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Tax Brief

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Sovereign Wealth Funds

The tax treatment of sovereign wealth funds (**SWFs**) in domestic and international tax law has recently been occupying the minds of tax officials in Australia and overseas. This Tax Brief examines recent proposals discussing the tax treatment of SWFs, proposals that will affect both the Australian tax position of SWFs themselves, and the Australian tax position of the entities into which they invest.

Background

In August 2009, the Government announced that it would move to codify current practices that can result in the income of SWFs being exempted from Australian income tax. In November, Treasury released a Consultation Paper, *Greater Certainty for Sovereign Investments* seeking submissions on how to implement this announcement. Interestingly, the Consultation Paper has taken the approach that Australia may well decide simply to mirror the current US rules because of 'the benefit of [their] familiarity to the global investment community and the confidence [this would bring] that investments into Australia will receive equivalent tax outcomes to those in the US.'

At the same time, tax officials at the OECD have been working on resolving some of the issues surrounding the ability of SWFs to enjoy benefits under tax treaties. In November, the OECD released a paper, *Discussion Draft on the Application of Tax Treaties to State-Owned Entities, Including Sovereign Wealth Funds*. The OECD paper proposes a number of changes to the Commentary on the OECD Model Tax Convention alluding to the special circumstances of SWFs.

These developments follow on the heels of a report in 2008 by the Joint Committee of Taxation in the US, *Economic And U.S. Income Tax Issues Raised By Sovereign Wealth Fund Investment In The United States* (the Joint Committee is a combined committee of the House of Representatives and Senate of the US Congress).

Treasury Paper

The Treasury Paper says that the goal of this project is not to change existing law and practice, but rather 'to codify the current administrative practice which, broadly speaking, provides an income tax and withholding tax exemption to foreign governments for income arising in respect of their non-commercial investments in Australia.' This practice follows from the customary international

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law doctrine of sovereign immunity – that a sovereign State, its agents, its property and activities are immune from the jurisdiction of the courts of another State, and this includes by implication, immunity from the tax laws of another State.

The Treasury Paper sets out three main issues for analysis:

- Which entities are eligible for the exemption? The Paper says that the regime will apply only to an entity that is either a foreign government, or is wholly owned, directly or indirectly, by a foreign government. The Paper does, however, ask whether the regime should be available to an entity owned by a monarch or other individual who is the ruler of a State. Interestingly, there is no discussion about residence issues – and so it seems the rules that apply to a SWF established offshore might also apply to an entity that is the Australian subsidiary of an offshore SWF (although this would make an Australian scheme potentially broader than the US Model – see below). There is also no specific discussion in the Paper about the kinds of issues that have concerned other countries, including the US – how to treat the activities of pension funds established by foreign governments and entities such as tourist boards, trade representative offices, government-owned airlines, shipping, postal and telecommunications companies.

- What kinds of income will be exempt? The Paper proposes that the exemption from Australian income tax has been and will remain confined to non-commercial operations or passive investments. Most of the discussion in the Paper concerns how to draw the distinction, rather than where to draw it.

The Paper cites as examples of passive income ‘income such as interest and dividend income.’ But difficult questions that will have to be resolved will include the treatment of commercial real estate held directly and the holding of majority (or at least, non-portfolio) share- and unit-holdings in Australian entities. There may be issues about the treatment of minority positions taken in Australian partnerships – whether they amount to the SWF carrying on business in Australia. There will also be issues about the appropriate consequences to flow where a SWF earns offending types of income or holds excessive levels of investment in a resident entity.

- What kinds of tax exemptions will apply? The Paper proposes continuing the current practice of giving exemption only from income tax (on income flows and realised gains) and withholding taxes, not taxes such as GST, FBT or stamp duty.

Treasury is seeking submissions on the Paper by 5 February 2010.

US model

Interestingly, the Treasury Paper takes seriously the idea of simply adopting the US model and applying it in Australia. Such a practice has not been favoured in the past – think of the FBT, GST, consolidation, CGT, forex, the rules for REITs,

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or any number of other examples – where Australia has decided to go its own very idiosyncratic way.

Under US rules, an ‘integral part’ of a foreign government and any entity controlled by a foreign government enjoy an exemption from US income tax and withholding taxes. Controlled entities only enjoy the exemption, however, if they are 100% owned by the foreign government and are formed under the law of the foreign State. A second leg to this test disqualifies a controlled entity if any of its earnings ‘inure’ to the benefit of a private person. This test can obviously cause some concern if the earnings of the SWF are earmarked to pay benefits to particular people or groups – for example, pensions for government employees or social benefits for certain targeted groups of citizens.

Until 1986, the US exemption was extended to all US source income derived by a foreign government or controlled entity. Today, the exemption applies just to income and gains derived from investments in US shares, bonds, other securities and interest on deposits in US banks. There is also a special extension to income and gains arising on ‘financial instruments held in the execution of the [foreign government’s] financial or monetary policy’ which is understood to refer to the activities of foreign central banks.

In fact, the US exemption for SWFs is perhaps less generous than it first appears as US domestic law does not purport to tax portfolio capital gains on shares and securities (unless the entity is land-rich) nor interest on portfolio loans or interest on certain deposits with US banks. It is, however, worth noting that the US exemption extends to gains made on the sale of portfolio interests in land-rich US corporations.

The exemption does not apply if any income is earned from commercial activities conducted through a ‘controlled commercial entity.’ The US approach is all-or-nothing – that is, the exemption is lost entirely once any commercial income is earned. The US disqualification applies if the controlled commercial entity conducts its commercial operations anywhere in the world. (This can apparently lead to SWFs that operate in the US using complex ‘blocking structures’ to prevent the triggering this penalty.) Separate rules apply where the foreign entity is a government-controlled pension fund (such as Australia’s Future Fund).

This brief description hides much of the complexity in the US provisions, although their scope and effect is elaborated in detailed US Treasury regulations and IRS Revenue Rulings (and a number of private letter rulings) which have been issued interpreting the section.

OECD discussion paper

The focus of the OECD Paper is on a different issue, namely, the circumstances in which SWFs can enjoy treaty benefits.

The Paper makes it clear that it is trying to avoid any discussion about the boundaries of the customary international law doctrine of sovereign immunity, which is the basis for the current exemption for SWFs. Indeed, for many SWFs

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only the doctrine of sovereign immunity is relevant to their position as many SWFs are established by countries without a substantial treaty network.

The problem that the OECD Paper is trying to address arises in this way. Under the OECD Model, treaty benefits are typically extended to 'residents' of each of the contracting States, a definition which requires that the entity is liable to tax in one of the contracting States. The definition of 'resident' in some of Australia's tax treaties uses this formulation. In order to deal with this difficulty, some of Australia's treaties (for example, UK, New Zealand, Canada and Japan) extend to cover the government of the State, its 'political subdivisions' and 'local authorities'. The OECD Paper notes that some countries even include a 'statutory body,' 'agency' or 'instrumentality' of a State as a 'resident' for the purposes of the treaty. However, this is not a universal practice in Australia's treaties, and, where the definition of 'resident' does require that the entity is liable to tax, there can be issues about the entitlement of a tax exempt SWF to enjoy treaty benefits.

The OECD paper proposes a number of particular revisions to the Commentary to the OECD Model. For the most part, these revisions to the Commentary serve simply as reminders of the issue and do not express a position on whether SWFs are intended to (or do) enjoy treaty benefits. One revision says simply,

whether a sovereign wealth fund qualifies as a 'resident of a Contracting State' depends on the facts and circumstances of each case.

The OECD is inviting comments by 31 January 2010.

Some final observations

First, there is an obvious tension underlying the two positions in the Treasury Paper: to codify but not change current administrative practice, and yet to codify that practice by enacting the US rules. It remains to be seen just how this tension will be resolved.

Secondly, it was noted above that the US exemption for SWFs is perhaps less generous than it first appears as US domestic law does not purport to tax many kinds of US source income earned by foreigners. In such cases a SWF exemption is redundant. The same can be said of Australia. We already have a relatively attractive regime for foreign investors, be they SWFs or other type of passive investor.

For example, under existing law:

- during the life of the investment, while Australia will typically expect to collect corporate tax from any resident company into which a SWF invests, little Australian tax will likely be collected at the entity level if the foreign investor operates in Australia through a managed investment trust, and is subject to the MIT withholding rates. (Current ATO practice seems to be that even this tax will be removed where an investor holding a portfolio interest qualifies as a SWF);

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- the same is true of periodic distributions from entities into which the SWF has invested. Australia does not seek withholding tax on franked dividends leaving the country and foreign pension funds that are tax-exempt in their own country are also exempted from Australian withholding tax on interest income leaving the country; and
- when the foreign investor seeks to exit its investment in Australia, tax on any profit made on the sale or redemption will (usually) only arise if the foreign investor directly owns Australian land, or has more than 10% of an Australian entity that is 'land rich.'

Given this position, any added benefits from a dedicated SWF regime may ultimately prove to be modest. Indeed, despite the proposition that the new regime will codify but not change existing practice, the real significance of the regime may end up being in the restrictive nature of the rules that could emerge from the drafting exercise – for example, in bright line rules denying the exemption to SWFs holding more than 10% of a resident entity, or in rules which disqualify the direct holding of assets.

On the other hand, not having to rely upon the MIT rules can make life easier in the sense of lower compliance costs, even a 7.5% tax cost may make some investments not feasible and the benefit of greater statutory certainty is not insignificant.

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