THE TAXATION OF FOREIGN INVESTMENT IN AUSTRALIA BY SOVEREIGN WEALTH FUNDS: WHY HAS AUSTRALIA NOT PASSED LAWS ENSHRINING THE DOCTRINE OF SOVEREIGN IMMUNITY?

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The doctrine of sovereign immunity as it is applied in taxation law allows for foreign governments to be exempt from income tax on their passive investments, as opposed to direct foreign investments ('FDI') in a number of jurisdictions. The US, for example, has legislated for the recognition of sovereign immunity in relation to withholding taxes on foreign investments by foreign governments and sovereign wealth funds ('SWFs'). However, Australia has not passed similar laws enshrining this exemption for SWFs or State Owned Enterprises ('SOEs'). The Australian Treasury and other interest groups have advocated the need to have similar laws enacted in Australia in order to compete for foreign investment and to formalise the law. Simply requiring SWFs and SOEs to apply for a private ruling from the Australian Taxation Office is not sufficient when other countries have enshrined this immunity in their domestic law. Private rulings only apply to the particular taxpayer and are only granted for a limited number of financial years. However, with the growth in foreign investment by China and in particular through SOEs predominantly in mining and agricultural land, it would appear that the Australian government is reluctant to formalise the taxation exemption for political reasons. The issue of Chinese

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investment in mining and agricultural land has been politicised by various sides of politics in Australia and appears to be of great public concern. The paper will examine the doctrine of sovereign immunity in relation to taxation and then discuss the current situation with foreign investment by China through SOEs and other government sovereign funds. The paper will then assess the merits of formally granting the sovereign immunity from taxation for SWFs and Chinese SOEs and the likely political repercussions in Australia. The main thrust of the paper is that the political considerations appear to have dominated this area of taxation law and that the lack of formal recognition of the immunity from taxation is threatening the future of foreign investment in Australia.

1. INTRODUCTION

The government of Australia welcomes foreign investment.[1] It is regarded as enhancing the wellbeing of Australians by supporting economic growth and prosperity.[2] Moreover, it is seen as bringing many benefits in the form of supporting existing jobs; creating new jobs; encouraging innovation and opening access to new overseas markets.[3] For the financial year ending June 2012, the Foreign Investment Review Board ('FIRB') had approved foreign investment of AUD 170.7 billion with real estate attracting the largest percentage of investment.[4] Foreign investment from investors in the United States is by far the largest source followed by investors from the United Kingdom and then China.[5]

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[1] Commonwealth, *Australian Government, Foreign Investment Review Board: Annual Report 2011-2012* (2012) 35.
[2] Ibid.
[3] Ibid.
[4] Ibid xi.
[5] Ibid.

Foreign investment in Australia takes the form of passive or portfolio investment, or direct investment, FDI. In the case of passive investment, a foreign national purchases a minor interest in the shares of a private or public company or units in a private or public unit trust. The level of investment, if less than ten percent, is considered to be a passive investment due to the fact that the investor has no direct involvement in the management of the particular business or the intention of establishing a long term interest in the business. As the OECD Report states, the objectives of direct investment are different from those of portfolio investment whereby investors do not generally expect to influence the management of the enterprise.[6] On the other hand a FDI in a business is greater than ten percent and is usually of a 'lasting interest'. It may involve a 'hands on' or direct involvement in the management of the business activity. The OECD Report provides the following explanation of FDI:

> Direct investment enterprises are corporations, which may either be subsidiaries, in which over 50% of the voting power is held, or associates, in which between 10% and 50% of the voting power is held, or they may be quasi-corporations such as branches which are effectively 100% owned by their respective parents.[7]

This article is concerned with the issue of sovereign immunity applying to foreign investment by SOEs and SWFs which would result in the elimination of withholding taxes on their passive investments in Australia as opposed to FDI. FDI does and should attract income tax on profits generated through commercial activity in Australia and, as will be discussed later in this article, is not covered by the doctrine of sovereign immunity.

The issue of foreign investment in Australia has become a highly sensitive political issue especially in relation to Chinese

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[6] OECD, *OECD Benchmark Definition of Foreign Direct Investment* (4th ed, 2008) 17 ('OCED Report').
[7] Ibid.

investment in resource projects and agricultural land. For example, the controversy over the sale of the 'Cubbie station' to Chinese interests elicited the following headline in *The Australian* newspaper: 'Cubbie station goes to China for "a steal".'[8] According to Drysdale and Findlay, the rapid rise of China and Chinese investment in the Australian resources sector has caused some discomfort for Australian governments especially as a result of the BHP takeover bid for Rio Tinto and the involvement of Chinalco and the Sinosteel investment in Western Australia.[9] Added to this is the Chinese investment in the Cubbie Station, an agricultural property producing cotton which reportedly sold for $240 million.

The above examples of Chinese investment in Australia are not examples of passive investment but FDI. It is only passive investment that is the focus of this article, and it is only passive investment by foreign entities that would attract the doctrine of sovereign immunity.

On 24 July 2012, the then Opposition leader, Tony Abbott, now the Prime Minister of Australia, created controversy when he stated that 'it would rarely be in Australia's national interest to allow a foreign government or its agencies to control Australian businesses.'[10] In effect he reinforced the 'national interest' test as the major determinant of allowable foreign investment which would exclude Australian business ownership by a foreign government or government agency such as a Chinese SOE. This much publicised statement added to the public perception that in some way foreign investment by SWFs or SOEs was harmful to

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[8] J Walker, 'Cubbie station goes to China for "a steal"', *The Australian* (Sydney), 26 January 2013.
[9] P Drysdale and C Findlay, 'Chinese foreign direct investment in Australia: policy issues for the resources sector' (2009) 2 *China Economic Journal* 133, 153.
[10] Angus Grigg, 'Abbott warns China on takeovers', *Australian Financial Review* (Sydney), 24 July 2012.

the national interest. However, the Prime Minister, in his recent efforts to develop a free-trade agreement between Australia and China, stated that the FIRB restrictions on foreign investment by Chinese SOEs should be reduced and that the public should not be overly concerned about 'selling off the farm'.[11] This new attitude is a complete about face by the Prime Minister from two years ago and may help in bringing about a formalisation of the taxation exemption under the doctrine of sovereign immunity.

Drysdale and Findlay examine the additional guidelines that were introduced by the Australian government in February 2008 specifically to address investment by Chinese SOEs.[12] These guidelines were intended to strengthen the national interest test, but it is arguable as to whether or not they were necessary.[13] Over the past 10 years the political response to foreign investment in Australia, and in particular by Chinese SOEs and SWFs, has been to cater to the electorate by threatening to strengthen the scrutiny of all foreign investment while at the same time being receptive to foreign investment by all foreign investors. It is contended in this paper that the main reason why the sovereign immunity from withholding taxes by SOEs and SWFs has not been formalised is for political reasons and not sound economic reasons. Put simply, the government does not want to be seen favouring foreign investment in Australia where Chinese SOEs may be involved. A further example of anti-Chinese investment in Australia can be seen in the poll conducted by the Lowy Institute. The *Lowy Institute Poll 2013* shows that 57 percent of Australians believe that the Australian government allows too much foreign investment by Chinese SOEs and SWFs, and this may have had an influence on the Commonwealth government when it comes

[11] David Crowe, 'Trust Key to FTA, PM tells China', *The Australian* (Sydney), 12 April 2014, 1.
[12] Drysdale and Findlay, above n 9, 147.
[13] Ibid 149.

to formalising the immunity from withholding taxes.[14] The percentage of Australians opposed to Chinese investment has remained at this level for the past three years.[15] Indeed, the *Lowy Institute Poll 2012* showed 81 percent of Australians saying that they were against foreign companies buying Australian farmland to grow crops and livestock.[16]

On 14 December 2013, the former Assistant Treasurer, Senator the Hon Arthur Sinodinos, announced the outcome of consultations over the backlog of 92 announced but unlegislated tax and superannuation measures. One of those measures was to clarify the sovereign immunity exemption. Measure 58 – 'Taxation exemptions for foreign governments (sovereign immunity)' which was to 'clarify and codify the exemption currently provided to foreign governments and their investment bodies for dividend and interest income from passive investment in Australia', was not to proceed. It was first proposed to be legislated by the former government as a result of the 2005-06 Mid- Year Economic and Fiscal Outlook ('MYEFO').[17] This action by the current Australian government would appear to finally relegate the formalisation of sovereign immunity to the back of the line and it may not reappear for many years to come. This could have serious repercussions for future investment in Australia by SWFs and SOEs.

Foreign investment in Australia is made directly or indirectly by a variety of foreign entities, and it is investment by foreign governments or government agencies that has attracted a form of

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[14] Alex Oliver, 'The Lowy Institute Poll 2013: Australia and the World', (2013) *Lowy Institute for International Policy*, 6 ('*Lowy Institute Poll 2013*').
[15] Drysdale and Findlay, above n 9,149.
[16] Fergus Hanson, 'The Lowy Institute Poll 2012: Public Opinion and Foreign Policy', (2012) *Lowy Institute for International Policy*, 3 ('*Lowy Institute Poll 2012*').
[17] Arthur Sinodinos, 'Integrity restored to Australia's taxation system' (Media Release, 14 December 2013) <https://axs.ministers.treasury.gov.au/media-release/008-2013/>.

exemption from certain income taxes. The second part of the paper will examine the doctrine of sovereign immunity as it applies to taxation maters. This will include an examination of the current foreign investment environment that exists in Australia, and will clarify the type of investment that is being made and the entities making the investment. From this perspective two issues will be briefly discussed: FDI as opposed to indirect or portfolio investment and second, the nature of the entities making an investment in Australia. In this context sovereign wealth funds, state owned pension funds and state owned enterprises are the main groups that are affected by immunity from certain income taxes. These different bodies of investor will be discussed briefly in this part of the paper. The third part of the paper will assess the taxation immunities granted to SWFs and SOEs by other countries keen to attract foreign investment, especially from China. The final part of the paper will draw a conclusion as to what the Australian government should do in the future.

2. DOCTRINE OF SOVEREIGN IMMUNITY

Under customary international law sovereign states are granted immunity from the jurisdiction of another state, thus endorsing the concept that all sovereigns are equal.[18] In effect this means that no sovereign is subject to the courts in another country except where they engage in commercial activities.[19] The doctrine of immunity has been extended not only to sovereign states but also to representatives and agencies of those states. This paper is not intended to examine the rationale for the doctrine as the focus of this paper is on the taxation aspects of sovereign immunity in Australia. For a full examination of the doctrine of sovereign immunity, the 1984 Law Reform Commission report on 'Foreign

[18] G Triggs, *International Law: Contemporary Principles and Practices* (LexisNexis Butterworths, 2006) 380.
[19] Ibid.

State Immunity' provides a most comprehensive examination of the history of the immunity and the exclusions from the immunity for commercial transactions and other matters.[20] The following examination of the domestic law formalising the existing customary international law relating to sovereign immunity is important because it specifically states that it does not apply to taxation. It would appear that the ATO has been given the role of applying their own interpretation as to how customary international law should apply to sovereign states when confronted by taxation issues. This aspect of the doctrine of sovereign immunity is discussed below.

As a result of the Law Reform Commission Report the Australian government formalised the doctrine of sovereign immunity by enacting the *Foreign States Immunities Act 1985* (Cth) ('*FSIA*'). The Act provides for a restricted immunity from the jurisdiction of Australian courts for foreign states and their separate entities. A 'foreign state' is defined in s 3 as a country which is outside Australia and is an independent sovereign state or a separate territory that is not part of an independent state. In terms of a SWF or SOE, s 3 provides a definition of a 'separate entity' which covers those particular entities. The definition states that a 'separate entity means a natural person or a body corporate or corporation sole (not Australian) who or that is an agency or instrumentality of a foreign State and is not a department or organ of the executive government of the foreign State.'[21]

The next issue is whether the immunity applies where the foreign investor is a SWF or SOE, and they are investing directly or indirectly in an Australian business or entity which may be construed as being of a commercial nature.

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[20] Australian Law Reform Commission, *Foreign State Immunity*, Report No 24 (1984) [17]-[31] ('*Law Reform Commission Report*').
[21] *FSIA* s 3 (definition of 'separate entity').

The immunity is restricted to the extent that it excludes the exemption where the sovereign State is engaged in commercial transactions, s 11.

> Sub-section 11(3) states that a 'commercial transaction' means a commercial, trading, business, professional or industrial or like transaction into which the foreign State has entered or a like activity in which the State has engaged and, without limiting the generality of the foregoing, includes:
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> (a) A contract for the supply of goods or services;
> (b) An agreement for a loan or some other transaction for or in respect of the provision of finance; and
> (c) A guarantee or indemnity in respect of a financial obligation; but does not include a contract of employment or a bill of exchange.[22]

A good example of a SOE engaging in a commercial transaction is found in the High Court case of *P.T. Garuda Indonesia Ltd v Australian Competition & Consumer Commission*[23] where the High Court upheld an action by the ACCC against Garuda Airlines for price fixing. Garuda Airlines, which is 95.5 percent directly owned by the Republic of Indonesia, with the remaining 4.5 percent shareholding held by government controlled corporations associated with Indonesian airports, was found to be a separate entity of a foreign State.[24] Further, the High Court confirmed the decision of the Full Bench of the Federal Court that the sovereign immunity did not apply to Garuda Airlines because it was engaged in a commercial transaction as defined in s 11(3), *FSIA*. The conduct of commercial airline freight services to Australia were dealings of a commercial, trading and business character and therefore

[22] Ibid s 11(3).
[23] [2012] HCA 33.
[24] *FSIA* s 22.

satisfied the definition pursuant to s 11(1), *FSIA*.[25] The conduct of engaging in price fixing arrangements with other airlines engaged in the transport of goods to Australia contravened Part IV of the *Trade Practices Act 1974* (Cth). The Garuda Airlines case is relatively clear in determining what activity constitutes a commercial transaction, but this issue is far from clear in many instances. The spectrum of conduct that relates to the issue of sovereign immunity ranges from passive investment in a portfolio of equities at the bottom of the spectrum through to FDI of 10 percent or more, and at the other end commercial activity that is covered by subsection 11(3) of the *FSIA*. This range of activity and its implications for sovereign immunity in the taxation area will be examined in detail in the third part of this paper. However, prior to that examination it is important to note that the *FSIA* specifically excludes immunity from taxation.

2.1 Immunity from Taxation

It is of note that the *FSIA* specifically states at s 20 that a foreign state is not immune in proceedings that concern an obligation or law with respect to taxation. In effect the section confirms that if a foreign state, or an entity of that state, is involved in court proceedings for the payment of tax then it will not be able to obtain immunity from the proceedings. The Act does not define the term 'tax' and it is arguable that all forms of tax, both direct and indirect by all levels of government in Australia, would be included. The Australian Law Reform Commission 'recommended that a foreign state be not immune in proceedings concerning an obligation imposed on it by a provision of a law of Australia that relates to taxation …'[26] The Commission also stated that if a sovereign state should not be

[25] *Garuda Indonesia Ltd v Australian Competition & Consumer Commission* [2012] HCA 33, [46].
[26] Australian Law Reform Commission, above n 20, 66.

subject to a specific tax then this should be reflected in taxation legislation and not foreign state procedural immunity.[27]

In 1984 the Australian Law Reform Commission contended that an immunity from income tax or any other tax should be reflected in the appropriate piece of taxation legislation and not part of the foreign state immunity process. The ATO appear to have departed from this approach to the interpretation of the principles of customary international law by issuing the ATO Interpretative Decision 2002/45 and the subsequent private rulings which allow for sovereign immunity from withholding taxes in certain circumstances.[28]

It is contended that the current state of sovereign immunity in relation to taxation has reached a ludicrous state. From 1984 until 2015 no further change has been made by an Australian government. In 2009 the Australian Labor Government asked Treasury to investigate the introduction of legislation, and then on 14 December 2013 the current Coalition government postponed any further action on this issue. For a period of over 30 years nothing has been done to formalise an exemption from taxation that has been allowed only by way of an administrative process through the ATO. As stated in the introduction to this paper, an Australian government should pass appropriate laws to amend the *Income Tax Assessment Act 1997* (Cth) (*'ITAA 97'*) to properly formalise an exemption for certain income taxes for SWFs and SOEs. Clearly successive governments in Australia have been concerned with the political repercussions, and as such have been very reluctant to proceed with this matter. The current situation in Australia with SWFs and SOEs and the tax exemption will now be examined.

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[27] Ibid 65.

[28] ATO ID 2002/45 'Withholding tax sovereign immunity' (2001) Australian Government Legal Database (24 January 2002) ('*ATO Interpretative Decision 2002/45*').

3. The Australian situation

The basic contention in this paper is that a codification of the existing administrative practices to exempt sovereign investors' passive income from withholding taxes would provide certainty and thus encourage investment into Australia by Chinese SOEs and other SWFs. This contention is supported not only by the Australian Treasury but also many of the large accounting and law practices.[29] It is also supported by the fact that the previous Labor Government intended to pass legislation amending the *ITAA 97*. It is important for Australia to provide an incentive for Chinese SOEs to continue to invest in Australia because although Australia is currently the largest recipient of Chinese investment, other countries such as the US are quickly becoming more attractive. Despite the gains that could be made from formally amending the *ITAA 97*, the reluctance to change the current administrative practice is largely a political one. The previous Australian government formally requested the Australian Treasury to conduct a public enquiry into the merits of formally codifying the law instead of relying on the long standing practice of ATO private rulings. Since the original request for submissions to the Australian Treasury, which opened in November 2009, three consultation papers have been released, the last on 20 April 2011, however nothing has changed.[30]

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[29] Rhys Jewell, 'Sovereign Immunity back to the Future' (April 2014) *Corrs Tax Newsletter* 6 <https://www.corrs.com.au/assets/thinking/downloads/10729388NewsletterTAXCorrsTaxationApr14.pdf>; Tony Mulveney, *Sovereign Immunity exemption remains nebulous* (26 February 2014) KPMG <www.kpmg.com/au/en/issuesandinsights/articlespublications/tax-insights/>.

[30] Australian Treasury, *Codification of the Tax Treatment of Sovereign Investments* (2009) <http://archive.treasury.gov.au/content/int_tax_codification.asp?ContentID=760&titl=Review%20of%20International%20Taxation%20Arrangements>. The first consultation paper was released on 30 November 2009 requesting submissions from the public. The second consultation paper was released on 23 June 2010 requesting further submissions from the public. The third

This part of the paper will briefly discuss the current situation in Australia where no formal immunity from withholding taxes has been granted for SOEs and SWFs. At best, SOEs and SWFs rely on administrative practices. Prior to examining the current situation in Australia it is important to understand the role that the FIRB plays in granting approval for SOEs and SWFs to invest in Australian businesses or corporations. This will be followed with an examination of what constitutes a SOE and a SWF.

3.1 The role of the Foreign Investment Review Board

FDI in Australia is regulated by the *Foreign Acquisitions and Takeovers Act 1975* (Cth), and administered by the FIRB. The FIRB also has an advisory role on policy for the Australian Treasurer and the government, especially in relation to investment proposals that may not be consistent with the 'national interest'. Ultimately the Treasurer makes the final decisions on whether or not an investment proposal is rejected on the basis that it is contrary to the national interest.[31] Foreign investors have no right of review from a decision made by the Treasurer, and the *Administrative Decisions (Judicial Review) Act 1977* (Cth) specifically exempts review of those decisions under the Act.[32] In terms of FDI, the FIRB will scrutinise investments that exceed certain thresholds or are a certain type of investment. However, all direct investment proposals by foreign governments or their related entities must seek prior approval regardless of the value of the investment.[33] Moreover, if the foreign government or related entity wishes to start a new business or to acquire an

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proposals paper was released on 20 April 2011 and again inviting submissions by the public.

[31] Drysdale and Findlay, above n 9, 148.

[32] *Administrative Decisions (Judicial Review) Act 1977* (Cth) para (h) sch 1.

[33] Commonwealth, *Australian Government, Foreign Investment Review Board*, above n 1, Appendix A 'Australia's Foreign Investment Policy' 36.

interest in land, including any interest in a prospecting, exploration, mining or production tenement, then they must obtain prior approval from the FIRB.[34] Passive or indirect investment by foreign entities or private foreign investors are not subject to FIRB approval if the level of investment in the Australian corporation or business is less than 15 percent.

For non-foreign government or related entity investors, prior FIRB approval must be obtained if the proposed investment amounts to 15 percent or more in an Australian business or corporation that is valued above AUD 248 million.[35] However, for US and New Zealand investors the prior approval threshold is AUD 1078 million.[36] For investment in developed commercial property the threshold is AUD 54 million, except that the higher threshold applies for US, New Zealand, Chilean, Japanese and Korean investors.[37] For investment in residential property, all foreign investors must obtain prior approval unless the developer has obtained pre-approval to sell to foreign investors.[38]

The next issue to be examined is what is the difference between a FDI requiring FIRB approval and an indirect or portfolio investment that does not require prior approval? As stated above, direct investment in an Australian business or company by a foreign investor requires prior approval from the FIRB if the investor is a foreign country or related entity. The FIRB considers that an investment constituting 15 percent or more of a business or company will create a direct investment.

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[34] Ibid.

[35] Ibid 37.

[36] Ibid.

[37] Ibid. As a result of the Japan-Australia Economic Partnership Agreement and the Korean-Australia Free Trade Agreement the higher thresholds now apply to the three extra countries.

[38] Ibid 45.

3.2 Current administrative practice

The current administrative practice of exempting certain income derived by foreign governments is contained in the ATO Interpretative Decision 2002/45.[39] This interpretive decision essentially states that income from non-commercial activities undertaken by a foreign government or a foreign government agency is exempt from withholding tax in Australia. In effect, ATO Interpretative Decision 2002/45 provides a 'soft law' approach to exempting a foreign government agency from withholding tax on dividends and interest instead of a formal legislative provision in the *ITAA 97*. An interpretative decision only provides a certain level of comfort to a taxpayer in so far as it will prevent interest or penalties being applied by the ATO if at some future date the government makes law contrary to the ATO Interpretative Decision 2002/45. It is not as secure as a private ruling, but again both administrative approaches to this issue of sovereign immunity fall short of a formal legislative solution. There is no domestic law in existence in Australia which provides support for this approach by the ATO, even though it complies with the customary international law.

The ATO Interpretative Decision 2002/45 states that sovereign immunity applies to exempt dividend and interest income from withholding tax provided the following three tests are satisfied:

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

[39] *ATO Interpretative Decision 2002/45*.

The ATO Interpretative Decision 2002/45provides a guide as to what the ATO considers to be commercial activity. Commercial activity is described as being concerned with the trading of goods, such as buying, selling, bartering and transportation, and includes the carrying on of a business. This is in line with the definition contained in the *FSIA*, s 11(3). The Commissioner of Taxation expressly adopts the approach contained in the *FSIA* as guiding the application of the customary international law principles in relation to sovereign immunity. As discussed above, this type of activity is at the end of the spectrum of commercial activity. The ATO Interpretative Decision 2002/45 goes on to identify the type of investment activity that would be exempt. The decision states that income derived from holding shares in a company as a passive investment would not constitute the carrying on of a business. A holding of 10 percent or less of the equity of a company will generally be accepted as a non-commercial activity and dividends would be exempt from tax. The 10 percent holding limit is regarded as a ‘safe harbour’ test. More details of this test are discussed below.

Over the years, foreign governments, SWFs and SOE have applied to the ATO for private rulings in order to confirm the application of the sovereign immunity to their investments in Australia. They apply for the ruling before making an investment in Australia and it may take some time before the ruling is issued. Ruling applications require the services of large accounting or legal practices. However, it must be noted that private rulings are just that: private in the sense that they are between the Commissioner and a particular taxpayer about their own tax affairs. They apply only to the applicant for the ruling and are used by an applicant who wants to know the Commissioner’s view of the tax law. A taxpayer who does not abide by the ruling may be subject to penalties for ignoring or not applying the ruling. Section 357-60 in Schedule 1 of the *Tax Administration Act 1953* (Cth), makes private rulings binding on the Commissioner in

relation to a person to whom the ruling specifically applies and who also relies on the ruling. The private rulings only apply for specific financial years and not necessarily for the entire period of investment. The Commissioner publishes a sanitised version of most private rulings to help other taxpayers gain some understanding of his views on the operation of the tax laws in particular circumstances. As the Commissioner makes clear on the Register of private binding rulings, and echoing the legislation, 'the advice is binding on the Commissioner only in relation to the specific entity named in the written binding advice.'[40]

For the purpose of this paper two examples taken from the private rulings will be discussed briefly: first relating to a foreign government entity such as an SOE, and second an investment fund established by a foreign government's legislation such as a SWF.

The first example, private ruling 1011705592297, covers the financial years 2011 to 2015. The question raised in the ruling request is whether X Ltd is exempt from Australian income tax and withholding tax on its interest income, dividend income, trust distributions and any other income including capital gains derived from its minority investment in the Y Fund under the principle of sovereign immunity. The ruling confirms the acceptance of the international law doctrine of sovereign immunity. The ruling confirms the distinction between passive investment attracting the exemption and commercial activities. A 10 percent or less equity holding in a company is generally regarded as a non-commercial activity. The foreign investor is required under the ruling to: establish that it is an agent of a foreign government, that the moneys invested will remain government moneys and that the income is being derived from non-commercial activities. In

[40] The Commissioner of Taxation, *Register of Private Binding Rulings Disclaimer* Australian Taxation Office <https://www.ato.gov.au/rba/search/>.

relation to the issue of non-commercial activity, the ruling goes on to state that, in relation to X Ltd's investment in a managed investment scheme ('MIS') that an investment of more than 10 percent may not constitute commercial activity as the investor will not be involved in day-to-day management. Moreover, matters requiring an 80 percent investor approval such as the sale of assets could not be vetoed by the foreign government agency if the investment was less than 20 percent. Therefore in the case of an investment in a MIS, the threshold for passive investment could be greater than 10 percent.

In the second example, private ruling 1011433959713, the foreign government established an investment fund to invest in Australia. The ruling confirms the existence of the doctrine of sovereign immunity from dividend withholding tax and income tax on sundry other income. The ruling goes on to confirm that the exemption is only available for passive investment and reiterates the threshold of 10 percent as being the generally accepted level of investment. As discussed below, this approach to what constitutes commercial and non-commercial investment activity is common to all rulings and the recommendations by Treasury.

3.3 Recommendations by Treasury

On 20 April 2011 the Australian Treasury issued a proposals paper on the options to codify the tax treatment of sovereign investments.[41] Treasury confirmed that 'certain income derived by foreign governments has traditionally been exempt from Australian taxation under the international law doctrine of sovereign immunity.'[42] Moreover, Treasury confirmed that 'the doctrine of sovereign immunity is a principle of customary

[41] Commonwealth, *Australian Government Treasury, Options to codify the tax treatment of sovereign investments, Proposals paper April* 2011 (2011) 8.
[42] Ibid 1.

international law according to which one country is immune from suit in another country.'[43] The scope of this doctrine has evolved from an 'absolute, wide-ranging immunity to a more restrictive one.'[44] As has been discussed above, Treasury reiterated the fact that this evolution from a wide immunity is primarily due to the fact that governments have increasingly engaged in commercial activities for which it may be inappropriate to extend sovereign immunity. Gradually, therefore, the doctrine has been narrowed so that a country 'only enjoys immunity with respect to its non-commercial activities.'[45] It should also be noted that a direct investment in real property in Australia is not covered by the doctrine of sovereign immunity from taxation. A sovereign investor with a direct investment in real property or an indirect investment in a land rich company will still be subject to income tax on the ordinary and statutory income generated from that investment in Australia. This fact is reinforced by the Treasury proposals paper.[46]

The Treasury proposals paper provides two options as to the tax treatment of sovereign investments in Australia. These options are designed around three core concepts: first, the possible tax treatment of the investment; second, what entities are eligible for the tax treatment; and third, what constitute eligible investment interests by the sovereign.[47] The proposals paper treats ordinary or statutory income as non-assessable and non-exempt income ('NANE income'), and not subject to withholding taxes.[48] This means that any income losses or capital losses are disregarded as well as deductions.[49] The entities that are eligible for this tax treatment are foreign government agencies such as

[43] Ibid.
[44] Ibid.
[45] Ibid.
[46] Ibid 5.
[47] Ibid 2.
[48] Ibid 5.
[49] Ibid 7.

SOEs and sovereign funds such as SWFs. These entities are discussed in detail below. The third requirement is that the investment must satisfy tests relating to debt or equity interests.[50] A 10 percent or less equity holding is regarded as a 'safe harbour' investment.[51] Option two requires all of the rules in option one to be satisfied, but allows a SOE or SWF to be able to obtain the tax advantages even if their equity investment exceeds the 10 percent safe harbour test. However, they must be able to demonstrate that they are not engaged in a 'commercial activity'.[52] This concept of a 'safe harbour' is examined in detail below. Rule 9 sets out four factors that will be taken into account in determining whether the sovereign entity is participating in a commercial activity.[53] The key determinant is whether the sovereign entity has the ability to influence the financial, operating or policy decisions of the corporation that it has invested in or has provided debt financing.[54] Clearly the size of the investment is an important determinant in the 'commercial activity test'.

The Treasury paper also reiterates the accepted principle that SWFs have been included in the doctrine of sovereign immunity in recent years where they have been considered to be a part of the government itself. The term 'SWF' is a 'relatively expansive concept that covers a range of different entities.'[55] The International Working Group of Sovereign Wealth Funds ('IWG') which was established in 2008 has produced 'generally accepted principles and practices' for sovereign wealth funds known as the Santiago Principles.[56] The IWG have provided an

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[50] Ibid.
[51] Ibid 16.
[52] Ibid 21.
[53] Ibid 22
[54] Ibid.
[55] Ibid.
[56] International Working Group of Sovereign Wealth Funds, 'Sovereign Wealth Funds – Generally Accepted Principles and Practices "Santiago

extensive definition of what is a SWF and this definition is as follows:

> Sovereign wealth funds are special purpose investment funds or arrangements that are owned by the general government. Created by the general government for macro-economic 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. SWFs have diverse legal, institutional, and governance structures. They are a heterogeneous group, comprising fiscal stabilasion funds, savings funds, reserve investment corporations, development funds, and pension reserve funds without explicit pension liabilities.[57]

The term 'general government' is used to denote both a central government and a sub-national government.[58] The IWG state that 'SWFs are commonly established out of a balance of payments surplus, official foreign currency operations, the proceeds of privatisations, fiscal surpluses and receipts resulting from commodity exports.'[59] However, the IWG specifically exclude SOEs and government-employee pension funds or assets managed for the benefit of individuals.[60]

Interestingly, the ATO has extended the immunity to cover foreign government agencies such as SOEs that are not regarded as SWFs by the IWG. This is consistent with the customary international law principles and the approach taken by the *FSIA*. It is important to note that the Treasury proposals only apply to foreign governments, foreign government agencies and sovereign

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Principles"' (October 2008) <http://www.iwg-swf.org/pubs/eng/santiagoprinciples.pdf>.

[57] Ibid 3.

[58] Ibid.

[59] Ibid nn 7.

[60] Ibid nn 6.

funds, but they do not cover private or public entities that are not wholly owned by a foreign government agency. The example given of what is not a SWF is a foreign government accumulation retirement fund where the employees' money is invested on behalf of the employee members. In that case the fund does not qualify for the tax exemption because the members' interests in the fund are not beneficially owned by the foreign government. This is in line with the definition of a SWF that is provided by the IWG and set out above.

The Treasury proposals paper use the definition of 'government agency' contained in s 995-1, of ITAA 1997:

> "foreign government agency" means:
>
> (a) the government of a foreign country or of part of a foreign country; or
>
> (b) an authority of the government of a foreign country; or
>
> (c) an authority of the government of part of a foreign country.

According to the rules proposed by Treasury, not only must the SWF be wholly owned by a government or government agency, it must be financed solely with public money or public property.[61] As stated by Treasury, these rules are deigned to preserve the integrity of the provisions applying only to government agencies and to prevent private interests from benefiting from these sovereign immunity tax concessions.[62]

The stated policy objective of the proposed codification of sovereign immunity tax treatment is to 'enhance Australia's attractiveness as a destination for foreign government investment by providing greater certainty as to the Australian tax consequences for investment by foreign governments and the

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[61] Ibid r 5-2, 5-4, 10.
[62] Ibid 11.

withholding obligations for Australian residents and reduce compliance costs.'[63] However, as has been stated above, the current Australian government has postponed taking action to formalise this area of taxation law. While the Treasury proposals are unlikely to be implemented for many years to come, it is worthwhile for the various options to be briefly discussed in this paper in order to understand what may become law in the future.

3.4 Safe Harbour Test – 10 percent interest

These rules are deigned to preserve the integrity of the provisions applying only to government agencies and to prevent private interests from benefiting from these sovereign immunity tax concessions. Income or gains arising from a debt interest will be NANE income, unless that debt interest contains a right to vote at director's board meetings, participate in making financial, operating and policy decisions, or deal with the assets of the issuer of the debt interest. This prevents the debt interest from taking on the form of a commercial activity

Income or gains relating to equity interests where the entity has a less than 10 percent total participation interest in a corporate tax entity, fixed trust or partnership will be NANE income. As Treasury confirm, the 10 percent limit is the internationally recognised benchmark for what constitutes 'non-portfolio' or 'direct' investment as opposed to portfolio investment where investors do not generally expect to influence the management of the organisation they are investing in.[64] FDI is investment exceeding 10 percent, and therefore any dividends would be assessable income. Where one government has two sovereign investors each owning less than 10 percent equity interest but combined to exceed 10 percent, the income earned will not be NANE income because the foreign government

[63] Ibid 8.
[64] OCED, above n 6.

indirectly holds more than 10 percent and therefore the safe harbour test is not satisfied.[65]

Where four different governments each have sovereign investors owning less than 10 percent equity interest but combined to exceed 10 percent, the income earned will be NANE income because the test is judged on each country individually.[66]

As explained by Treasury:

> In effect, this 10 per cent threshold acts as a proxy for whether an investment is commercial or non-commercial in nature and relates to the total or aggregated interests held by the foreign government in the relevant corporate tax entity, fixed trust or partnership... This approach eliminates the need for any facts-and-circumstances considerations by the foreign government agency, SF or the Commissioner of Taxation and greatly reduces the timing and interpretive issues which underpin the administrative and compliance difficulties associated with current administrative practice.[67]

The Treasury proposal confirms that existing Private Rulings and Advance Rulings issued by the ATO will continue to be upheld after the enactment of legislation.

Sovereign funds are prevented from claiming losses and deductions against their assessable income. As Treasury states, ‘the policy is essentially if you are not going to be taxed on income from an asset you cannot claim losses and deductions from that asset.’[68]

3.5 Alternative Commercial Activity Test

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[65] Commonwealth, *Australian Government Treasury,* above n 41, 16.
[66] Ibid.
[67] Ibid 22.
[68] Ibid 7.

Option two is composed of the same features as Option one, but also adds an additional facility for determining whether an interest will be eligible for the concessional tax treatment set out under the proposed regime. There is an additional 'commercial activity test' whereby entities that did not satisfy the 10 percent safe harbour rule may still seek to gain exemption from taxation. In determining whether there is a commercial activity the following factors are taken into consideration:

- The size of the foreign government or sovereign fund's interest
- The degree of influence that the foreign government agency or sovereign fund is able to exercise
- The overall activities of the foreign government agency or sovereign fund.

Furthermore, income or gains in respect of an equity interest that is an indirect interest in Australian real property will be NANE income. Section 855-25 of the *ITAA 97* defines indirect interest in Australian real property. Losses and deductions in respect of a direct investment in Australian real property interests will not be disregarded.

3.6 Conclusion

The Treasury proposals are an excellent statement of what the domestic law should be, and support the approach to the customary international law that has been adopted by the ATO in their private rulings and ATO Interpretative Decision 2002/45. The 'two options' approach by Treasury provides a very clear set of tests to be used in determining the eligibility of an SOE or SWF to taxation relief from withholding tax. The tests are balanced by clear and precise practical examples that can be used to apply the various tests. Overall it is an excellent approach to an area of taxation law that is in need of clarification. This approach would

be an excellent starting point for the drafting of specific provisions to be included in the *ITAA 97*, which would formalise the doctrine of sovereign immunity.

4. COMPARISON WITH OTHER COUNTRIES

A number of countries have formalised the taxation treatment of SWFs and SOEs in order to encourage foreign investment. The exemption from income tax for passive investments in debt or equity interests is found in either the domestic taxation law or in the Double Taxation Agreements (DTAs) of several countries. The following part of this paper provides a brief overview of some of these foreign arrangements.

4.1 The United States

Subpart D, section 892(a)(1) of the United States *Internal Revenue Code 1986* exempts from US federal tax:

> income of a foreign government derived from investment in the US in stocks, bonds, or other domestic securities owned by such foreign governments; income derived from financial instruments; and interest on deposits in banks in the US of monies belonging to foreign governments.

For the purpose of s 892, a 'foreign government' means 'only the integral parts or controlled entities' of a foreign sovereign. An integral part of a foreign sovereign 'is any person, body of persons, organization, agency, bureau, fund, instrumentality, or other body, however designated, that constitutes a governing authority of a foreign country'.[69] The term 'integral part' is used to specifically exclude an individual who is a sovereign, official

[69] *Notice of Proposed Rulemaking Income of Foreign Government and International Organisations,* Fed Reg 146537-06 (2011); *Foreign government defined (temporary regulations),* 26 CFR 1.892-2T (2011).

or administrator acting in a private or personal capacity.[70] It is clear that the Chinese SOEs fall within this legislative exemption, as they are government controlled and do not pursue a private purpose or gain for non-government individuals. This definition was part of a proposed regulation issued by the Internal Revenue Service on 3 November 2011. The regulation also covers a sovereign entity such as a SWF or SOE that inadvertently engages in commercial activity. In such a situation the sovereign entity may not lose its tax exemption or if it does may regain the exemption in a subsequent year.[71] The United States legislative treatment of sovereign investment income would appear to have similar issues as the Australian Treasury when it comes to determining what constitutes 'commercial activity' by the sovereign investor. This may always be an issue for all countries when trying to formulate tests relating to what constitute commercial activity.

4.2 Singapore

Singapore does not levy capital gains tax, and dividends distributed by a Singapore resident company to its shareholders, regardless of the shareholders tax residence, are not subject to tax in Singapore. These two provisions may make investment in Singapore attractive despite the lack of other tax exemptions. Singapore's double tax agreement ('DTA') with China exempts interest income earned by sovereign entities. Under Article 11:

> ...interest derived from a Contracting State is exempt from tax in that State, if the beneficial owner is:
>
> (a) in the case of China:

[70] Ibid.
[71] Ibid.

(i) the Government of the People's Republic of China and any local authority thereof;(ii) the China Development Bank;

(iii) the Agricultural Development Bank of China;

(iv) the Export-Import Bank of China;

(v) the National Council for Social Security Fund;

(vi) the China Export & Credit Insurance Corporation; and

(vii) any institution wholly owned by the Government of China as may be agreed from time to time between the competent authorities of the Contracting States.

(b) in the case of Singapore:

(i) the Government of the Republic of Singapore;

(ii) the Monetary Authority of Singapore;

(iii) the Government of Singapore Investment Corporation Pte Ltd;

(iv) a statutory body; and

(v) any institution wholly owned by the Government of Singapore as may be agreed from time to time between the competent authorities of the Contracting States.

As shown above, both Singapore and China recognise the existence of the doctrine of sovereign immunity from withholding tax on interest and have enshrined this law in their DTA. It would appear that Singapore and China may have developed a method of recognition that is far more straight forward that the legislative proposal considered by Australia and as implemented in the US.

4.3 Australia - China DTA

Articles 10, 11 and 12 of the Australia – China DTA which respectively govern the taxation of dividends, interest and royalties allows a discretion for sovereign income to be exempt by stating that each item 'may be taxed...'. Under these articles, dividends have a maximum withholding tax rate of 15 percent and interest and royalties a maximum withholding tax rate of 10 percent. Therefore there is no need to modify the China-Australia DTA to formally exempt sovereign passive income as the discretion already exists in the agreement. DTAs have as one of their main objectives the allocation of the taxing rights of each state in relation to the different categories of income or gain. They are not established for the purpose of imposing taxes on the other state. By creating a provision in the domestic taxation legislation as currently proposed by the Australian Treasury, such income would be able to be exempt from withholding tax on such amounts and would be consistent with at least this DTA.

4.4 New Zealand (NZ) DTAs

Article 10, paragraph 4 and Article 11, paragraph 3 of the New Zealand – Hong Kong DTA exempt dividends and interest that are paid to the Hong Kong Government, Hong Kong Monetary Authority, any institution wholly or mainly owned by the Hong Kong Government, the NZ Government, NZ Reserve Bank, NZ Superannuation Fund or any institution wholly or mainly owned by the NZ Government. An institution that is wholly or mainly owned by the NZ or Hong Kong government must perform functions of a government nature to be exempt.[72]

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[72] *Double Tax Agreement*, New Zealand–Hong Kong, signed 1 December 2010, 2824 UNTS 1 (entered into force 9 November 2011) art 35 [2].

In the New Zealand - China DTA, Article 11, paragraph 3 confirms that interest derived by the following institutions of either NZ or China are exempt from tax in the contracting State:

a) the government,

b) political subdivision,

c) local authority,

d) central bank, or

e) financial institution owned by the government or by a resident with debt claims financed, guaranteed or insured by any of the above.

The DTA formally exempts interest earned by sovereign entities from taxation in either country, and by virtue of the above definition Chinese SOEs would also be exempt.

The above approaches to the treatment of interest income derived by SOEs and SWFs provide a brief overview of how the issue of sovereign immunity has been dealt with in other jurisdictions. The legislative approach used by the US is still fraught with problems, especially in the area of what is a ‘commercial activity’ as opposed to mere passive investment by the sovereign. The recognition of the doctrine of sovereign immunity in the DTAs appears to be relatively clear, but the paragraphs lack detail and may still require certainty for the investor by way of a private ruling. The Australian Treasury approach in a form of legislation would be the best course of action.

5. Conclusion

A formal recognition of Australia’s acceptance of the doctrine of sovereign immunity from income tax on passive investments by SWFs and SOEs would be of benefit to Australia because it would encourage greater foreign investment, and in the

case of China would eliminate any confusion given the free-trade agreement that has been signed between Australia and China. An amendment to *ITAA 97* would be beneficial to Australia as it would provide foreign investors with a simple solution to a guarantee that no withholding tax would be imposed on interest or dividends derived from passive investments. There would be no need for a SWF or a SOE to apply for a private ruling or rely on the tax administrators to honour their view contained in the ATO Interpretative Decision 2002/45. This would be the recommendation of this paper. The new law embodying the change to *ITAA 97* would be along the lines of that used by the US. The new law would also set out tests such as a 'safe harbour' limit of 10 percent investment, but would also deal with the complex issue of commercial activity. This particular issue would still be subject to uncertainties as discussed in the Treasury proposal. However, it would create a more efficient process for sovereign investors compared with the system currently in place in Australia.

A formal amendment to the law would foster greater transparency between nations so that any sovereign investor could understand exactly what the taxation law was in Australia. This would in turn generate a greater perception that Australia welcomes foreign investment, especially by SWFs and SOEs. Furthermore, an amendment to the domestic law would clarify the distinction between passive investment and commercial investment, especially where the investment requires Board of Director representation on behalf of the SWF or SOE and a more active role in the management of the company in order to safeguard the investment.

Unfortunately, public opinion is against foreign investment especially by the Chinese. The public perception that foreign investors own too much agricultural land would appear to be acting as a barrier to a formal process of changing the law in order to adopt the doctrine of sovereign immunity. At present,

governments are reluctant to be seen to be promoting taxation benefits for foreign governments. However, the Abbott Government's recent actions of signing a free-trade agreement with China and Korea may change the attitude of the government and help dispel the negative perceptions of the Australian public. Moreover, if the reform proposals as discussed above were to eventuate, then the public would be able to see that only passive investment was receiving preferential taxation treatment, and that investments in agricultural land and mines would be subject to all Australian income taxes and more. This could only be a positive step for sovereign investors and Australia.