

Sovereign Wealth Funds: Tax Makes a Difference

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Although U.S. Treasury Department sources suggest that the term “sovereign wealth fund” has existed only since 2005, the United States Internal Revenue Code has included special provisions for certain sovereign funds since 1917. The preferential tax treatment for some sovereign funds has recently been a topic of increasing discussion on Capitol Hill, and no discussion of investment opportunities in the United States would be complete without considering the tax consequences of such investments, as well as debunking some myths that have arisen in public literature and Congressional testimony.

NOT ALL SOVEREIGN WEALTH FUNDS ARE CREATED EQUAL

Congress enacted Section 892 to provide special rules for the taxation of foreign governments. Congress did not benefit all entities that trace their ownership to a foreign government. In its current form, the statute reserves its benefits only for “foreign governments”, which includes (i) the integral parts of a foreign government and (ii) to a limited extent, entities controlled by the foreign government. For example, the central bank of a foreign country will normally qualify; but the Delaware subsidiary of a stateowned oil company will not benefit from Section 892.

The statute also distinguishes between entities that are owned by the foreign government and entities that are owned by a ruler as the ruler’s personal assets, although the line between the assets of the state and the assets of the ruler can sometimes be murky. Certainly not every “sovereign wealth fund” as proclaimed by the popular press will qualify for the special rules of Section 892.

NOT ALL INCOME IS CREATED EQUAL

A sovereign fund that qualifies under Section 892 will generally enjoy the following benefits:

- Income from investments in stocks, bonds or other US securities will be exempt from tax.
- Gain from the sale of minority interests in REITs and in other real estate companies, known as “FIRPTA”¹ companies, will be exempt from US tax.

Section 892’s benefits do not extend to all income:

- Commercial activity income is not covered.
- Investment income earned from a “controlled commercial entity” is not covered; for example, both dividend income received from a 50% or more owned US company and capital gains from the sale of a 50% or more interest in a FIRPTA1 company are not covered.
- Control means not just ownership of 50% or more of the relevant entity, but also includes a minority stake if the sovereign fund has “effective practical control” over the investment entity.

Sovereign fund investors need to understand whether they are investing as an “integral part” of a foreign government or as a “controlled entity.” Although both types of investors enjoy Section 892 benefits, different and more stringent rules apply to controlled entities. For example, a controlled entity with \$3 million of investment income and only \$1 of commercial activity income will lose the benefits of Section 892 on all of its income; but, an integral part of a foreign government in the same situation will pay tax on \$1 of commercial activity income, while still enjoying Section 892 benefits

on its investment income.

Finally, if Section 892 does not apply, all is not lost. Sovereign funds may rely on other US laws to exempt certain income, including most capital gains on stock and interest earned on portfolio debt. Although income tax treaties also provide beneficial tax treatment, the US does not have any tax treaties with, for example, Saudi Arabia, Kuwait or the UAE, so Gulfbased sovereign funds are generally unable to reduce their taxes under an income tax treaty with the United States.

NOT ALL COUNTRIES TREAT SOVEREIGN FUNDS EQUALLY

Other countries have different rules. For example, the UK adopts principles of sovereign immunity, such that a foreign government is immune from UK tax on income earned in its governmental function, but it is not exempt on commercial income. Furthermore, governmentowned entities do not benefit from the immunity.

French law exempts foreign states and certain foreign state entities from French capital gains tax and the French 3% tax, and also exempts dividend income. Whether this legislation would apply to most sovereign funds is not always clear. Germany, on the other hand, has no specific rules in its domestic law dealing with sovereign funds or foreign governments.

SCANNING THE HORIZON

For many years, the US tax system has exempted all foreign investors from tax on certain passive income, in part to make our stock markets accessible to foreigners and to encourage passive foreign investment into our country. Section 892 provides additional limited exemptions to sovereign funds, and these exemptions have been very useful for US financial institutions seeking funding to shore up capital in this turbulent economy.

What lies ahead for sovereign funds in the area of US taxation? Section 892 may receive legislative attention in the United States in 2009 once the election cycle is finished, particularly if Democrats are successful. Congress has already asked the New York State Bar Association to comment on possible changes to Section 892, but any legislative action will likely wait until the International Monetary Fund (IMF) and the World Bank conclude separate studies and announce their findings later this year. Due to the sometimes sensational coverage given to “sovereign wealth funds”, proposals to change the applicable tax regime are unlikely to fade soon.

Footnote: ¹ The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) is a law of the United States that applies to the sale of interests held by foreign corporations in real property located within the US.