SOVEREIGN WEALTH FUNDS AND THE PRINCIPLE OF STATE IMMUNITY FROM TAXATION. WHICH IMPLICATIONS FOR ECONOMIC DEVELOPMENT?

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Abstract: *Taxes levied by host States on transnational investments undertaken in their territory by Sovereign Wealth Funds (SWFs) owned by other countries have a relevant impact on the financial performance of SWFs and, finally, on the amount of wealth available to the States owning SWFs. As most owners of SWFs are developing countries and economies in transition and as SWFs are tools such States can use to promote sustainable economic development, the taxation of SWFs by host countries often has an impact on the developmental policies of the States which own SWFs. Starting from the analysis of the principle of State immunity, the paper will try to elaborate a theory on the taxation of SWFs which at the same time takes into consideration the role that SWFs play in the promotion of economic development.*

Contents

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Introduction

Sovereign Wealth Funds (SWFs) are State-owned and State-controlled investment vehicles which invest in foreign assets at least a part of the State-owned resources under their management[2]. In the last few years they have increased in size (according to recent estimates the assets under their management would amount to 3,752 billion USD[3]) and they have massively invested in foreign assets, in particular in sovereign and corporate bonds as well as in equity. In the present economic crisis many of them have reported severe losses and some SWFs are re-considering the investment strategies they have pursued so far[4]. Nevertheless, before the inception of the crisis, SWFs have obtained returns on their portfolio investments overseas and such a situation is expected to occur again as soon as the current turmoil in financial markets comes to an end. Therefore, the issue whether SWFs should pay taxes on income earned from their investments overseas remains important under the point of view of recipient and home States both[5].

From the point of view of recipient countries, granting immunity from taxation to SWFs and not to any other non-State investor could result into a discrimination of the latter and into an unreasonable

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[2] This is a concise definition I elaborated. See: Jen, Stephen; The Definition of a Sovereign Wealth Fund; Morgan Stanley; 2007; Kern, Steffen; Sovereign Wealth funds; State investments on the rise; Deutsche Bank Research; 2007; p 2; Das, Dilip K.; Sovereign-Wealth Funds: Assuaging the Exaggerated Anguish about the New Global Financial Players; Global Economy Journal; 2008; p.2. The definition provided by the International Working group for Sovereign Wealth Funds, which in many respect is regarded as the official definition, reads as follows: "Sovereign wealth funds (SWFs) are special purpose investment funds or arrangements that are owned by the general government. Created by the general government for macroeconomic purposes, SWFs hold, manage, or administer assets to achieve financial objectives, and employ a set of investment strategies that include investing in foreign financial assets". See: International Working group for Sovereign Wealth Funds Generally accepted principles and practices - "Santiago Principles"; IMF; 2008 p. 3

[3] Data reported by Sovereign Wealth Funds Institute. http://www.swfinstitute.org/ visited on 30-12-2009. Other studies suggest different figures (ranging from 2 trillion USD to 4 trillion USD) . The exact size of SWFs is unknown, among other things because in many cases data available are provided spontaneously by the SWFs themselves and, when they decide not to disclose such information, data are based on unreliable estimates. Moreover, the value of assets held by SWFs can change, in particular in the current period of high volatility of financial markets.

[4] Miracky, William; Bortolotti, Bernardo, ed.; Weathering the Storm: Sovereign Wealth Funds in the global economic crisis of 2008; FEEM; 2009; p. 53-58.

[5] In the present paper the expressions: "home State", "owner of SWF" and "State owning SWFs" can be used interchangeably, given the particular nature of SWFs as State-owned entities. Clearly, in case of non-State investment funds, like mutual funds, hedge funds and private equity funds, the owner of the fund and the home States clearly are different entities.

advantage to the SWFs. This would risk to distort competition, prevent an efficient allocation of resources and finally to damage the economies of the recipient countries[6].

From the point of view of home countries, which are the countries owning SWFs, exemption from source taxation in host States in principle entails relevant benefits, as a bigger share of the returns generated by the investments of SWFs should be available for the States which own SWFs. This would be of the utmost importance in developing countries which own SWFs and especially when such SWFs constitute a fundamental tool to stabilize and diversify the economy, reduce the dependency on the exploitation of natural resources, improve the management of foreign exchange reserves and, finally, contribute to the economic development. Likewise, the same fact that SWFs could be considered as performing a fundamental or even a vital function in the economy of the home State may constitute a further element supporting the argument that SWFs should be exempt from source taxation on their investment overseas. The present paper will focus on the issue of the immunity from taxation of the investments of SWFs from the point of view of home countries, and especially of those which can be classified as developing economies or economies in transition. It will also discuss the extent to which the role SWFs may play with respect to the promotion of the economic development of home States can be regarded as a valuable reason to recognize immunity from taxation to such SWFs.

When discussing the reasons supporting or opposing the SWFs exemption from taxation, two main arguments emerge. On one side, it could be argued that SWFs are State entities and immunity of States (and, to a certain extent, of State entities and instrumentalities) from the jurisdiction of other States is regarded as a principle of public international law. Therefore, SWFs should not be subject to the jurisdiction and also to the taxation of other States, consistently with the maxim "*par in parem non habet jurisdictionem*". On the other side, it could be held that, as SWFs undertake commercial activities in a way similar to any other investor, they should be subject to the same treatment to which any other investor is subject, also with respect to taxation.

In an attempt to address this issue, the present paper will first outline the current situation of SWFs owned by developing countries and economies in transition and of their foreign investments. It will also briefly review the tax policies that the main recipients of SWFs investments adopt with respect to them. Then the paper will try to develop a theory of taxing Sovereign Wealth Funds. It will start with the analysis of the issue of the immunity of States and of State agencies and instrumentalities. It will discuss whether the principles developed in the field of immunity from adjudication and from enforcement might apply to immunity from taxation as well. It will explain the development of the

[6] Fleischer; Victor; A Theory of Taxing Sovereign Wealth; New York University Law Review; 2009; p. 468-476; Desai, Mihir and Dharmapala, Dhammika; Taxing the Bandit Kings; Yale Law Journal Pocket Part, Vol. 118, 2008; p. 2.

law of State immunity and of its sources, highlighting the distinction which is currently drawn between the public activities of a State (*acta jure imperii*) and the State activities which do not entail the exercise of sovereign powers and which can be assimilated to commercial activities which can be performed by non-State actors too (*acta jure gestionis*). It will study which of them enjoy immunity from foreign jurisdiction and from taxation. Then it will discuss in which of the above mentioned categories of State acts the creation of SWFs and their investment activity can fall and this will make it possible to understand whether SWFs should be entitled to immunity from taxation. The paper will also study whether SWFs could be exempted from taxation on grounds other than the principle of State immunity. In particular it will be investigated whether, to the extent SWFs play an essential role in promoting development, tax exemption for their operations could be devised as a form of aid to development granted by the recipient States to the States which own SWFs (at least when the latter are developing countries). The last chapter of the paper will review the main instruments adopted by the International Community with the aim to governing the operations of SWFs and the policies of recipient States adopted in relation to the investments undertaken by such State-owned entities. An attempt will be made to underline their relevance with respect to the tax treatment of SWFs and their potential role in enhancing the application of the theory on the taxation of SWFs elaborated in the present paper.

1. The investments undertaken by Sovereign Wealth Funds and their tax treatment in recipient countries

A SWF is created with the aim to invest State-owned wealth. In particular its establishment is a consequence of windfall revenues a State experiences as a result of the sale of its natural resources in a period in which commodity prices are especially high (this is the case of commodity SWFs), or as a result of sustained and prolonged surpluses of the balance of payments which allow it to hoard relevant amounts of foreign currency (in the case of non-commodity or forex -foreign exchange- funds). A part of such State-owned wealth is not immediately consumed or invested in the domestic economy, also because the economy might be unable to absorb it immediately and entirely without the risk of waste, inefficient allocation of resources and macroeconomic backlashes like a rise of the inflation. On the contrary, wealth "in excess" is transferred to a SWF, which will invest it also overseas. The returns on such investments would be later available to the State owning the SWF, for future investments also in the domestic economy or future consumption or for macroeconomic stabilization purposes. For this reason SWFs play an important role in promoting sustainable economic development in States establishing and owning them[7]. Although SWFs are owned by developed countries too (for instance Norway, Ireland, Australia, some States of the US and Canada) many of them are established by developing countries and economies in transition, which are particularly dependent on the revenues from the exploitation of natural resources and/or which are especially vulnerable to sharp and destabilizing inflows and outflows of foreign currency. Therefore, especially in the case of developing countries and economies in transition, SWFs constitute a fundamental tool in the hands of State authorities in the pursuit of domestic developmental goals. The investments and the performance of SWFs are deeply intertwined with the economic development policies of the States establishing them. Therefore, source taxes levied by recipient States on the operations of SWFs owned by other States, as they can affect the performance and finally the amount of wealth under the management of SWFs, have a relevant impact on the economic development of the States owning SWFs.

As anticipated above, many SWFs are owned by developing countries and economies in transition. Amongst the biggest SWFs, two of them are owned by China: they are the SAFE Investment Company and the China Investment Corporation and they are reported to have assets under their management amounting to USD 347.1 billion (bn.) and USD 288.8 bn. respectively. In Africa the Libyan Investment Authority owns assets worth USD 70 bn., the Algeria Revenue Regulation Fund USD 47 bn., the Nigeria Excess Crude Account USD 9.4 bn. and in 1996 the small State of Botswana has created through the exploitation of diamonds, on which it is almost entirely dependent, the Pula Fund, which owns assets worth USD 6,9 bn. Several Latin American States have established SWFs: with the purpose to stabilize domestic revenues despite the high volatility of the international price of copper, Chile has established since 1985 its Social and Economic Stabilization Fund which now manages assets amounting to USD 21.8 bn. and in 2000 also the small Caribbean State of Trinidad & Tobago has used its oil revenues to establish a SWF. Brazil is currently creating its own SWFs to which almost USD 9 bn. have already been transferred.

Among the main countries regarded as economies in transition, Russia has established the National Welfare Fund which, together with the Oil Stabilization Fund, manages assets worth USD 178.5 bn. Other post soviet countries rich in oil reserves, like Azerbaijan and Kazakhstan, have established SWFs too.[8]

The main recipients of the investments of SWFs have been so far developed countries; in particular from 1995 to mid 2008, 37% of the total transaction volume of the investments of SWFs has been related to North American enterprises and 32% to Europe-based firms (especially British ones).

[7] For a more detailed explanation of the macroeconomic and developmental function of SWFs in the States owning them, see below chapter 4, 5 and 6 of the present paper and the literature quoted in the related notes.

[8] All data are provided for by Sovereign Wealth Funds Institute. http://www.swfinstitute.org/ visited on 30-12-2009.

This choice is largely explained by the fact that European and American capital markets traditionally offer the widest selection of investment opportunities denominated in safe currencies and a high level of liquidity. For this reasons they have seemed particularly able to absorb the large volumes big institutional investors like SWFs typically seek to allocate[9]. For instance, the main investments undertaken by China Investment Corporation in the last few years have targeted companies in the US (with the purchase of 9,9% stake in Morgan Stanley and other relevant participations in Visa and AES) and in Canada (a 17,2% stake of Teck Resources Limited, active in the mining sector)[10]. Libyan SWF has acquired stakes, *inter alia* in two of the biggest Italian enterprises respectively in the oil and in the banking sector: Eni and Unicredit. Investments undertaken by SWFs owned by Gulf States in particular in the American and European financial and banking sectors are countless.

Because so far developed countries have been the main recipients of the investments of SWFs, for the purposes of the analysis undertaken in the present paper it will be provided a short review only of the tax laws applicable to the investment of SWFs in developed countries. However, it should be remarked that in 2009 a change in the investment path of SWFs seems to have occurred, with a reduction of foreign investments in OECD countries and an increase of domestic investments and of investments directed to emerging markets[11]. If this trend will be confirmed, the approach followed in this chapter, which focuses on the taxation of SWFs in developed countries only, should be changed and tax laws of many other countries should be taken into consideration.

In the USA, SWFs' immunity from taxation is provided for in section 892 of Foreign Sovereign Immunities Act of 1976 ("FSIA").[12] This situation rises acute criticism and several authors argue that in such a way State-owned investors are given undue advantages relative to private-sector investors, thus causing distortion to free competition[13]. In any case it cannot be concealed the paradox that, while many policymakers and commentators emphasise the threats SWFs can pose to national security and while they ask for tougher regulation of their operation (or even a prohibition *tout court* of many investments of theirs)[14] the actual legal framework governing SWFs investment,

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[9] Steffen Kern; SWF's and foreign investment policies - an update; Deutsche Bank Research; 2008; p. 8-10

[10] Sovereign Wealth Funds Institute. http://www.swfinstitute.org/ page: http://www.swfinstitute.org/fund/cic.php visited on 30-12-2009.

[11] Miracky and Bortolotti; ed.; cit.; p. 14-19; Miracky William, Barbary Victoria, Fotak Veljko Bortolotti Bernardo; Sovereign Wealth Fund Investment Behavior: Analysis of Sovereign Wealth Funds Transactions during Q2 2009; Monitor Group and FEEM; 2009; p. 14-15.

[12] Joint Committee on taxation; Economic and US income tax issues raised by Sovereign Wealth Fund investments in the United States; 2008; available at http://www.house.gov/jct/x-49-08.pdf.; p. 56; Fleischer; cit.; p. 465-467

[13] Fleischer; cit.; p. 468-472; Melone, Matthew A.; Should the United States tax Sovereign Wealth Funds?; Boston University International Law Journal; 2008; Desai and Dharmapala; cit.; p. 2. However, other authors who do not share such a concern: Cui, Wei; Is Section 892 the Right Place to Look for a Response to Sovereign Wealth Funds; Tax Notes, Vol. 123, 2009; available online at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1413137##

[14] For a survey of the literature analyzing both the real and exaggerated dangers posed by SWFs see: Dilip K. Das; Sovereign-Wealth Funds: Assuaging the Exaggerated Anguish about the New Global Financial Players; Global

at least with respect to tax issues, is much more favourable than the one applicable to other categories of investors.

Also in the United Kingdom a SWF is exempted from taxation on passive investment income, but only if it is an integral part of the government of a foreign State, while the exemption is denied if it is an entity that is separate from the Government although owned by it. [15] This causes an unjustified discrimination between SWFs on the ground of the legal status they have in the country which owns them and irrespective of the nature of the actual activities they perform. In fact, if a State creates a SWF which is organised as a branch of the ministry of economy or of the central bank, its investments in UK shall be tax exempt; nevertheless the same economic operations shall be taxed in the UK whenever they are undertaken by a SWF which is organised as a State-owned corporation.

Many other important recipients of SWFs' investments do not follow the approach of the US and the UK. Australia and Canada, for instance, permit commercial investments by foreign sovereigns to be taxed: therefore SWFs should pay taxes, except when a tax treaty grants immunity from taxation to the SWFs of the other contracting party.[16] Japanese legislation provides that foreign government shall pay taxes on incomes earned in Japan; nevertheless a custom has developed according to which foreign States enjoy immunity *de facto*. There is not a specific provision related to SWFs in Japanese law: however SWFs are treated as any other investment fund and therefore they are liable to pay taxes[17].

Germany and Switzerland tax foreign governments on their passive investments in the same manner as any other foreign corporate entity. Therefore SWFs do not enjoy immunity from taxation in these States except otherwise provided in bilateral treaty: for instance the Swiss-Norwegian tax treaty

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Economy Journal; 2008; Truman, Edwin; A Blueprint for Sovereign Wealth Fund Best Practices; Peterson institute for international economics; 2008; Truman, Edwin; The Rise of Sovereign Wealth Funds: Impacts on US Foreign Policy and Economic Interests; Peterson Institute for international economics; 2008; Truman, Edwin; Four Myths about Sovereign Wealth Funds; Peterson Institute for international economics ; 2008; Truman, Edwin; Sovereign Wealth Funds: New Challenges from a Changing Landscape; Peterson Institute for International Economics; 2008; Siniscalco, Domenico; Governi alle porte. Crisi del credito e fondi sovrani; Mercato, Concorrenza Regole; 2008; p. 82 ; Steffen Kern; Sovereign Wealth funds; State investments on the rise; cit.; p. 14; Goldstein, Andrea and Subacchi, Paola; I fondi sovrani e gli investimenti internazionali - Salvatori o sovvertitori? In VVAA; L'Italia nell'economia internazionale. Rapporto ICE 2007-2008; ICE; 2008; p. 62 Biard, Jean-François; Fonds souverains; Revue de Droit bancaire et financier; 2008; Bahgat, Gawdat; Sovereign wealth funds: dangers and opportunities; International Affairs; 2008; p.1201; Rieltveld, Malan; ed.; New perspectives in sovereign asset management; Central Banking Publication; 2008; p. 26; Audit, Mathias; is the erecting of barriers against foreign sovereign wealth funds compatible with international investment law?; Society of international economic law; Working Paper No. 29/08; 2008; Lossani, Marco ed.; Osservatorio Monetario 3/2008; Laboratorio di Analisi Monetaria – Università Cattolica del S. Cuore; 2008 p. 33; Backer, Larry Catá; The Private Law of Public Law: Public Authorities as Shareholders, Golden Shares, Sovereign Wealth Funds, and the Public Law Element in Private Choice of Law; Tulane Law review; 2008; p. 56

[15] Directorate of Legal Research for International, Comparative, and Foreign Law of the US Congress; p. 49.

[16] Ibid.; p. 7 and p. 26

[17] Ibid.; p. 34

specifically exempts Norway's government, central bank, and oil fund from taxation on dividends earned from investments in Swiss companies.[18]

2. Immunity from taxation and its relations with the main principles of State immunities. The distinction between *acta jure imperii* and *acta jure gestionis*

From the review of the laws and practices of the main recipients of the investments of SWFs, it emerges quite clearly that an harmonised approach with respect to the taxation of SWFs substantially lacks, as some States apply the principle of State or Sovereign immunity, while others tend to treat SWFs as any other investor. In the following chapters it will be studied which should be the most correct approach, taking into account the commercial or governmental nature of the acts through which States create SWFs and of the acts through which SWFs carry out financial investments. The first step in this analysis shall consist in outlining the basics of the principle of State immunity from taxation. Only later it will be possible to study the applicability of such principle to the particular category of investors represented by SWFs. Most doctrinal studies on State immunity have focused on immunity from adjudication (the right not to be sued before the Courts of another State) and from enforcement (the entitlement not to have one's properties attached by enforcement measures adopted by another State). The present chapter will first outline the relation between immunity from adjudication and enforcement on one side and immunity from taxation on the other, it will assess to what extent the principles developed in the field of the former can apply to the latter and then it will study the current sources and the content of the principle of State immunity.

It should be preliminarily observed that the concept of immunity depends on that of jurisdiction. If State A is entitled to affect the right of persons by legislative, judicial and administrative means, this implies that State A has the jurisdiction to prescribe, to adjudicate and to enforce over such persons. Immunity of State B from the jurisdiction of State A means that B shall not be judged by the Courts of State A and shall not be affected by enforcement measures adopted by the authorities of State A.[19] However, with respect to the jurisdiction to prescribe, it can be denied that there is immunity. In fact, in their activities within the territory of a State, foreign States do not operate outside the local law and immunity is therefore not from the power of the forum to prescribe, but from the power to enforce the rules so prescribed. To exercise substantive jurisdiction over a

[18] Ibid; p. 29 and p. 45.

[19] ICJ: Arrest Warrant of 11 April 2000 (Democratic Republic of the Congo v. Belgium); Separate Opinion of Judge Koroma; par. 5.; Conforti, Benedetto; Diritto internazionale; 7. ed.; Editoriale scientifica, 2006; p. 178-179

foreign State is not to prescribe the rule, but it consists in applying such rule, even through the use of coercion, when necessary.[20]

According to some respects, immunity from taxation would fall within the notion of immunity from jurisdiction to prescribe, as taxing properties or income of a State located in the territory of another State depends on the existence of a law of the latter providing for such a possibility. Nevertheless, the power of the territorial State to levy taxes would rather relate to the notion of enforcement measures or *rectius*, to the sphere of the measures undertaken to ensure the application of the rules prescribed. I will not get into this complex, doctrinal question, I would only like to stress that the principle according to which foreign States and their properties should not be subject to taxation in other States, lies on the same theoretical and functional basis as the principles of immunity from adjudication and enforcement. They all draw from the principles of sovereignty, equality between States and non-interference in the affairs of other Sovereigns, as well as from the functional need to leave foreign States unencumbered in the pursuit of their mission. Once State A taxes the properties of State B located in its territory, it behaves as if B was subject to it instead of being its peer; in addition, this might affect the sovereignty of B and finally this might cause an undue interference in the ability of B to manage its sovereign affairs, by reducing its ability to freely dispose of its properties to this purpose.[21]

The sources of public international law providing for the principle of State immunity are the European Convention on State Immunity signed in Basle on 16 may 1972 and the United Nations Convention on Jurisdictional Immunities of States and Their Property, adopted by the United Nations on 2 December 2004. By January the 2nd 2010, the latter has not come into force yet, therefore it could not be regarded as a treaty source *strictu sensu*, but rather as a manifestation of the *opinion juris* of the international community about the issue of State immunity. Nevertheless, these two documents do not deal with immunity from taxation: in fact the UN Convention never mentions taxation and at art. 1 it specifies that it only applies to the “immunity of a State and its property from the jurisdiction of the courts of another State.” The European Convention, at art. 29 explicitly excludes tax issues from its scope, even when taxation is the object of a judicial proceeding. Therefore in the analysis undertaken in this paper more attention must be paid to another source of international law mentioned, *inter alia*, at art. 38 of the ICJ Statute: it is the international custom, which rises when the members of the international community follow a consistent practice for a relevant period of time *(duiturnitas)* with the convincement this is

[20] Crawford, James; Execution of judgement and foreign sovereign immunity; American Journal of International Law; 1981; p. 854; Fox, Hazel; The law of state immunity; Oxford University Press; 2002; p. 19.

[21] Fleischer; cit.; p .456-460; Brownlie, Ian; Principles of public international law; 6th ed.- Oxford: Oxford University Press; 2003; p. 322; Fox; cit.; p. 30 and p. 170.; Desai and Dharmapala; cit.; p. 2; Crawford; cit.; p. 856.

necessary and this corresponds to a legal obligation (*opinio juris sive necessitatis)*. State practice which is particularly relevant under this point of view is constituted by the decisions of domestic Courts establishing case by case whether they have jurisdiction in claims involving foreign States. They should be analysed in conjunction with the reaction of other States to such practice, with a focus on those States which are sued and on those States whose judges are required to enforce the decisions adopted by foreign courts on these issues. Finally, it is possible to derive the basic principles applicable to State immunity from a comparative survey of domestic legislation[22]. Such a comparative study cannot be carried out in this paper; which therefore will refer to principles and trends found out in the works of other authors. [23]

Until the beginning of the 20th century the basic principle of public international law applicable to State immunity was that of absolute immunity: States could never be sued before the courts of any other State and no enforcement measure was possible against their properties. A State could waive its immunity and subject itself to the jurisdiction of other States (and to enforcement measures too, although it was even rarer), but only pursuant manifesting its explicit consent to such a limitation of its own sovereignty. The principle of absolute immunity started to evolve during the first half of the 20th century. That age was characterised by the increase of the scope of State activities and of the sphere of intervention of States in the economy. Most States, not only in the socialist world but also in Europe and North America, undertook to directly manage an increasing number of activities which were no more strictly related to their sovereign powers (which traditionally were, for instance, diplomacy, war, fiscal issues) but which rather had a commercial character. This involved problems in particular when such commercial activities were performed abroad or when they entailed relations with other States or with persons which were nationals of other States. For instance the national of one State which concluded a contract with a foreign State entity on commercial matters (suppose for the sale of goods) would have not been able to sue it if this State entity decided not to pay him. This made it necessary to develop a restricted theory of State immunity, which today is still prevailing in State practice. It implies that immunity applies to *acta jure imperii* only, which means to public, governmental, acts that a State performs as a Sovereign, for example those related to immigration policies, the administration of justice, the conduct of war and diplomacy. *Acta jure gestionis* or *acta jure privatorum*, i. e. commercial acts a State performs as a private individual, like running a commercial enterprise or entering in business relations with

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[22] This method is in particular recommended by: Fox.; cit.; p. 67-130

[23] For a comparative study of provisions applicable to State immunity from adjudication and enforcement I especially relied on: Fox; cit.; and Dickinson, Andrew et al.; State immunity : selected material and commentary; Oxford University Press; 2004; Conforti; cit.; p. 178-179; Brownlie cit.; p. 322-337. For a comparative study of provisions applicable to State immunity from taxation: Directorate of Legal Research for International, Comparative, and Foreign Law of the US Congress; cit.

individuals, are not entitled to immunity anymore. The private or public character of the act of a State determines whether it can claim immunity from jurisdiction to adjudicate. Likewise, immunity from jurisdiction to enforce should apply only to State properties which are used to perform *acta jure imperii*. In the beginning States tended to follow a mixed approach, consisting in the application of the principle of restricted immunity from jurisdiction to adjudicate and of the principle of absolute immunity from jurisdiction to enforce. Nevertheless, this entailed the risk to make it useless the possibility to sue a State when there was not the possibility to force it to abide by unfavourable judicial decisions. Today most States endorse, although with some differences, the principle of restricted immunity with respect to adjudication and enforcement both. Also the UN Convention on Jurisdictional Immunities of States and Their Property tends to follow this approach, providing for the possibility, at art. 19 to waiver "State immunity from post-judgment measures of constraint" not only when the State has previously expressed its consent to this (par. a), but also when the property which makes the object of enforcement measures "is specifically in use or intended for use by the State for other than government non-commercial purposes and is in the territory of the State of the forum, provided that post-judgment measures of constraint may only be taken against property that has a connection with the entity against which the proceeding was directed" (par. c).[24] Some authors point out that some States still apply the absolute immunity, with the possibility to submit foreign States to domestic jurisdiction only when consent of the latter has been previously given. Therefore, it is better to consider the principle of the restrictive immunity as a current trend in the practice of the majority of States instead of as a well-established rule of customary international law.[25]

It might seem unclear whether the public character of a State act or of a State property depends on the status of the entity performing it or owning it (immunity *ratione personae*) or on the nature and the purpose of the act or of the property themselves (immunity *ratione materiae*). Nevertheless, if it is supported the principle of restricted immunity, then it could be argued that while it is necessary, in order to grant immunity, that an act and a property are respectively performed and owned by a State or a State entity, it is also necessary that such act or property are directly related to a manifestation of the sovereign and public power of the State (immunity *ratione materiae*). Some

[24] Donoho, Justin; Minimalist Interpretation of the Jurisdictional Immunities Convention; Chicago Journal of International Law; 2009; p. 663; Conforti; cit.; p. 227; Fox; cit.; p. 100-120; Brownlie, cit.; p. 323-326; De Meester, Bart; International legal aspects of Sovereign Wealth Funds: Reconciling international economic law and the law of State Immunities with a new role of the State; European Business Law Review; 2009; p. 811-812 Blane, Alexis; Sovereign immunity as a bar to the execution of international arbitral awards; New York University Journal of International Law and Politics; 2009; p. 454-504; Mafi, Homayoun; Iran's Concession Agreements and the Role of the National Iranian Oil Company: Economic Development and Sovereign Immunity; Natural Resources Journal 2008; p. 421-428; Pengelley Nicholas; Waiver of sovereign immunity from execution: arbitration is not enough; Journal of International Arbitration; 2009; p. 59-60. Foakes, Joanne and Wilmshurst, Elizabeth; State Immunity: The United Nations Convention and its effect; ILP BP 05/01; Chatham House; 2005

[25] Brownlie, cit.; p. 325; Pengelley, cit.; p. 861-871.

authors have finally underlined that the public character should be assessed with respect to the *nature* rather than to the *purpose* of the act or of the property of the State, but on this point there is neither broad consensus nor certainty[26].

3. The applicability of the principle of restricted immunity to the taxation of SWFs

The principles of restricted immunity from adjudication and enforcement should apply to immunity from taxation as well, because they all lie on the same theoretical and functional basis, as it had been explained in the previous chapter. For these reasons States, and State entities like SWFs, should be taxed on income or on properties which are related to their commercial or business activities and they should be entitled to immunity from taxation only with respect to assets and incomes strictly related to governmental activities. The mere fact that SWFs are State entities is not enough to conclude that they should be entitled to immunity from taxation. It is necessary to study their operations and to assess whether such operations are governmental or commercial in character, irrespective of the sovereign nature of the entity performing them. A further element which limits the utility of an approach which is exclusively based on the definition of SWFs as State entities and which does not consider the real nature of their activities, is related to the fact that SWFs are organised under the law of the State owning them in very different ways and therefore also the degree they are enshrined within the structure of the State-owner significantly varies. As it has been pointed out by the International Working Group on SWFs[27], many SWFs are established as separate legal entities of public law, with full capacity to act and governed by a specific constitutive law (first group). This is the case of the SWFs established by Kuwait, Korea, Qatar, and United Arab Emirates (Abu Dhabi Investment Authority, ADIA). Other SWFs take the form of state-owned corporations (second group). They are created in accordance to the corporate law of the State owning them and they differ from other investment vehicles, for instance mutual funds, because they are owned by the State. This solution has been adopted, *inter alia*, by the Singapore's Temasek Fund, by the Government of Singapore Investment Corporation (GIC) and by China Investment Corporation (CIC). Finally, SWFs can consist in pools of assets without a separate legal identity, owned and managed directly by the central bank or the ministry of economic affairs (third group). This occurs, for instance, in Botswana, Canada (Alberta), Chile, and Norway[28]. If an approach only

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[26] Foakes and Wilmshurst; cit. p. 4; De Meester, cit.; p. 813-814; Fox; cit.; p. 284-286; Donoho; cit.; p. 668.; Brownlie, cit.; p. 327; Mafi; cit. p. 421-428.
[27] For further information on the International Working Group for Sovereign Wealth Funds and the documents it has adopted see *infra*, chapter 7.
[28] International Working Group for Sovereign Wealth Funds; Generally accepted principles and practices - "Santiago Principles"; IMF; 2008; p. 11; International Working Group for Sovereign Wealth Funds; Sovereign Wealth Funds -

based on immunity *ratione personae* is followed, then there is the risk that recipient States could consider as States, and therefore recognise as entitled to sovereign immunity, only those SWFs belonging to the above mentioned third group and consider as corporations not entitled to immunity those SWFs included in the second group. In other words, some SWFs might enjoy State immunity and other might not, solely depending on the extent to which authorities of recipient States consider SWFs embedded in the organization of the State of origin and irrespective of the fact that the investment activities different kind of SWFs perform in the host States are actually the same[29]. In particular it must be underlined that most States secure immunity in relation to the acts and the properties of central banks[30]. As in some cases SWFs manage official reserves which have been transferred to them by central banks or they are even controlled or owned by central banks, then such SWFs would enjoy a special protection from the jurisdiction of the host State and an exemption from its taxation, thus provoking a discrimination against those SWFs which are established as separate entities from central banks.

This supports the need to look at the nature of the operations SWFs undertake. If SWFs' activity falls within the notion of *acta jure imperii*, then their income should not be taxed. Otherwise, they should be taxed like any other private investment fund. To address this issue, it is necessary to distinguish between two separate categories of home State acts concerning SWFs: first, those related to the creation of SWFs and second, those related to the investments SWFs undertake. Then it should be studied whether either or both of such categories of State acts fall within the notion of *acta jure imperii*. As SWFs, with respect to their source of financing, the reasons why they are established and the function they are required to perform, are divided between commodity funds and non commodity (foreign exchange or "forex") funds, it will be necessary to undertake such analysis for both categories of SWFs.

4. May the creation of SWFs be regarded as an act *jure imperii*?

There is a strong link between the creation of forex funds and the management of official reserves (foreign currency reserve), which in turn falls into the scope of the conduct of the monetary policy of a State. Usually official reserves are invested in short term and low return financial assets, for instance US treasury bonds, in order to ensure the maximum degree of safety and liquidity. When

current institutional and operational practices; IMF; 2008; Kern, Steffen and Reisen, Helmut; Commodity and non-commodity Sovereign Wealth funds; Deutsche Bank Research; 2008.

[29] Kirchner, Stefan; State-Owned Corporations and State Immunity in Europe; Institute for Public Law, University of Goettingen; 2006; p. 1-4; Centner, Terence J.; Discerning Immunity for Governmental Entities - Analyzing Legislative Choices; Review of Policy Research, Volume 24, Number 5; 2007; p. 425-440; Chamlongrasdr, Dhisadee; Defining a State for the Purposes of Immunity and Liability of a State and its Entities; European Business Law Review; 2005; p. 1287-1323; Fox; cit.; p. 323-360; Brownlie, cit.; p. 336.

[30] Blair, William; The legal status of central bank investment under English law; Cambridge Law Journal; 1998; p. 374-390; Fox; cit.; p. 360-367; Chamlongrasdr; cit.; p. 323-360

the amount of official reserves held by a State exceeds the level needed to effectively manage a State's short-term monetary policy, foreign currency in excess is transferred to a Fund controlled and managed directly or indirectly by the government or by the central bank and whose task is to invest such resources in a more profitable way, also purchasing riskier assets denominated in foreign currency. In this way forex SWFs are created. Differently from what occurs with other pools of official reserves, the main objectives the management of SWFs must pursue are the profitability and the safety (but with an higher level of risk tolerance) of investments, while liquidity is less important.[31] Therefore, SWFs are a tool for the management of official reserves and the creation of SWFs can be regarded as an integral part of the conduct of the monetary policy of a State. No one doubt that the exclusive management of the monetary policy by the State is a fundamental feature of its sovereignty: it can be concluded that the creation of forex SWFs is an act *jure imperii*.

With respect to commodity funds, it is more difficult to reach similar conclusions. Commodity funds are created in States rich in natural resources whose sale in the international markets determines to a great extent their level of wealth. It has been established, in particular by domestic Courts of European States as well as by international arbitral tribunal that the mere exploration, exploitation and sale of natural resources located on the territory of a State by the State itself cannot be regarded as a governmental activity. Likewise, State-owned companies established with the aim to exploiting local national resources, even though they are State entities, perform acts *jure gestionis* and are not entitled to sovereign immunity[32]. However, the issue of the immunity of commodity SWFs must be distinguished from that of State-owned companies operating in the field of natural resources, since SWFs' activity is related to the management of the *revenues* obtained from the sale of natural resources, rather than to the direct exploitation of the natural resources themselves. Any analysis of commodity funds should start from the evidence that commodities are very volatile assets as their price can change faster and more widely than that of many other assets like bonds, real estate and even shares. Commodity price fluctuations may have disruptive effects

[31] Johnson-Calari, Jennifer and Rieltveld, Malan, ed.; Sovereign wealth management; Central Banking publications; 2007; p. 15 -44; Rieltveld, ed.; cit.; p. 67; Goldstein and Subacchi; cit.; p. 56; Griffith-Jones, Stephany and Ocampo, José Antonio; Sovereign Wealth funds: a developing country perspective; Columbia University; 2008; Kern, 2007; cit.; p. 2; Kern and Reisen; cit.; p. 3; Reisen, Helmut; Fonds souverains et économie du développement; La Vie économique- Revue de politique économique; 2008; Subacchi, Paola Capital flows and emerging market economies: a larger playing field?; Chatham House; 2007; Van der Ploeg, Rick and Venables, Anthony; Harnessing windfall revenues in developing economies; VOX; 2008; available online at http://www.voxeu.org/index.php?q=node/1725; Beck, Roland and Fidora, Michael; The impact of Sovereign Wealth Funds on global financial markets; Occasional Paper series No 91 / July 2008; European Central Bank; Lossani, ed. cit.; p. 3; Butt Shams; Shivdasani, Anil; Stendevad, Carsten and Wyman, Ann; Sovereign Wealth Funds: A Growing Global Force in Corporate Finance; Journal of applied corporate finance; 2008.

[32] Delaume, Georges; Economic development and sovereign immunity; American Journal of International Law; 1985; p. 319-327; Mafi, cit.; p. 415-429.

on economies heavily relying on the proceeds from the exploitation of their natural resources. Therefore, States highly dependent on the proceeds of the sale of their natural resources and willing to reduce the problems this entails, have undertaken to create stabilization funds. States will transfer to stabilization funds a quota of the proceeds from the exploitation of natural resources when commodity prices are high and then they will be able to draw money from such funds when commodity prices are so low as to provoke a slump in State revenues.

A proper management of the revenues from natural resources would also require the creation of saving funds. The rationale underlying their establishment is the following one. Most natural resources (in particular mineral ones) are exhaustible. As their exploitation at present causes their depletion in the future, future generations will not be able to rely on the same proceeds current and past generations have obtained from such resources. This has severe consequences in States which have not been able to develop profitable sectors other than those related to the exploitation of natural resources. Saving funds allows to exploit natural resources at present and, at the same time, to set aside a part of the proceeds in a fund. The fund shall carry out investments in sectors others than those related to the exploitation of natural resources. The returns from such investments will ensure that future generations will enjoy the same level of wealth of current generations even when natural resources are exhausted.[33] When stabilization funds and saving funds invest abroad, then fall into the definition of SWFs.

Commodity funds undertake an activity which is indispensable to ensure the stability of State revenues related to natural resources. One could wonder whether this can be regarded as an act *jure imperii*, in which there is a clear manifestation of the sovereign power of the State. Some States establishing SWFs are low-income countries, with a relevant number of people under the threshold of poverty and they are highly dependent on the exploitation of their natural resources. In their case sharp fluctuations of revenues from the sale of commodities can have disruptive effects on their safety and security. Preventing these dangers from occurring is therefore a fundamental task of a State and the acts it undertakes to this purpose, which can consists *inter alia* in the creation of stabilization and saving funds, could be regarded as *acta jure imperii*. However, it should be noted that not all the States with commodity SWFs are in the conditions described above. Among the owners of commodity funds there are also Norway, Alaska, Alberta, and it would be difficult to assess that fluctuation of commodity prices might threaten their national security or the survival of their populations. The situation is even more blurred in case of middle-income countries which are not completely dependent on their natural resources (Russia, for example) or several States of the

[33] Johnson-Calari; cit.; p. 47-70; Barbieri, Michele; Developing countries and their natural resources – From the elaboration of the principle of permanent sovereignty over natural resources to the creation of Sovereign Wealth Funds; UNCTAD -Virtual Institute; 2009; p. 26-27; Griffith-Jones, and Ocampo, cit; p. 9-12; Kern and Reisen; cit.; p. 1-10.

Gulf region which are even high-income countries but whose degree of dependency on oil revenues is extreme. It is hardly conceivable that tax authorities or Courts of the States where commodity SWFs invest might undertake, case by case, an effective and correct analyse of the level of wealth and of dependency on natural resources of the State owner of the SWF and that on such a basis decide whether the creation of SWFs is an act *jure imperii* giving rise to the obligation to accord immunity from taxation to the income earned by the SWFs at issue.

In addition, it can be argued that the acts of a State establishing a commodity SWF are not so different from the acts any private individual may undertake when he decides to set aside some money during a period in which he earns more in order to be able to have easy access to liquidity in the future if its income decreases. When an act of a State is similar to those activities private individuals perform, this constitutes a strong evidence that it falls within the category of *acta jure gestionis*. As a result, in this case a SWFs should not be entitled to sovereign immunity.

In summary, it seems that while the creation of forex SWFs can be regarded as an act *jure imperii*, it can be difficult to assess that the same occurs in case of commodity SWFs. With respect to the consequence this may entail in relation to the issue of immunity from taxation, it can be questioned whether a different fiscal treatment of commodity and forex funds is feasible. In my view the answer should be negative for two reasons. First, as it will be better explained in the next chapter, the asset management and the investment activity undertaken overseas by commodity and non commodity SWFs does not present differences which might justify different tax treatment. Second, it is not always easy to distinguish between these two categories of SWFs in practice. For instance the sale of oil by a State-owned enterprise in the international market entails an increase of the governmental revenues and at the same time an increase of the reserves of foreign currency (mainly dollars) the government itself or the central bank own. In this case, if such revenues are transferred to a SWF it is questionable to assess that it is a commodity and not a forex fund.

The approach consisting in focusing on the reasons why SWFs are created does not allow to answer to the question whether SWFs should be entitled to immunity from taxation. It is thus necessary to analyse SWFs investment activity and to assess if it can be regarded as a sovereign or commercial act.

5. May the investments of SWFs be regarded as acts *jure imperii*?

A popular idea, which in the last months has been dismissed by an increasing number of authors and policymakers, is that the investments of SWFs are driven by political and not by commercial reasons. In other words, SWFs investment strategies would not aim at maximizing returns (as any other investment fund, like a private equity or an hedge fund might do), but at unduly pursuing political and strategic advantages. For instance SWFs could be tools used by a State to seize direct control of strategic sectors of other States (for instance the defence sector, but also the telecommunications and the utilities), thus enabling it to obtain information related to the national security of the host State or to unduly interfere with its domestic affairs. In addition, SWFs could invest and divest in the financial markets of another State (maybe its enemy or its competitor) in order to disrupt the stability of its financial markets[34]. In these cases qualification of the investments of SWFs as *acta jure gestionis* would be doubtful. Although the operations of SWFs would be formally commercial in character, actually their purpose and nature would be clearly governmental and political. However, in these cases the host State would not admit the investment of SWFs, so the issue of taxing the income obtained by SWFs from to their investments overseas would be no more relevant.

Actually evidence has so far demonstrated that SWFs are mainly portfolio investors and even when the stake they own in a foreign company allows them to appoint some members of the board, they often do not avail themselves of such a possibility. For these reasons they have been defined as passive investors, and they have not threatened to seize control of strategic firms. They have invested in sectors which were supposed to ensure the higher profitability (for instance banks, although given the losses they have reported so far, today this might sound strange), while they have practically neglected the defence sector and other sensitive industries. They have proven long term and counter-cyclical investors, therefore the fear they can contribute to the instability of financial markets is ungrounded. In summary, it can be affirmed that SWFs have pursued investment strategies similar to those of other long-term non-State investors[35]. On one side this means that SWFs in principle do not represent a threat and therefore that their operations should not be prevented as a rule, but only monitored, controlled and restricted in limited circumstances. On the other hand this implies that SWFs undertake a commercial activity which clearly falls within the scope of *acta jure gestionis*: therefore, income they earn in this way must be taxed.

An objection can be made. In the case of forex funds, the performance and the return of the investments of SWFs have direct consequences on the amount of the official reserves of a State (at least on those transferred to the SWF itself) and, as a result, on the monetary policy of the State. In case of commodity funds, the outcome of the investments affects the size of saving and stabilization

[34] Mason, Ruth; Sovereign Wealth Funds and the Efficient Management of the Wealth of Nations; Tax Notes; 2008; p. 1321-1322; Edwin M. Truman; Four Myths about Sovereign Wealth Funds; Peterson Institute for international economics; 2008; Edwin M. Truman; Sovereign Wealth Funds: New Challenges from a Changing Landscape; Peterson Institute for International Economics; 2008; Goldstein; cit.; p. 63.

[35] Kern, Steffen; SWF's and foreign investment policies - an update; Deutsche Bank Research; 2008; p.6-17; Fernandes, Nuno; Sovereign Wealth Funds: Investment Choices and Implications around the World; IMD working paper series; 2009; p. 11-20; Rose, Paul; Sovereign Wealth Funds: Active or Passive Investors?, The Yale Law Journal pocket part; 2008; p. 104-108;

funds ad as a result the possibility to achieve the aim that their creation pursues. As some of these issues, in particular those concerning the management of official reserves, fall within the scope of the sovereign activities of a State, it could be argued that investment activity of SWFs is only apparently commercial, but actually it has a governmental character, to the extent to which its outcome affects sovereign functions of a State. This argument should be rejected for two reasons. First of all this approach would end up focusing again on the establishment of SWFs rather than on their investment activity: in the previous chapter it has already been explained why this method is unworkable. Second, it can be argued that almost any act *jure gestionis* performed by a State can have an impact on the wealth and on the finances of such State and in this sense it might affect the availability of State's resources to finance other State activities falling within the category of *acta jure imperii*. If we adopt such approach the category of *acta jure gestionis* shall result dramatically restricted or it would even cease to exist. This would be inconsistent with the development of the law of State immunity which has been described above at chapter 2.

Another reason why SWFs should not be immune from taxation is that they are the first ones to claim that they act as any other investor. They declare they just seek to maximize the return on their investments and they don't pursue any political aim. Clearly such a pledge is motivated with the fact that SWFs don't want to be perceived as pursuing political objectives and therefore as constituting a threat to the public security of the host State. In this way they try to convince recipient States not to hinder or restrict their investments. Therefore, on these basis an acceptable compromise can be found. As SWFs demand to be treated like any other commercial investor in the sense that they require not to be subject to restrictions and controls other than those applicable to any other foreign investor in the recipient State, they should also accept to be treated as any other private investor also with respect to the fiscal treatment[36]. This means that it would be reasonable to argue that income tax levied on SWFs should be the same levied on any other subject which report similar income: SWFs should pay taxes on interests, dividends and capital gains in the countries where they invest. In case of tax treaties in force between the State owning SWFs and the recipient State, the benefits accorded to taxpayers of the contracting party, shall be extended to SWFs, which should be regarded as a national of the State owning them.[37]

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[36] De Meester, cit.; p. 814-815.

[37] As regards the applicability of tax treaties to SWFs see *infra*, chapter 7

6. Immunity from taxation granted to SWFs owned by developing countries as a form of aid to development

In chapter 4 it has been explained why commodity SWFs play an important role in the efficient management of the wealth generated by the exploitation of the natural resources of States and it has been investigated whether this should be sufficient to consider their creation and their subsequent investment activity as an *act jure imperii*. Although it has been demonstrated that the answer to this question must be negative, this nonetheless does not mean that a tax exemption granted by host States to the income earned by SWFs would be irrelevant with respect to the purpose of achieving sustainable economic and social development in the States creating SWFs.

With respect to Forex SWFs, no in depth discussion in relation to their role in promoting development has been undertaken in chapter 4 and 5 where it only had been proved that the establishment of forex SWFs (but not their subsequent investments) since it is intertwined with the conduct of the monetary policy of a State, is an act *jure imperii*. Nevertheless forex funds also are a fundamental tool in the hands especially of developing countries and economies in transition to promote sustainable economic development and in the next part of the present chapter it will be briefly explained why. As it was stressed in chapter 4, Forex SWFs are created when a State owns foreign exchange reserves in excess and when it therefore decides to transfer a part of them to a SWFs which shall manage them differently from the way central banks and monetary authorities usually manage their reserves of foreign currency. The proper management of foreign exchange, be it under the responsibility of the central bank or of a SWF, (but sometimes the distinction between these two entities is very blurred[38]) has a relevant impact on the ability to ensure sustainable economic and social development, as it can reduce the risk of massive and destabilising capital inflows and outflows and of sharp fluctuations of the exchange rate with the severe effects they may have on the competitiveness of the economy of a State, its inflation and its ability to continue to finance its developmental policies. As developing countries and economies in transition have traditionally proven particularly vulnerable to sudden stops in capital inflows or to massive capital outflows accompanied by disruptive devaluation, inflation and budgetary crisis, the accumulation of foreign exchange reserves has increasingly been regarded as a way to cope with this kind of risks. For instance, it is not a coincidence that the accumulation of relevant foreign exchange reserves in South East Asia has started in the aftermath of the 1997 crisis, when the States of that region, desiring to prevent another crisis of this nature from occurring and disappointed by the support they received in previous occasions by international economic organizations like the International

[38] In several cases, the SWF is an agency of the central bank itself, so the distinction between a central bank and a WFs is very difficult to operate in practice. See above, chapter 3

Monetary Fund, decided to increase and strengthen their own foreign currency reserves.[39] The issue is to assess which is the proper level of such reserves, because while insufficient reserves are not able to protect a State against the macroeconomic problems mentioned above, also maintaining excessively broad reserves entails relevant economic costs. The prevailing approach in the past suggested that reserves should cover at least 3 months of imports: in this way States would have avoided import bottlenecks in the event of an adverse external shock in their trade balance. Since the late 1990s, this theory has been gradually replaced by the Guidotti-Greenspan rule, which states that reserves should equal short-term external debt (one-year or less maturity), implying a ratio of reserves-to-short term debt of 1. This theory is considered more suitable for financially integrated countries, as in today world most countries, even developing and in transition, are. It focuses more on the impact of short-term financial flows than on the trade balance. The rationale of the Guidotti-Greenspan Rule is that countries should have enough reserves to resist a sudden and massive withdrawal of short term foreign capitals. If we apply either methods to several emerging economies, in particular China and the countries of South East Asia, it emerges that the reserves they have far exceed the recommended level. [40] The reserves in excess constitute the wealth which could and should be transferred to SWFs, also in order to reduce the costs that maintaining a too much high level of reserves might entail. The extent to which forex SWFs can smoothly carry out their investments overseas thus affects the quality and the effectiveness of the management of the reserves of foreign currency and, in conclusion it has an impact on the economic development of the owners of SWFs.

In chapter 4 and 5 and in the first part of this chapter it has been explained that the the principle of State immunity from taxation should not be used as a valid justification to exempt SWFs from paying taxes on the income they earn from their investments overseas. However it has also been proven that both commodity and non-commodity SWFs play a relevant role in the promotion of economic development in the States owning them, in particular when such States are developing countries or economies in transition. Therefore it could be discussed whether exemption from taxation to the investments of SWFs owned by developing countries or economies in transition could be justified not on the ground of the principle of State immunity, but to the extent it constitutes a form of aid to development. In other words, the host States, when refraining from taxing the returns obtained in their territories by a SWF owned by a developing country would act as if they were facilitating the achievement of the developmental goals pursued by a SWF and as if

[39] Lossani; ed. cit.; p. 3-11; Elson, Anthony; Sovereign Wealth Funds and the International Monetary System; The Whitehead Journal of Diplomay and International Relations; 2008; p. 71-79

[40] South Centre; Capital flows from south to north: a new dynamic in global economic relations; South Centre Analytical Note SC/GGDP/AN/GEG/8; July 2008; p. 3-4; Kern and Reisen; cit.; p. 8-9

they were transferring to the developing country at issue a relevant quota of wealth. This theory can also be supported by the evidence that many States owning a SWF and using it to invest overseas are also recipients of official aid to development: this occurs for instance in the case of Algeria, Azerbaijan, Botswana, Chile China, Kazakhstan, Libya, Nigeria, Oman, Trinidad and Tobago, Venezuela[41].

The idea of exempting SWFs from taxation as a form of aid to development should nonetheless be refined and detailed, in order to prove useful in practice. Following the rationale underlined above, only SWFs owned by developing countries and economies in transition should be exempt from taxation. But then several doubts emerge. First: should all the SWFs established by States belonging to such categories be exempted? Or should exemption be limited to SWFs owned by LDCs only, or by countries particularly dependent on the exploitation of their natural resources or by those especially vulnerable to capital outflows and where the need to keep large foreign exchange reserves to prevent currency crisis is extremely acute? Another issue which should not be neglected is that SWFs *could be* and *should be* a tool for the promotion of sustainable development, but this does not mean that they always and necessarily act like this. When SWFs are opaque instruments in the hands of corrupt and unaccountable elites which use the enormous wealth under their management in order to pursue their personal interests or other objectives inconsistent with the promotion of the wellbeing of the People of the State which has established the SWF (the same People which should always be regarded as the ultimate owner and beneficiary of the SWF), then granting a more favourable tax treatment to such SWFs would not result in an effective form of aid to development. According to these concerns, further requirements should thus be attached to SWFs owned by developing countries and economies in transition in order to make them eligible to tax exemptions. For instance it should be required that they should meet certain standards of transparency: in this way recipient States will be able to verify that tax exemption in favour of SWFs really results in a valuable aid to development.[42] Finally it could be questioned whether only developed countries which are the recipients of the investments of SWFs should exempt such State-owned investors, or whether developing countries too should be encouraged to do so. For instance the tax exemption accorded by a poor African State to the China Investment Corporation would result into an aid to development granted by the former to China and its opportunity and fairness could clearly rise several doubts. This last issue is getting more important as the number of

[41] Keenan, Patrick J.; Sovereign Wealth Funds and Social Arrears: Should Debts to Citizens be Treated Differently than Debts to Other Creditors?; Virginia Journal of International Law; 2009; p 440-442

[42] Keenan; cit.; p. 439-471; Barbieri, Michele; Developing countries and their natural resources – From the elaboration of the principle of permanent sovereignty over natural resources to the creation of Sovereign Wealth Funds; UNCTAD -Virtual Institute; 2009;

investments by SWFs owned by emerging economies undertaken in developing countries has been increasing in 2009[43].

It is difficult to provide a satisfactory answer to all these questions and to decide in practice the criteria according to which certain SWFs should be exempt from taxes to the extent they can be regarded as tools for development. The ambition of the present paper is not to solve all these issues, but only to stress that any attempt to consider whether SWFs could be exempt from taxes because of their developmental function cannot escape an in depth discussion of all such problems. However, it is even possible that at the end of such a discussion it will be concluded that the idea of granting selective tax exemptions to SWFs in relation to their developmental function is not feasible or useful, also because of the impossibility to properly address all the questions and concerns I have highlighted above.

In any case one suggestion can be made. The criteria which would allow to assess which SWFs should be entitled to tax exemptions because of their developmental functions should not be autonomously decided host States acting individually, also because this would further jeopardise the tax treatment of the transnational operations of SWFs and it would offer a pretext for disputes concerning alleged unreasonable discriminations between SWFs owned by different States. It would be better to establish at the international level some standards providing for a guidance to States which desire to differentiate the tax treatment they mean to apply to SWFs. This would entail that the International Community, also through the adoption of an instrument of soft law, might first of all enhance the principle that the income earned by some SWFs from their investment overseas should be tax exempt, to the extent such a more favourable tax treatment constitutes a form of aid to development. The same instrument of soft law should also provide the basic criteria according to which recipient States shall decide which SWFs are eligible to tax exemptions. The elements that could be taken into consideration might be: the level of income of the States owning the SWFs, their degree of dependency on a few natural resources, further particular elements of vulnerability of its economy. In addition, also the level of transparency of the SWFs at issue, together with the soundness and effectiveness of their legal framework and of their operational strategies, should be considered. The next chapter will provide a short overview of the international instruments adopted in relation to SWFs and of the ongoing works of the main international organisations on this subject[44]. It will study the extent to which they might have a relevance in relation to tax issues too

[43] Miracky and Bortolotti; cit.; p. 14-19; Miracky, Barbary, Fotak and Bortolotti; cit.; p. 14-15;

[44] For a more detailed review of such works, see: Audit; cit.;. p. 3-5; Barbieri, Michele; The international regulation of Sovereign Wealth Funds – Which role for the European Union? UNCTAD -Virtual Institute; 2009; p. 9-10; Gugler, Philippe and Chaisse, Julien; Sovereign Wealth Funds in the European Union: General trust despite concerns; NCCR TRADE Working Paper No 2009/4; 2009; Epstein, Richard A. and Rose, Amanda M.; The Regulation of Sovereign

and if they could be used as a preliminary step towards the establishment of a legal framework governing the taxation of SWFs at the international level.

7. International instruments governing the operations of SWFs and their relevance with respect to tax issues

A brief review of the ongoing works of international organizations in relations to SWFs should focus on the initiatives promoted by the International Monetary Fund (IMF) and the Organization for Economic Cooperation and Development (OECD). The IMF has supported the creation of the International Working Group of Sovereign Wealth Funds (IWG), which is a summit of 23 IMF member countries with SWFs trying to identify the best investment practices SWFs can voluntarily promise to follow when they undertake investments overseas. In October 2008 the IWG has adopted a set of general accepted principles and practices (GAPP) which have also become known as the "Santiago Principles". Such document describes itself as a voluntary code of conduct "that the members of the IWG support and either have implemented or aspire to implement".[45] On April 6, 2009 in Kuwait City the IWG reached a consensus to establish the International Forum of Sovereign Wealth Funds. The Kuwait Declaration[46] provides that the Forum "will be a voluntary group of SWFs" whose "purpose will be to meet, exchange views on issues of common interest, and facilitate an understanding of the Santiago Principles and SWF activities". Nevertheless such international institutionalized meetings, actually focus on *the practice of SWFs* and they do not seem to be the most suitable context to deal with *tax policy issues of recipient States*. To the purposes of the present paper, only one issue deserves particular attention, among those addressed by the Santiago principles: it is the issue of transparency, to which also the GAPP devote special consideration. In fact, the Santiago Principles leave broad discretion to SWFs as regards their organization, structure, legal framework and investment strategies, merely recommending SWFs to refrain from taking advantage of privileged information or inappropriate influence in the conduct of their businesses and from abusing of their particular status in competing with private firms. However, the GAPP require SWFs to disclose which are, *inter alia*, their governance framework, their organization, investment strategies (in particular if they use derivatives and leverage), the degree of independence of their management, their relations with the government of the State

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Wealth Funds: The Virtues of Going Slow; The University of Chicago Law Review; 2009; p. 111-141; De Meester; cit.; p. 797-800

[45] IMF; Sovereign Wealth Funds—A Work Agenda; IMF; 2008; p. 3; International working group for sovereign wealth funds; Generally accepted principles and practices - "Santiago Principles"; IMF; 2008; p. 3 ; Kern; 2008; cit.; p. 18; Rieltveld; ed.; cit.; p. 55.

[46] International Working Group of Sovereign Wealth Funds; "Kuwait Declaration": Establishment of the International Forum of Sovereign Wealth Funds; April 6, 2009 available online at: http://www.iwg-swf.org/mis/kuwaitdec.htm

owning them. In summary, SWFs are not recommended to behave in a specific way but only to disclose how they have decided to behave. The promotion of an higher degree of transparency could help SWFs themselves to increase their accountability and finally their effectiveness in order to enhance their function as real tools of economic development. In addition, this could help host States to better evaluate which SWFs should be entitled to a tax exemption because they will be able to understand when a tax exemption to a SWF really contributes to the economic development of the owner-State or when it simply results into a "gift" made to unaccountable elites managing the fund and benefiting of it to the exclusion of anyone else.

The other international organisation which is undertaking important works as regards SWFs is the OECD, which has focused on those policies and practices recipient States have adopted or are likely to adopt in relation to the investments of SWFs in their territories. In April 2008 the OECD has prepared a report on SWFs and Recipient Country Policies and on its basis it has adopted, on the occasion of the Ministerial Council Meeting on 4-5 June 2008 in Paris, the “declaration on SWFs and Recipient Country Policies”. This non-binding document affirms some general ideas according to which SWFs in principle bring a beneficial contribution to the world economy and that they could rise legitimate concerns only when they are not sufficiently transparent, they are not economically motivated and they unduly pursue political objectives. Therefore recipient countries should not erect protectionist barriers to foreign investment and should not discriminate among investors in like circumstances. Foreign investments should only be restricted when they raise national security or public policy concerns; in any case measures taken to this purpose should be transparent, predictable and proportional to clearly-identified national security risks. [47] Tax issues are not explicitly mentioned, nevertheless it can be argued that when the declaration stresses the importance of “treat[ing] similarly situated investors in a similar fashion” might also refer to the principle of tax neutrality according to which persons in similar situations should be similarly taxed, unless a competitive advantage to the less taxed person is meant to be granted. This could be interpreted, under a fiscal point of view, as a non-binding recommendation not to apply higher taxes on SWFs in order to discourage their investments. Actually, as it has been explained in the first chapter, in some countries like the US and the UK there is rather the opposite problem: that SWFs are even secured a more favourable tax treatment.

On November 25th 2009, the OECD has published a short document titled "discussion draft on the application of tax treaties to State-owned entities, including Sovereign Wealth Funds"[48] (the

[47] OECD; Sovereign Wealth Funds and recipient countries- Working together to maintain and expand freedom of investment; OECD; 2008; available online at: http://www.oecd.org/dataoecd/0/23/41456730.pdf ; Rieltveld; ed.; cit.; p. 55.

[48] OECD; discussion draft on the application of tax treaties to State-owned entities, including Sovereign Wealth Funds; OECD; 2009, available online at: http://www.oecd.org/dataoecd/59/63/44080490.pdf

"discussion draft") whose aim is to start a debate on the taxation of the cross-border investments undertaken by State-owned entities, also in relation to the need to update the OECD model tax Convention and the related commentaries.

The first issue analysed in the discussion draft is whether tax treaties concluded by States on the basis of the OECD model convention should apply to SWFs too and, as a result, whether SWFs should be entitled to the same benefits accorded to other persons covered by the tax treaties. According to art. 1 of the most recent version of the OECD model tax Convention[49], it "shall apply to persons who are residents of one or both of the Contracting States"; art 4 then specifies which persons shall be regarded as residents and *inter alia*, it mentions contracting States themselves and all their political subdivisions or local authorities. The discussion draft points out that "issues may arise, however, in the case of *entities set up and wholly-owned* [emphasis added] by a State or one of its political subdivisions or local authorities. Some of these entities may derive substantial income from other countries and it may therefore be important to determine whether tax treaties apply to them (this would be the case, for instance, of sovereign wealth funds [...])." The discussion draft seems therefore to distinguish between SWFs on one side and the State or the State political and local subdivisions which may establish SWFs on the other side. It also takes into consideration that in some cases States, when concluding tax treaties based on the OECD model convention, "modify the definition of "resident of a Contracting State" in paragraph 1 of Article 4 and include in that definition a "statutory body" or an "agency or instrumentality" of a State, a political subdivision or local authority, which would therefore cover wholly-owned entities that are not considered to be a part of the State or its political subdivisions or local authorities" as it is the case of several SWFs. In fact, as it was explained above in chapter 3, SWFs are organised under the law of the State owning them in very different ways: some of them can be regarded as political/administrative subdivision of the State, while others are constituted as separate legal entities of public law or corporate law. The latter can be regarded as covered persons under a tax treaty if a modification of the definition provided for at art. 4 of the OECD model convention is made as suggested above. In conclusion, if States desire to ensure the application of tax treaties to SWFs too, when they conclude a tax treaty they should specify, in the articles providing the scope *ratione personae* of the treaty itself, that it shall also apply to statutory bodies or agencies or instrumentalities of a contracting State or of its political subdivisions and local authorities as well as to other entities owned by a contracting State or by its political subdivisions and local authorities. This is especially important to the extent States, as it has been recommended in the present paper, regard the operations of SWFs owned by third countries as *acta jure gestionis* and therefore to be

[49] OECD; articles of the model convention with respect to taxes on income and on capital [as they read on 17 July 2008]; OECD; available online at http://www.oecd.org/dataoecd/43/57/42219418.pdf

treated like the transactions undertaken by any other investor also with respect to the applicability of the provisions of tax treaties. However, when States grant immunity from taxation to SWFs, the importance of ensuring them some of the benefits provided for by the articles of tax treaties is significantly reduced; in fact, if an entity simply is not subject to taxation, it has no interest in benefiting, for instance, of the provisions against double taxation contained in a tax treaty. The discussion draft recognises that several States grant immunity from taxation to other States, to their local and political subdivisions as well as to their agencies and their instrumentalities. It declares that the tax treaties adopted on the basis of the model convention shall not "be interpreted, however, as affecting in any way the possible application by each State of the customary international law principle of sovereign immunity." The discussion draft reminds that "there is no international consensus, however, on the precise limits of the sovereign immunity principle. Most States, for example, would not recognise that the principle applies to business activities and many States do not recognise any application of this principle in tax matters. There are therefore considerable differences between States as regards the extent, if any, to which that principle applies to taxation " In fact, as it was underlined in chapter 2 of the present paper, the principle of State immunity first of all is devised with respect to immunity from jurisdiction to adjudicate and to enforcement and its extension to taxation, although in my view recommendable and correct, rises nonetheless some theoretical and practical difficulties. In addition, the distinction between *acta jure imperii* and *acta jure gestionis*, whose utility and validity has been supported in the present paper, could be described more as a prevalent trend in the practice of the international community rather than as a well established rule of customary international law whose content is clear and well defined[50]. The discussion draft underlines that "States often take account of various factors when considering whether and to what extent tax exemptions should be granted, through specific treaty or domestic law provisions or through the application of the sovereign immunity doctrine, with respect to the income derived by other States, their political subdivisions, local authorities, or their statutory bodies, agencies or instrumentalities." Then it provides a non-exhaustive list of such relevant factors, which include the issue of reciprocity, the distinction between *acta jure imperii* and *acta jure gestionis*, the distinction between income derived from a portfolio or a direct investment and whether the assets and income of State-owned entity, like the SWFs, which are carrying out investments overseas, are used for "public purposes". The discussion draft specifies neither the scope of the notion of "public purposes", nor its relation with the character *jure imperii* an act of a State might have[51]. However it has been explained in chapter 4, 5 and 6 of the present paper that

[50] See, *supra*, note 25

[51] In other words, it remains unclear whether, according to the discussion draft, an act performed by a State for public purposes is for this same reason an act *jure imperii* and vice versa or if the notion of act *jure imperii* and act performed

both commodity and forex SWFs play an important role in the promotion of sustainable economic development in the States owning them (especially when such States are developing countries and economies in transition) since they contribute to the improvement, respectively, of the management of the revenues from the exploitation of natural resources and of the conduct of monetary policy and the use of foreign exchange reserves. The pursuit of such aims must be regarded as pertaining to the notion of "public purposes" mentioned in the discussion draft. This could therefore support the theory of exempting SWFs from taxation because of their role in promoting sustainable and sound economic development in developing countries and economies in transition, as this can actually be regarded as a public purpose.

According to the discussion draft itself, the revised version of the OECD model convention and of the related commentaries is scheduled for the second half of 2010. From the wording of the discussion draft it does not seem that the model convention will include provisions establishing whether the principle of State immunity from taxation should be applied to the operations of SWFs. It is also unlikely that it will establish whether SWFs should be exempted from taxation with respect to other motivations. This choice shall remain in the power of States, in accordance with their domestic law and the way in which they interpret and apply the principle of State immunity. The proposals for the upgrading of the commentaries of the OECD model convention could suggest States to specify in the tax treaties they conclude whether SWFs and other State-owned entities investing overseas shall be covered persons and therefore whether the provisions of the tax treaties shall also apply to them. In addition, the same tax treaties should specify whether contracting parties will mean to exempt SWFs from taxation and possibly under which conditions, in order to ensure an higher level of predictability in the tax-related aspects of the cross-border investments undertaken by SWFs and other State-owned entities.

Conclusions

This paper has tried to answer to the following fundamental question: shall SWFs pay taxes on the income they earn on their investments overseas?

It has explained that, with respect to this issue, the current practice of States which are the main recipients of the capitals of SWFs is rather inconsistent, as some apply the principle of State immunity from taxation to SWFs while others subject SWFs to income taxes as they do with any other investor. The paper has then tried to develop a theory of taxing SWFs. It has explained why

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for public purposes should remain separate. In the last hypothesis also an act which is commercial in nature could be undertaken with the aim to pursuing public purposes. In the present paper the latter approach will be endorsed and therefore it will be reasonable to consider that the operations of SWFs, although they are not *acta jure imperii*, in any case pursue public purposes too.

the principles elaborated by the doctrine in the field of the immunity of foreign States from jurisdiction to adjudicate and to enforce should be extended to immunity from taxation too. It has supported in particular the need to distinguish between *acta jure gestionis* and *acta jure imperii* and to grant immunity from taxation to the latter only. It has demonstrated that while the creation of SWFs in some cases may be regarded as an act *jure imperii*, actually their investments activity always fall within the notion of commercial activity. Therefore SWFs should pay taxes on income earned from their portfolio investments overseas. This is linked to the more general concept that, to the extent SWFs act like private investors seeking to maximize their revenues and not pursuing political aims, they should be treated in the same way as any other investor, also as regards taxation. Then this paper has explained the role played by SWFs in promoting sustainable development in the countries establishing and owning them. It has underlined that such function is really fundamental in developing countries and economies in transition and it has investigated whether this could justify an exemption of SWFs from income taxes on an autonomous ground than the one represented by the application of the principle of State immunity. In this way host State tax policies exempting SWFs would be regarded as a form of aid to development. Although the present paper has concluded that tax exemption in favour of certain SWFs owned by developing countries and economies in transition and effectively used by them as a tool for development could be desirable in principle, it has also stressed that this could prove extremely difficult to implement in practice. In fact the criteria host States shall adopt in order to decide which SWFs shall be eligible to tax exemptions risk to end up to be unpredictable and discriminatory. The best solution should be therefore to decide such criteria at the international level, for instance through the adoption of instruments of soft law providing standards and guidance to States desiring to grant exemptions from taxation to some SWFs as a form of aid to development. Existing international instruments applicable to SWFs have been quickly reviewed, but it has emerged that none of them explicitly deal with the issue of the taxation of SWFs. However, the emphasis they put on transparency can have an impact on tax issues too and on the possibility to implement the theory proposed in the present paper. In fact, if tax exemptions must be granted to SWFs which actually and effectively pursue developmental goals in the interest of the population of the States owning them, transparency is necessary to assess whether SWFs really are tools for development and therefore entitled to tax exemptions. Finally, the present paper has discussed the ongoing works undertaken by the OECD with the aim to revising and upgrading the OECD model tax Convention and the related commentaries, so that they might take into consideration the tax-related issues of the growing cross-border investments undertaken by State owned entities like SWFs. It seems to emerge that they will not provide a conclusive answer as to whether SWFs should be tax exempt, but they could recommend States to specify, when they conclude tax treaties, whether they intend to exempt from taxation SWFs owned by the other contracting parties. This should help to increase the level of predictability and effectiveness of the cross-border operations of SWFs.

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