TAXATION OF SOVEREIGN WEALTH FUNDS – A SUGGESTED APPROACH

SALLY-ANN JOSEPH,¹ MICHAEL WALPOLE² AND ROBERT DEUTSCH³

ABSTRACT

Sovereign wealth funds (SWFs) are used for large-scale offshore investment of government funds. In accordance with the sovereign immunity doctrine, a SWF is generally immune from the jurisdiction of another sovereign State – including tax laws. There has been little research on the application of tax to SWFs. Yet it is an issue of vital importance to Australia and to its international competitiveness and security. In 2009, the Australian Government announced its intention to codify its practices in dealing with SWFs and an Options Paper was released in 2011.

This article reviews the practices adopted by Australia and selected countries in relation to taxing SWFs. It considers best practice principles, which Australia should adopt in developing policy for taxing these foreign investment vehicles. Australia’s current taxation regime and the model proposed in 2011, are discussed, and a model suggested for Australia.

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Governments around the world use Sovereign wealth funds (SWFs) as the investment vehicle for large-scale offshore investment of government funds. These funds have assumed new political significance through increased participation of nations considered to be more capitalist authoritarian states than democracies.¹

In accordance with the doctrine of sovereign immunity, which is customary in international law, a sovereign State and its agents are generally immune from the jurisdiction of another sovereign State – including its tax laws.² Australia has largely observed this principle over the years since Federation in 1901. In August 2009 the Australian Government announced its intention to codify its practices in dealing with SWFs.

A set of voluntary, internationally agreed principles and practices, generally known as the Santiago Principles, establish best practices for SWFs. They cover legal, institutional and management frameworks.³ Tax, however, is excluded.

The application of tax to SWFs has seen limited research. Yet this is an issue of vital importance to Australia and to its international competitiveness and security. This article proposes a set of best practice principles which Australia could adopt for taxing the foreign investment vehicles of the world’s governments.

Part II provides an overview of SWFs. This includes their importance globally, the application of the doctrine of sovereign immunity and their different legal forms and governance structures. This is followed in Part III by a review of the practices adopted by Australia and nine selected countries in relation to taxing SWFs. These are Australia’s top five trading partners, being the United States (US), Japan, Republic of Korea, Singapore and China. Also included are the United Kingdom (UK), Canada and New Zealand as other common law countries whose approaches are a helpful guide to how SWFs might be treated in Australia. Norway is also assessed as it is the home country of the largest SWF. Australia’s taxation regime, in both its current form and that proposed in 2011 (hereafter the 2011 proposed model), is discussed in Part IV. Part V discusses framework principles for world best tax practice. These are applied in Part VI, which also assesses the 2011 proposed model rules and suggests a model for Australia that embraces best practice in an important area for Australia’s international competitiveness as an investment destination.

A detailed discussion of regulatory controls is beyond the scope of this paper. Nevertheless, to illustrate their effect and implications, an overview of the requirements of Australia and China are provided. In Australia, prior approval is required under the


federal government’s foreign investment policy before a foreign government investor can make any direct investment in Australia, regardless of its value.\(^4\) China introduced the Qualified Foreign Institutional Investor (QFII) in 2002, which allows foreign investors access to the A-share market and to other types of Chinese investments which foreign investors are otherwise prohibited from owning and trading.\(^5\) It is a dual-approval scheme requiring the SWF first to apply for QFII designation and then to obtain an investment quota.

II SOVEREIGN WEALTH FUNDS

A. Overview

SWFs are major players in international financial markets and in the global economy.\(^6\) They are unique and special investment vehicles primarily for three reasons:

- They are beneficially owned by a government or government related agencies;
- They generally adopt investment strategies which are based on very long-term perspectives; and
- They focus on investment with a broader perspective than profit making (for example, looking for strategic advantages for a sovereign nation as a whole, such as food security in purchasing agricultural land).

In other respects they tend to differ (for example, in policy objectives or in structure), creating complex legal and economic issues associated with such matters as governance, regulation and security.

SWFs have been increasing in popularity but are by no means a uniquely twenty-first century phenomenon. Two of the earliest SWFs are the Texas Permanent School Fund and Texas Permanent University Fund, established in 1854 and 1876 respectively.\(^7\) Many have been established in the last 15 years, however. In 2007, China initiated three: the China Investment Corporation (currently the 4\(^{th}\) largest SWF with US$652.7 billion in assets); the National Social Security Fund; and the China-Africa Development Fund.\(^8\) Countries establishing SWFs in the 2000s include Australia, Republic of Korea, Qatar, Russia, United Arab Emirates, Libya, France, Indonesia, Vietnam, Chile and Brazil.\(^9\)

The number of funds and their total holdings vary depending on how a SWF is defined. Preqin, a UK-based research and consultancy firm operating globally in the financial services industry, asserts that the value of total assets under management as at October

\(^8\) Ibid.
\(^9\) Ibid.
2013 was US$5.38 trillion. Of this, 47 per cent of the assets are held by Asia-based SWFs, notwithstanding that these represent less than a quarter of the number of SWFs. According to the SWF Institute, total assets under management at December 2013 amounted to US$6.05 trillion and at November 2014 this had grown to US$6.98 trillion. Of this, over two-thirds are attributable to SWFs of developing countries.

SWFs were important during the global financial crisis of 2008 onwards. It has been argued that their injections of capital into financial institutions had a stabilising effect ‘because they came at a critical time when risk-taking capital was scarce and market sentiment was pessimistic’. Indeed, the China Investment Corporation, a SWF of the Chinese Government, provided the equity that investment bank Morgan Stanley required after posting a US$5.7 billion subprime mortgage write-down. Singapore’s Temasek Holdings, the largest shareholder in Merrill Lynch, further increased its stake during the subprime crisis. Because SWFs are long-term investors, they are better positioned to withstand financial upheaval.

The increase in both number and size of SWFs has heightened public attention. This has generated an ongoing policy debate about the proper role of foreign government regulation and the taxation of these funds. Around 2008 there was a flurry of activity regarding developing guidelines and ‘best practice’ for SWFs. These include the Organisation for Economic Cooperation and Development (OECD) Investment Committee report commissioned by the G7 Finance Ministers, International Monetary Fund (IMF) reviews, a report prepared by the United States Congress Joint Committee on Taxation and a policy brief from the Peterson Institute for International Economics. These

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11 Ibid
12 SWF Institute, above n 7.
14 OECD Investment Committee, Sovereign Wealth Funds (SWFs) and Recipient Country Policies (OECD, 2008) 2. See also Nick Sherry, ‘International Forum of Sovereign Wealth Funds’ Press Release No 014 Assistant Treasurer, Sydney, 6 May 2010).
17 Leonard Schneidman (ed), Sovereign Wealth Funds: A Legal, Tax and Economic Perspective (Practising Law Institute, 2010).
18 OECD Investment Committee, above n 14.
20 Joint Committee on Taxation, ‘Economic and U.S. Income Tax Issues Raised by Sovereign Wealth Fund Investment in the United States’ (JCX-49–08, Joint Committee on Taxation, 2008). Members of the Joint Committee on Taxation are from the Senate Finance Committee and the House Ways and Means Committee.
resulted from concerns that the increased activity and resulting influence of SWFs may have distorting effects on capital markets or threaten national security.

In October 2008, generally accepted principles and practices of SWFs, known as the Santiago Principles, were agreed and published. This was followed in 2010 by a comprehensive review of foreign state immunity and foreign government controlled investors by the OECD as well as a discussion paper on the application of tax treaties to state-owned entities, including SWFs. In November 2013 the IMF released a paper regarding the governance structures and investment management of SWFs.

SWFs provide economic benefits to both home and host countries. For home countries these include tempering volatility in commodity markets, while for host countries they stimulate business activity and the creation of jobs – benefits normally associated with foreign investment. As a result of these benefits, countries actively compete for these investments. One way this can be achieved is through taxation policy.

**B. Sovereign Immunity**

Briefly, the doctrine of foreign state or sovereign immunity asserts that one State is not subject to the full range of rules applicable in the other State. A more restrictive approach to immunity, however, has been developed at a global level, although not universally adopted. This is in reference to the type of activity carried out by the State. For example, courts recognise immunity for acts carried out by a State in the exercise of its sovereign authority but will deny immunity for acts of a commercial or private nature. For sovereign immunity purposes, an investment activity is considered commercial if it is related to commerce, as opposed to diplomatic or humanitarian goals.

The restrictive theory of sovereign immunity focuses primarily on the nature of the transaction at issue, rather than on the status or structure of the foreign entity. In a 2005 UK case, AIG Capital Partners Inc. and Another v Kazakhstan (AIG), the court took the view that a SWF that invests in securities is engaged in immune sovereign activity by virtue of its general purpose of accumulating assets in the public interest. The transaction was analysed on the basis of its purpose: the nature of the activity as engagement in

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23 Edwin M Truman, *Sovereign Wealth Funds: Threat or Salvation* (Petersen Institute, 2011); Philip Whyte and Katinka Barysch, ‘What should Europe do about sovereign wealth funds’ (Centre for European Reform, 2007).
24 IWC, above n 3.
28 Ibid; OECD Investment Committee, above n 14; Gaukrodger, above n 25.
29 Gaukrodger, above n 25.
31 Fleischer, above n 15.
financial transactions was irrelevant in light of the overall purpose of earning money for the State (ie ‘commercial’). The invested assets were accordingly immune from action.

Countries adopting the restrictive approach include Australia, United States (US), United Kingdom (UK), Canada, Singapore and Japan. The restrictive approach appears not to be universally accepted with China and Hong Kong providing examples of contrary practices.

The implication of this, if broadly adopted, is that SWFs are likely to benefit from immunity regardless of their structure. This also causes the treatment of sovereign debtors and creditors to be different: a State that raises funds in the sovereign market is now generally considered to engage in private or commercial activity (immunity denied) even if the funds are destined for immediate public purpose.

In contrast, following the reasoning in AIG, investment activity by a SWF would benefit from immunity. The issue of whether the investment activities of a SWF are commercial/private acts or sovereign acts is not settled, which may lead to considerable uncertainty.

National laws also define foreign States differently. Of relevance to SWFs are the varying approaches taken to state-owned enterprises, state-controlled enterprises and central banks. One aspect of state immunity laws is to maintain jurisdictional attractiveness as a financial and banking centre. Central banks often gain special treatment to protect their positions as investment centres for foreign state reserves. With more central banks playing a role in SWFs, the competitive issues have expanded beyond attracting reserves, to issues affecting investment more generally. Rules on immunity from execution of central banks vary significantly. While no special immunity is provided by Australia or Canada, the UK, US and China all provide some form of special protection.

C. Legal Forms and Governance Structures

As noted above, SWFs can have different legal forms and governance structures and this affects their degree or level of sovereign immunity. As separate legal entities SWFs may be governed by a specific constitutive law or they may be state-owned corporations. Alternatively, as pools of assets without separate legal standing, they may be controlled either by a central bank or by a separate statutory agency. Examples of SWFs are shown in Table 1. While the UK and Japan are included in the commentary, they are absent from Table 1, as neither has a SWF.

33 Discussed in Gaukrodger, above n 25.
34 Ibid.
35 See generally Al-Hassan et al, above n 27.
36 Gaukrodger, above n 25.
37 Ibid.
Table 1: Legal forms and governance structures of selected SWFs

<table>
<thead>
<tr>
<th>As separate legal entities</th>
<th>As pools of assets</th>
</tr>
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<tbody>
<tr>
<td><strong>Governed by a specific constitutive law</strong></td>
<td><strong>Controlled by central bank</strong></td>
</tr>
<tr>
<td>Future Fund (Australia)</td>
<td>Temasek Holdings (Singapore)</td>
</tr>
<tr>
<td>New Zealand Superannuation Fund</td>
<td>GIC Private Ltd(^{39}) (Singapore)</td>
</tr>
<tr>
<td>Korea Investment Corporation</td>
<td>China Investment Corporation</td>
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</tbody>
</table>

The different legal forms and governance structures have implications both for immunity of investments and for taxation. For example, the UK exempts SWFs from tax on passive investment income, but only if it is an integral part of the government of a foreign state. The exemption is denied if it is an entity that is separate from the government although owned by it, such as a state-owned corporation. Thus, for example, the UK would exempt the Norway Pension Fund Global earnings on passive investment but not those of China Investment Corporation.

The form and structure may also have implications for SWFs that have sovereign wealth enterprises (SWE). SWEs are investment vehicles owned and controlled by a SWF.\(^{39}\)

It can therefore be concluded that, because the scope and application of sovereign immunity differs between countries, SWFs can affect their degree of sovereign immunity through the structure they use for their investments as well as their choice of jurisdictions in which to operate. The international law of sovereign immunity is not, however, definitive. It does not preclude countries from offering additional immunities such as via bilateral tax treaties.

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\(^{38}\) Previously Government of Singapore Investment Corporation.


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III TAXATION OF SWFs

A. Ways of taxing

The OECD notes that ‘[t]here is no international consensus ... on the precise limits of the sovereign immunity principle’. Just as many countries do not recognise the principle as applying to commercial activities, so there are differences between countries as to the extent, if any, to which the principle applies to tax matters. Even where it is recognised, its application differs depending on whether it has been incorporated into domestic law or is applied as customary international law with or without limitations. Accordingly, a diverse range of practices exists and a diverse set of options is open to Australia and other countries.

As the taxation of SWFs is not standardised, each country follows its own policies and practices. Indeed, both the United Nations Convention on Jurisdictional Immunities of States and the European Convention on State Immunity exclude taxation from the scope of their conventions. Nevertheless, there are essentially two mechanisms employed: the sovereign immunity doctrine and tax treaties.

Commonwealth countries and Japan generally base their practice of exempting foreign governments and their agencies from taxation on the international law concept of sovereign immunity. This may be codified through domestic legislative provisions or applied administratively. European and Asian countries generally treat foreign governments as they do other foreign entities, with any exemptions generally resulting from double tax treaties.

The source of the authority differs. This is shown in Table 2 for the 10 countries under review.

40 OECD, above n 26, [6.11].
41 Gaukrodger, above n 25.
Table 2: Authority for taxing SWFs

<table>
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<tr>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>UK (if SWF beneficially owned)</td>
<td>US</td>
<td>Australia – private ruling</td>
<td>China – application required</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Canada – information circular</td>
<td>Republic of Korea</td>
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<tr>
<td></td>
<td></td>
<td>Japan – customary practice</td>
<td>Singapore</td>
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<td></td>
<td></td>
<td></td>
<td>New Zealand</td>
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<td></td>
<td></td>
<td></td>
<td>Norway</td>
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<td></td>
<td></td>
<td></td>
<td>UK (if separate entity)</td>
</tr>
</tbody>
</table>

Various factors are generally taken into consideration when determining whether, and to what extent, tax exemptions should be granted for SWFs. These factors include: whether the income is derived from ‘government’ as opposed to commercial activities; the purpose of the assets and/or income; whether there is reciprocity; and whether the income is derived from a portfolio or direct investment.42

Similarly to the discussions in 2008, as noted in section IIA above regarding the practices of SWFs, their tax treatment was also examined. A combined committee of the House of Representatives and Senate of the US Congress issued a report on SWFs and associated income tax issues.43 One of the discussions initiated by the OECD concerned the application of tax treaties to state-owned entities, including SWFs.44 A number of changes to the Commentary on the OECD Model Tax Convention were proposed. While the report acknowledges that the international law doctrine of sovereign immunity underpins most exemptions for SWFs, it does not deal with the doctrine. Rather the focus is more on the definition of what is deemed a ‘resident’ and therefore liable to tax. In Australia there is useful research on the investment and management practices of SWFs,45 there is little available on the application and potential application of tax rules to such funds.

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42 OECD, above n 30, [6.39].
43 US Joint Committee on Taxation, above n 20.
44 OECD, above n 26.
B. Country Analysis

(1) Domestic Law

A broad categorisation based on the domestic law and practice for the 10 countries under review is given in Table 3. Note that these may be subject to provisions in tax treaties.

<table>
<thead>
<tr>
<th>Exemption For All Investments</th>
<th>Exemption For Non-commercial Investments</th>
<th>No Exemption (but see below)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Own domestic</td>
<td>Australia</td>
<td>China</td>
</tr>
<tr>
<td></td>
<td>Canada</td>
<td>Japan</td>
</tr>
<tr>
<td></td>
<td>UK (if SWF beneficially owned)</td>
<td>New Zealand</td>
</tr>
<tr>
<td></td>
<td>United States</td>
<td>Norway</td>
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<tr>
<td></td>
<td></td>
<td>Republic of Korea</td>
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<td>Singapore</td>
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<tr>
<td></td>
<td></td>
<td>UK (if separate entity)</td>
</tr>
</tbody>
</table>

As noted above, the governance of the SWF may determine the tax treatment. For example, the UK provides an exemption to all investments (both portfolio and controlling) provided the income and gains are beneficially owned by the foreign state. This exemption does not extend to entities separate from their government although wholly owned by the government.

The purpose of the SWF may also be determinative of the tax treatment. For example, in Australia the SWF must establish that the generated passive investment income results from the performance of a governmental function in Australia;\(^{46}\) in Canada the focus is 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.\(^{47}\)

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**Full exemption**

It would appear that no country provides a tax exemption for all income derived by a foreign SWF. However, the literature suggests that jurisdictions exempt their own domestic SWFs from their tax regimes.\(^{48}\)

**Partial exemption**

The international doctrine of sovereign immunity does not formally nor specifically impose any restrictions on a country’s ability to tax SWFs.\(^{49}\) Nevertheless, many countries originally exempted all income derived by SWFs from tax. Historically, SWFs were established from excess funds generated by oil or trade surpluses and invested in Treasury bonds and foreign exchange in order to further governmental purposes.\(^{50}\) This exemption was originally grounded in the international law principle of sovereign immunity.\(^{51}\) However, adoption of the restrictive view of sovereign immunity dispenses with the notion that all income received by a foreign government should be immune from taxation. Many countries therefore narrowed the tax exemption to exclude income arising from commercial activities. That commercial and governmental functions are mutually exclusive is consistent with the decision of the British House of Lords in the case *I Congreso del Partido*,\(^{52}\) which held that activities of a trading, commercial or other private law character were not governmental functions.’\(^{53}\)

An example of a jurisdiction that has narrowed the tax exemption is the US, which has codified the restrictive view of sovereign immunity. Whether an activity is commercial is determined on the basis of the nature of the transaction rather than the purpose of the transaction.\(^{54}\) Similarly, for tax purposes, it is the nature of the activity conducted by the foreign sovereign that is determinative rather than the organisation conducting the activity.\(^{55}\) As such, the tax exemption was similarly narrowed to exclude income from commercial activities. However, for tax purposes, the commercial activities do not have to occur in the US.\(^{56}\)

What is deemed ‘non-commercial’ differs between jurisdictions. For example, in Australia an equity holding of 10 per cent or more is considered commercial (or ‘non-portfolio’);\(^{57}\)

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\(^{49}\) See, for example, *Qantas Airways Ltd v United States*, 62 F.3d 385, 388–90 (Fed.Cir 1995) where the Court upheld the regulatory authority to tax income derived from commercial activities by government-owned enterprises.

\(^{50}\) Fleischer, above n 15.

\(^{51}\) Ibid; Wm. W. Bishop, Jr, ‘Immunity from Taxation for Foreign State-Owned Property’ (1952) 46(2) *The American Journal of International Law* 239.

\(^{52}\) [1981] 2 All ER 1064.

\(^{53}\) Ibid.

\(^{54}\) Foreign Sovereign Immunities Act 1976: 28 USC s 1603(d).

\(^{55}\) Revenue Ruling 87–6, 1987–1 C.B. 179 defining commercial activity for the purposes of exemption under s 892.


\(^{57}\) ITAA 1997 s 960–195 ‘Non-portfolio interest test’; ITAA 1936 s 317 definition of ‘non-portfolio dividend’.
in the US the equity holding must be 50 per cent or more,\textsuperscript{58} and trust interests and certain commodity derivatives are also considered commercial.\textsuperscript{59} The US also makes a distinction between portfolio and direct investment with income from portfolio investment (being portfolio income and capital gains) being exempt.\textsuperscript{60} Income that is fixed or determinable periodically such as interest, dividends, rents and royalties are subject to withholding tax (subject to any treaty).\textsuperscript{61} However, SWFs are exempt from: all US-sourced dividends paid by non-controlled corporations; from interest paid by a corporation where the SWF owns at least 10 percent (that is, above the ‘portfolio interest’ exemption) but less than 50 per cent (that is, less than a controlling interest) of it; and exempt from tax on certain gains from real estate transactions.\textsuperscript{62} This, therefore, broadens the scope of the exemption. The different treatment of portfolio and direct investment is reflective of the qualified immunity policy established in the Foreign Sovereign Immunities Act of 1976\textsuperscript{63} and contributes to the international complexity faced by SWFs.\textsuperscript{64}

Some countries, instead of specifically taxing income related to commercial activities, provide exemptions for specific income. For example, the Hong Kong\textsuperscript{65} tax legislation provides a tax exemption for income derived by non-residents from certain specified transactions, broadly defined to cover most types of transactions typically engaged in by investment funds.\textsuperscript{66} These include transactions involving securities, commodities and future and currency contracts and transactions incidental to those transactions. There is also no tax payable on dividends paid to either domestic or foreign shareholders\textsuperscript{67} nor is there a capital gains tax.\textsuperscript{68}

Yet other jurisdictions apply additional constraints to merely differentiate between commercial and governmental activities. An example is Canada, which sets out the tax treatment of foreign SWFs in an Information Circular.\textsuperscript{69} (Note, however, that Information Circulars do not have the force of law and are merely the Canadian tax authority’s interpretation of the legislation.)\textsuperscript{70} Here, a foreign government or its central bank is required to request authorisation for tax exemption provided three conditions have been met.\textsuperscript{71} First, the applying country must provide a reciprocal exemption to the Canadian

\textsuperscript{58} Philip Sutton et al, ‘US tax implications for sovereign wealth funds of financial derivative investments’ (PricewaterhouseCoopers, December 2010).
\textsuperscript{59} Ibid.
\textsuperscript{60} US Internal Revenue Code ss 871(h) and 881(c).
\textsuperscript{62} Joint Committee on Taxation, above n 20.
\textsuperscript{64} See further US Joint Committee on Taxation Report note 20 above.
\textsuperscript{65} Included here as a ‘Special Administrative Region’ of China.
\textsuperscript{66} Inland Revenue Ordinance Cap 112 s 20AC. Hong Kong legislation to impose a tax on property, earnings and profits.
\textsuperscript{67} Inland Revenue Ordinance Cap 112 s 26.
\textsuperscript{68} Ernst & Young, ‘Hong Kong Special Administrative Region (SAR) of China’ Worldwide Corporate Tax Guide (EYGM Limited, 2013).
\textsuperscript{69} See Information Circular IC77–16R4 ‘Non-Resident Income Tax’.
Government or its agencies. Second, the income to be exempted must be derived from non-commercial activities. Finally, the exemption is limited to interest ‘on an arm’s length’ debt or portfolio dividends on listed company shares. What constitutes ‘commercial activity’ is not defined in the tax legislation and has not been considered by any tax court ‘with significant precedential authority’. It is generally agreed to mean that the SWF pursues activities with a governmental or humanitarian objective. Further, ‘arm’s length investments’ have been held to mean ‘portfolio investments’ to differentiate them from ‘non-arm’s length or direct investments’.

The tax treatment is yet again different in the UK where investment income (that is, of a non-commercial nature) is exempt from tax but only if it is an integral part of the activities of the foreign government. That is, a fund that is an entity separate from the government, although owned by it, would not qualify.

No exemption

It was noted in Table 3 that some countries do not provide any specific exemption. However, this does not necessarily mean that an exemption does not apply. In some jurisdictions the law does not tax interest, dividends and/or capital gains. Thus, while SWFs are not exempt, they are also not taxable on much of their income. For example, Norway does not impose withholding tax on interest and royalties; dividends paid by domestic UK companies are not subject to withholding tax.

Singapore also does not tax capital gains. However, in certain circumstances transactions involving the acquisition and disposal of real estate, stocks or shares are considered to be the carrying on of a trade. Consequently, such gains may be taxable with each decision about whether the exemption applies based on a consideration of the facts and circumstances of the particular case.

In Japan, foreign companies without a permanent establishment are required to file a corporate tax return when income arises from the transfer of assets in Japan notwithstanding that withholding tax does not apply. Such assets include marketable securities or financial assets and real estate.

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72 Kandev, above n 48, 653.
73 Jog and Mintz, above n 71; Michael Podolny, ‘the Limits of Sovereign Immunity: A Study and Analysis of the Canadian Income Taxation of Sovereign Wealth Funds’ (2012) 70(Spring) University of Toronto Faculty of Law Review 90.
75 The Law Library of Congress, above n 47.
76 Joint Committee on Taxation, above n 20; Ernst & Young, ‘Norway’ Worldwide Corporate Tax Guide (EYGM Limited,2015).
79 Japan Corporate Tax Law Article 138–1.
80 Ibid.
Tax Treaties

The OECD Model Tax Convention does not expressly address state or sovereign immunity from tax. Nevertheless a number of articles are worth noting. Article 4 provides that the definition of a ‘resident of a Contracting State’ extends to the Contracting States themselves, their political subdivisions and their local authorities. Thus, Article 4 generally extends to a foreign State the benefits that tax conventions grant to private residents of that State and recognises the foreign State as a potential taxpayer in the other State. Where foreign governments are not afforded specific treatment under Article 4, they are subject to the income tax treatment of foreign persons generally.

However, whether a SWF qualifies as a ‘resident of a Contracting State’ depends on the facts and circumstances of each case. Whether a SWF is considered to come within the scope of the State and any political subdivision or local authority would depend on its legal form and governance structure. For example, a SWF that is a statutory body or incorporated company is unlikely to be so classified. In order to clarify the tax treatment of SWFs, the definition of ‘resident of a Contracting State’ may be modified under the OECD Model treaty to include a statutory body, an agency or instrumentality.

Alternatively, specific provisions may grant an exemption to other States or to specific state-owned entities such as central banks with respect to specific items of income. In particular, interest or dividends derived from activities of a governmental nature may be made exempt from tax. For example, certain tax treaties provide an exemption where the government, authority, institution or central bank, of the other Contracting State, beneficially owns the interest. Article 11 in each of the Australia-New Zealand, United States-Singapore and the Japan-UK tax treaties are examples of this.

Treaty tax exemptions may be for a specific entity. For example, the Japan–Singapore tax treaty exempts the Government of Singapore Investment Corporation (now GIC Private Limited) from tax on interest income earned in Japan. In the Japan–Australia tax treaty interest derived by ‘a public authority that manages the investments of the Future Fund’ is exempt from tax on interest income derived in Japan.

Thus, a tax treaty may provide an outright exemption from tax such as under Article 4, or may exempt some income items only – such as for interest income under Article 11. If neither of these applies, treaties usually provide for a lower withholding rate relative to what would arise were no treaty in place. For example in the Republic of Korea interest (other than on bonds), dividends and royalties are taxed at 20 per cent whereas treaty rates vary between 5 and 15 per cent. In Australia, SWFs have access to the Managed Investment Trust withholding tax regime. Prior to 1 July 2012, this concessional rate of 7.5 per cent was generally lower than treaty rates which range between 5 and 15 per cent.

81 OECD, above n 30, [6.36].
82 Ibid, [7.4] and [13.2], respectively.
83 Singapore-Japan Tax Treaty Article 11.
84 Japan-Australia Tax Treaty Article 11 paragraph 3(c)(ii).
85 PricewaterhouseCoopers, Sovereign Wealth Funds: Investment trends and global tax risks – Asia (PwC, 2010).
86 From 1 July 2012 the MIT withholding tax rate is 15 per cent.
for dividends and are 10 per cent for interest.\(^{87}\) Where there is no tax treaty in place, the withholding tax rate is 30 per cent.\(^{88}\)

Notwithstanding that a tax treaty may provide for the reduction or exemption of tax payable, some countries require an application to be made to claim these. Failure to comply with the formalities will result in the denial of treaty benefits. In China, treaty relief is subject to an approval application procedure for passive income or record-filing procedure for active income. Guidance is provided in ‘Administrative Measures on Tax Treaty Treatment of Nonresidents’ (Circular 124).\(^{89}\) Japan has separate forms and instructions for exemption for each income type, entitled ‘Application Form for Income Tax Convention’.

### IV Australia’s Taxation Regime

#### A. Current Approach

The Australian approach has followed the tradition of others and it has been to exempt certain income derived by foreign governments from Australian tax pursuant to the doctrine of sovereign immunity. The practice is, however, somewhat discretionary and uncertain. Currently, SWFs seeking an exemption under Australian tax have to request a private ruling from the Australian Taxation Office (ATO).\(^{90}\) These are binding in that the taxpayer is protected from further liability if they have followed the advice in the ruling which later turns out to be incorrect.\(^{91}\)

The application of the law can be gleaned from administrative documents, particularly Interpretative Decision ID 2002/45 (ID)\(^{92}\) Here the ATO, as Australia’s tax authority, recognises the doctrine of sovereign immunity and indicates that

*An activity undertaken by a foreign Government Agency will generally be accepted as the performance of governmental functions provided that it is functions of government, provided that the agency is owned and controlled by the government and does not engage in commercial activities.*\(^{93}\)

It is evident from this that the meaning of ‘commercial activities’ is a key concern in determining the extent of the immunity in a particular case. Unsurprisingly the ID explains that the question whether or not an operation or activity is commercial is

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\(^{87}\) See for example Australia–New Zealand, Australia–United Kingdom and Australia–Norway tax treaties Articles 10 and 11.


\(^{90}\) The Law Library of Congress, above n 47.

\(^{91}\) Inspector-General of Taxation, above n 70.

\(^{92}\) See ATO ID 2002/45, above n 46. This records, for purposes of the Freedom of Information law, a decision made by the ATO concerning whether an exemption from dividend withholding tax was justified in the case of a foreign government agency’s fund that received dividends on investments held in Australian securities.

\(^{93}\) Ibid.
dependent on the facts in each case. The ID suggests that ‘...a commercial activity is generally an activity concerned with the trading of goods and services, such as buying, selling, bartering and transportation, and includes the carrying on of a business’.\textsuperscript{94} Thus:

\textit{Income derived by a foreign government or by any other body exercising governmental functions from interest bearing investments or investments in equities is generally not considered to be income derived from a commercial operation or activity. Accordingly, provided the funds used to make such investments are and remain government moneys, the income is accepted as being exempt from tax under the common law doctrine of sovereign immunity.}\textsuperscript{95}

Notwithstanding this, the facts of the specific situation may affect whether it can be said that a holding in an investment is of such scale as to amount to the carrying on of a business rather than passive investment.

The ID sets up three tests to be applied, viz whether: the person deriving the income is a foreign government or an agency of a foreign government; the moneys being invested are and will remain government moneys; and whether the income is derived from a non-commercial activity.

For example, in ATO ID 2002/45 the foreign government agency fund was eligible for an exemption from Australian withholding tax on dividends received, while in ATO ID 2005/355 a German state-owned bank was denied such an exemption on interest income on the basis that it was not the central bank of Germany (notwithstanding the fact that the State bank performed some central banking activities).\textsuperscript{96}

\textbf{B. The 2011 Proposed Model Approach}

It is noted that the process of determining the eligibility of the income of a sovereign fund for the exemption is one that involves a degree of judgment and therefore some uncertainty for the fund until a decision has been made. Presumably this was a cause for disquiet because the then government had set about trying to reduce the uncertainty. The current government has subsequently made the decision not to proceed with this measure.\textsuperscript{97}

On 20 April 2011 the (Federal) Assistant Treasurer of the day released a consultation paper, \textit{Options to Codify the Tax Treatment of Sovereign Investments}, (the Options to Codify paper) setting out the 2011 proposed model options to legislate for tax treatment of sovereign investments. It was said that this would clarify and provide certainty concerning the tax consequences in Australia for investments made by foreign

\begin{footnotesize}
\begin{itemize}
\item[94] Ibid.
\item[95] Ibid.
\item[97] Arthur Sinodinos, Assistant Treasurer, ‘Integrity restored to Australia’s taxation system’ (Media Release, 14 December 2013).
\end{itemize}
\end{footnotesize}
governments, as well as the withholding obligations for Australian residents. That set of proposals came in the wake of an earlier consultation (Greater Certainty for Sovereign Investments) and eleven submissions made in response to it.

The Options to Codify paper identified two possibilities for codifying the exemption of certain income earned by foreign governments and sovereign funds. It is to be noted that the sole purpose of this project was to codify the current administrative practice and not to change existing law and practice. Notwithstanding this, it suggested adopting the rules applicable in the US.

The first of these options established rules according to which eligible entities that derived income from eligible interests would be taxed on that income – including eligibility requirements (both for the entity and the relevant interests) and ‘safe harbour’ rules for the equity interests of these entities. That option also set out the treatment to be accorded arrangements under existing private rulings and advanced opinions.

The second option extended the first one by adding a test that may have been applied to equity interests that failed the safe harbour test in option 1. This test was termed the ‘commercial activity test’. The option discussed details of the limitations of the ‘commercial activity test’.

The options are rule-based rather than principles based. That had the effect that they are detailed and complex to read. But they had the advantage of being clear, certain, and thus, arguably, simple. Briefly, the rules were as follows. Rules 1 to 4 described the tax treatment which rendered the income or gains ‘non-assessable non-exempt’ provided the other rules were satisfied. While rule 5 set out the eligibility requirements for entities, rules 6 and 7 set out the eligibility requirements for debt and equity interests, respectively. The equity interest test was described as the ‘safe harbour’ test. Rule 8 provided that existing private rulings and advance opinions could be relied upon for the duration of their term, notwithstanding that they may have been inconsistent with the 2011 proposed model rules. The additional ‘commercial activity’ test was provided for in rule 9, followed by the application of its limitations with respect to indirect Australian real property interests in rules 10 and 11. The Options to Codify paper had also helpfully set these rules out diagrammatically as shown in Figure 1.

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100 Of which five are public and six are confidential <archive.treasury.gov.au/contentitem.asp?ContentID=2017>.
101 Australian Federal Treasury, above n 99, [3.2].
102 Ibid, [3.3].
103 Australian Federal Treasury, above n 98, 2.
104 Ibid, 2.
Figure 1: Option 1 to codify

Ibid, 4 and 20. “CGT” means capital gains tax; “NANE” means non-assessable not exempt.
An ‘eligible entity’ was defined to be restricted to ‘foreign government agencies’ \(^{106}\) and to their wholly owned entities. Determining what is an ‘equity interest’ was more complex, being based on the debt/equity tax rules currently applying. The ‘safe harbour’ test was essentially the application of the current non-portfolio interest test.\(^{107}\) That is, the safe

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\(^{106}\) As defined in the tax legislation. See ITAA 1997 s 995–1 ‘foreign government agency’.  
\(^{107}\) ITAA 1997 s 960–195.
harbour encompassed passive or portfolio income; a non-portfolio interest would breach the safe harbour. The ‘commercial activity’ test was more prescriptive, taking into account the size of the SWF’s voting rights in the entity, the degree of influence that was, or could potentially have been, exercised in respect of the financial, operating and policy decisions as well as the overall activities of the SWF. That test was to apply on an interest-by-interest basis. That is, each interest was to be assessed individually and separately.

While there are some differences in the application of the 2011 proposed codification of the current practice, the principles remain the same. That is, the person deriving the income is a foreign government or an agency of a foreign government; the moneys being invested are and will remain government moneys; and whether the income is derived from a non-commercial activity.

C. Application of Approach

This section applies the approach proposed in the 2011 Options Paper to four specific funds to determine whether they would qualify for tax relief under the 2011 proposed model Australian law. These four funds are the New Zealand Superannuation Fund, Singapore’s Temasek Holdings, the Government Pension Fund Global of Norway and Canada’s Alberta Heritage Fund.

(1) Criteria

The types of entities that are eligible for relief from Australian tax are prescribed under ‘Rule 5: Entities to which these rules apply’. There are criteria with respect to ownership, funding and receipt of benefit.

Ownership

Only foreign government agencies and the wholly owned entities through which they invest in Australia are eligible for relief from Australian tax. The term ‘foreign government agency’ is defined in s 995-1 Income Tax Assessment Act 1997 (‘ITAA’) to mean:

- the government of a foreign country or of part of a foreign country; or
- the authority of the government of a foreign country or of part of a foreign country.

A broad interpretation is provided in the Acts Interpretation Act 1901 s 2B. In addition, the ITAA covers all levels of a government such as national, regional and local governments. The class of eligible entities is extended to include wholly owned entities of foreign government agencies such as wholly owned companies and investment vehicles. The Options Paper refers to these entities as ‘sovereign funds’.

It is important to note that, while indirect ownership of a sovereign fund is permitted, ultimately all membership interests must be wholly beneficially owned by a foreign government agency. To avoid any doubt, the test is whether the foreign government

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agency beneficially owns the membership interests\textsuperscript{109} in the entity. In determining this, control or influence over the entity is not considered to be a directly relevant consideration.

Further, sole ownership is not required. A sovereign fund will exist where an entity is jointly owned:

- by two or more wholly owned entities of a foreign government agency;
- by a foreign government agency and one or more of its wholly owned entities; or
- by two or more foreign government agencies.

However, a sovereign fund will not exist where it is jointly owned by a foreign government agency and another entity that is not wholly owned by a foreign government agency. This does not extend to arm’s-length commercial services provided to the sovereign fund. For example, where it is normal commercial practice to remunerate contracted fund management services through an entity holding, this will not preclude the entity from being a sovereign fund.

The requirement of owning all membership interests means that superannuation and pension funds will not be classified as sovereign funds as the superannuants or pensioners actually hold the membership interests. This also goes to the internationally accepted definition of a ‘sovereign wealth fund’,\textsuperscript{110}

\textit{Funding}

A further requirement is that the sovereign fund must be funded solely with public money or property. Such funding will meet this requirement if it is in the custody or under the control of a foreign government agency, or of a person acting for or on behalf of the foreign government agency. Sources include fiscal surpluses, balance of payment surpluses, the proceeds of privatisations, the proceeds of commodity exports, mineral royalties or official foreign currency operations.

If an entity is acquired by a foreign government agency or its wholly owned entity, it will be considered to be ‘financed’ by that acquiring entity. However, it still needs to be wholly owned. That is, any entity acquired must be 100 per cent acquired in order for it to become a sovereign fund.

\textit{Receipt of benefit}

Any asset, income or gain generated by the foreign government agency or sovereign fund must be for the benefit only of that foreign government agency or sovereign fund. This is an integrity measure designed to prevent any individual (including foreign sovereigns,

\textsuperscript{109} ‘Membership interest’ is defined in ITAA 1997 s 960–135 to mean an interest, or set of interests, or a right, or set of rights, in an entity of which one is a member.

officials or administrators acting in a private capacity) or ineligible entity receiving a tax benefit designed solely for a foreign government agency or sovereign fund.

A limited number of exceptions apply. One exception is where there is a commercial arm’s-length agreement with an investment manager. Incentive-based consideration is permitted provided the arrangements relate directly to remuneration for the investment manager’s role as a service provider.

(2) **Assessment**

The SWFs identified for assessment are the Future Fund (Australia), Temasek Holdings (Singapore), the Government Pension Fund Global (Norway), the Alberta Heritage Fund (Canada) and New Zealand’s Superannuation Fund (as Australia’s Future Fund is exempt from Australian tax,\(^{111}\) and cannot be properly tested for the purposes of this exercise).

These selected SWFs represent examples of different fund arrangements. Their legal forms and governance structures were given in Table 1 and replicated in Table 4.

**Table 4: Legal forms and governance structures of selected SWFs**

<table>
<thead>
<tr>
<th>As separate legal entities</th>
<th>As pools of assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Governed by a specific constitutive law</td>
<td>Controlled by central bank</td>
</tr>
<tr>
<td>New Zealand Superannuation Fund</td>
<td>Government Pension Fund Global (Norway)</td>
</tr>
<tr>
<td>Temasek Holdings (Singapore)</td>
<td>Alberta Heritage Fund (Canada)</td>
</tr>
</tbody>
</table>

*The New Zealand Superannuation Fund*

The New Zealand Superannuation Fund (“NZ Fund”) is a pension reserve fund managed and administered by a Crown entity called Guardians of New Zealand Superannuation (“Guardians”). It was established in 2003 with NZ$2.4 billion cash, for the purpose of partially providing for the future cost of funding superannuation payments for all eligible New Zealanders. That is, it seeks to reduce the tax burden on future taxpayers of the cost of New Zealand superannuation.

Both the NZ Fund and the Guardians were established under the *New Zealand Superannuation and Retirement Income Act 2001*. This Act also provides for the amount of required annual capital contribution, based on a formula that includes projected GDP.\(^{112}\) However, provided certain conditions are met, a lesser amount is permissible.\(^{113}\) There is

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\(^{111}\) ITAA s 50–25 read with *Future Fund Act 2006* s 84A.

\(^{112}\) Sections 42 and 43.

\(^{113}\) Section 44.
an additional requirement to top-up the fund annually to meet entitlements payable during that year.\textsuperscript{114} Additional contributions are also provided for.\textsuperscript{115} The New Zealand Government suspended annual capital contributions to the Guardians in July 2009, having made one additional contribution to the Fund of $250 million.\textsuperscript{116}

The Guardians is a Crown entity. Crown entities are bodies established by law in which the government has a controlling interest.\textsuperscript{117} The \textit{Crown Entities Act} 2004 is administered by the Treasury and the State Services Commission. However, it is membership interest that is more of a determining factor than controlling interest. The legislation states that the 'Fund is the property of the Crown'.\textsuperscript{118}

The function of the Guardians is ‘...to manage and administer the Fund in accordance with this Act’.\textsuperscript{119} This covers the investment, management and custodianship of the NZ Fund and ensures the Fund receives any benefit generated.\textsuperscript{120}

In summary, the New Zealand Superannuation Fund is a separate legal entity governed by a specific constitutive law and funded by the New Zealand Government. It meets the criteria of ownership, funding and receipt of benefit. As a result, this SWF would qualify for tax relief under the 2011 proposed Australian law.

\textit{Temasek Holdings}

Temasek Holdings is an investment company wholly owned by the Singapore Ministry of Finance and governed by the \textit{Singapore Companies Act}. In the early 1960s the Singapore Government acquired stakes in a wide range of companies in the manufacturing, financial, trading, transportation, shipbuilding and services sectors to jump-start the economy. Many of these companies were joint ventures with foreign investors. These companies included the Development Bank of Singapore Ltd and Singapore Airlines Ltd. Temasek Holdings was incorporated in 1974 to hold and manage investments and assets previously held by the Singapore Government.\textsuperscript{121}

With an initial portfolio of S$354 million, Temasek Holdings now funds its investments using dividends and other cash distributions it receives from its portfolio companies and other investments, divestment proceeds from sale of its investments, and borrowings and debt financing sources such as Temasek Bonds.

In summary, Temasek Holdings is a state-owned corporation, funded with public money and reinvestments of any asset, income or gain generated. It meets the criteria of

\textsuperscript{114} Section 45.
\textsuperscript{115} Section 46.
\textsuperscript{116} NZSuperfund, ‘FAQs’ \textasciitilde\texttt{http://www.nzsuperfund.co.nz/index.asp?pageID=2145831988} accessed 22 May 2014.
\textsuperscript{117} The Treasury, ‘Crown Entities’ 8 May 2013 \textasciitilde\texttt{http://www.treasury.govt.nz/statesector/crownentities} accessed 22 May 2014.
\textsuperscript{118} New Zealand Superannuation and Retirement Income Act 2001 s 40.
\textsuperscript{119} New Zealand Superannuation and Retirement Income Act 2001 s 51.
\textsuperscript{120} New Zealand Superannuation and Retirement Income Act 2001 ss 58–63.
\textsuperscript{121} Temasek, ‘Why was Temasek established?’ \textasciitilde\texttt{http://www.temasek.com.sg/abouttemasek/faqs} accessed 22 May 2014.
ownership, funding and receipt of benefit. As a result, this SWF would qualify for tax relief under the 2011 proposed Australian law.

The Government Pension Fund Global

The Norwegian Government Pension Fund Global ("GPFG") was established in 1990 'as a fiscal policy tool to underpin long-term considerations in the phasing-in of petroleum revenues into the Norwegian economy',\(^\text{122}\) It was also to serve as a tool to manage the financial challenges of an ageing population and an expected decrease in petroleum revenue.\(^\text{123}\) Prior to 2006 it was called the Petroleum Fund.

The GPFG is managed by Norges Bank Investment Management ("NBIM") on behalf of the Ministry of Finance. NBIM is a division of the Norwegian Central Bank. That the Norwegian Government has sole ownership is inferred from the Government Pension Fund Act 2005 that states the capital 'may only be used for transfers to the central government budget pursuant to a resolution by the Storting (Norwegian parliament)'.\(^\text{124}\)

Funding is integrated with the government’s annual budget. All petroleum revenue (net of financial transactions related to petroleum activities) and any budget surplus make up the capital inflows.\(^\text{125}\) All income generated by the GPFG is reinvested.\(^\text{126}\)

In summary, the GPFG is under the control of the government’s central bank, funded with public money and reinvestments. It meets the criteria of ownership, funding and receipt of benefit. As a result, this SWF would qualify for tax relief under the 2011 proposed Australian law.

The Alberta Heritage Fund

The Alberta Heritage Fund ("AH Fund") is a savings fund governed by Alberta’s Treasury Board and Finance. Alberta is a province of Canada. The AH Fund was established in 1976 with 30 per cent of Alberta’s non-renewable resource royalties. This funding ceased in 1987. It now generates revenue from its investment activities.

The assets are managed by the Alberta Investment Management Co, formerly part of the Ministry of Finance of Alberta before being converted to a provincial Crown corporation in 2008. It provides investment management to a variety of public sector funds. However, the Crown is the legal and beneficial owner of the AH Fund.\(^\text{127}\)

Originally designed for economic development, it is now primarily a long-term savings and investment fund. In the 1980s the AH Fund made loans to other provincial

\(^{122}\) Norway, 'Norway's Government Pension Fund Global (GPFG)'  
\(^{123}\) Norges Bank Investment Management, 'About the Fund' 4 April 2014  
\(^{124}\) Section 5.  
\(^{125}\) Government Pension Fund Act 2005 s 3.  
\(^{127}\) Alberta Heritage Savings Trust Fund Act s 2.
governments. Since then funds have been used for capital infrastructure projects and to support government programs such as health care and education. Legislation requires that a portion of its income be retained for inflation-proofing.\textsuperscript{128} Currently the earned investment income, less the inflation-proofing amount, is transferred to Alberta’s General Revenue Fund to support program spending. A new savings plan introduced as part of the 2013 Budget will see the fund retain all its income by 2016–17.\textsuperscript{129} However, the \textit{Fiscal Management Act} allows for amounts to be transferred to the AH Fund.\textsuperscript{130}

The AH Fund is a fund owned by the Crown, controlled by a provincial government agency and funded by the Alberta government. It meets the criteria of ownership, funding and receipt of benefit. As a result, this SWF would qualify for tax relief under the 2011 proposed Australian law.

\textbf{D. Concluding Remarks}

Currently a SWF is required to obtain a private ruling before being able to access relief from Australian tax. The proposal contained in the Options Paper is an attempt to codify what is currently an administrative practice. By meeting the prescribed criteria, all four SWFs assessed are types of entities that are eligible for relief from Australian tax under the 2011 proposed scheme. The outcome is therefore identical to what would result currently (assuming a favourable outcome to a private ruling request) but with more certainty and with lower compliance and administrative costs.

\textbf{V PRINCIPLES FOR ‘GOOD’ TAXATION}

Over two hundred years ago Adam Smith set out four principles of good taxation – taxes should be simple, certain, efficient in terms of collection cost and fair.\textsuperscript{131} Since then these principles have been distilled into ‘efficiency’, ‘equity’ and ‘simplicity’ to which variants of these have been added. The purpose reviewing the principles here is to distil from the literature a set of principles concerning the tax system that can be applied to taxation of SWFs and thus be used as a means to evaluate the Australian approach.

The Asprey Committee discussed the principles under the three headings of efficiency, fairness and simplicity.\textsuperscript{132} This was, by their own admission, for the sake of brevity, noting that ‘each of these three when one seeks to define it closely proves to embrace several distinct qualities’.\textsuperscript{133} Economic management, encompassing revenue integrity and flexibility, and economic growth were singled out as ‘other objectives’.\textsuperscript{134} On the other hand, the Henry Review added the principles of sustainability and policy consistency to

\begin{itemize}
\item \textsuperscript{128} Alberta Heritage Savings Trust Fund Act ss 8, 11.
\item \textsuperscript{129} Treasury Board and Finance, ‘Heritage Fund’ <http://www.finance.alberta.ca/business/ahstf/faqs.html> accessed 22 May 2014.
\item \textsuperscript{130} Fiscal Management Act Section 3.
\item \textsuperscript{133} Ibid, paragraph 3.6.
\item \textsuperscript{134} Ibid, paragraphs 3.27 and 3.28.
\end{itemize}
equity, efficiency and simplicity. The Meade Committee, reviewing the UK tax structure, considered six principles to be 'the most important' as 'desirable characteristics of a tax structure'. These are (1) incentives and economic efficiency, (2) distributional effects, (3) international effects, (4) simplicity and costs of administration and compliance, (5) flexibility and stability and (6) transitional problems. Similarly, a review of the New Zealand tax system determined that six principles were considered 'important for a sound tax system'. These are (1) efficiency and growth, (2) equity and fairness, (3) revenue integrity, (4) fiscal cost, (5) compliance and administration cost and (6) coherence. Thus it is becoming increasingly evident that merely assessing a tax model under the three principles of equity, efficiency and simplicity is not sufficient. A broader range of principles is required.

As a result it is suggested that the approach to taxation of SWFs should conform to a number of principles. Many lists and sub lists could be drawn, each emphasising major or lesser features, and the ranking of these would be subject to the values and perceptions of the list's compiler. For practical purposes, and because little is to be gained from endless refinement of principles that will in any event have to be adapted to the exigencies of dealing with a particular fund, this analysis will consider the taxation of SWFs from the perspective of the following generally accepted principles (in no particular order):

- Simplicity;
- Low compliance costs;
- Economic incidence and encouragement of growth;
- Neutrality (to the extent this is consistent with the point above);
- Consistency;
- Revenue integrity;
- Desirable international relations;
- Flexibility;
- Stability; and
- Ease of transition to a new model.

We think that these represent desirable principles for taxing SWFs. Each point requires some elaboration.

A. Simplicity

The question to be asked is whether the approach to taxation of SWFs in Australia is simple, both in regard to the processes required to exempt SWFs from tax, and in regard to the conceptual framework for the chosen taxation approach. Simplicity may be found in an alignment with other processes undertaken by SWFs or with a separate form of

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137. Ibid.
139. Ibid.
compliance activity which is different but nevertheless is simple. Simplicity may also be found in the concepts underpinning the taxation of SWFs. There is a need for simple clear rules that, inter alia, identify what is an SWF and identify precisely what income, from what activities, is exempt.

**B. Low Compliance Costs**

Related to simplicity, low compliance costs would be found in the ease and simplicity of processes involved in complying with tax rules for dealing with SWFs. In light of comments of the Meade Committee,\(^ {140} \) it is submitted that it may be preferable, where it is possible to choose, for the burden of compliance costs to be borne by the administration rather than the taxpayer so that costs may be shared through the community. The latter outcome may be difficult to achieve in a self-assessment environment, but a clearer process for SWFs ought not to be difficult to achieve and would result in lower compliance costs.

**C. Economic Incidence and Encouragement of Growth**

For various reasons, including international competitiveness and general economic growth, the treatment of SWFs in the tax system should provide incentives for creation of employment, investment in business and for general growth in the economy. If SWFs are becoming more important in the modern economy the tax incentives provided should both recognise this and promote the use of Australia for investment as a means to encourage growth. This must, nevertheless, be tempered with containment of fiscal costs. The balance here will usually be a question of (political) judgment.

**D. Neutrality**

The principle of neutrality generally competes with the principle of encouraging growth, requiring a compromise. It can be forgotten that distortion, the opposite of neutrality, can be found in an approach to taxation of SWFs that encourages tax avoidance, thus resulting in unintended revenue shortfalls and economically irrational (except for the tax consequences) taxpayer behaviour. A form of neutrality should therefore be sought, which achieves appropriate revenue targets, which avoids placing stress on which investment vehicles are used. A narrow set of definitions and clear terms ought to address this challenge.

**E. Consistency**

Consistency is intricately linked with neutrality, and aims to treat all SWFs the same under the tax rules. Particularly important, consistency of treatment is desirable also in relation to the manner in which different parts of the tax system impact on SWFs so that there is consistency between, for example, the ordinary income tax treatment and the capital gains tax treatment of their dealings. In particular, qualifications for exemptions should be consistent within the taxation system. This can also be considered as ‘coherence’ where individual reforms conform to, or complement, the tax system as a whole. The principle

\(^ {140} \) The Institute for Fiscal Studies, above n 136.
of consistency also extends to consistency of policy. This delivers certainty and is tied to the concept of simplicity.

F. Revenue Integrity

Revenue integrity is a basic requirement of any tax system given that the principle purpose of taxation is to raise revenue to fund government activities. The tax system should therefore be sustainable over time as well as providing a sustainable revenue base to meet the changing revenue needs of government on an ongoing basis. As the Henry Review noted, ‘[t]o be sustainable the tax system ... must contribute to a fair and equitable society’.\textsuperscript{141} Opportunities for tax avoidance and arbitrage must necessarily be minimised. This could be an argument for not exempting SWFs from tax at all. It is certainly an argument for clear drafting and tightly circumscribed access to exemptions as discussed under the topic of neutrality.

G. Desirable International Relations

It is desirable that Australia have a system of taxing SWFs that conforms to some degree with the treatment that it is accorded in jurisdictions with which Australia trades. On the other hand, in some cases, the encouragement of economic growth in Australia may dictate that a degree of competition with other jurisdictions would be desirable. In order to be sustainable, such competition would obviously need to fall short of classification as a harmful tax practice or similar unfair competition. Australia’s leading role in the G20 initiatives to contain tax avoidance is relevant here as it should not be seen to criticize tax minimisation while simultaneously encouraging it.

H. Flexibility

The tax treatment accorded SWFs in Australia should also be capable of easy change in response to developments in worldwide government and investment behaviour and should not become rigid and calcified. The tax system should be responsive to the needs of the economy and to SWF investor practices, as well as flexible enough to allow the government to respond as required. It would be undesirable to establish a framework in Australia that is not flexible enough to be easily changed should the need arise.

I. Stability

On the other hand, the approach to taxation of SWFs should be certain and stable and should not be prone to sudden change without notice, nor at the whim of the administration. It should be possible for SWF investors to predict that the method of taxation of their income will remain the same for the foreseeable future, or if there are to be changes, it should be possible for them to know precisely what the changes are, when they will occur, and, if necessary, there should be an ability to move to the changed method without unreasonable adverse tax consequences.

\textsuperscript{141} Australia’s Future Tax System, above n 135, 17.
J. Ease of Transition

As has been suggested above, in order to avoid major disruption within the investment community and in order to avoid inequitable consequences of change in the manner of taxing SWFs, it should be possible for the SWF community to adapt to any tax change without unreasonable adverse tax consequences and a minimum of additional compliance costs. Similarly it should be possible for the tax administration to adapt and change in conformity with any change in policy.

VI Australia’s Possible Future Rules

A. SWFs and the Future

SWFs will become more prominent in capital markets and, with pressure to increase financial returns, investment strategies are becoming increasingly aggressive. Attraction as an investment destination will become progressively more competitive at an international level. Foreign investment in the Australian economy is a key element in Australia’s future economic growth.

SWFs act as both financial institutions and political institutions. From a tax perspective, they could be treated like private financial investors subject to corporate and banking laws, or like sovereigns acting to further political or humanitarian agendas or a combination of these. Alternatively, a new model could be devised solely for the taxing of SWFs.

B. Alternative Approaches to Taxation of SWFs

From the above discussion, alternative approaches can be suggested.

First, Australia provides a ‘unilateral exemption’ from tax on the passive (that is, non-commercial) investment income of SWFs. In this it joins the UK (provided the SWF is beneficially owned) and the US. Applying the principles above, this approach does engender simplicity, low compliance costs, economic incidence and encouragement of growth and flexibility while promoting desirable international relations. It meets the ease of transition requirement. This approach, however, offends the principles of neutrality, revenue integrity and stability. As to how it meets the principle of consistency, this is considered to be beyond the scope of this study but an investigation of this would be an opportunity for further research.

A second approach might be a ‘reciprocal exemption’ such as that granted in Canada after application and substantiation. Such an exemption is made subject to conditions

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142 Al-Hassan et al, above n 27; Fleischer, above n 15; Melone, above n 61.
144 See also Irish, above n 22.
which might include similar principles to the Australian approach (for example income of a non-commercial nature). What distinguishes this from the ‘unilateral exemption’ is that the other country provides a reciprocal exemption to Australian SWFs. Reciprocal exemptions are commonly established under tax treaties and are particularly common amongst countries with significant SWFs.\textsuperscript{145} Australia has only recently created a SWF and there has therefore been limited opportunity to introduce such clauses in its tax treaties.

With the reciprocal approach, the principle of simplicity (although not to the same extent as under the unilateral approach), desirable international relations, stability and ease of transition are all met. The principle of economic incidence and encouragement of growth is also met but, as preference is given to Australia in foreign jurisdictions, this may be higher than under the unilateral approach. Again, consistency is considered to be out of frame.

A third approach to taxing SWFs is to provide \textbf{no exemptions} on the basis that all taxpayers should be taxed alike on the benefits derived as a result of the host country’s infrastructure.\textsuperscript{146} Examples of countries with such approaches include China, Japan, New Zealand, Norway, Republic of Korea, Singapore and the UK where the SWF is a separate entity from the government.

This is the simplest of all three approaches as no special rules are required. It does, however, have higher compliance costs, falls short in economic incidence and encouragement of growth, as well as failing in creating desirable international investment relations and in ease of transition. Its advantages are that it is neutral, consistent, flexible, and stable and provides revenue integrity.

The application of the principles to the three alternative approaches is shown in Table 6.
Table 2: Application of principles to alternative approaches

<table>
<thead>
<tr>
<th>Principle</th>
<th>Unilateral</th>
<th>Reciprocal</th>
<th>No Exemption</th>
</tr>
</thead>
<tbody>
<tr>
<td>Simplicity</td>
<td>Meets</td>
<td>Meets</td>
<td>Meets</td>
</tr>
<tr>
<td>Low compliance costs</td>
<td>Meets</td>
<td>Offends</td>
<td>Offends</td>
</tr>
<tr>
<td>Economic incidence, growth</td>
<td>Meets</td>
<td>Meets</td>
<td>Offends</td>
</tr>
<tr>
<td>Neutrality</td>
<td>Offends</td>
<td>Offends</td>
<td>Meets</td>
</tr>
<tr>
<td>Consistency</td>
<td>N/A</td>
<td>N/A</td>
<td>Meets</td>
</tr>
<tr>
<td>Revenue integrity</td>
<td>Offends</td>
<td>Offends</td>
<td>Meets</td>
</tr>
<tr>
<td>International relations</td>
<td>Meets</td>
<td>Meets</td>
<td>Offends</td>
</tr>
<tr>
<td>Flexibility</td>
<td>Meets</td>
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<tr>
<td>Transition</td>
<td>Meets</td>
<td>Meets</td>
<td>Offends</td>
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</tbody>
</table>

It will be evident from this that the principles thus applied are somewhat inconclusive (both the Unilateral and No Exemption approach address six principles, the reciprocal approach is close behind meeting five of them) without trying to weight the principles in some way. This inconclusiveness highlights the fine balance between the three approaches and therefore the different policy options these present.

It has been suggested that, theoretically, the most desirable approach is to provide no exemptions.\(^\text{147}\) This would achieve equity of treatment between all foreign investors (whether government or private) and would maximize revenue. On the other hand, were it in Australia’s best interests it might obtain the optimal outcome for the tax treatment of the Australian Future Fund in other jurisdictions and attract the foreign investment it wants by establishing a reciprocal regime. This gives it the added advantage of being able to attract foreign investment on a case-by-case basis by negotiation.\(^\text{148}\) Thus, if outcomes for the Future Fund were seen as overriding, the reciprocal approach would be best.

\(^\text{147}\) Ibid.
\(^\text{148}\) Ibid.
C. The 2011 Proposed Model Approach

Applying the principles established in section 5, it would appear that the Option to Codify, being a unilateral approach, meets the requirements of simplicity because although it is detailed and complex, it is clear and imposes low compliance costs to a degree. It does score favourably with respect to economic incidence and encouragement of growth, as it should attract investment, and it addresses revenue integrity and stability because its detail quarantines the concession. The suggestion offends neutrality – but that is the point of concessions for special categories of investor. It does seem to offend the principle of flexibility, and the model would be difficult to transition to. It seems it would be indifferent towards international relations, as this model does not permit individual negotiations. Consistency, as a principle, is not applicable here.

These misgivings having been expressed, however, the earlier analysis has highlighted the difficulty encountered when trying to reach a conclusion on the various models, and is somewhat inconclusive. The Australian approach that was under consideration does seem to be preferable to the lack of transparency we now have, and perhaps for that reason might be regarded as a viable option. Based on the best practice principles proposed in this paper, all approaches are equally problematic.

Further in-depth analysis of the experiences of other countries by expanding the study beyond the 10 discussed here may assist in devising a model for Australia that could be considered to emulate and embrace best practice. Reduced compliance costs and greater certainty would be in Australia’s best interests. On the other hand, it may be that in an area of tax policy as difficult as this it would be advisable to simply settle on an approach, afford it as much transparency as possible, and allow economic behaviour to demonstrate the efficacy or otherwise of the approach adopted.