countries because of its substantial oil revenues. The Government Pension Fund was established in 2006 and consists of two funds: the "Government Pension Fund – Global," which was formerly called the Government Petroleum Fund, and the "Government Pension Fund – Norway," which was formerly the National Insurance Scheme Fund.[22]

The Government Petroleum Fund was established in 1990 as a fiscal tool to manage national petroleum revenues. The Fund was renamed in 2006 as part of a broader national pension reform, designed to facilitate government savings to meet the rapidly raising needs of public pension expenditure.[23] In 2007, the size of the Government Pension Fund – Global was about US$373 billion.[24] The Norwegian Ministry of Finance is responsible for the management of the Government Pension Fund. It is the Norwegian Central Bank, Norges Bank, that invests the Government Pension Fund – Global's capital abroad in bonds and equities, in accordance with guidelines issued by the Norwegian Ministry of Finance.[25]

Prepared by Linda Forslund
Contract Foreign Law Specialist
May 2008

---

[19] *Id.*

[20] *Id.*, art. 13.

[21] *Id.*

[22] Ministry of Finance, *The Government Pension Fund*, http://www.regjeringen.no/en/dep/fin/The-Ministry/Underliggende-etater/The-Government-Pension-Fund-.html?id=270410 (last visited May 5, 2008). For information on the Government Pension Fund, please visit the Norwegian Ministry of Finance official Web site at http://www.regjeringen.no/en/dep/fin/Selected-topics/The-Government-Pension-Fund.html?id=1441.

[23] Ministry of Finance, *The Government Pension Fund –Global, Fact Sheet*, Apr. 2008, *available at* http://www.regjeringen.no/upload/FIN/Statens%20pensjonsfond/summary-apr08.pdf (official Web site of the Ministry of Finance).

[24] *Id.*

[25] *The Government Pension Fund, supra* note 22.

2008–00763

LAW LIBRARY OF CONGRESS

POLAND

TAXATION OF PASSIVE INCOME EARNED BY FOREIGN GOVERNMENTS AND SOVEREIGN WEALTH FUNDS

Executive Summary

Polish tax legislation is based on principles of limited and unlimited tax liability and does not exempt entities established and/or owned by foreign governments from taxation. There is no special tax regime for foreign direct investments either. All income originated in Poland is subject to a flat-rate 19 percent corporate income tax. Taxation of dividends may vary depending on provisions of a bilateral tax treaty.

I. Tax Status of Foreign Governments

Legislation of Poland does not provide for a special tax regime in regard to foreign direct investments, including those conducted by a foreign government. Mechanisms of investment, the status of investors, and guarantees provided to investors by the Government of Poland are established by a number of legislative acts, including the Law on Investment Funds[1] and the Law on Securities.[2] These documents emphasize the equality of all forms of investment in Poland and expand the domestic regime to all foreign investors, including foreign governments. No special permits are required to conduct investment activities in Poland, except in a few special sectors. Rules on minimum capital contributions by foreign investors and minimum share requirements, which were previously in force, were abolished by present legislation. The repatriation or reinvestment of dividends received from investment activities in Poland can be conducted without restrictions regardless of the source of the company's revenue or its origin, and is subject to regular taxation. There is no controlled foreign corporation legislation in Poland as well as other laws that would address foreign government investment entities. Dividends received by foreign governments can be taxed under domestic law, and according to the provisions established by bilateral treaties. Depending on the terms of a treaty, Polish law expands the definition of foreign government institutions to Central banks, public state organizations, municipal authorities, certain government agencies, pension funds, and investment funds.

II. Tax Status of Sovereign Wealth Funds

Basic principles of the taxation legislation are determined by the Tax Ordinance Act, which entered into force on July 1, 2007.[3] Provisions of the Act regarding the equal status of all taxpayers in the country (art.3) and principles of limited and unlimited tax liability were confirmed and explained by the Minister of Finance in his letter of April 12, 2005.[4] The letter established that all companies with their seats or management on the territory of Poland are liable for tax on the whole of their income regardless of the location of its sources. Taxpayers with no seat or management in the territory of Poland are liable for tax on income earned only in the territory of Poland. There is no special tax regime regarding Sovereign Wealth Funds, and therefore there is no provision in Polish tax legislation that would grant tax exemption to them. The existing legislation exempts from taxation foreign investment companies, which operate in

---

[1] DZIENNIK USTAW RZECZYPOSPOLITEJ POLSKIEJ (Journal of Laws of the Republic of Poland (official gazette), hereinafter Dz. U.) 2004, No. 146, Item 1546.
[2] Dz.U.2002, No. 41, Item 363.
[3] Dz.U.2005, No. 8, Item 60.
[4] Dz.U.2005, No. 36, Item 1521.

special economic zones, and this exemption applies to all types of investment funds. The Income Tax Treaty concluded between the United States and Poland on October 8, 1974,[5] is also based on the principle that a resident of one state may be taxed by another state on any income from sources within this state. It appears that the only exemptions provided are for foreign shareholders from the European Union Member States in regard to taxation of dividends paid by Polish companies.

III. Domestic law

The Polish law provides for a flat-rate 19 percent corporate income tax, which is applicable to all resident and non-resident business income except exempt income or where different tax rates apply. Capital gains, interest, royalties, and other forms of income are included in the taxable income base. Dividends are subject to withholding 19 percent tax, which may be reduced by relevant provisions of a tax treaty if the recipient is a non-resident.

IV. Treaties on Double Taxation

Within the scope of this request, Poland has concluded treaties on avoidance of double taxation with China, Kuwait, Russia, and Singapore. All of them establish special rates for taxing dividends paid to a foreign company by a Polish resident company. In regard to the withholding tax rates that are applicable to dividends paid to non-residents under the tax treaties, these rates are 10 percent for China, Russia, and Singapore, and 5 percent for non-government Kuwaiti companies. Kuwait is the only country in this group whose government is exempt from withholding tax on dividends. The Treaty, which entered into force in 1996 states (art.8) that no tax shall be paid if a dividend is paid to a company that belongs to the government of the other state or a company in which at least 25 percent of the capital is owned by the government.

Prepared by Peter Roudik
Senior Foreign Law Specialist
May 2008

[5] IBFD Tax Treaty Database at http://ip-online.ibfd.org/treaty/.

2008-00763

LAW LIBRARY OF CONGRESS

TAXATION OF PASSIVE INCOME EARNED BY FOREIGN GOVERNMENTS AND SOVEREIGN WEALTH FUNDS

SWITZERLAND

Executive Summary

Swiss domestic law does not exempt foreign governments or foreign sovereign wealth funds from taxation on passive income earned from Swiss sources.

Such exemptions may occur as the result of tax treaties or of the practice arising from these. The Swiss-Norwegian treaty on double taxation specifically exempts Norway's government, central bank, and oil fund from taxation on dividends earned from Swiss companies, and this treaty exempts all Norwegian taxpayers from taxation on interest earned from Swiss sources.

Swiss domestic law imposes a 35 percent withholding tax on Swiss source interest and dividends, but substantial shareholders enjoy participation exemptions on their dividend income. Swiss domestic law imposes a federal gains tax of 8.5 percent on capital gains of portfolio shareholders while exempting substantial shareholders.

I. Tax Status of Foreign Governments

Swiss domestic law does not exempt foreign governments from taxation on their passive income earned in Switzerland.[1] Therefore, it appears Swiss domestic law should operate to the effect that foreign governments and their entities are, as a rule, taxed by Switzerland on their Swiss source income from interest, dividends, and capital gains like other foreign corporate taxpayers. There is only one statutory exemption, and it provides that foreign governments are not taxed on their real estate that is used for diplomatic and consular purposes.[2]

In the absence of statutory unilateral exceptions, foreign governments may nevertheless be exempted from taxation of their passive Swiss-source income by treaty or by the practice resulting from a treaty. Whereas the Vienna Conventions on Diplomatic Relations[3] and Consular Relations[4] exempt foreign governments from taxation only for the narrow, mission-related purposes stated therein,[5] bilateral double taxation treaties may exempt governmental entities from taxation on various categories of passive income.[6] There is, however, much variance in the respective treaty provisions, as is explained below (*see* section on Double Taxation Treaties).

---

[1] Information obtained from Mr. Dieter Leutwyler, Press Speaker of the Swiss Federal Finance Ministry.

[2] Bundesgesetz über die direkte Bundessteuer [DBG], Dec. 14, 1990, as amended, SYSTEMATISCHE SAMMLUNG DES BUNDESRECHTS [SR] no. 642.11, art. 56 (i) (official source).

[3] Convention on Diplomatic Relations, Apr. 18, 1961, 23 UST 3227; TIAS 7502; 500 UNTS 95 (official source).

[4] Convention on Consular Relations, Apr. 24, 1963, 21 UST 77; 596 UNTS 261 (official source).

[5] One Swiss authority views these conventions as replacing former international customary law on governmental immunity from taxation. *See* E. BLUMENSTEIN & P. LOCHER, SYSTEM DES SCHWEIZERISCHEN STEUERRECHTS 69 (Zürich, 2002).

[6] *Id.*

II. Tax Status of Sovereign Wealth Funds

There is no domestic statutory rule exempting foreign sovereign wealth funds from taxation on their passive income in Switzerland. It appears, therefore, that in the absence of a tax treaty providing otherwise, these funds should be taxed in Switzerland. If a treaty exempts certain governmental entities from taxation, sovereign wealth funds may qualify for an exemption to the extent that they live up to the treaty criteria in terms of the nature of the fund and its relationship to government by virtue of ownership, management, purpose, and control.[7]

III. Domestic Law

In General

Switzerland has a high level of cantonal taxation and a great degree of variance among the cantonal taxes.[8] Switzerland also has federal taxes, and of these, the federal withholding tax[9] is the most relevant for passive income. It is imposed on dividend and interest income, and the revenue is shared with the cantons. The federal income tax,[10] on the other hand, is imposed on certain capital gains. There are many cantonal income taxes, some of which may also tax capital gains, but these are not discussed in this report.

Interest

Non-resident taxpayers are subjected to a withholding tax of thirty-five percent on interest received from Swiss obligations or customer accounts of Swiss banks.[11] The withholding may be adjusted accordingly if interest is taxed at a lower rate under an applicable double taxation treaty (*see below*, section on Double Taxation Treaties). Corporate taxpayers from member countries of the European Union (EU) are not taxed by Switzerland on interest earned from an affiliated Swiss company. This is provided in the Swiss–EU agreement adopting the EU Savings Directive.[12]

Dividends

Non-resident taxpayers are subjected to a thirty-five percent withholding tax on dividends received from a resident Swiss corporation.[13] There are, however, the following exceptions from this tax rate or liability:

- Double taxation treaties usually provide lower rates for portfolio dividends and even lesser rates or total exemptions for substantial holdings.[14]

---

[7] Information obtained from Mr. Dieter Leutwyler, Press Speaker of the Swiss Federal Finance Ministry.

[8] X. OBERSON & H. HULL, SWITZERLAND IN INTERNATIONAL TAX LAW (Amsterdam, 2006).

[9] Bundesgesetz über die Verrechnungssteuer [VStG], Oct. 13, 1965, as amended, SR no. 642.21, *available at* the official Web site http://www.admin.ch/ch/d/sr/c642_21.html.

[10] DBG.

[11] VStG, art. 4 par. 1 & art. 13.

[12] Agreement between the European Community and the Swiss Confederation providing for measures equivalent to those laid down in Council Directive 2003/48/ECof 3 June 2003, on taxation of savings income in the form of interest payments, Oct. 26, 2004, effective July 1, 2005, SR 0641.926.81, art. 15; Oberson, *supra* note 8, at 303.

[13] VStG, art. 4.

[14] R. Wüthrich, *Switzerland, in* International Bureau of Fiscal Documentation, 2 THE TAXATION OF COMPANIES IN EUROPE 8.5.2. 1 (Amsterdam, 2007-).

- According to the EU Parent-Subsidiary Directive,[15] foreign corporations from European Union countries who own at least twenty-five percent of the stock of a Swiss company are not taxed on their dividend income.

- The Swiss participation relief applies to holdings of at least twenty percent of the Swiss stock-distributing company.[16] Technically, this privilege is not an exemption, but it has the same effect as an exemption.[17]

Capital gains

Foreign entities must pay federal gains tax on their capital gains realized from shares in Swiss corporations.[18] The rate of the federal gains tax is 8.5 percent of the net profit,[19] yet the participation exemption applies to substantial holdings.[20] The taxable gain of all profits realized in Switzerland is determined according to Swiss principles of income taxation.[21]

IV. Treaties on Double Taxation

In general

Switzerland has bilateral double taxation treaties for income with more than eighty countries,[22] so that, in effect, the treaties are more indicative of the actual practice than the unilateral provision of Swiss domestic law. Although many of the newer treaties follow the OECD model treaty,[23] they nevertheless vary significantly on the treatment of foreign governments and their entities and on the taxation of interest, dividends, and capital gains received by foreign creditor or shareholders from Swiss sources. Moreover, the wording of the treaties cannot always be regarded as conclusive for determining the actual practice, because the contracting states may interpret the treaty according to their mutual intentions.[24]

Norway

The double taxation treaty with Norway exempts each other's governments from the taxation of source country dividends and extends that privilege also to the Swiss Central Bank, the Norwegian Central Bank, the Norwegian Oil Fund, and any other governmentally owned entity that is designated by

---

[15] Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different member states, 1990 OFFICIAL JOURNAL OF THE EUROPEAN COMMUNITIES (L225) 6, applicable between Switzerland and the EU member states on the basis of Agreement between the European Community and the Swiss Confederation providing for measures equivalent to those laid down in Council Directive 2003/48/ECof 3 June 2003 on taxation of savings income in the form of interest payments, Oct. 26, 2004, effective July 1, 2005, SR no. 0641.926.81, art. 15.

[16] DBG, art. 69.

[17] Wüthrich, *supra* note 14, at 7.1.3.1.

[18] DBG, art. 51, in conjunction with DBG, art. 49, par. 3; Wüthrich, *supra* note 14, at 4; 8.4.2.3 and 7.1.6.

[19] DBG, art. 68.

[20] DBG, art. 69.

[21] DBG, arts. 58 – 67.

[22] Wüthrich, *supra* note 14, at 8.5.2.

[23] Organization for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital* (electronic version), Feb. 1, 2005, *available* by subscription from the official Web-site http://www.oecd.org/document/17/0,3343,es_2649_33747_35035793_1_1_1_1,00.html;Oberson, *supra* note 8, at 77.

[24] Oberson, *supra* note 8, at 89.

agreement of the authorities of in both countries.[25] No corresponding provision exists for exempting interest earned by the other government and its entities, because article 11 of the treaty provides that interest is not taxed by the source country.

The general rate of the taxation of dividends in the source country is up to fifteen percent, but substantial holdings in a source country company are exempt from dividend taxation. The only capital gains from dividends that are taxed in the source country are substantial holdings owned by individual taxpayers.

Kuwait

The double taxation treaty with Kuwait[26] specifies in its article 4, paragraph 2 that the government of a treaty state and its subdivisions qualify as residents of the respective treaty country and that the same status applies to governmental institutions that have been created by a government to exercise public functions and that are recognized as such by mutual agreement of the competent authorities. The Protocol to the treaty specifies several Kuwaiti entities as falling within the scope of article 4, paragraph 2. Listed are:

- the Central Bank of Kuwait;
- Public Institution for Social Security;
- governmental corporations;
- government offices;
- government agencies;
- foundations; and
- the Development Fund.

According to article 11 of the treaty, the source country may tax interest of a creditor who resides in the other treaty country with a maximum rate of ten percent, and creditors who are foreign governments, their subdivisions, and agencies are tax residents within the meaning of this provision. Nevertheless, the actual treaty practice cannot be deduced from the treaty itself, due to discretionary clauses contained therein that allow for mutual understandings by the treaty countries.

Source country dividends are taxable with a maximum of fifteen percent, but substantial holdings enjoy the participation exemption. Due to discretionary clauses that allow for mutually agreeable interpretations, the actual practice of dividend taxation cannot be cannot be ascertained from the treaty provisions.

According to article 13 of the treaty, capital gains from the sale of stock are not taxed in the source country.

Prepared by Edith Palmer
Senior Foreign Law Specialist
May 2008

[25] Abkommen zwischen der schweizerischen Eidgenossenschaft und dem Königreich Norwegen zur Vermeidung der Doppelbesteuerung auf dem Gebiet der Steuern vom Einkommen und vom Vermögen, as amended, SR no. 0.672.959.811, art. 10 (official source).

[26] Abkommen zwischen der schweizerischen Eidgenossenschaft und dem Staat Kuwait zur Vermeidung der Doppelbesteuerung auf dem Gebiet der Steuern vom Einkommen und vom Vermögen, Feb. 16, 1999, with Protocol, SR no. 0.672.947.61 (official source).

2008–00763

LAW LIBRARY OF CONGRESS

TAXATION OF PASSIVE INCOME EARNED BY FOREIGN GOVERNMENTS AND SOVEREIGN WEALTH FUNDS

UNITED KINGDOM

Foreign governments are not typically taxed in the UK, based upon the principle of sovereign immunity. The UK government has specifically noted that sovereign wealth funds are excluded from taxation on the basis of this principle.

I. Tax Status of Foreign Governments

Foreign states are typically exempt from taxation in the UK under the longstanding principle of sovereign immunity, provided for by customary international law. The UK has a practice of exempting foreign governments from taxation on passive income based on the above principle of customary international law.[1]

II. Tax Status of Sovereign Wealth Funds

Investment in the United Kingdom through sovereign wealth funds has been actively encouraged, and UK Trade and Investment notes that the high profile recently garnered by these funds generates opportunities for inward investment.[2]

The investments of foreign states recognized by the United Kingdom are typically exempt from tax under the longstanding principle of sovereign immunity provided for by customary international law. Her Majesty's Revenue and Customs has stated that "Income and gains arising to, and in the sole direct beneficial ownership of: the Head (for example a reigning Monarch or a President) of a foreign Sovereign independent State; the Spouse of such a Head of State; a foreign independent Sovereign Government, are … normally immune from taxation."[3] This immunity only extends to income and gains that are beneficially owned by the foreign state and not to entities that are separate from the government, even though these may be wholly owned through shares by the government.[4] The government has recently stated in Parliament that:

> Where a sovereign wealth fund is an integral part of the government of a foreign sovereign state it will benefit from immunity from UK tax. As a result of this immunity no taxation will have been received from sovereign wealth funds. The United Kingdom recognises the principle of international law known as sovereign immunity whereby one sovereign state does not seek to apply its domestic laws to another sovereign state. In accordance with this principle, current UK practice is to regard as immune from direct taxes all income and gains which are beneficially owned by the head of state and the government of a foreign sovereign state recognised by the UK.[5]

---

[1] UK Trade and Investment, *UK to Attract Sovereign Wealth Funds*, Apr. 11, 2008, *available at* http://www.ukinvest.gov.uk/OurWorld/4019411/en-GB.html

[2] *Id.*

[3] HM Revenue and Customs, *INTM155010 - Sovereign and Crown Immunity*, http://www.hmrc.gov.uk/manuals/intmanual/INTM155010.htm (last visited Apr. 17, 2008).

[4] *Id.*

[5] 28 Apr. PARL. DEB., H.C. (6th ser.) (2008) 144W.

III. Domestic Law

Interest

The domestic rate of taxation on the payment of interest to non-residents is the savings income tax rate of twenty per cent, unless these are quoted Eurobonds or short interest.[6] Interest from bank deposits may be paid without this tax if a declaration of non-residence is filed with the bank.[7]

Dividends

There is no tax on dividends that are paid in the UK to a non-resident.[8]

Capital Gains

Non-resident companies are liable to UK corporate tax on any capital gains that are attributable to a UK permanent establishment, notably those that arise

> on the disposal of assets situated in the United Kingdom while the UK trade is being carried on and use or acquired for use in the trade carried on through the permanent establishment (s. 11(2)(b) ICTA[9] and s 10(3) TCGA;[10] [and] any unrealized capital gains on assets situated in the UK and used for the purpose of the trade if the business in the UK increases or the assets are removed from the UK (s. 25(3) The CGA).[11]

The current rate was reduced from thirty percent to twenty-eight percent in April 2008.[12]

IV. Double Tax Treaties

The UK has concluded over 100 tax treaties on the avoidance of double taxation, and claims to have the largest network of treaties on this subject.[13] The UK currently uses the OECD Model Convention for its tax treaties.[14]

An example of the tax treatment of foreign governments is present in the double taxation treaty of the UK and Singapore.[15] In this treaty, the government exempts interest arising in each of its states from

---

[6] II THE TAXATION OF COMPANIES IN EUROPE, ¶ 8.5.1.2 (1972-).

[7] *Id.*

[8] THE TAXATION OF COMPANIES IN EUROPE, *supra* note 6, at II, ¶ 8.5.1.1.; HM Revenue and Customs, *IR20 - Residents and Non-Residents: Liability to Tax in the United Kingdom*, 1999, *available at* http://www.hmrc.gov.uk/pdfs/ ir20.htm.

[9] Income and Corporation Taxes Act 1988, c. 1, *available at* http://www.opsi.gov.uk/acts/acts1988/Ukpga_1988 0001_en_1 (official source).

[10] Taxation of Chargeable Gains Act 1992 c. 12, *available at* http://www.opsi.gov.uk/acts/acts1992/Ukpga_1992 0012_en_1 (official source).

[11] THE TAXATION OF COMPANIES IN EUROPE, *supra* note 6, at ¶ 8.4.2.1.

[12] Finance Act 2007, c. 11, § 2, *available at* http://www.opsi.gov.uk/acts/acts2007/pdf/ukpga_20070011_en.pdf (official source).

[13] UK Trade and Investment, *Tax in the UK*, Dec. 2007, *available at* http://www.ukinvest.gov.uk/United-Kingdom/4016067/en-GB.html.

[14] THE TAXATION OF COMPANIES IN EUROPE, *supra* note 6, at II, ¶ 8.6.1.

[15] Agreement Between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, Feb. 12, 1997, Gr. Brit.-Singapore, Gr. Brit. T.S. No. 41 (2000), (Cm. 4683), *available at* http://www.hmrc.gov.uk/international/singapore-dtc.pdf (unofficial source).

tax. The term "government" in this treaty is extended, in the case of Singapore, by the government of Singapore, to include:

> the Monetary Authority of Singapore and the Board of Commissioners of Currency; the Government of Singapore Investment Corporation Pte Ltd; a statutory body; and any institution wholly or mainly owned by the Government of Singapore as may be agreed from time to time between the competent authorities of the Contracting States.[16]

For the UK, the term "government" in the treaty covers the Government of the United Kingdom of Great Britain and Northern Ireland and includes:

> the Bank of England; the United Kingdom Export Credits Guarantee Department; the Commonwealth Development Corporation; and any institution wholly or mainly owned by the Government of the United Kingdom as may be agreed from time to time between the competent authorities of the Contracting States.[17]

Under the terms of this Treaty, non-residents may be charged up to fifteen percent in taxes for dividends and interest in the source country.

Prepared by Clare Feikert
Foreign Law Specialist
May 2008

---

[16] *Id.*, art. 11(4).

[17] *Id.*