



Australian Government

Greater certainty for Sovereign Investments

Consultation Paper
November 2009

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CONSULTATION PROCESS

Request for feedback and comments

The Government is seeking your feedback and comments on the legislative design of its announcement to introduce amendments to the income tax law to formalise the existing tax practice of exempting certain income earned by foreign governments.

While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please email responses in a Word or RTF format. An additional PDF version may also be submitted.

All information (including name and address details) contained in submissions will be made available to the public on the Treasury website, unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in-confidence should provide this information marked as such in a separate attachment. A request made under the *Freedom of Information Act 1982* (Commonwealth) for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

Closing date for submissions: 5 February 2010

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FOREWORD

I am very pleased to release this consultation paper on proposed changes to the income tax laws to formalise the existing tax practice of exempting certain income earned by foreign governments.

These changes will provide greater certainty to foreign governments in respect of the tax treatment that applies to their Australian investments.

During this time of global recession, we need to be providing as much certainty for capital investors as we can, and this tax measure will achieve that.

Codifying existing exemptions will give foreign governments certainty about the tax treatment of their investments in Australia which, in turn, will make Australia an even more attractive and certain investment destination and contribute towards Australia's financial centre hub strategy.

The proposed tax changes will significantly assist in this regard and we look forward to receiving the community's view.

A handwritten signature in black ink, appearing to read 'Nick Sherry', written in a cursive style.

Assistant Treasurer
Senator The Hon Nick Sherry

1. BACKGROUND

1.1 SOVEREIGN WEALTH FUNDS (SWFs)

Sovereign wealth funds (SWFs) have grown rapidly over recent years both in size and number. There are currently more than 50 SWFs in operation around the world, with total assets under management estimated at US\$3.8 trillion.¹ A list of current top twenty largest SWFs is contained at Appendix A.

It is anticipated that the SWF market will continue to grow, with some sources estimating that assets under management will reach US\$10 trillion by 2015.² Australia's Future Fund ranks 15th globally in terms of the value of its assets.³

While early SWFs tended to invest mainly in international bond markets, in more recent times the search for higher returns has witnessed SWFs expand into equity markets and in some cases direct investment, including into real property.⁴

The US currently attracts the largest portion of the world's SWF investments. According to Deutsche Bank Research, the US accounted for 37 per cent of the world's SWF investment by destination in 2008.⁵

It is clear that international SWFs have the potential to provide Australia with a significant additional source of capital, but in order for Australia to compete, and improve its attractiveness as a destination, for these funds it is important that Australia's taxation laws set out clear and certain outcomes for potential investors.

Against this backdrop, the Government announced on 20 August 2009 that it would codify the current administrative practice that exempts from Australian taxation, income arising from certain investments made by foreign governments.

In codifying the current administrative practice it may be desirable to model the rules on those that apply in the US, given that it is the destination for most of the world's SWF investments. The advantage with this approach is the benefit of familiarity to the global investment community and the confidence that investments into Australia will receive equivalent tax outcomes to those in the US. A summary of the US tax laws that apply to SWFs is included in Appendix B.

In responding to this consultation paper, the Government would find it useful to hear the community's views on whether the US model poses particular advantages or disadvantages and whether basing our laws on the US model would assist or deter SWF investment into Australia.

¹ <http://www.swfinstitute.org/funds.php>

² Deutsche Bank Research, 'SWFs and foreign investment policies – an update', 22 October 2008

³ <http://www.swfinstitute.org/funds.php>

⁴ Will Devlin and Bill Brummitt; *A Few Sovereigns More: the rise of sovereign wealth funds*; Treasury Economic Roundup Paper; Spring 2007

⁵ Deutsche Bank Research, 'SWFs and foreign investment policies – an update', 22 October 2008

While an important design feature of the law will be to ensure that the rules create certainty and encourage investment into Australia, an equally important design feature will be to ensure that the concessional tax treatment does not shelter the commercial operations of SWF investments. Such an outcome would provide an unfair competitive advantage over domestically operating businesses.

2. POLICY OBJECTIVES

The policy objective behind the proposed changes is to enhance Australia's attractiveness as a destination for foreign government investment by providing greater certainty as to the Australian tax consequences of investing in Australia.

The proposed changes will reduce compliance costs (by allowing foreign governments to self-assess their tax position) and will also assist in promoting Australia as a financial services hub in the Asian region.

The means by which this policy objective is achieved will be to codify the current administrative practice which, broadly speaking, provides an income tax and withholding tax exemption to foreign governments for income arising in respect of their non-commercial investments in Australia. This practice has its origins in the doctrine of sovereign immunity. Traditionally, the exemption has been confined to the foreign government's non-commercial or passive investment income such as interest and dividend income.

2.1 WHAT IS THE DOCTRINE OF SOVEREIGN IMMUNITY?

The doctrine of sovereign immunity is a principle of customary international law according to which one country is immune from the jurisdiction of another country. The scope of this doctrine has evolved from an absolute, wide-ranging immunity to a more restrictive one.

This evolution is primarily due to the fact that governments have increasingly engaged in commercial activities, activities for which it would be inappropriate to extend an exemption. Gradually, therefore, the doctrine has been narrowed down so that a country only enjoys immunity with respect to its non-commercial activities.

2.2 WHAT IS THE CURRENT ADMINISTRATIVE PRACTICE?

Certain income derived by foreign governments and many SWFs has traditionally been exempt from Australian taxation under the international law doctrine of sovereign immunity. This practice is set out in ATO ID 2002/45.

Under current arrangements, each entity must apply to the Australian Taxation Office for a Private Binding Ruling (PBR) in order to determine whether the income derived from its Australian investments is exempt from income tax and withholding tax.

ATO ID 2002/45 explains that:

Certain income derived from within Australia by foreign governments is exempt from Australian tax under the international law doctrine of sovereign immunity. In accordance with that doctrine, Australia accepts that any income derived by a foreign government from the performance of governmental functions within Australia is exempt from Australian tax. 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.

When determining whether sovereign immunity applies to a particular operation or activity, it is necessary to establish whether the operation or activity is commercial in nature. Whether an operation or activity is commercial in nature will depend on the facts of each particular case. However, as a guide, 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.

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.

In relation to holding shares in a company, there would be instances where the extent of the holding gives rise to questions as to whether it constitutes a passive investment or the carrying on of a business; this would depend on the particular circumstances. A portfolio holding in a company (i.e. a holding of less than 10 per cent of the equity in a company) will generally be accepted as a non-commercial activity and any dividends received from such a holding would be exempt from tax.

To establish that sovereign immunity applies to exempt dividend and interest income from withholding tax, it is necessary to establish the following:

- that the person making the investment (and therefore deriving the income) is a foreign government or an agency of a foreign government ;
- that the moneys being invested are and will remain government moneys; and
- that the income is being derived from a non-commercial activity.

If these three conditions are satisfied, then the dividend and interest income will not be subject to Australian income or withholding taxes.

The doctrine of sovereign immunity only applies to foreign governments and their instrumentalities that engage in governmental functions. In determining whether a particular activity constitutes the performance of governmental functions we need to examine the nature of the activity conducted by the foreign government or its instrumentality. This approach is consistent with the decision of the British House

of Lords in the case *I Congreso del Partido* [1981] 2 All ER 1064 which held that activities of a trading, commercial or other private law character are not governmental functions.

3. LEGISLATIVE PRINCIPLES

To give effect to the policy objective of this proposal, the following legislative principles are relevant. The Government invites your comments on these principles, including any specific issues raised in the 'consultation question' boxes. You may also like to raise other issues that may be relevant to the Government's considerations:

- what kinds of entities are eligible for the exemption?
- what kinds of income will be exempt?
- what kinds of tax exemptions will apply?

3.1 WHAT KINDS OF ENTITIES ARE ELIGIBLE FOR THE EXEMPTION ?

In order to be eligible for the exemption, an entity must either be:

- a foreign government; or
- wholly owned, directly or indirectly, by a foreign government.

It is intended that the term 'foreign government' be broad enough to include political subdivisions, statutory authorities, agencies and instrumentalities, as well as government-owned enterprises. Many SWFs are indirectly owned by a foreign government and would therefore potentially be eligible for the exemption (subject to satisfying the other criteria).

A number of alternatives could be considered with respect to defining the term 'foreign government', including:

- (a) allowing the definition of 'foreign government' to take its ordinary meaning. Under this option there would be no definition included in the legislation, however, commentary would be included in the extrinsic materials;
- (b) using the current definition of 'exempt foreign government agency' in section 995 of the *Income Tax Assessment Act 1997* (ITAA 1997). This definition explains that an exempt foreign government agency is:
 - (i) the government of a foreign country, or part of a foreign country;
 - (ii) an authority of the government of a foreign country, if the authority is of a similar nature to an authority that is an exempt Australian government agency; or
 - (iii) an authority of the government of part of a foreign country, if the authority is of a similar nature to an authority that is an exempt Australian government agency;

- (c) inserting a new definition into section 995 of the ITAA 1997 relevant to SWFs. This could capture the features of SWFs as described in submissions or as usually understood (for example, in preparing the table in Appendix A).

Consultation questions

3.1.1 What should the definition of ‘foreign government’ entail?

3.1.2 Should the definition include monarchs and kingdoms and, if so, how should they be defined?

3.1.3 Which, if any, of the above options is most suitable for achieving this purpose?

3.1.4 Are there any other alternatives that should be considered?

3.2 WHAT KINDS OF INCOME WILL BE EXEMPT?

Consistent with current practice and international norms, it is intended that only passive or non-commercial income will be exempt from Australian taxation. Active or commercial income will continue to be subject to Australian tax, thereby ensuring a level playing field for competing Australian businesses.

In terms of legislative design, there are three alternatives that could be used for distinguishing between non-commercial (or passive) income and commercial (or active) income:

- First, ‘non-commercial income’ could be positively defined, with ‘commercial income’ taken to be anything that is not non-commercial income.
- Alternatively, ‘commercial income’ could be positively defined, with ‘non-commercial’ income taken to be anything that is not commercial income.
- Finally, non-commercial and commercial income could be both positively defined.

In terms of positively defining non-commercial and commercial income, the following alternatives could be used.

Non-commercial or passive income

Non-commercial or passive income could be based on one of the following:

1. relying on the ordinary meaning of non-commercial or passive income. Under this option there would be no definition included in the legislation, however, commentary would be included in the extrinsic materials;
2. relying on the existing definition of ‘eligible investment business’ in section 102M of the *Income Tax Assessment Act 1936* (ITAA 1936) (as modified, if at all, by the Review of Managed Investment Trusts);
3. relying on the existing definition of passive income in section 446 of the ITAA 1936;
4. adopting a ‘white list’ approach, whereby certain listed types of income are considered passive or non-commercial income and anything not included is, by default, considered

to be active or commercial income. This is consistent with the US approach which only exempts specific types of income listed in the regulations (see Appendix B);or

5. inserting a new concept of 'passive income' into section 995 of the ITAA 1997 based on the suggestions received during consultations.

Commercial or active income

Active or commercial income could be based on one of the following:

1. relying on the ordinary meaning of commercial or active income. Under this option there would be no definition included in the legislation, however, commentary would be included in the extrinsic materials;
2. drawing on the existing active business exemption in section 523 of the ITAA 1936;
3. inserting a new definition of active income into the ITAA 1997 based on the suggestions received during consultations.

Consultation questions

3.2.1 Which of the three alternatives is the preferred design approach and why?

3.2.2 How should non-commercial or passive income be defined and what should it entail?

3.2.3 How should active or commercial income be defined and what should it entail?

3.2.4 Are there other alternatives to these terms that should be considered?

While the above tests focus on the nature of income arising from particular activities, an additional test that looks at the level of concentration of the investment may also be warranted. Under the US rules, for example, an exemption from taxation does not arise for foreign government investments if they are closely held by the foreign government. There are a range of existing definitions in the Australian tax laws that measure the level of concentration that could be used for this purpose including the definitions of 'closely held' and 'non-portfolio interests'.

Consultation questions

3.2.5 Should a widely held concept be incorporated into the rules?

3.2.6 If so, what should the concept be based on?

3.3 IMPACT OF DERIVING ACTIVE INCOME — 'TAINTING'

A key design feature of the proposed rules will be to ensure that active income continues to be taxable in Australia, thereby ensuring that Australian businesses are not at a competitive disadvantage to the commercial activities of foreign governments.

The main issue to be considered with respect to the derivation of active income by SWFs is what effect, if any, the derivation of active income has on the tax treatment of an entity's

passive income; that is, should the derivation of active income 'taint' the passive income of the entity such that all of its income (both passive and active) becomes subject to Australian taxation.

As mentioned above, given that a large proportion of SWF assets are invested in the US, it may be desirable for Australia's rules to be modelled on those that apply in the US. One of the requirements under the US system is that an SWF can not derive any active/commercial income from *anywhere in the world*. Further, the sovereign exemption is also forfeited if income is:

- received by or from (directly or indirectly) a 'controlled commercial entity' (as defined); or
- derived from the disposal of an interest in a 'controlled commercial entity'.

The Government is considering the effect, if any, the derivation of active income should have on the treatment of an SWF's passive income in Australia. The following options are being considered:

- (a) having a rule similar to that in the US;
- (b) having a rule which allows an SWF to derive foreign-sourced active income but not Australian-sourced active income. This would mean that if an SWF derived Australian-sourced active income, *all* of its Australian source income (both passive and active) would be taxed in Australia;
- (c) having a de minimis rule which allows an SWF to derive a certain percentage (say 10 per cent) of active income from any source; or
- (d) providing an exemption to the passive income component only and maintaining taxing rights over the SWF's income from commercial activities.

Consultation questions

3.3.1 Which of the above options is the preferred option?

3.3.2 Are there other alternatives that should be considered?

3.4 INCOME TAX AND WITHHOLDING TAXES ONLY TO BE AFFECTED

The exemption will only apply in respect of Australian income tax and withholding taxes. It is not proposed that it apply to other taxes, such as GST, FBT or stamp duty. This is consistent with current practice and international norms.

Consultation question

3.4.1 Is there a case for extending the exemption to other forms of taxation? If so, which ones?

3.5 INTEGRITY RULES

The Government will include appropriate integrity rules in order to ensure that the proposed exemptions are appropriately targeted and do not allow private individuals to unintentionally benefit from the tax exemptions.

The current administrative practice states that 'income derived by a foreign government from the performance of governmental functions within Australia is exempt from Australian tax. An activity undertaken by a foreign government 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.' This is often referred to as the 'governmental function test'.

The Government is considering the following options with respect to the required integrity rules:

- (a) including a similar 'governmental functions test', as per the existing administrative practice;
- (b) including an 'inurement test', similar to that used in the US. Under this test, an entity will not satisfy the definition of a foreign government (and will therefore be ineligible for any exemption) if any of its earnings can inure to the benefit of a private person or a sovereign acting in an individual capacity.

Consultation questions

3.5.1 Is a governmental functions test necessary?

3.5.2 If a governmental functions test is included, what kinds of activities should it entail?

3.5.3 Are there other integrity rules that the Government should consider?

APPENDIX A: SOVEREIGN WEALTH FUNDS – TOP 20 FUNDS RANKED BY ASSETS UNDER MANAGEMENT

Country	Fund Name	Assets (\$billion)	Inception	Origin	SWF to Foreign Exchange Reserve Ratio
UAE - Abu Dhabi	Abu Dhabi Investment Authority	\$627.0	1976	Oil	13.9
Norway	Government Pension Fund – Global	\$445.0	1990	Oil	8.8
Saudi Arabia	SAMA Foreign Holdings	\$431.0	n/a	Oil	1.1
China	SAFE Investment Company	\$347.1		Non-Commodity	0.2
China	China Investment Corporation	\$288.8	2007	Non-Commodity	0.1
Singapore	Government of Singapore Investment Corporation	\$247.5	1981	Non-Commodity	1.4
Kuwait	Kuwait Investment Authority	\$202.8	1953	Oil	10.6
Russia	National Welfare Fund	\$178.5*	2008	Oil	0.4
China - Hong Kong	Hong Kong Monetary Authority Investment Portfolio	\$139.7	1993	Non-Commodity	1.0
Singapore	Temasek Holdings	\$122.0	1974	Non-Commodity	0.7
China	National Social Security Fund	\$82.4	2000	Non-commodity	nil
UAE - Dubai	Investment Corporation of Dubai	\$82.0	2006	Oil	1.8
Libya	Libyan Investment Authority	\$65.0	2006	Oil	0.8
Qatar	Qatar Investment Authority	\$65.0	2003	Oil	8.6
Australia	Australian Future Fund	\$49.3	2004	Non-Commodity	1.8
Algeria	Revenue Regulation Fund	\$47.0	2000	Oil	0.3
Kazakhstan	Kazakhstan National Fund	\$38.0	2000	Oil	1.1
Ireland	National Pensions Reserve Fund	\$30.6	2001	Non-Commodity	36.6
Brunei	Brunei Investment Agency	\$30.0	1983	Oil	
France	Strategic Investment Fund	\$28.0	2008	Non-Commodity	0.2
Source: http://www.swfinstitute.org/funds.php					

APPENDIX B: OVERVIEW OF US TREATMENT OF SOVEREIGN WEALTH FUNDS

In the US, section 892 of the Internal Revenue Code grants foreign governments a tax exemption for:

- investments in the US in stocks, bonds, or other securities owned by such foreign governments;
- investments in the US in financial instruments held in the execution of governmental financial or monetary policy; and
- interest on deposits in banks in the US of moneys belonging to such foreign governments.

For the purposes of section 892, 'foreign government' means the integral part and the controlled entities of a 'foreign sovereign'.

'Integral part' is broadly defined by regulations and includes, inter alia, any person, body of persons, organisation, agency, bureau, or fund that constitutes a governing authority of a foreign country, but does not include any individual who is acting in a private or personal capacity.

A 'controlled entity' is any entity separate in form from a foreign sovereign that: (1) is wholly owned and controlled (directly or indirectly) by the foreign sovereign, (2) is organised under the laws of the foreign sovereign by which it is owned, (3) has its net earnings credited to its own account or to the accounts of the foreign sovereign, with no portion inuring to the benefit of any private person, and (4) whose assets vest in the foreign sovereign upon dissolution.

Sovereign wealth funds will generally constitute either an integral part or, more likely, a controlled entity of a foreign sovereign for the purposes of section 892.

Tainting

Broadly speaking, there are 'tainting' or attribution rules contained in section 892. Under these rules, any sovereign exemption is lost if a foreign government's income is derived from commercial activities conducted *anywhere in the world*. The exemption is also forfeited if income is:

- received by or from (directly or indirectly) a 'controlled commercial entity'; or
- derived from the disposal of an interest in a 'controlled commercial entity'.

'Controlled commercial entity' and 'commercial activities' are defined terms for these purposes.

These 'tainting' rules mean that the commercial activities of one entity are imputed onto another entity. For example, the commercial activities of a parent corporation and partnership are attributed to its subsidiary and partners respectively (even if they do not conduct any commercial activities in their own right). However, the activities of a subsidiary or brother corporation are not attributed to its parent.