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## Responding to Sovereign Funds: Are We Looking in the Right Place?

By Wei Cui

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### Background and Summary of Arguments

Over the past year, the topic of federal income taxation of U.S. investments made by sovereign wealth funds (SWFs) has attracted considerable attention from policy-makers, scholars, and practitioners.<sup>1</sup> A focus of the debate so far is whether the existing framework for taxing foreign governments' U.S. investments requires an overhaul. That framework, mostly embodied in section 892 and related Treasury regulations, exempts many types of U.S.-source income received by foreign government investors (hereinafter sovereign investors) from U.S. taxation. Compared with other code provisions, section 892 offers sovereign investors more favorable treatments than are available to foreign private investors. While sovereign and private investors are treated alike concerning exemption from most interest income and capital gain on U.S. investments and are similarly taxed concerning most real estate investments, sovereign investors may also be exempt from taxation on special types of interest and real estate income that, if received by private investors, would be subject to tax.<sup>2</sup> Moreover, sovereign investors can typically derive dividend income free of U.S. tax on U.S. companies that they do not control, whereas private investors need to acquire derivative instruments regarding U.S. equity securities to achieve the same result.<sup>3</sup>

It has been suggested (for example by Prof. Victor Fleischer) that this unequal treatment of foreign private and government investors creates an uneven playing

field among them.<sup>4</sup> If, for instance, a private investor and a sovereign investor are both considering a U.S. investment expected to generate a 10 percent pretax return, and if the former investor is subject to a 30 percent U.S. tax on the return, whereas the latter is exempt, the latter may be able to bid a higher price for the investment because it would receive a higher after-tax return. This tax advantage could lead to economic inefficiencies, allowing the sovereign investor to become the preferred buyer even when it is otherwise less competitive than the private investor. Prof. Fleischer therefore recommends the repeal of section 892 and recommends that U.S. tax law follow the principle of neutrality, treating "the investment income of foreign sovereigns no better and no worse than private investors' income."<sup>5</sup>

This apparently simple case for the repeal of section 892, however, faces two important objections, both of which have been made in recent articles by Mihir Desai and Dhammika Dharmapala and by Michael Knoll.<sup>6</sup> The first objection is that it is erroneous to infer that because A is taxed more lightly than B on a given investment, X, that A has a tax advantage relative to B concerning its investment in X. This is because investors measure their tax advantage regarding a particular investment relative to their other investment options. For example, if A is taxed at a 30 percent rate on all of its potential investments, including X, and if B is taxed at a 0 percent rate on all of its investments, also including X, B enjoys no tax advantage over A concerning X (or concerning any other investment). All other things being equal, A and B would allocate the same amount to invest in X, even though A pays more tax on the investment returns. This is because, for A, X is no worse, from a tax point of view, than the other investment options.<sup>7</sup> In general, it is the comparative (and not absolute) advantage of an investor that determines its competitiveness on a given investment.<sup>8</sup>

The second objection is that it is not generally true that U.S. taxation determines the marginal tax burden on

<sup>4</sup>Victor Fleischer, "A Theory of Taxing Sovereign Wealth," coming in *N.Y.U. L. Rev.* (2009) and available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1234410](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1234410) (all page references below regarding this article are based on the Nov. 20, 2008, version available on SSRN).

<sup>5</sup>*Id.* at p. 26. Further, Prof. Fleischer argues that because SWF poses significant "geopolitical risks" and "negative externalities" for the United States, an excise tax on SWFs on their U.S. acquisitions should be considered. *See id.* at Part III.B and C.

<sup>6</sup>Mihir Desai and Dhammika Dharmapala, "Taxing the Bandit Kings," *Yale Law Journal Pocket Part*, vol. 118, 2008 (hereinafter Desai and Dharmapala); Knoll, "Taxation and the Competitiveness of Sovereign Wealth Funds," *supra* note 3.

<sup>7</sup>Alternatively, if all of the above hypotheticals hold, except that A is taxed at 25 percent on an investment in X, then A is at a comparative advantage relative to B on investing in X, even though A is more heavily taxed in absolute terms than B when investing in X. This is because X is subject to a relatively lighter tax for A compared with A's other options. For a general discussion of this view, see Michael S. Knoll, "Taxes and Competitiveness," available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=953074](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=953074).

<sup>8</sup>*See* Knoll, "Taxation and the Competitiveness of Sovereign Wealth Funds," *supra* note 3, and text accompanying note 104.

<sup>1</sup>*See, e.g.,* Press Release, "Baucus, Grassley Seek JCT Analysis of U.S. Taxation of Sovereign Wealth Funds," Mar. 13, 2008, *Doc 2008-5571*, 2008 *TNT* 51-35; New York State Bar Association Tax Section, "Report on the Tax Exemption for Foreign Sovereigns Under Section 892 of the Internal Revenue Code" 16-26 (June 2008), *Doc 2008-13195*, 2008 *TNT* 116-53 (hereinafter NYSBA report); Joint Committee on Taxation, "Economic and U.S. Income Tax Issues Raised by Sovereign Wealth Fund Investment in the United States," JCX-49-08 1-2 (June 17, 2008), *Doc 2008-13379*, 2008 *TNT* 118-13 (hereinafter JCT report).

<sup>2</sup>*See* JCT report, *supra* note 1, at 2; NYSBA report, *supra* note 1, at 2.

<sup>3</sup>*Id.* *See also* Michael Knoll, "Taxation and the Competitiveness of Sovereign Wealth Funds: Do Taxes Encourage Sovereign Wealth Funds to Invest in the United States?" coming in *Southern California Law Review* and available at <http://ssrn.com/abstract=1291878> (all page references below regarding this article are based on the Mar. 23, 2009, version available on SSRN).

foreign investors' U.S. investments. Foreign investors may be subject to tax in their countries of residence on the income they earn on U.S. investments, and in those cases, would generally claim foreign tax credits for U.S. tax paid. If the tax rate in the home country is higher than the U.S. tax rate, the foreign investor would have a residual tax liability in its home country. Therefore, the marginal tax burden on a U.S. investment may depend on the home country's tax rate, and changing the U.S. tax rates may have no effect in changing the investors' overall tax position. Prof. Fleischer seems to have made the fundamental error of supposing that source country tax rules are the only tax rules determining cross-border investment decisions.

On the basis of those objections, Prof. Knoll argues that section 892 does not necessarily put sovereign investors at an advantage relative to private investors; whether section 892 confers an advantage depends on the type of U.S. investment being considered, what the investors' default (benchmark) investment option is, and how the foreign private investor is taxed by its home country. Profs. Desai and Dharmapala argue more forcefully than Prof. Knoll against the proposal to repeal section 892, but make significant additional assumptions regarding how SWFs are taxed on their equity investments in their home countries and in countries other than the United States.

In this article, I suggest that the two objections to repealing section 892 are even stronger than has been recognized, in light of two considerations hitherto not given enough attention. The first is that the application of worldwide taxation by foreign private investors' home countries is a much more prevalent phenomenon than one might suppose. At least in theory, U.S. tax should determine the marginal tax burden on foreigners' U.S. investments only in a very small number of circumstances. While it's likely that a significant population of foreign investors illegally evade home country taxation, this fact does not justify the pretension that they are only taxed on a territorial basis. Not only is it normatively questionable whether the United States should be concerned about ensuring that SWFs enjoy no tax advantage over foreign investors who evade home country taxes, but those latter investors can also be shown to already enjoy a tax-related advantage that complicates the assessment of their competitiveness.

The second consideration is that, contrary to the explicit and implicit assumptions made by the authors cited above, there are important known cases in which SWFs are subject to home country taxation. This perhaps surprising fact has several implications. For one, it suggests that, despite section 892, foreign government and foreign private investors may sometimes *already* bear similar tax burdens thanks to their home countries' tax regimes. This strengthens the second objection to repealing section 892. Moreover, even if one continues to believe that SWFs are somehow subject to favorable home country tax treatments, that belief actually strengthens the first objection to repealing section 892. This is because *if* SWFs are treated more favorably on investments in their home countries than are private investors, but receive equal treatment on investments in

other countries, SWFs are potentially at a *comparative disadvantage* relative to private investors when making investments abroad.

When the prevalence of worldwide taxation and the taxation of SWFs in their home countries are taken into account, I believe the objections to the idea that section 892 disadvantages private investors are even stronger and more persuasive than those Profs. Desai, Dharmapala, and Knoll have put forth. But there may be a more fundamental issue at stake. The often overlooked fact that SWFs may be subject to home country taxation suggests that there has been inadequate understanding of the organizational characteristics of SWFs, and that framing the debate about SWF taxation in terms of whether section 892 should be retained may itself be inadequate. In several important ways — including their tax treatment in their home countries and the policy concern they raise for the United States — SWFs bear greater resemblance to commercial state-owned enterprises (SOEs) (that are not eligible for section 892 benefits) than to the rest of the section 892 investors, such as foreign pension funds. Framing the tax policy response to SWF investments in terms of whether to retain or repeal section 892 produces poor results: The repeal of section 892 would not only hurt too many innocent sovereign investors (such as public pension funds), it would also do little to address the purported policy concerns raised by SWFs.

I elaborate on the foregoing arguments in the following three sections.

### The Prevalence of Home Country Taxation

When a foreign investor (sovereign or private) is subject to home country taxation on its U.S. investments, and when the relevant home country tax rates are higher than the relevant U.S. tax rates (U.S. tax being thus fully creditable), the U.S. tax rates no longer determine the marginal tax burden on the foreigner's U.S. investments and cease to affect the foreigner's investment decisions. This seems clear in the abstract. What may seem less clear is how often foreign investors are taxed at home on investment income from the United States, and whether home country tax rates are higher than U.S. rates. One may understandably prefer to be skeptical about how foreign countries tax their residents in conducting the debate about taxing SWFs.<sup>9</sup> A few simple observations, however, show that there is a reasonable alternative to this skepticism, at least regarding private investors.

When assessing how the relative positions of sovereign and private investors are affected by section 892, there is a question about what type of foreign private investors are relevant: foreign individuals or corporations? Suppose we take foreign individual investors as the reference class.<sup>10</sup> In this case, however, it must be pointed out that, at least for purposes of analyzing inbound portfolio investments into the United States, relatively few countries can be assumed to exempt their

<sup>9</sup>This is the approach taken by Prof. Knoll, *id.*, and by Desai and Dharmapala, *supra* note 6.

<sup>10</sup>Knoll, "Taxation and the Competitiveness of Sovereign Wealth Funds," *supra* note 3, at note 171.

resident individuals on foreign investment income. Relatively few, that is, adopt territorial systems, in the sense the term is used by Prof. Knoll, for their individual residents.<sup>11</sup> For example, among the 16 largest sources of private, non-foreign direct investment equity investment in the United States in 2007 (which together accounted for 93.6 percent of total investment in this category), only Singapore, Hong Kong, and the Caribbean financial centers exempt their resident individuals' foreign investment income from taxation. Similarly, of the 13 largest sources of foreign private investments in U.S. corporate and agency bonds in 2007 (accounting for 94.6 percent of total investments in this category), only Hong Kong and the Caribbean financial centers adopt a territorial approach to their individual residents' foreign income.<sup>12</sup>

If we assume that investments identified by the U.S. Department of Commerce data as coming from certain countries are made by residents of these countries,<sup>13</sup> then much of foreign individuals' investment in U.S. portfolio debt and equity is taxed at home. Also, given the portfolio interest exemption, as well as the fact that the United States has entered into income tax treaties with many countries to reduce the U.S. withholding tax rate on dividends to 15 percent or less, we can surmise that the marginal tax burden on much of those investments is determined by the home country tax rates and not by U.S. rates.

Of course, it would be too naïve to suppose that foreign individuals for the most part pay tax in their home countries on income generated on their U.S. investments. The high proportion of foreign investments coming from the Caribbean financial centers (17.22 percent for bonds and 16.12 percent for portfolio equity) could

<sup>11</sup>"A country that exempts the foreign source income of residents from taxation has a territorial, source or exemption tax system." *Id.* at 11.

<sup>12</sup>"International Investment Position of the United States at Year-End 2007," U.S. Department of Commerce, Bureau of Economic Analysis, available at [http://www.bea.gov/scb/pdf/2008/07%20July/0708\\_iip.pdf](http://www.bea.gov/scb/pdf/2008/07%20July/0708_iip.pdf), Table M (equity investments) and Table L (debt investments). The 17 largest sources of equity investments are Australia, Belgium, Canada, the Caribbean financial centers, Denmark, France, Germany, Hong Kong, Ireland, Italy, Japan, Luxembourg, Netherlands, Singapore, Sweden, Switzerland, and the U.K. *Id.* The 14 largest sources of debt investments sources are Australia, Belgium, Canada, the Caribbean financial centers, China, France, Germany, Hong Kong, Ireland, Japan, Luxembourg, Netherlands, Switzerland, and the U.K. *Id.* Relevant information about the taxation of foreign investment income of residents in these countries can be obtained from the BNA Tax Management Portfolio "Business Operations Abroad" series. Citations to particular portfolios are omitted here.

<sup>13</sup>Data gathered by the IRS through Form 1042S show that the countries receiving the largest amounts of dividend and interest payments from the United States basically match the countries with the largest U.S. equity and bond holdings according to Department of Commerce data. See Sources of Income Tax Statistics — Foreign Recipients of U.S. Income, available at <http://www.irs.gov/taxstats/indtaxstats/article/0,,id=96993,00.html>. At least for countries with treaties with the United States, treaty provisions ensure that treaty benefits are claimed only by residents of the treaty partner countries.

itself be read as evidence that many foreign investors are evading home country taxation by using tax havens. But how do we take this fact into account? The current debate concerning section 892 is centered on whether U.S. tax law confers a tax advantage on SWFs relative to private investors and thereby distorts competition. Should we assume that the policy goal is to ensure that SWFs enjoy no tax advantage over foreign investors who have successfully avoided paying home country taxes that are legally due, on the ground that those investors may represent a significant portion of the totality of foreign investors investing in the United States? Or should we only aim to ensure that SWFs enjoy no tax advantage over foreign investors who abide by their home countries' tax laws, even supposing that those investors represent a minority?

We need not dwell on the ethical dimension of those questions to see their importance: The evasion of home country tax creates an important complication for any analysis of competitiveness. Consider an individual investor, E, who comes from a country that practices worldwide taxation, but who evades paying home country tax on income from U.S. investments. It is crucial to note that E *already* has an implicit tax advantage not enjoyed by his law-abiding peers — or by an SWF from the same country. This is the advantage E enjoys on foreign investments relative to domestic investments: E can manage to avoid home country tax on the former but not the latter. By contrast, E's law-abiding peers pay tax on both types of investments. For them, there is no tax-related comparative advantage associated with foreign investments. Similarly, E's SWF counterpart is either taxed or exempted by its home country on both foreign and domestic investments (see the next section for further discussion), and therefore is indifferent toward the two types of investments, from the perspective of home country taxes. The very fact that E is investing in the United States, in other words, implies a tax-related comparative advantage over E's SWF counterpart.

If E is taken as the representative case of a foreign private investor with whom to compare SWFs, then equalizing the U.S. tax treatment of E and his SWF counterpart does not put them on an equal footing, but instead preserves an illegitimate advantage E enjoys. There are thus both ethical and analytical difficulties with pretending that foreigners who evade their home countries' worldwide taxation are just like foreigners from territorial systems.

In summary, if we take foreign individual investors as the relevant class with which to compare the tax position of SWFs, it's difficult to ignore the prevalence of home country taxation among countries generating the most portfolio debt and equity investments into the United States. What if we take the reference class to be foreign corporate investors? Actually, the practice of worldwide taxation for corporate residents is also fairly widespread among those countries generating the most investments into the United States.<sup>14</sup> Many countries that are credited

<sup>14</sup>Needless to say, corporate investors can attempt to evade home country tax just like individual investors. The same  
(Footnote continued on next page.)

with territorial systems (for example, Belgium, France, Luxembourg, the Netherlands, and Switzerland) are territorial only in the narrow sense that their corporations are exempt on foreign branch income and dividends from subsidiaries. Foreign interest income typically is not exempt; neither are dividends on portfolio equity.<sup>15</sup> For example, although France and the Netherlands exempt dividend income from foreign subsidiaries, the exemption is conditioned on a minimum ownership percentage of 5 percent.<sup>16</sup> Below this threshold, home country tax is imposed and foreign withholding taxes are creditable under either domestic or treaty law.

Corporate investors from countries that adopt territorial systems in the narrow sense offer an interesting case for comparison with SWFs. Suppose that those investors use U.S. portfolio debt and equity as benchmarks for measuring the desirability of investment options in the United States. Because, as noted, those corporate investors are taxable in their home countries on income from foreign portfolio debt and equity, computing the after-tax returns on those investments will have to take into account home country tax rates. This makes certain other U.S. investments attractive from a tax perspective. Take, for example, a French investor considering acquiring 10 percent of the voting stock of a U.S. company. Not only would dividends on that stock be exempt from French taxation, but the tax treaty between the United States and France reduces U.S. withholding tax on the dividends to 5 percent. Overall, the French investor may be much better off, from a tax perspective, in making the "strategic" U.S. investments rather than investing in U.S. portfolio equity. If one assumes that an SWF is treated equally, both in the United States and in its home country, between strategic and portfolio U.S. equity investments,<sup>17</sup> the French investor is then at a comparative advantage, in terms of tax, in making strategic U.S. investments. This is the case even though the SWF would be subject to no tax on those investments, and even though the U.S. tax rates represent the marginal burden on those investments made by the French corporation.

None of the analysis above is meant to deny that there are bona fide cases of territorial taxation in the wide

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arguments as those advanced in connection with individual investors suggest that this does not justify pretending that these investors are subject to territorial taxation.

<sup>15</sup>The major exception to this is Germany; since 2001, a statutory exemption has excluded 95 percent of any foreign dividend from a German resident corporation's taxable income, regardless of the ownership level in the foreign corporation. Before January 1, 2001, these dividends were exempt only when earned by subsidiaries in treaty partner countries and only if a 10 percent minimum holding requirement was satisfied. See National Foreign Trade Council, "The NFTC Foreign Income Project: International Tax Policy for the 21st Century, Part Two: Relief of International Double Taxation," p. 259.

<sup>16</sup>*Id.* at pp. 253-254. See also BNA Portfolio 961-3rd: "Business Operations in France," VI.B.3.c.; BNA Portfolio 973-2nd: "Business Operations in the Netherlands," V.K.

<sup>17</sup>This is assumed, for example, in Knoll, "Taxation and the Competitiveness of Sovereign Wealth Funds," *supra* note 3. Things of course would be different if SWFs were taxed at home just like private firms.

sense (that is, exemption of all foreign investment income) among countries generating investments into the United States. Moreover, even in relation to countries that practice worldwide taxation, U.S. tax rates on passive investments by foreign investors may sometimes exceed home country tax rates.<sup>18</sup> Thus, there will be circumstances when the U.S. tax rates are determinative of the marginal tax burden on foreigners' U.S. investments. However, if we leave aside the class of foreign investors who avoid home country taxes that are legally due, those circumstances appear limited. Those arguments support the use of foreign private investors subject to home country taxation on a worldwide basis as the central case for evaluating the relative competitiveness of SWFs. This is what Profs. Desai and Dharmapala do, and their analysis shows that section 892 does not confer any tax advantage on SWFs.<sup>19</sup>

In the next section, I suggest that instead of being agnostic about whether foreign private investors are generally subject to home country taxation on U.S. investments, we should be agnostic about whether SWFs are generally exempt from taxation at home.

### Taxability of SWFs at Home

Although Profs. Desai, Dharmapala, and Knoll all regard home country taxation of foreign private investors' U.S. investments as important to evaluating whether section 892 gives SWFs a tax advantage, they are less interested in how SWFs are taxed at home. Profs. Desai and Dharmapala claim that "SWFs are . . . by definition, tax-exempt at home."<sup>20</sup> Prof. Knoll also treats SWFs as exempt from home country taxation, but justifies this treatment by stating that it is a simplifying assumption and not a factual assertion. He writes:

Because SWFs are government owned and controlled, any tax they would pay at home would be paid to the governments that own them. It, thus, makes little sense to talk about how SWFs are taxed in their home countries. Any such taxes are merely transfers from one pocket controlled by the government to another pocket. Thus, such investment funds are effectively taxed on the territorial system. The only tax that they pay, if any, is located in the countries where they invest.

In other words, even if SWFs are nominally taxed on their worldwide income in their countries of residence, that is substantively no different from exempting SWFs from home country taxation on their foreign income.

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<sup>18</sup>This is particularly true for U.S. real estate investments that trigger the 1980 Foreign Investment in Real Property Tax Act.

<sup>19</sup>Desai and Dharmapala, *supra* note 6. See also Knoll, "Taxation and the Competitiveness of Sovereign Wealth Funds," *supra* note 3, Part VI, which reaches similar conclusions.

<sup>20</sup>Desai and Dharmapala, *supra* note 6, at 3. In Fleischer, "A Theory of Taxing Sovereign Wealth," *supra* note 4, Prof. Fleischer neglects home country taxation of foreigners' U.S. investments entirely, and *ipso facto* neglects the home country taxation of SWFs.

The assumption that SWFs are exempt from home country taxation is incorrect. The China Investment Corporation (CIC) is subject to tax, as is the Korea Investment Corporation (KIC).<sup>21</sup> Moreover, both China and Korea tax their resident corporations' worldwide income.<sup>22</sup> Temasek, one of Singapore's two SWFs, is also subject to the corporate income tax, although Singapore has a tax system that is territorial in the broad sense that foreign income of residents is generally exempt from Singaporean taxation.<sup>23</sup> These unsystematic factual findings are conceptually unsurprising: When an SWF is not an integral part of the government, but a separate legal entity controlled by the government, it is an SOE. There is no general presumption that SOEs are exempt from income taxation, and there are many instances of taxable SOEs all over the world.

What about Prof. Knoll's argument that worldwide taxation of SWFs is substantively equivalent to taxing SWFs on a territorial basis? Implicit in that argument is the idea that because the home country government owns an SWF, both the government and the SWF should be indifferent to tax payments from the SWF to the government, on one hand, and retained earnings that the SWF keeps, on the other. In other words, even if SWFs are taxable at home, they should not be sensitive to home country taxes. If this reasoning were valid, it should apply to all SOEs. That, however, would render it puzzling that so many countries (not only those just named that tax their SWFs) tax their SOEs. Why bother?

There is no need to settle the interesting matter of why SOEs are taxed and whether taxable SOEs are tax sensitive here.<sup>24</sup> Instead, we can explore the implications of two alternative assumptions: (1) that SWFs are either not taxed like private investors from the same countries, or, even though they are nominally taxed just like private investors, they are tax insensitive; or (2) that SWFs are taxed just like private investors and are

sensitive to home country tax. Either assumption, it turns out, can imply that equal U.S. tax treatment of SWFs and private investors (for example, via the repeal of section 892) is not necessary to ensure that foreign private investors are not disadvantaged on U.S. investments. This is, of course, a conclusion that Profs. Desai and Dharmapala and even Prof. Knoll should be sympathetic to; it's the arguments offered here for the conclusion that are new.

Consider first an SWF that is categorically exempt from taxation by its home country. Using this example, as well as the additional assumption that SWFs are exempt from source country taxation in countries other than the United States,<sup>25</sup> Profs. Desai and Dharmapala argue that if section 892 is repealed, the SWF would be put at a comparative disadvantage on U.S. investments relative to a private investor subject to worldwide taxation by its home country. The same conclusion can be derived using a different assumption, namely that SWFs and private investors both have the option of investing either domestically or abroad. If the SWF is subject to any U.S. tax on U.S. investments, it would pay more tax on a U.S. investment than on any domestic investment. This constitutes a comparative disadvantage relative to taxable foreign investors on U.S. investments: Under either worldwide or territorial taxation, taxable foreign investors generally do not bear more tax on U.S. investments than they bear on any domestic investment (assuming lower source country tax rates for nonresidents than home country tax rates for residents). In other words, the tax-exemption of SWFs at home could actually systematically disadvantage them on foreign investments, if both they and private investors are subject to source country taxation.

The same logic applies to an SWF that is indifferent about any home country tax it has to pay. Domestic and foreign taxes hurt private investors the same way. If, on the other hand, the SWF is sensitive only to foreign taxes but is indifferent to home country tax, it suffers a comparative disadvantage on foreign investments if any foreign tax is imposed.

While previous authors have compared the different U.S. investment options open to foreign government and private investors, as well as the choice between investing in the United States and other countries outside the investor's home country, they do not compare SWFs and private investors in terms of the option, which both may have, of staying home and investing domestically.<sup>26</sup> Yet

<sup>21</sup>Article 1 of China's Enterprise Income Tax Law (the EIT Law) imposes the corporate income tax on all corporations as well as other corporation-like entities regardless of ownership. See also the Ministry of Finance and State Administration of Taxation, "Notice Regarding Enterprise Income Tax Payments by Experimental Enterprise Groups," *Caishui* 119 (Nov. 6, 2008) (listing CIC as a consolidated taxpayer). KIC's tax status can be found in its 2007 annual report, available at <http://www.kic.go.kr/program/kicboard/view.jsp?did=en&id=ekn020000&no=169>.

<sup>22</sup>See article 3 of the EIT Law, *supra* note 21; BNA Portfolio 970-3rd: "Business Operations in the Republic of Korea," Section V.B.1.

<sup>23</sup>See <http://www.temasekholdings.com.sg/temasekreview/2008/Group-Income-Statements.html> (Temasek's gross income statements); BNA Portfolio 983-3d: "Business Operations in Singapore," Section IV.B.

<sup>24</sup>In "Income Taxation of State-Owned Enterprises: Theory and Chinese Evidence" (manuscript available at <http://ssrn.com/abstract=1410463>), I argue that taxation of SOEs can serve as a mechanism for forcing SOE distributions, in view of the divergent interests between managers and shareholders that characterize SOEs as well as private firms. On this theory, taxable SOEs are generally tax sensitive.

<sup>25</sup>This assumption may seem too strong. Many countries do not offer section 892-like treatment to sovereign investors. See JCT report, *supra* note 1, Appendix One.

<sup>26</sup>See Knoll, "Taxation and the Competitiveness of Sovereign Wealth Funds," *supra* note 3, at note 123, for a justification for "ignoring the possibility of non-US investors making investments in their home countries." This approach, however, is in tension with two facts: the "home-bias" in international investment decisions observed in many countries, and the fact that many of the countries generating the largest amount of investment in the United States, for example, Canada, China, France, Germany, Japan, the U.K., etc., are very large economies themselves.

that possibility is both logically and factually important. CIC and Temasek, as well as several other SWFs, all make both domestic and foreign investments.<sup>27</sup> And it would not be surprising if the performance of those funds is measured on the basis of their mixed portfolios comprising both domestic and foreign assets. In those cases, the supposition that SWFs have some kind of special tax status at home (being untaxed or tax-insensitive) implies a tax disadvantage, relative to private investors, on foreign investments subject to foreign tax. Because of this, section 892 may actually have an equalizing effect, as opposed to the opposite.

Finally, consider the case of an SWF that is taxed at home just like private investors from the same country and, moreover, is sensitive to any home country tax. If the SWF comes from a country practicing worldwide taxation, then U.S. tax rates generally fail to determine the marginal tax burden on its U.S. investments just as they do for private investors from the same country (section 892 provides a pleasant but unnecessary benefit). If the SWF comes from a country practicing territorial taxation in the narrow sense (*à la France*), then on portfolio debt and equity, the SWF is on equal footing with private investors from the same country (both being subject to home country taxation), but may derive an advantage from section 892 concerning strategic equity investments and some real estate investments. Finally, if the SWF comes from a country practicing territorial taxation in the broad sense (*à la Singapore*), then SWFs may be advantaged by virtue of section 892, regarding a wider class of investments (for example, possibly portfolio equity). In short, the practices of home countries matter to the evaluation of the effect of section 892 as much because they apply to SWFs as because they apply to private investors.

In the last section, we argued that, methodologically, it may be sounder to treat the foreign private investors with whom SWFs compete as taxed at home on a worldwide basis. Not only is that approach more consistent with the laws of the countries actually generating private investment in the United States, but noncompliance with such laws (that is, when foreigners evade home country taxation) is also analytically significant for evaluating the competitiveness of SWFs and private investors. Similarly, in this section, we have argued that the taxation of SWFs in their home countries cannot always be ignored. This is not only because there are important instances of home country taxation of SWFs, but also because the assumption that SWFs are not taxed in their home countries or are insensitive to home country tax is not an innocuous simplification, but can itself be analytically significant for evaluating competitiveness.<sup>28</sup>

<sup>27</sup>This appears to be the case, for example, with the Kuwait and Qatar Investment Authorities. The Government of Singapore Investment Corporation, by contrast, invests only abroad. The Government Pension Fund of Norway offers another variation: It comprises two separate funds, one investing in Norway and the other investing globally.

<sup>28</sup>Another technical reason why SWFs may be taxed at home is the following. As the NYSBA report, *supra* note 1, pp. 33-34,

(Footnote continued in next column.)

From the discussion so far, we have uncovered several nontrivial instances — there are no doubt more — in which equal U.S. tax treatment of SWFs and foreign private investors (for example, via the repeal of section 892) would put the former at a tax-induced disadvantage instead of equalizing the two. In the next and final section, we question whether, even granting the importance of evaluating the effect of taxation on the competitiveness of SWFs and private investors, focusing on section 892 is a fruitful way of doing so.

### Section 892: The Wrong Place to Look?

Although we should be careful about assuming that SWFs are necessarily exempt from home country taxation, that assumption may be more straightforward regarding another (more long-standing) class of section 892 beneficiaries: foreign government-sponsored pension funds. The recent communications from the Canada Pension Plan Investment Board and the Pension Investment Association of Canada<sup>29</sup> to the U.S. Department of Treasury concerning the possible contravention of section 892 by Notice 2007-55, 2007-27 IRB 13, *Doc 2007-14105*, 2007 TNT 115-12, serve as a timely reminder of the importance of this group of investors. The recent discussions of section 892 in the context of the SWF debate have tended to conflate section 892 investors with SWFs,<sup>30</sup> but there are obvious and important differences between SWFs and foreign public pension funds. For example, although the latter have been making U.S. investments for a long time, there has been little concern, relative to the concern expressed regarding SWFs, that the management of such funds may be subject to political interference by their sponsoring governments. This different perception of foreign pension funds may also be because, historically, they have rarely made the kind of strategic equity investments in U.S. companies as SWFs were making during 2007 and 2008.

Some scholars have also highlighted another difference among public pension funds and SWFs: The former have well-defined liabilities, that is, pension obligations to retirees, with which investments should (at least in theory) be matched, whereas the latter “lack stated or

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discusses, to cope with the “all or nothing” nature of the U.S. tax law requirement that claimants of section 892 benefits must not engage in “commercial activities,” section 892 investors often set up subsidiary “blocker corporations” to hold investments that might be suspected of constituting commercial activities. Often, it is these subsidiary holding companies that are the actual claimants of section 892 benefits. Even if the parent SWF is tax exempt, it’s not always clear that its multiple subsidiary companies are.

<sup>29</sup>See “Canada’s Pension Investment Board Comments on Guidance on Distributions Between Foreign Governments, REITs,” Oct. 28, 2008, *Doc 2008-23437*, 2008 TNT 215-10; “Canadian Pension Association Criticizes Guidance on Distributions Between Foreign Governments, REITs,” Nov. 14, 2008, *Doc 2008-27029*, 2008 TNT 248-20 (hereinafter the PIAC letter).

<sup>30</sup>For instance, Prof. Fleischer speaks of “sovereign investors” interchangeably with SWFs. See generally Fleischer, “A Theory of Taxing Sovereign Wealth,” *supra* note 4.

specified liability profiles.”<sup>31</sup> To put it differently, unlike public pension funds, SWFs do not have obvious distribution requirements.<sup>32</sup>

Keeping these differences between public pension funds and SWFs in mind, consider the similarities between SWFs and another group of potential foreign investors in the U.S.: foreign commercial SOEs. Foreign SOEs, when they invest in the United States, make strategic or direct acquisitions, as well as portfolio investments. Those large investments have in the past provoked political responses in America similar to that provoked by the recent spate of SWF acquisitions,<sup>33</sup> largely because of suspicion of political interference in SOE management. Moreover, SOEs that are fully government owned may also lack well-defined distribution requirements. Despite those similarities between SWFs and commercial SOEs, the latter are not eligible for section 892 benefits.<sup>34</sup>

The contrasts between SWFs and government pension funds, as well as the similarities between SWFs and commercial SOEs, raise the question: Is focus on section 892 a poor way for framing any tax policy issue raised by SWFs? The following four considerations suggest that the answer is indeed yes.

First, both this article and others have identified several circumstances in which, if section 892 were to be repealed, the would-be claimant of section 892 benefits would be disadvantaged on U.S. investments relative to foreign private investors, rather than being put on an equal footing with the latter. Those circumstances include (but are not limited to): (1) the government investor (G) has the option of investing in other foreign countries free of both source and resident country taxation, and is competing with a private investor (W) taxed at home on a worldwide basis<sup>35</sup>; (2) G has the option of staying at home and investing domestically with tax exemption and

is competing with W<sup>36</sup>; and (3) G is tax exempt at home but is competing with a foreign private investor who has successfully evaded its home country’s worldwide taxation.<sup>37</sup> While many SWFs may find themselves in those circumstances, it is even more likely that foreign pension funds will so find themselves. For instance, foreign pension funds are more likely than SWFs to be investing both domestically and globally. Thus, for those claimants of section 892 benefits, the arguments are even stronger that it is the repeal of section 892, and not the status quo, that would have an unequal effect.

Second, to the extent that a tax policy response to SWFs is thought to be required in the first place because of the special characters of SWF investments — for example, the geopolitical risks and negative externalities they pose<sup>38</sup> — a response that punishes foreign pension funds’ investments that do not possess those characteristics clearly seems unjust. As bad as “guilty by suspicion” is, “guilty by association” is even worse.

Third, as suggested above, even with their other characteristics put aside and considered purely as taxpayers, SWFs can be a rather mixed bunch. As a result, the effects of both section 892 and its repeal not be uniform. For example, given that KIC is taxed on a worldwide basis (and supposing it is sensitive to home country tax), whereas Temasek is subject to Singapore’s territorial tax regime, the repeal of section 892 would presumably hurt the latter more than the former. This effect neither “levels the playing field” for the parties affected, nor possesses any other imaginable policy justification.

Fourth, most importantly, it is a fundamental misreading of section 892 to think that eligibility for its benefits carves out a line between public and private ownership.<sup>39</sup> What makes this transparent is the fact that one group of foreign investors that SWFs may compete with on U.S. investments (especially strategic investments) are commercial SOEs. It is completely plausible, for example, to imagine one set of bidders for the equity of a U.S. bank to be SWFs, like the Abu Dhabi Investment Authority, and another set consisting of state-owned banks from China or other countries. The issues for the U.S.’s national interest raised by these competing bidders are likely to be similar, despite their different U.S. tax treatment under section 892. If any tax policy response is necessary to these government-controlled foreign investors, repealing section 892 offers no help.

investments relatively more costly for G whereas the relative cost of U.S. investments for the private investor remains unchanged.

<sup>36</sup>See *supra* text accompanying notes 32 and 33.

<sup>37</sup>See example of individual “E” in Section I, p. 5, *supra*.

<sup>38</sup>See *supra* note 4.

<sup>39</sup>This is Prof. Fleischer’s preferred reading. See Fleischer, “A Theory of Taxing Sovereign Wealth,” *supra* note 4, at 7 (“there is no compelling reason to favor state-controlled investment over private capitalism”) and 12 (justifying the proposal to impose an excise tax on SWFs by its “appeal to policymakers . . . who want to make a strong statement in favor of private capitalism over state capitalism”).

<sup>31</sup>Olivia S. Mitchell, John Piggott, and Cagri Kumru, “Managing Public Investment Funds: Best Practices and New Challenges,” NBER Working Paper 14078, available at <http://www.nber.org/papers/w14078>.

<sup>32</sup>The distribution requirements of public pension funds may help explain why they are rarely taxed in their home countries. See, e.g., the PIAC letter, *supra* note 29 (Canadian pension funds, whether in the public and private sectors, are generally tax exempt in Canada).

<sup>33</sup>Examples from the recent past include the proposed acquisitions of Unocal by the China National Offshore Oil Corporation, and of 3M by a consortium of investors including China’s Huawei Corporation (which is not literally state owned but is suspected of government backing).

<sup>34</sup>Prof. Fleischer erroneously asserts that entities “that benefit from section 892 include . . . state-owned enterprises, like Russia’s government-controlled energy giant Gazprom.” Fleischer, “A Theory of Taxing Sovereign Wealth,” *supra* note 4, at 16. In general, government-controlled entities engaged in commercial activities are not eligible for section 892 benefits. Section 892(a)(2). Gazprom violates both this requirement and the requirement of being wholly owned by a foreign sovereign — it is a publicly listed company. See reg. section 1.892-2T(a)(3)(i).

<sup>35</sup>This is the central example offered by Desai and Dharmapala, *supra* note 6. The repeal of section 892 would make U.S.

(Footnote continued in next column.)



In summary, while analyses of the relative competitiveness of SWFs and other foreign investors in making U.S. investments can often be illuminating, the repeal of section 892 as a policy response to SWF investments seems ill-advised.

## Capital Gains and Tax Reform

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### Introduction

The problems with the current U.S. tax system are well known. It is far too complex. It unduly distorts economic and financial activity (for example, by treating debt and equity finance differently). There is an unacceptable level of tax avoidance and evasion. And many people believe that the federal tax system is insufficiently progressive.<sup>1</sup>

The U.S. income tax is far more complex than that of any other country. This imposes a tremendous drain on our economy and diverts the intelligence and efforts of highly talented people into tax planning and compliance — activities that do not enhance overall national welfare and that increase the cost of doing business. It also contributes to the unfairness of the tax system and makes compliance difficult by subjecting taxpayers to an impenetrable thicket of rules.

The system is therefore in need of fundamental reform, which will not be easy because of entrenched interests and technical challenges. However, the gains to the economy from a more streamlined tax system can be substantial. A robust tax system will also be needed to bring the budget into balance once the economy recovers from the current recession.

Given other priorities, fundamental tax reform does not appear to be on the legislative agenda for 2009, but the construction of a better tax system requires preparing the ground now so that a plan can be ready by the time Congress turns to the issue. This essay argues that a key element in fashioning a tax reform strategy is the taxation of capital gains. I don't claim originality for these ideas; variants of each of them have been proposed by a number of tax policy analysts.<sup>2</sup> Taxing capital gains at death is not (yet) an articulated element of the Obama administration's tax plan, so I thought it would be worthwhile to discuss the opportunity for progress that a bold position on this issue would provide.

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<sup>1</sup>This is at least implicitly the position of the Obama administration, as the president has proposed undoing many of the previous administration's tax cuts that favored the wealthy.

<sup>2</sup>See, e.g., Daniel Halperin, "Saving the Income Tax: An Agenda for Research," *Tax Notes*, Nov. 24, 1997, p. 967, *Doc 97-31881*, or 97 *TNT* 226-55.