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## The Unjustified Subsidy: Sovereign Wealth Funds the Foreign Sovereign Tax Exemption

Jennifer Bird-Pollan\*

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# The Unjustified Subsidy: Sovereign Wealth Funds the Foreign Sovereign Tax Exemption\*

Jennifer Bird-Pollan

## Abstract

The taxation of Sovereign Wealth Funds in the United States is outmoded and due for reconsideration. Offering a tax exemption to the billion dollar investment funds owned by foreign governments is both unfair and ineffective. Founded in the principles of sovereign immunity, the foreign sovereign tax exemption, codified in I.R.C. §892, fails to satisfy the Congressional goals that motivated its creation. This Article explains the current taxation of foreign sovereigns and, by extension, Sovereign Wealth Funds. It then illustrates that the current exemption is simultaneously too broad, providing a tax exemption for activities that are clearly nongovernmental activities, and therefore outside of the realm of sovereign immunity, and too narrow, failing to provide a tax exemption for activities that clearly are governmental activities. Finally, this Article explains that any exemption provided to foreign sovereigns should be offered only as a treaty matter, reserving the privilege as a negotiation tool, and thereby ensuring that the United States receives similar benefits.

**KEYWORDS:** Tax, Taxation, Law, Corporate, Business, Exemption, Foreign, Governments, Investment, Sovereign, Immunity, Congress, Wealth Funds

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\*Assistant Professor of Law, University of Kentucky College of Law. This Article benefited from comments provided by participants in the SEALS New Scholars Workshop, the Law, Society and Taxation workshop, the University of Cincinnati College of Law faculty brown bag workshop, and the University of Kentucky College of Law faculty brown bag lunch workshop. Special thanks to Professors Allison Christians, Daniel Halperin and Stephen Shay for their insightful comments. Thanks also to the editorial staff of the Fordham Journal of Corporate & Financial Law for their diligent work.

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FUNDS AND THE FOREIGN SOVEREIGN  
TAX EXEMPTION

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## ABSTRACT

The taxation of Sovereign Wealth Funds in the United States is outmoded and due for reconsideration. Offering a tax exemption to the billion dollar investment funds owned by foreign governments is both unfair and ineffective. Founded in the principles of sovereign immunity, the foreign sovereign tax exemption, codified in I.R.C. § 892, fails to satisfy the Congressional goals that motivated its creation. This Article explains the current taxation of foreign sovereigns and, by extension, Sovereign Wealth Funds. It then illustrates that the current exemption is simultaneously too broad, providing a tax exemption for activities that are clearly non-governmental activities, and therefore outside of the realm of sovereign immunity, and too narrow, failing to provide a tax exemption for activities that clearly are governmental activities. Finally, this Article explains that any exemption provided to foreign sovereigns should be offered only as a treaty matter, reserving the privilege as a negotiation tool, and thereby ensuring that the United States receives similar benefits.

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## INTRODUCTION

Investment in the United States by Sovereign Wealth Funds (“SWFs”) has grown significantly in recent years.<sup>1</sup> Several high profile deals have brought this activity into the headlines and have started conversations about just what SWFs should or should not be permitted to do.<sup>2</sup> However, despite this evolving attitude toward investment in the United States by foreign governments and the growing presence of SWFs in the U.S. economy, the taxation of SWFs and the related policy rationales are sorely outdated. Section 892 of the Internal Revenue Code

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1. For a discussion of the growth of SWFs and examples of specific well-publicized investments by SWFs in the United States in recent years see Joint Comm. on Tax’n, *Economic and U.S. Income Tax Issues Raised by Sovereign Wealth Fund Investment in the United States*, JCX-49-08, at 1 (June 17, 2008); Victor Fleischer, *A Theory of Taxing Sovereign Wealth*, 84 N.Y.U.L. REV. 440, 441-42 (2009); William M. Funk, *On and Over the Horizon: Emerging Issues in U.S. Taxation of Investments*, 10 HOUS. BUS. & TAX L.J. 1, 7-8 (2010); Michael S. Knoll, *Taxation and the Competitiveness of Sovereign Wealth Funds: Do Taxes Encourage Sovereign Wealth Funds to Invest in the United States*, 82 S. CAL. L. REV. 703, 703-05 (2009); Luca Schicho, *Pride and Prejudice: How the Financial Crisis Made Us Reconsider SWFs*, 2 GOETTINGEN J. INT’L. L. 63, 65-70 (2010).

2. See, e.g., Funk, *supra* note 1; Schicho, *supra* note 1.

(the section that provides a tax exemption to foreign governments, and, by extension, to SWFs) has remained substantially unchanged since it was written in 1917.<sup>3</sup> Now is the time to re-examine the U.S. tax treatment of foreign governments and SWFs to ensure that our tax law reflects and encourages the general U.S. policy towards investment by foreign governments and SWFs in particular.<sup>4</sup>

In this Article, I demonstrate that the current statutory structure offers SWFs a tax exemption that is both unfair (because it allows foreign governments to earn investment income in the United States without paying tax on that income while not offering a similar exemption to other similarly situated taxpayers) and incomplete (because currently the statute does not provide a complete exemption for income connected with the sovereign activities of foreign governments, which is the rationale for providing the exemption in the first place). I will reevaluate historical justifications for offering a tax exemption to foreign governments to show that those justifications are not served by the current form of the exemption. I begin by carefully outlining the current tax treatment of SWFs. I then demonstrate why this statutory framework fails to promote good U.S. tax policy. Finally, I identify an alternative statutory model that more adequately satisfies U.S. tax and foreign policy goals.

Good tax policy might justify offering foreign governments a lower rate of tax than foreign private investors.<sup>5</sup> What I point to in this Article, however, is that preferential rates for foreign governments and their investing SWFs should be offered, if at all, only after careful consideration by Congress, or by tax treaty negotiators. The current model is an historical accident and both over-taxes and under-taxes foreign governments earning income in the United States.

Based on the justification of sovereign immunity, the model adopted by the U.S. tax Code offers a tax exemption to foreign governments who earn income in their governmental capacity, but taxes

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3. Internal Revenue Code of 1986, as amended as of the date of this Article [hereafter "Code"]. All citations to sections are citations to the Code unless otherwise noted.

4. See *infra* Part IV for a discussion of the non-tax policy concerns regarding investment by SWFs and foreign governments in the U.S.

5. *Id.* Part II.C.1 of this paper discusses policy arguments for lowering the tax rate on investment for foreign governments investing in the U.S.

income earned from any so-called “commercial activity.”<sup>6</sup> However, despite the intention of taxing foreign governments in this way, the actual language of the Code exempts income earned from certain activities that ought to be treated as commercial,<sup>7</sup> while simultaneously taxing income earned by a foreign government engaging in activities that are central to its sovereign role.<sup>8</sup> Targeted changes to the Code could fix both of these problems, thereby both raising revenue by taxing foreign governments when they ought to be taxed and honoring sovereign immunity when governments are acting in a sovereign capacity.

### I. FAIRNESS IN INTERNATIONAL TAX POLICY

One of the basic rules of tax policy is that a good policy will impose tax fairly among taxpayers.<sup>9</sup> That is to say, taxpayers in similar situations will have similar tax bills (so-called horizontal equity), and taxpayers who are meaningfully differently situated financially will have proportionately different tax bills (vertical equity).<sup>10</sup> One of the primary rationales for relying on horizontal equity and fairness more generally is that observing equity principles allows the government to raise necessary revenue while, at the same time, increasing social equality.<sup>11</sup>

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6. See *infra* Part II.C. for a discussion of the U.S. tax treatment of foreign governments and SWFs.

7. See *infra* Part II.C.3 for a detailed account of the taxation of foreign governments’ investment income.

8. See *infra* Part V for a discussion of the current set of rules that inadvertently taxes foreign governments earning income while engaging in sovereign activities.

9. An in-depth discussion of vertical and horizontal equity is clearly outside of the scope of this paper. For further discussion of the general concept of horizontal equity, as well as more general discussions of the issues present in creating good tax policy, see, e.g., JOEL SLEMROD & JON BAKIJA, *TAXING OURSELVES: A CITIZEN’S GUIDE TO THE DEBATE OVER TAXES* (4th ed. 2008); Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 CAL. L. REV. 1905 (1987); Eric M. Zolt, *The Uneasy Case for Uniform Taxation* 16 VA. TAX REV. 39, 86-98 (1996).

10. “[E]conomists call *horizontal equity*, the principle that tax liability ought to be the same for any two families with the same level of well-being – equal treatment of equals.” Slemrod & Bakija, *supra* note 9, at 89. It should be noted, however, that there is a significant line of argument in the tax policy literature debating the role of horizontal equity in analyzing tax policy choices. See, e.g., Louis Kaplow, *Horizontal Equity: Measures in Search of Principle*, 42 NAT’L TAX J. 113 (1990).

11. Slemrod & Bakija, *supra* note 9 at 87-90.

However, this focus on levels of fairness in the domestic context does not necessarily clarify what role “fairness” should have in evaluating international tax policy.<sup>12</sup> My concern in this Article, however, is not so much whether we unduly burden international investors earning income in the United States, but whether we offer unjustified tax preferences to those investors, thereby both lowering tax revenues and *increasing* unfairness in the domestic context. Because the focus of this Article involves tax preferences offered to foreign government investors (and not to any other taxpayers), it is useful at this point to examine why, from a fairness perspective, this might be unjustified.

As a general rule, a tax preference (a lower tax rate, tax credit or deduction) should only be provided if it contributes to a particular policy goal.<sup>13</sup> Indeed any tax preference that gives certain taxpayers a lower tax bill than other similarly situated taxpayers is likely a violation of horizontal equity.<sup>14</sup> However, if that preference can be justified because of the other policy goals that it advances, then Congress may decide to violate horizontal equity in order to achieve that other goal.<sup>15</sup> Examples of such action by Congress in the Code include the deduction for home mortgage interest,<sup>16</sup> the education tax credits,<sup>17</sup> and the accelerated

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12. See, e.g., J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5 FLA. TAX. REV. 4 (2001) (arguing that ability to pay is a relevant consideration when evaluating world-wide versus territorial taxation for United States citizens and residents).

13. Slemrod & Bakija, *supra* note 9, at 89.

14. However, importantly, it is difficult to determine on what criteria we might judge situatedness (and its similarity) for horizontal equity purposes when one of the taxpayers in question is a foreign government. For a discussion of the difficulty of determining “likeness” when one of the taxpayers being analyzed is a non-resident, see Fleming, Peroni & Shay, *supra* note 12, at 314.

15. See *id.*

16. § 163(h). This deduction allows homeowners to deduct amounts they spend in interest on their home mortgages. As a result, homeowners will typically have lower tax bills than other taxpayers who are in the same situation in every respect except that they rent their homes. The policy goal of this provision is to encourage home ownership among American taxpayers. For an analysis of the effectiveness of this Code section and this policy more generally, see Dennis J. Ventry, Jr. *The Accidental Deduction: A History and Critique of the Tax Subsidy for Mortgage Interest*, 73 LAW & CONTEMP. PROB. 233 (2010).



depreciation rules.<sup>18</sup> Without a clear policy goal, a violation of horizontal equity would seem to violate one of the central premises of U.S. tax policy.<sup>19</sup> This Article will proceed on this assumption. Indeed, the ultimate conclusion of this Article will be that there is no clear non-tax policy goal that justifies giving a tax preference to the investment income of foreign governments and their SWFs over and above the tax treatment of foreign private investors.<sup>20</sup>

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17. § 25A. The Hope and Lifetime Learning Credits are tax credits available to taxpayers who are enrolled in higher education programs and pay tuition for those programs. The Hope Credit is only available for the first two years of post-secondary education, while the Lifetime Learning Credit is available for any other enrolled student. There are additional limitations based on adjusted gross income and applies to qualified tuition and related expenses. The policy behind these tax credits is clear enough—the credits are in place to facilitate lower-income individuals' enrollment in higher education courses. For further discussion of these credits, see generally Kerry A. Ryan, *Access Assured: Restoring Progressivity in the Tax and Spending Programs for Higher Education*, 38 SETON HALL L. REV. 1 (2008); Sean Stegmaier *Tax Incentives for Higher Education in the Internal Revenue Code: Education Tax Expenditure Reform and the Inclusion of Refundable Tax Credits*, 37 SW. U. L. REV. 135 (2008).

18. § 179. This section allows businesses to take up to \$500,000 (for the remainder of 2011 – the limitation is currently scheduled to drop to \$125,000 in 2012 and to \$25,000 for taxable years beginning after 2012) of depreciation as an expense in the year in which the property is placed into service. Intended to encourage capital expenditures in the face of a recession, the rule has received mixed reviews regarding its effectiveness. For more discussion of §179 and its implications, see Gabriel Aitsebaomo, *The Individual Alternative Minimum Tax and the Intersection of the Bush Tax Cuts: A Proposal for Permanent Reform* 23 AKRON TAX J. 109 (2008); James Edward Maule, *No Thanks, Uncle Sam, You Can Keep Your Tax Break*, 31 SETON HALL LEGIS. J. 81 (2006).

19. See generally Slemrod & Bakija, *supra* note 9, at 89. On the other hand, the explosion of tax expenditures means that Congress quite regularly decides to violate its equity goals in the name of policy. Tax expenditure analysis, the procedure by which the Code is analyzed from the perspective of the services and subsidies provided through it, was introduced by Stanley S. Surrey. STANLEY S. SURREY, *PATHWAYS TO TAX REFORM* (Cambridge, Mass., Harvard University Press, 1973). For a discussion of the application of tax expenditure analysis to the international tax world, see J. Clifton Fleming, Jr., & Robert J. Peroni, *Reinvigorating Tax Expenditure Analysis and its International Dimension*, 27 VA. TAX REV. 437 (2008).

20. As a matter of horizontal equity and fairness in tax policy more generally, it may be that the current tax treatment of foreign private investors ought to be changed as well. However, that discussion is outside of the scope of this paper. For a discussion of how to evaluate fairness in international tax policy more generally, see generally Fleming, Peroni & Shay, *supra* note 12.

## II. TAXATION OF SWFS

In this Article, I argue for the elimination of the current tax preferences offered to SWFs. However, in order to understand the problems with the current approach to taxing SWFs, one must first understand just what is at stake. Therefore, this Part will explain the current taxation of foreign governments generally, and SWFs in particular. This journey requires a short detour into the world of non-resident taxpayers and a side trip into a discussion of “commercial activity income,” a concept that applies only in the taxation of foreign sovereigns.

### A. WHAT IS A SOVEREIGN WEALTH FUND?

There is still no universally recognized definition of the term “Sovereign Wealth Fund.”<sup>21</sup> International organizations like the International Monetary Fund (the “IMF”), the Organisation for Economic Co-operation and Development (the “OECD”) and the European Central Bank, however, have working definitions.<sup>22</sup> SWFs generally operate like private equity funds, pooling capital for purposes

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21. See Fleischer, *supra*, note 1, at 453-55 (noting that it is unclear what exactly counts as a SWF).

22. The IMF identifies five possible types of SWF: “(i) *stabilization funds*, where the primary objective is to insulate the budget and the economy against commodity (usually oil) price swings; (ii) *savings funds* for future generations, which aim to convert nonrenewable assets into a more diversified portfolio of assets . . . (iii) *reserve investment corporations*, whose assets are often still counted as reserve assets, and are established to increase the return on reserves; (iv) *development funds*, which typically help fund socio-economic projects or promote industrial policies that might raise a country’s potential output growth; and (v) *contingent pension reserve funds*, which provide (from sources other than individual pension contributions) for contingent unspecified pension liabilities on the government’s balance sheet.” Int’l Monetary Fund *Sovereign Wealth Funds – A Work Agenda 5* (Feb. 29, 2008), available at [www.imf.org/external/np/pp/eng/2008/022908.pdf](http://www.imf.org/external/np/pp/eng/2008/022908.pdf). The European Central Bank defines an SWF as “[a] special investment fund created/owned by a government to hold assets for long-term purposes; it is typically funded from reserves or other foreign-currency sources, including commodity export revenues, and predominantly has significant ownership of foreign currency claims on non-residents.” European Central Bank, *Financial Stability Review 178* (June 2009), available at [www.ecb.int/pub/pdf/other/financialstabilityreview200906en.pdf](http://www.ecb.int/pub/pdf/other/financialstabilityreview200906en.pdf).

of investment.<sup>23</sup> However, unlike their private equity fund counterparts, the capital invested by SWFs is entirely owned by a sovereign entity. For U.S. tax purposes, and for purposes of this Article, the only entities that qualify as SWFs are those that are wholly owned by foreign governments and are otherwise eligible for § 892 benefits.<sup>24</sup> In addition, the financial benefits of the SWF's income must not inure to any private persons.<sup>25</sup> Finally, in order to qualify for the benefits of the foreign sovereign tax exemption in the United States, SWFs must not be engaged in commercial activity anywhere in the world.<sup>26</sup>

#### B. U.S. TAX TREATMENT OF FOREIGN PRIVATE CORPORATE INVESTORS IN THE UNITED STATES

The United States' system of taxation imposes income taxes based on both citizenship and residency criteria.<sup>27</sup> That is to say, United States citizens and residents are taxed on their worldwide income.<sup>28</sup> Non-U.S. citizens who are also non-residents, but who earn income that comes

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23. "Broadly speaking . . . SWFs are actively managed, government-owned pools of capital originating in foreign exchange assets." Joint Comm. on Tax'n, *supra* note 1, at 21-22.

24. In order to qualify for the foreign sovereign tax exemption provided by § 892, an entity must be a controlled entity. A controlled entity "means an entity that is separate in form from a foreign sovereign or otherwise constitutes a separate juridical entity if it satisfies the following requirements: (i) [i]t is wholly owned and controlled by a foreign sovereign directly or indirectly through one or more controlled entities; (ii) [i]t is organized under the laws of the foreign sovereign by which [it is] owned; (iii) [i]ts net earnings are credited to its own account or to other accounts of the foreign sovereign, with no portion of its income inuring to the benefit of any private person; and (iv) [i]ts assets vest in the foreign sovereign upon dissolution." Temp. Treas. Reg. § 892-2T(a)(3). SWFs that satisfy these requirements qualify as controlled entities, and therefore are eligible for the foreign sovereign tax exemption provided by § 892.

25. Temp. Treas. Reg. § 1.892-2T(a)(2). Note that all of the Treasury Regulations under § 892 are temporary. The applicable Regulations (Temp. Treas. Reg. §§ 1.892-1T—1.892-7T) were adopted as Temporary Regulations in 1986 by § 1247 of the Tax Reform Act of 1986, Pub.L. 99-514, § 1247, 100 Stat. 2085, 2583, and have not yet been made permanent.

26. §§ 892(a)(2)(A)(ii), 892(a)(2)(B). For a discussion of "commercial activity," see *infra* Part III.

27. See, e.g., §§ 861, 871, 872.

28. § 61.

from a U.S. source are taxed in the United States on that income.<sup>29</sup> However, by contrast with U.S. citizens and residents, non-residents are not taxed on their worldwide income, but generally are only required to report and pay tax to the United States government on U.S.-source income and certain other income connected to a U.S. business.<sup>30</sup> This model of taxation echoes the general source/residence divide found throughout the world.<sup>31</sup> Generally, countries assess income taxes on all income that is earned within their borders.<sup>32</sup> In the United States, “U.S. source income” includes any payment for services that are provided in the United States, or any investment income (such as dividend payments or interest income) that is generated from U.S. based investments.<sup>33</sup>

Generally, non-residents are also taxed in the United States on income that is effectively connected to a U.S. trade or business (so-called “effectively connected income” or “ECI”).<sup>34</sup> ECI is taxed at the same ordinary income rates to which U.S. citizens and residents are subject.<sup>35</sup> In addition, nonresidents subject to taxation on ECI are eligible to take deductions against their income, resulting in a net, rather than gross, income tax.<sup>36</sup> The goal of the ECI rules taxing nonresidents

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29. See § 871 and § 872 for the taxation of non-resident individuals and § 881 and § 882 for the taxation of non-resident corporations.

30. *Id.* Section 861 identifies which items of income will be treated as income from sources within the United States, while § 862 identifies items treated as income from sources without the United States.

31. See, e.g., RICHARD L. DOERNBERG, INTERNATIONAL TAXATION IN A NUTSHELL, 7 (9th ed. 2012).

32. The source of income is typically attributed to the jurisdiction in which it is derived. This is not always obvious, and the source of income can be the cause of some dispute. For a discussion of the ways in which taxpayers attempt to take advantage of complicated source rules and the gaps between the source rules of various countries, see Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699 (2011).

33. §§ 861 (identifying income from sources within the United States), 862 (identifying income from sources without the United States), 863 (explaining the allocation rules for income partially from within and partially from without the United States), and 865 (explaining the rules for determining the source of gain from the sale of a capital asset).

34. For the definition of “trade or business within the United States,” see § 864(b). For the imposition of tax on a non-resident alien on income connected with a United States trade or business, see § 871(b).

35. §§ 871(b), 882.

36. §§ 861(b), 871(b), 873, 882.

at resident rates on their U.S. trade or business income is meant to encourage fairness and competitiveness between nonresidents and residents. In other words, the tax rules should not provide an unjustified competitive advantage to those who are exempt from tax, eligible to take deductions so that they are taxed on net rather than gross income, or who otherwise receive competitive advantages merely based on tax treatment. Without clear policy goals indicating otherwise, the obligation to pay taxes should not put a taxpayer at a disadvantage, as compared with another individual who is entitled to a tax exemption. One relevant example of this distinction is found in the world of tax-exempt non-profit entities.<sup>37</sup> A tax-exemption is provided to non-profit entities for all income earned by the entity in connection with its charitable purpose.<sup>38</sup> However, if the non-profit earns income from an “unrelated business” then that income is subject to taxation at the same rates as a for-profit entity.<sup>39</sup> The rationale for this rule is that U.S. tax policy should not provide a business advantage to non-profit entities engaging in business outside of their charitable purposes.<sup>40</sup> The same rationale applies in the international tax context. The tax on ECI attempts to put U.S. taxable businesses and their foreign-owned competitors operating and earning income in the United States on a tax-neutral playing field.<sup>41</sup>

By contrast with the rule for ECI, non-residents are typically exempted in the United States from tax on gain from the sale of a capital

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37. §§ 511, 512.

38. § 501.

39. *Id.*

40. For an in-depth discussion of the role that the unrelated business income tax plays in effecting the competitiveness of businesses operated by tax-exempt entities, see Michael S. Knoll, *The UBIT: Leveling an Uneven Playing Field or Tilting a Level One?*, 76 FORDHAM L. REV. 857 (2007).

41. In addition to the goal of tax neutrality, there are jurisdictional limits to the U.S. taxation of non-resident businesses. If a non-resident business earns income outside of the United States, then, for the most part, that income will not be subject to United States tax. In that sense then, the U.S. business is at a tax disadvantage, especially if the non-resident is only subject to tax at a lower rate than the United States tax rate. However, the U.S. lacks the jurisdictional authority to draw that non-U.S. source income into the U.S. in order to tax it. For a more detailed discussion of this issue, see Stephen E. Shay, J. Clifton Fleming, Jr., & Robert J. Peroni, “*What’s Source Got to Do With It?*” *Source Rules and U.S. International Taxation*, 56 TAX L. REV. 81 (2002).

asset.<sup>42</sup> Because of this rule, appreciation on U.S. stock owned by a foreign investor goes untaxed in the United States.<sup>43</sup> The effective tax exemption provided by this jurisdictional rule can make investing in the United States particularly attractive to foreign investors.<sup>44</sup>

While non-resident taxpayers are subject to U.S. tax on their ECI, and generally exempt from U.S. tax on their capital gain income, there is a general rule that income that is fixed, determinable, annual or periodic (“FDAP income”) is subjected to a 30% withholding rate.<sup>45</sup> Examples of

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42. §§ 865. *See also* §§ 881, 882 (identifying the items of income subject to tax on non-residents engaged in a trade or business in the United States and on non-residents not engaged in a trade or business in the United States, and omitting capital gain as an item of income). *See also* Treas. Reg. § 1.1441-2(b)(2)(i) (excepting gains on the sale of capital assets from the withholding rules). This treatment of capital gain stems from generally accepted jurisdictional rules about the source of income. Capital gain is typically sourced to the residence country of the seller. In the case of a non-resident taxpayer, therefore, any capital gain earned on a sale is not taxed in the United States. One exception to this general rule lies in the world of real property interests. § 897 taxes non-residents on income earned from the sale of real property interests to the seller’s residency, even though that income, as capital gain income, would otherwise be sourced outside the U.S. An additional exception to the general rule is found in the rules related to the sale of inventory property. Unlike the sale of other kinds of personal property, the sale of inventory property retains a “title passage” rule, so that income is sourced to the country where title passes. § 861(a)(6). Therefore, if a non-resident sells inventory property in the U.S., that income will be sourced here, and she will likely be taxed on any gain.

43. Gain earned by a U.S. taxpayer on the sale of a capital asset in the U.S. is currently taxed at preferential rates. §1(h). This is one aspect of the current system of corporate double taxation, which assesses an income tax at the level of the corporation and also assesses a tax at the shareholder level. The distribution of profits results in a tax on dividends, but if the corporation retains profits, then typically the share price increases, and there will be capital gain on the sale of the stock, which is taxed at capital gain rates. One argument for lower rates for capital gains and dividends is that this income is taxed twice in the United States. For an explanation of the operation of the double corporate tax and an argument that the U.S. corporate tax is “unusual, unfair and inefficient,” see Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 YALE L. J. 325, 326 (1995). However, since capital gain realized by non-residents escapes this second level of taxation, it may be time to revisit this issue. That is, however, outside of the scope of this Article.

44. *See* § 865(a). Since § 865(a) sources gain to the seller’s residency, if a resident of a country with very low or no income tax earns income on the sale of a stock of a U.S. company, that seller may avoid tax on the gain altogether.

45. §§ 871(a), 881(a).

FDAP income include dividends, rents, royalties and interest payments, among other things.<sup>46</sup> With regard to dividends, this 30% withholding rate represents a significant deviation from the current 15% tax on dividend income that is assessed on the income of U.S. taxpayers.<sup>47</sup> In many instances, non-resident taxpayers who are residents of countries with whom the United States has a tax treaty will get the benefit of a dividend withholding rate that is reduced by the treaty.<sup>48</sup> Most commonly, the treaty reduces the withholding rate on non-residents to 15%.<sup>49</sup> Because of the “withholding” nature of the tax, the obligation to collect the tax lies with the income payor.<sup>50</sup> If a non-resident believes she is exempt from the tax, or otherwise eligible for some rate other than the 30% rate, then she must submit documentation to the payor establishing the reasons the payor should withhold a reduced amount.<sup>51</sup>

In addition to the treaty reduction on the dividend withholding rate, non-residents receive a tax benefit with regard to most interest that they receive.<sup>52</sup> As a general matter, interest income is FDAP income, which

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46. § 881(a).

47. See § 61. Note that this rate is part of the EGTRRA tax cuts, which are currently in place through December 2012, at which point this reduced tax rate may increase. It is unclear at the time of this writing whether or not this reduced rate will be extended.

48. Tax treaties are international agreements signed by the United States and the governing authority of a foreign country. Their authority controls the taxation of each country’s citizens in the jurisdiction of the other signing country.

49. Generally dividend withholding rates set by treaty are reduced to 15%, but some countries have signed treaties with the United States that reduce the withholding rate to a different percentage. Currently reduced dividend withholding rates are in place in the tax treaties that the United States has signed with Australia, Austria, Bangladesh, Barbados, Belgium, Canada, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Iceland, India, Ireland, Israel (25%), Italy, Jamaica, Japan (10%), Latvia, Lithuania, Luxembourg, Malta, Mexico, Morocco, the Netherlands, New Zealand, Portugal, Russia, Slovakia, Slovenia, South Africa, Spain, Sri Lanka, Sweden, Switzerland, Thailand, Tunisia, Turkey, Ukraine, the United Kingdom and Venezuela. In each case, see Article 10 of the appropriate treaty except for Israel and Iceland, where the appropriate provision appears in Article 12, available at <http://www.irs.gov/businesses/international/article/0,,id=96739,00.html>.

50. §§ 1441, 1442.

51. Treas. Reg. §1.1441-1(b)(3).

52. See § 871. Note that this is a statutory provision, so eligibility for the tax benefit is not contingent on eligibility to claim the benefits of a tax treaty, as the reduced dividend withholding rate is.

would be subject to the applicable 30% withholding rate.<sup>53</sup> However, U.S. source interest received by a non-resident that qualifies as “portfolio interest” is exempt from the U.S. income tax.<sup>54</sup> The portfolio interest rules apply to recipients of interest income who are not 10% shareholders in the entity that issues the note on which the interest is paid.<sup>55</sup> Also, interest that non-residents earn in the United States on bank deposits or other kinds of short-term interest are exempted from tax.<sup>56</sup>

### C. U.S. TAX TREATMENT OF FOREIGN SOVEREIGNS

The default treatment of foreign sovereigns earning income in the United States is that they are treated as foreign corporations resident in their home countries.<sup>57</sup> This means that, regardless of what additional tax benefits are afforded to foreign sovereigns, under the current rules, foreign sovereigns who invest in the United States will be eligible for

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53. § 871(a) imposes this tax.

54. §§ 871(h)(2), 881(c).

55. § 871(h)(3)(B) The statute provides that “[t]he term ‘10-percent shareholder’ means – (i) in the case of an obligation issued by a corporation, any person who owns 10 percent or more of the total combined voting power of all classes of stock of such corporation entitled to vote, or (ii) in the case of an obligation issued by a partnership, any person who owns 10 percent or more of the capital or profits interest in such partnership.” The Code goes on to apply the traditional § 318 attribution rules in determining 10-percent ownership in this context. *See* § 871(h)(3)(C).

56. § 871(i)(2)(A).

57. § 892(a)(3). The statute provides that “[f]or purposes of this title, a foreign government shall be treated as a corporate resident of its country. A foreign government shall be so treated for purposes of any income tax treaty obligation of the United States if such government grants equivalent treatment to the Government of the United States.” This second sentence is especially noteworthy, since it is a statutory reference to the treaty status of a foreign government. This provides a precedent for the central argument of this Article: that the United States should not be offering a tax benefit to a foreign government if that government does not offer the same benefit back to the U.S. for income earned by the U.S. in that country. The result of this rule is that foreign sovereigns will not receive worse tax treatment in the U.S. than the corporate residents of that country receive. This provision also ensures that foreign sovereigns are eligible for treaty relief, where that relief is provided to corporate citizens of the relevant country.



the tax regime explicated in the previous section.<sup>58</sup> However, the U.S. tax Code offers additional tax benefits to foreign sovereigns, their controlled entities, and their integral parts.<sup>59</sup> I will now turn to a discussion of these additional benefits, but will first discuss the rationale for providing a foreign sovereign tax exemption.

*1. Why Offer an Additional Tax Advantage to Foreign Sovereigns?*

One might ask why the United States would want to provide any additional tax benefits to foreign sovereigns above and beyond the benefits that are provided to nonresident taxpayers generally. The answer is historical, and refers back to the general idea of sovereign immunity.<sup>60</sup> Traditionally in the United States, foreign sovereigns have been found to be exempt from U.S. jurisdiction.<sup>61</sup> This meant that foreign sovereigns were exempt from both the jurisdiction of U.S. courts and the jurisdiction of the U.S. taxing authorities.<sup>62</sup> “Since the beginning of the modern federal income tax, the United States has treated sovereign immunity from taxation as a corollary to the general principle of sovereign immunity.”<sup>63</sup> While this originally applied to all actions taken by a foreign sovereign within the United States’ borders, Congress eventually decided to subject foreign sovereigns to the jurisdiction of U.S. courts when they act in a commercial capacity.<sup>64</sup> This same

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58. Since they are treated as corporate residents of their home countries, foreign governments are eligible for all the income tax benefits available to foreign corporations. These include the portfolio interest benefits of § 881 and the general rule that capital gain is not taxed to a non-resident corporation. Interestingly, any treaty reduction of the statutory 30% withholding rate on FDAP income will only be available to a foreign government if that government treats the U.S. government as a foreign corporation, for purposes of its income tax rules. *See supra* note 49 and the accompanying text for a discussion of the dividend withholding reduction treaty provisions.

59. *See* § 892.

60. For a discussion of the issue of sovereign immunity and its relation to the question of tax treatment of foreign governments, see Gregory May, *The Foreign Sovereign Tax Exemption*, TAX NOTES 389 (Jan. 19, 2009) at 390.

61. *Id.*

62. *See id.*

63. *Id.*

64. *Id.* (“Borne on winds stirred by the mid-century rise of political systems that treated entire economies as public enterprises, a restrictive theory of sovereign immunity began to etch a distinction between foreign governments’ public activities

treatment then appeared in the tax Code.<sup>65</sup> Sovereign immunity and this judicial and tax treatment of foreign sovereigns operating within domestic borders are not entirely uniform.<sup>66</sup> That is, many countries other than the United States offer judicial but not tax immunity to foreign sovereigns.<sup>67</sup>

The effect of the United States choosing to treat foreign sovereigns as corporate residents of their countries is that any additional tax rules regarding foreign sovereigns will merely improve their tax treatment.<sup>68</sup> At worst, foreign sovereigns will default to the tax rules applicable to foreign corporations resident in that country.<sup>69</sup> This is a policy decision. There might very well be reasons to tax foreign sovereigns more heavily (or less heavily) than we tax foreign private investors.<sup>70</sup> I will discuss this issue later in this Article.<sup>71</sup>

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(public acts) and what seemed to be their commercial activities (private acts).”) (internal citation omitted).

65. For a thorough discussion of the history of the exemption, and the relation between the general principles of sovereign immunity and immunity from tax, see Fleischer, *supra* note 1, at 457-61; May, *supra* note 60, at 389-91.

66. May, *supra* note 60, at 389.

67. *Id.*

68. A foreign government can always be treated as a foreign corporation for tax purposes because that is the default treatment for such entities. If the foreign government is eligible for any other tax preference beyond that baseline, it will merely serve to improve the foreign government’s tax result.

69. Importantly, this rule may result in foreign governments receiving better tax treatment than foreign corporations resident in another country. For instance, if country A has many favorable treaty provisions that apply to its resident corporations, but country B does not have such provisions in its treaty with the U.S., or has *no* treaty in place with the U.S., then country A’s government will receive better tax treatment than a corporation resident in country B. In addition, country A’s government will receive better tax treatment than country B’s government.

70. For a discussion of why a rational foreign policy might involve a heavier tax on foreign governments than on foreign private investors, see Fleischer, *supra* note 1, at 480-94 (identifying the positive and negative externalities associated with departing from the so-called “neutrality norm” with regard to taxation of foreign sovereigns).

71. *See infra* Part IV.

## 2. Who Qualifies for the Exemption for Foreign Sovereigns

The benefit provided to foreign sovereigns by the Code is available not only to foreign governments themselves, but also to the “integral parts” and “controlled entities” of those governments.<sup>72</sup> Integral parts include agencies and departments of the foreign government.<sup>73</sup> By contrast, “[c]ontrolled entities are separate legal persons wholly owned and controlled by the sovereign that do not have governmental authority.”<sup>74</sup> Controlled entities, even though they are legally distinct from the foreign sovereign, benefit from the tax treatment of foreign sovereigns because of their status as entities that are wholly owned by a foreign sovereign.<sup>75</sup> However, this treatment only applies to entities that are not “controlled commercial entities.”<sup>76</sup> A controlled commercial entity is an entity that is effectively owned by a foreign sovereign, and that engages in commercial activity anywhere in the world.<sup>77</sup> If a controlled entity engages in commercial activity and thereby rises to the level of a controlled commercial entity, as defined in the Code, then it

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72. See Temp. Treas. Reg. § 1.892-2T(a)(1) (“The term ‘foreign government’ means only the integral parts or controlled entities of a foreign sovereign”). The Treasury Regulation goes on to define both “integral part” and “controlled entity.”

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. The net earnings of the governing authority must be credited to its own account or to other accounts of the foreign sovereign, with no portion inuring to the benefit of any private person.

Temp. Treas. Reg. § 1.892-2T(a)(2).

The term ‘controlled entity’ means an entity that is separate in form from a foreign sovereign or otherwise constitutes a separate juridical entity if it satisfies the following requirements: (i) [i]t is wholly owned and controlled by a foreign sovereign directly or indirectly through one or more controlled entities; (ii) [i]t is organized under the laws of the foreign sovereign by which owned; (iii) [i]ts net earnings are credited to its own account or to other accounts of the foreign sovereign, with no portion of its income inuring to the benefit of any private person; and (iv) [i]ts assets vest in the foreign sovereign upon dissolution.

Temp. Treas. Reg. § 1.892-2T(a)(3).

73. Treas. Reg. § 1.892-2T(a)(2).

74. May, *supra* note 60, at 391.

75. “[An SWF] formed to provide resources for the support of governmental functions and the common welfare generally is a controlled entity of the foreign government.” *Id.* at 392.

76. § 892(a)(2).

77. *Id.*; see also May, *supra* note 60, at 391-92.

will not be entitled to claim the tax benefits afforded to foreign sovereigns.<sup>78</sup> The argument for this distinction is similar to the rationale behind the tax treatment of ECI to foreign private investors.<sup>79</sup> A controlled entity that is engaged in commercial activity will be competing with U.S. commercial entities.<sup>80</sup> Offering a tax exemption to a controlled commercial entity would provide that entity (and the foreign sovereign who controls it) with a significant competitive advantage over its U.S. commercial counterpart. The policy of sovereign immunity does not justify providing foreign governments with such a competitive advantage. Therefore, any controlled entity that engages in commercial activity loses the tax benefit for foreign sovereigns.<sup>81</sup> Clearly, this is a strong incentive for foreign sovereigns and their controlled entities to avoid engaging in commercial activity.<sup>82</sup>

### 3. Tax Benefits for Foreign Sovereigns

Again, foreign sovereigns are, at a minimum, eligible for treatment as foreign corporate residents of their home countries.<sup>83</sup> However, in addition to this (relatively advantageous) tax treatment, foreign sovereigns and their integral parts and controlled entities are also eligible for the tax benefits provided by § 892.<sup>84</sup> The tax preferences

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78. § 892(a)(2); *see also* May, *supra* note 60, at 391-92 (“Because sovereigns govern through their integral parts, integral parts receive wider immunity. They can engage in commercial activities without losing the sovereign exemption for their noncommercial income. *Controlled entities cannot*. If they engage in any commercial activity, they lose their sovereign exemption entirely.”) (emphasis added).

79. *See supra* Part II.B.

80. This raises the question of what import it should have for U.S. tax purposes if a controlled entity is engaged in commercial activity *outside* the U.S. Currently, *any* commercial activity that a controlled entity engages in anywhere in the world will be sufficient to cause that entity to be treated as a controlled commercial entity for U.S. tax purposes. However, if the point of the provision is to level the playing field with regard to commercial activities engaged in within the U.S., then it is not immediately clear why non-U.S. activity should be a relevant factor.

81. § 892(a)(2).

82. “The typical concern of a[n] SWF] is involvement in investments that might cause it to become taxable as a controlled commercial entity.” May, *supra* note 60, at 392.

83. § 892(a)(3).

84. *See id.* § 892(a)(1).

provided in § 892 are statutorily provided benefits available to all foreign sovereigns earning income in the United States.<sup>85</sup> As addressed earlier, the United States is a signatory to many tax treaties, some of which offer additional benefits to foreign sovereigns of the other signatory country.<sup>86</sup> Later in this Article I will discuss the possibility of making the foreign sovereign tax exemption a treaty benefit, thereby limiting its extent, and simultaneously strengthening the U.S. position in asking for reciprocal treatment.<sup>87</sup> For the moment, it is sufficient to remember that any benefits provided by § 892 are available to all foreign governments, their integral parts, and any of their controlled entities that are not controlled commercial entities.

Section 892 exempts from U.S. taxation any investment income earned by a foreign government, its integral parts, or its controlled entities that is *not* earned from a commercial activity.<sup>88</sup> The language of the statute provides an exemption, not on the basis of whether or not the income earned by the foreign sovereign is connected with the sovereign, governmental activities of that entity, but only if the income comes from investments or interest on deposits.<sup>89</sup> The statute focuses the exemption on income earned from what are traditionally viewed as passive (or non-commercial) activities.<sup>90</sup> Indeed, the statute goes on to explicitly remove any income derived from commercial activities from the exemption provided by the previous paragraph.<sup>91</sup> Reading these two paragraphs together, income of foreign governments from stocks or bonds, if derived from a commercial activity, will not qualify for the foreign

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85. *See generally id.* § 892.

86. *Supra* note 49 and accompanying text.

87. For a discussion of this issue, see *infra* section VII.

88. § 892.

89. § 892(a) (emphasis added).

(1) In general. The income of foreign governments received from – (A) investments in the United States in – (i) stocks, bonds, or other domestic securities owned by such foreign governments, or (ii) financial instruments held in the execution of governmental financial or monetary policy, or (B) interest on deposits in banks in the United States of moneys belonging to such foreign governments, shall not be included in gross income and *shall be exempt from taxation* under this subtitle.

90. *See id.* Investing in stocks and bonds and earning interest on bank deposits are traditionally viewed as passive sources of income, also within the world of tax-exempt entities and the Unrelated Business Income Tax. *See infra*, Part VI.

91. “Paragraph (1) shall not apply to any income (i) derived from the conduct of any commercial activity (whether within or outside the United States) . . . .” *Id.* § 892(a)(2)(A).

sovereign tax exemption, even though such income *would* qualify for that exemption if it had not been earned commercially.

Remember, though, that income earned by the foreign sovereign in the form of interest on bank deposits (provided that the interest income was not earned in connection with a trade or business in the United States) would be exempt regardless of the application of § 892, because of the application of the exemption for interest on deposits provided in § 871.<sup>92</sup> Because the foreign sovereign receives all the tax benefits available to foreign corporations, the benefits of portfolio interest and the exemption for interest on deposits that are available to foreign corporations will also be available to foreign sovereigns, even if the income does not qualify for the exemption provided by § 892.<sup>93</sup> As a result, the effect of § 892 is the tax exemption it provides to income earned in the form of dividends, where the dividend is primarily attributable to corporate income earned in the United States.<sup>94</sup>

Importantly, the benefits available to foreign sovereigns under § 892 are not available if the foreign sovereign (or its integral parts or controlled entities) is engaged in commercial activity.<sup>95</sup> Unlike foreign private investors and the analysis applied to ECI, commercial activity by the foreign sovereign *anywhere in the world* will make that foreign sovereign ineligible for the benefits of the foreign sovereign tax exemption.<sup>96</sup> Any income earned by a foreign sovereign that is derived from a commercial activity will be “commercial activity income” (“CAI”) and will be ineligible for the benefits of § 892.<sup>97</sup>

One of the particularly severe elements of this rule stems from the “tainting” nature of commercial activity income. Obviously, any income

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92. § 871(i).

93. §§ 892(a)(3), 871(h).

94. § 871(i). If the dividend is a payout of income earned primarily outside the United States, and if the dividend is paid to an owner with the relevant ownership percentage of the payor corporation, then the dividend would already be exempt from U.S. tax under the Code. *See* § 871(i)(2)(B).

95. § 892(a)(2) (dealing with “Income Received Directly or Indirectly from Commercial Activities”).

96. *Id.* (“IN GENERAL – Paragraph (1) [providing a tax exemption] shall not apply to any income – (i) derived from the conduct of any commercial activity (whether within or outside the United States) . . .”).

97. *Id.*

that is itself earned by engaging in a commercial activity will be CAI.<sup>98</sup> However, in addition, any other income—that is, income that is *not* by its origins CAI—is *also* treated as CAI if earned by the same entity that earned the CAI.<sup>99</sup> That is to say, CAI taints non-CAI, making all income earned by an entity that earns any CAI ineligible for the foreign sovereign tax exemption.<sup>100</sup>

Foreign sovereigns have a strong incentive to avoid engaging in activities that generate CAI.<sup>101</sup> However, even if they do earn income that is statutorily defined as income generated by a commercial activity, foreign sovereigns are not subject to higher tax rates on that income than foreign private investors would be.<sup>102</sup> But foreign sovereigns can easily plan around the tainting rule in order to isolate CAI and limit the possibility of tainting other income. Because income is not attributed from one of a foreign government's controlled entities to another of its controlled entities, any foreign sovereign that expects to earn CAI can create an entity specifically to engage in activities expected to generate CAI. Doing so keeps that income segregated from any other income that is not CAI. While this structuring work can be expensive, it is a relatively straightforward way to avoid the tainting problem. Having one investment vehicle that only generates non-CAI, and a separate vehicle where all investments that might generate CAI are held, ensures that the

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98. § 892(a)(2)(A)-(B).

99. § 892(a)(2)(A)(ii) & (B). Because engaging in any commercial activity at all makes a controlled entity into a controlled commercial entity, and because any income earned by a controlled commercial entity is ineligible for the exemption, the commercial activity in effect taints the other non-commercial income of the controlled commercial entity. For instance, if a corporation that is wholly owned by a foreign government earns commercial income by operating a business, the corporation will meet the definition of a “controlled commercial entity.” As a result, *all* of its income will be ineligible for the § 892 exemption, even though some of its income might be dividend income resulting from the passive ownership of publicly traded stock. If the foreign government owned the stock through another entity that was not a controlled commercial entity, then the dividend would be eligible for the § 892 exemption. The mere existence of some CAI earned by the controlled entity taints all the other income earned by that same entity.

100. *Id.*

101. Income that is not identified as CAI and is not tainted by CAI is eligible for the exemption provided in § 892. Earning CAI makes an entity ineligible for those benefits. Therefore foreign sovereigns will want to minimize the amount of income they earn that is identified as CAI, and, if the generation of CAI is inevitable, they will want to isolate the CAI from all other income.

102. § 892(a)(3).

non-CAI vehicle will qualify for the foreign sovereign tax exemption.<sup>103</sup> The CAI-generating vehicle will not qualify for the foreign sovereign tax exemption, but will still receive the relatively beneficial treatment afforded to foreign private corporations, provided that the income is not ECI.<sup>104</sup>

#### D. DIFFERENCES BETWEEN THE TREATMENT OF FOREIGN PRIVATE CORPORATE INVESTORS AND FOREIGN SOVEREIGNS

The exemption provided in § 892 provides important additional tax exemptions to the already preferential tax treatment received by foreign sovereigns due to their treatment as corporate residents of their own countries. Perhaps most notably, any dividends, which would be taxed for a foreign private investor at 30% (or a treaty-reduced 15% rate),<sup>105</sup> would be eligible for a complete tax exemption if received by a foreign sovereign.<sup>106</sup> The effect of this, while advantageous for all foreign sovereigns, is particularly advantageous for foreign sovereigns who have not signed a treaty with the United States.<sup>107</sup> For these countries, the withholding rate on dividend payments is reduced from 30% to zero.<sup>108</sup> Even for countries that have signed tax treaties with the United States, the lowest dividend withholding rate that the United States

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103. § 892(a)(1) & (2).

104. Because foreign sovereigns are, as a default treated as corporate residents of their countries, the commercial activity analysis is not necessary for determining all of their tax treatment. The tax treatment of a foreign sovereign's income under the corporate non-resident rules will not depend on whether or not the entity has any income from a commercial activity. *See* § 892(a)(3).

105. § 871(a)(1); *see also supra* note 49 and accompanying text.

106. Dividends are income from investments, and therefore qualify for the exemption provided by § 892.

107. Without a treaty benefit in place, foreign governments, subject to tax as foreign corporate investors from their home countries, would be subject to a withholding rate of 30% on dividend payments received from the U.S. § 871.

108. § 892(a)(1). Note that, from a certain perspective, this may be a strong argument in favor of leaving the foreign sovereign tax exemption as a statutory benefit, rather than making it a treaty provision, as I argue later in this Article. Because it is typically only the relatively wealthy and powerful countries that have negotiated tax treaties with the United States, the costs of removing the statutorily provided tax preferences for foreign governments will fall most heavily on poorer and less politically powerful countries. For a further discussion of this issue, *see infra* Part VII.



typically agrees to is generally around 15%,<sup>109</sup> so the statutory provision that lowers that rate to zero is meaningfully beneficial to all foreign sovereign recipients of dividends.<sup>110</sup>

The primary additional benefit that foreign sovereigns receive as a result of § 892 relates to the taxation of interest. The only kinds of interest exempted from tax for foreign private corporate investors, as discussed above, are so-called “portfolio interest” and interest on deposits in banks.<sup>111</sup> By contrast, § 892 provides foreign sovereigns, their integral parts and their controlled (non-commercial) entities, with a tax exemption for *all* earned interest.<sup>112</sup> The effect of this, while relatively minor since § 871 exempts most types of interest, is that interest paid where the foreign sovereign is a greater than 10% owner of the issuer is still exempt from tax for that foreign sovereign.<sup>113</sup> A similarly situated foreign private investor would be subject to withholding and income tax on that interest.<sup>114</sup>

### III. WHAT IS “COMMERCIAL ACTIVITY”?

Any income that is generated to a foreign sovereign by engaging in a commercial activity will be ineligible for the foreign sovereign tax exemption.<sup>115</sup> Clearly, then, one must understand just what commercial activity *is*. The Treasury Regulations under § 892 define commercial activity for purposes of the foreign sovereign tax exemption.<sup>116</sup> This definition is remarkably broad. Anything that is an activity “with a view towards the current or future production of income or gain” is a commercial activity.<sup>117</sup> This broad definition is narrowed by an explicit

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109. See *supra* note 49 and accompanying text.

110. “The principal benefits of the sovereign exemption . . . are limited to portfolio dividends, contingent interest, interest from non controlled, 10% owned entities, and gain on interests in non-controlled U.S. real property holding corporations.” May, *supra* note 60, at 391.

111. § 871(h)-(i); see also *supra* notes 54 to 56 and accompanying text.

112. § 892(a)(1)(B).

113. Section 871 would not apply in such a scenario, but § 892 exempts all interest, regardless of ownership of the borrower.

114. § 871.

115. § 892(a)(2).

116. Treas. Reg. § 1.892-4T(b).

117. *Id.* (“*In general.* Except as provided in paragraph (c) of this section, all activities (whether conducted within or outside the United States) which are ordinarily

list of excluded activities.<sup>118</sup> The excluded activities are primarily pursuits that are traditionally considered to be within the purview of governmental activities, such as cultural events, governmental functions and purchasing.<sup>119</sup> Remember, the primary argument for offering a tax exemption to foreign governments in the first instance was a jurisdictional argument about the sovereign immunity of those foreign governments.<sup>120</sup> On the sovereign immunity argument, these are the activities that *should* be exempted for foreign governments. In these instances, the foreign government is acting in its capacity as a foreign sovereign, and therefore, on sovereign immunity grounds, it should be entitled to a U.S. tax exemption. These particular activities, however, are not performed by SWFs.<sup>121</sup> Most relevant for foreign sovereigns planning to invest in the United States, usually through a SWF, is the first activity that is identified in the Treasury Regulations as non-commercial: investing.<sup>122</sup> According to the Treasury Regulations, “investments in stocks, bonds and other securities, loans, [and] investments in financial instruments held in the execution of government financial or monetary policy . . . ” are *not* commercial activity.<sup>123</sup> While investing is clearly engaged in with a “view towards the current or future production of income or gain,” the exclusion of investing from the definition of commercial activity parallels the definition of ECI for foreign private investors.<sup>124</sup> Again, the difference

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conducted by the taxpayer or by other persons with a view towards the current or future production of income or gain are commercial activities. An activity may be considered a commercial activity even if such activity does not constitute the conduct of a trade or business in the United States under section 864(b).”).

118. § 1.892-4T(c) (“*Activities that are not commercial.* – (1) *Investments . . .* (2) *Cultural Events.* . . . (3) *Non-profit activities . . .* (4) *Governmental functions . . .* (5) *Purchasing . . .*”).

119. *Id.*

120. *See supra* notes 60 to 71 and accompanying text.

121. Remember the definition of SWFs offered earlier in this article—these are not governments operating in a governmental capacity, but merely pools of capital investing with the same goal as any other investor. *See supra* Part II.A.

122. Treas. Reg. § 1.892-4T(c)(1).

123. *Id.* § 1.892-4T(c)(1)(i).

124. This is the language used to define “commercial activity.” Treas. Reg. § 1.892-4T(b).

relates to the “passive” or “active” nature of the activity that generates the income.<sup>125</sup>

The Regulations go on to treat as “non-commercial” income that is earned by a foreign government by engaging in trading.<sup>126</sup> The Treasury Regulations state that “effecting transactions in stocks, securities, or commodities for a foreign government’s own account does not constitute a commercial activity . . . .”<sup>127</sup> Traditionally, trading is viewed as a less-passive (more active) income-producing activity than investing. However, the list of trading activities that are *not* commercial activities is more expansive than the list of investing activities that is included in the Regulations.<sup>128</sup> In particular, the Regulations include trading commodities as a non-commercial activity, whereas investing in commodities is not explicitly identified as a non-commercial activity.<sup>129</sup> There is currently significant debate about the implications of this distinction, and the confusion about whether or not investing in commodities is, in fact, a commercial activity that will “taint” the other non-commercial income earned by an SWF in any particular year is likely having an effect on the amount of SWF investment in commodities.

What is important to note here is that the list of “non-commercial” activities in the Treasury Regulations is meant to encompass the world of governmental activities entitled to sovereign immunity.<sup>130</sup> It is these activities that Congress intended to exempt from tax when creating the foreign sovereign tax exemption. This adds to the incongruity of finding

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125. *Id.*; see also *infra* Part VI.

126. *Id.* § 1.892-4T(c)(ii).

127. *Id.*

128. In particular, the Treasury Regulations explicitly identify trading in commodities as a non-commercial activity, but do not explicitly identify investing in commodities as non-commercial. One might extrapolate from trading back to the (less active) activity of investing, but it does seem strange that the Regulations explicitly include commodities in one subsection and not the other. Compare Treas. Reg. § 1.892-4T(c)(i) (identifying non-commercial investing activities, and not including investing in commodities), with Treas. Reg. § 1.892-4T(c)(ii) (identifying non-commercial trading activities, and explicitly including trading in commodities).

129. While this might seem an obvious point, there is a significant debate on this issue currently. In particular, see May, *supra* note 60, at 395-97; N.Y. ST. B.A. TAX SEC., REPORT ON THE TAX EXEMPTION FOR FOREIGN SOVEREIGNS UNDER SECTION 892 OF THE INTERNAL REVENUE CODE 19-20, 27, 39-40 (2008).

130. See *supra* note 120 and accompanying text.

“investing” on this list.<sup>131</sup> A further discussion of how investing is viewed as “non-commercial” (or “non-business,” depending on the section) in other Code sections appears later in this Article.<sup>132</sup>

#### IV. NON-TAX POLICY CONCERNS REGARDING INVESTMENTS BY SWFS

If there were strong policy reasons for encouraging SWFs to invest in the United States then, absent other strong countervailing policy reasons (tax or otherwise) to discourage investment, the tax law should be crafted to encourage that investment. However, the non-tax rationale for encouraging SWF investment in the United States has not yet been clearly stated. On the contrary, there are strong reasons to be concerned about SWFs investing in the United States, and to establish a tax policy that does not unnecessarily encourage such investment.

One of the most commonly repeated concerns regarding investment by SWFs (and, by implication, their foreign government owners) relates to national security concerns.<sup>133</sup> This argument centers around the thought that a foreign government can obtain meaningful amounts of power over the United States through the use of its SWF by establishing the SWF as a significant actor in the U.S. economy and thereby becoming the owner of large amounts of U.S. equity interests. This power could exert itself in a number of ways. First, the foreign government, acting through the SWF, could negatively influence the U.S. economy by selling off large amounts of stock. Clearly any such action would also negatively affect the SWF itself, lowering the value of its U.S. investments. This would not be the action of a rational economic actor, and, indeed there is no evidence of any SWF engaging in such actions thus far.<sup>134</sup> However, the possibility remains, and any tax policy

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131. Indeed, it feels a bit like that old Sesame Street song “One of These Things is Not Like the Others.”

132. See *infra* Part VI.

133. See Joint Comm. on Tax’n, *Economic and U.S. Income Tax Issues Raised by Sovereign Wealth Fund Investment in the United States*, *supra* note 1, at 30.

134. For a discussion of the behavior of SWFs and their investment strategies, see Lynann Butkiewicz, Nicholas Pettifer & Tom Young, *Panic*, 27 INT’L FIN. L. REV. 22 (2008); Philip Lader, *Massive, Passive and Patient . . . or Naughty Knights to the Rescue?*, 43 INTL. SOC’Y BARRISTERS Q. 403 (2008); Richard A. Epstein & Amanda M.

decision should reflect this possibility. Second, a foreign government, acting through its SWF, may take advantage of its ownership interest in a U.S. company to gain access to critical information, or to force the company to act in such a way that the SWF-controlled U.S. company becomes less competitive than its counterpart located in the SWF's home country. Again, there is no evidence of a SWF having acted in such a way, and, in fact, SWFs have not yet taken more than a 10% ownership interest in any U.S. company.<sup>135</sup> But, again, such scenarios should be contemplated when crafting a coherent tax policy.

On the other hand, encouraging foreign governments to invest in the United States may have positive consequences for national security. Having a foreign government intricately invested in the stability of the United States' economy will give these governments a financial incentive to help protect the United States and its economy.<sup>136</sup> Any economic instability or security threat to the United States would have a meaningful financial impact on the SWFs invested here—an impact that the beneficiaries of those SWFs (the foreign governments themselves) will want to avoid. Therefore, on this theory, extensive SWF entanglement in the United States economy will positively affect national security and economic stability, to the extent that foreign governments have influence on those issues.

As is clear from this discussion, there may be non-tax policy reasons to encourage SWFs to invest in the United States economy, but simultaneously there may be reasons to raise hurdles to such investment. Until there is clear legislative intent regarding investment by SWFs in the United States, tax policy should neither encourage nor discourage such investment, as compared to the general tax approach to investment by foreign entities. Unfortunately, the current statutory arrangement offers an additional tax advantage to foreign governments and SWFs

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Rose, *The Regulation of Sovereign Wealth Funds: The Virtues of Going Slow*, 76 U. CHI. L. REV. 111, 111 (2009); Justin O'Brien, *Barriers to Entry: Foreign Direct Investment and the Regulation of Sovereign Wealth Funds*, 42 INT'L LAW. 1231 (2008); Brendan J. Reed, *Sovereign Wealth Funds: The New Barbarians at the Gate? An Analysis of the Legal and Business Implications of Their Ascendancy*, 4 VA. L. & BUS. REV. 97, 99 (2009).

135. See Butkiewicz et al., *supra* note 134, at 2.

136. This analysis of investment is not new. As the proverb goes, "If you owe the bank \$100, that's your problem. If you owe the bank \$100 million, that's the bank's problem."

beyond what is available to foreign investors more generally.<sup>137</sup> This tax subsidy is unjustified, as there is no current policy objective that the subsidy achieves.

### V. INCOMPLETENESS OF THE CURRENT RULE

If the rationale for offering foreign governments a tax exemption is to respect their autonomy and their immunity from U.S. jurisdiction while performing governmental activities, then the current form of § 892 and the affiliated Treasury Regulations fail in two respects. The rule is both too broad, offering a tax exemption for activities that are not, in fact, governmental activities, and too narrow, failing to provide a tax exemption for certain income earned by foreign governments while performing governmental activities. In this Part, I will turn to the narrowness concern.

As I discussed earlier in this Article, the current rule providing a tax exemption for investment income to foreign governments earning such income in the United States cannot be justified by reference to the general rule of sovereign immunity.<sup>138</sup> The current jurisdictional sovereign immunity rules provide immunity from the U.S. court system only to the extent that the foreign sovereign is engaged in a government activity. Congress has determined, however, that foreign governments engaged in commercial (as opposed to governmental) activity *are* subject to the jurisdictional authority of the U.S. courts.<sup>139</sup> The tax rule attempts to track this distinction by allowing an exemption from United States taxation if income is earned by a foreign government engaged in governmental activities, but simultaneously denies that exemption to any income earned by a foreign government as a result of a “commercial

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137. In response to this, one might argue that there is also a tax preference for foreign investors that is not available to domestic investors. Indeed, non-resident taxpayers do not pay U.S. capital gain tax on investment gains they earn on U.S. securities, while their domestic counterparts are subject to that tax. If the taxpayer is resident in a country without a capital gains tax, such as Switzerland, then that taxpayer will receive her gains tax-free. This may also be an unjustified tax preference, but an analysis of that particular argument is outside of the scope of this Article.

138. *See supra* Part III.

139. *Id.*

activity.”<sup>140</sup> Again, the rationale for taxing a foreign sovereign’s income from commercial activities is that a foreign government acting in a commercial capacity is a competitor to a U.S. resident taxpayer engaged in the same commercial activity. Providing a tax exemption to the foreign government would give that foreign government an unjustified competitive advantage. In addition, since the foreign government is not engaging in governmental activities related to its sovereign responsibilities, the rationale of sovereign immunity should not apply. Tax policy considerations that compete with the principle of sovereign immunity argue in favor of ensuring the competitiveness of resident taxpayers in the commercial arena, at least to the extent this can be affected by federal taxation. However, despite this tax policy goal, as I have already explained, the Code and the Regulations go on to except investment activity from the definition of commercial activity.<sup>141</sup> Therefore, foreign government investors receive a tax-based competitive advantage as compared with their non-government foreign counterparts, and their U.S. resident counterparts, in the arena of investing.

If the rationale for excluding commercial activities from the tax exemption provided to foreign governments is that commercial activities are not governmental activities, it is difficult to see how “investing” is properly categorized as a non-commercial (and therefore governmental) activity. Excluding investing from the definition of commercial activity means that foreign governments receive a tax exemption for income earned from investing, which seems to be primarily a non-governmental activity.<sup>142</sup>

By contrast (and here is where the rule seems importantly too narrow), income earned by a foreign government that *is* earned from a governmental activity, but where that activity is *not* investment-related

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140. See § 892(a)(2)(A).

141. See Treas Reg. § 1.892-4T(c)(1).

142. One can imagine that this exemption for investing, when it was drafted in 1917, applied in very specific cases, radically different from its current application to SWFs. Imagine, for instance, that the government of France opens a new consulate in the United States. France will likely open bank accounts to support its consulate, and may even have certificates of deposit or a money market account in order to keep up with inflation. The exemption provided by § 892 protects any income France earns on these accounts from U.S. taxation. However, this example conceives of “investing” as a radically different thing than the current version of investing by SWFs, which more closely resembles the classic private equity model, and likely involves significantly higher dollar amounts accruing annually to the investors..

will be ineligible for the exemption.<sup>143</sup> This unintended consequence violates the policy rationale for providing the exemption in the first place. Sovereign immunity justifies exempting income earned by foreign governments in the performance of governmental activities. Whether that income comes in the form of investment income, or in another form altogether should be irrelevant to the provision of the exemption.

The unintended taxation of the non-commercial, non-investment income of foreign governments arises because of the structure of the statute. Section 892(a)(1) states that income from investing or earned as interest on bank deposits is exempt from tax. Then Section 892(a)(2) says that if the income referred to in § 892(a)(1) is income from a commercial activity then it is not exempt.<sup>144</sup> The Treasury Regulations go on to define commercial activity.<sup>145</sup> But pause here for a moment. The *only* exemption offered in § 892 is to income earned by investment activity.<sup>146</sup> There is *no* statutory tax exemption for income of a foreign government earned while engaging in governmental activities *unless* that income is investment income.<sup>147</sup>

Imagine how this tax rule might apply in the case of a foreign government participating in a cultural festival in the United States. The foreign government may earn some income from its participation in the festival, perhaps from the sale of tickets, t-shirts or souvenirs. The Treasury Regulations under § 892 explicitly state that participation in cultural events is *not* commercial activity for the purposes of § 892.<sup>148</sup> However, does this mean that the income earned by this foreign government is therefore exempt from U.S. taxation? Not under the current statute. In order to qualify for the exemption provided by § 892, the income earned by the foreign government must be income from investment.<sup>149</sup> This imagined income from a cultural festival is clearly not income from “investment in the United States in stocks, bonds, or

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143. See § 892(a)(1). Only income from investments and interest on deposits are exempted under § 892.

144. § 892(a)(1)-(2).

145. Treas. Reg. §1.892-4T(b).

146. § 892(a)(1).

147. *Id.*

148. Treas. Reg. §1.892-4T(c)(2).

149. § 892(a)(1).



other domestic securities . . . or . . . financial instruments held in the execution of governmental financial or monetary policy, or . . . interest on deposits in banks in the United States . . . ” which is the language authorizing a tax exemption for foreign governments.<sup>150</sup> Therefore, this income would not benefit from the § 892 exemption, and would, in fact, be subject to tax in the United States.

This example illustrates the way in which the structure of Section 892 violates the policy behind providing the foreign sovereign tax exemption. The Treasury Department identified participation in cultural events as the kind of governmental activity that it had in mind when it listed such activity as an exception from “commercial activity” in the Treasury Regulations.<sup>151</sup> But the current statutory structure ends up taxing income earned from that activity, rather than providing an exemption. A better model would provide a clear exemption for income earned by engaging in governmental activities, and then make an exception for commercial activities, rather than identifying income from investment as the only income for which the exemption will be provided.

## VI. ACTIVE/PASSIVE DISTINCTION IN THE TAX CODE

The distinction between commercial and non-commercial activity in the context of the income earned by foreign governments in the United States has parallels in other sections of the Code. Indeed, many Code sections make a distinction for tax purposes between income that is earned actively and income that is earned passively.<sup>152</sup> For instance, not-for-profit entities that qualify for a tax-exemption under § 501(c)(3) may earn income that is unrelated to their tax-exempt purpose on a tax-

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150. *Id.*

151. Treas. Reg. § 1.892-4T(c)(2) (“*Cultural Events* – Performances and exhibitions within or outside the United States of amateur athletic events and events devoted to the promotion of the arts by cultural organizations are not commercial activities”).

152. *See, e.g.*, § 864(b)(2)(A)(ii) (stating that trading in securities or commodities for a taxpayer’s own account does not rise to the level of a trade or business for U.S. tax purposes), and § 512(a)-(b) (defining “unrelated business taxable income” in the area of tax-exempt organizations, and then exempting from the definition of “unrelated business taxable income” “all dividends, interest, payments with respect to securities loans . . . amounts received or accrued as consideration for entering into agreements to make loans, and annuities, and all deductions directly connected with such income”).

free basis, as long as it is passive investment income.<sup>153</sup> However, any income that a non-profit actively earns from engaging in a trade or business unrelated to its exempt purpose is taxed at corporate rates, rather than qualifying for exemption from federal income tax.<sup>154</sup> The typical justification for this treatment follows the same lines as the argument for taxing foreign governments on their income from commercial activity. If a non-profit entity were exempt from tax on its income from a commercial activity (so called “unrelated business taxable income” or “UBTI”), then it would have a competitive advantage compared with for-profit entities in the same field. If the activity in question is unrelated to the exempt purpose of the non-profit, then that advantage is unjustified.<sup>155</sup> However, if the income is earned through passive investments, then the non-profit is exempt from tax on the income that it earns.<sup>156</sup>

The argument for allowing non-profit entities to earn tax-free investment income centers on their tax-exempt status. Generally speaking, if the entity is not-for-profit and has a charitable purpose, then its income should be exempt from tax, unless there is a clear reason to tax the income in question. The reason to tax unrelated business income is to avoid providing the entity with an unfair competitive advantage. There is no such competitive advantage with regard to investment income, therefore there is no need to impose tax on it. We can, as a policy matter, accept the tax-free nature of the non-profit’s investment income because the income will further the charitable purposes of the non-profit.

This may be a convincing argument with respect to non-profits, as Congress and the IRS have made explicit decisions to exempt those entities from tax, and have identified the charitable purposes that justify

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153. *See, e.g.*, § 512(b)(1).

154. *See* § 511 (imposing tax on the unrelated business income of charitable organizations), § 512(a) (defining unrelated business taxable income).

155. For a discussion of the rationale for instituting a tax on the unrelated business income of charitable organizations, *see* Treas. Reg. 1.513-1(b) (“The primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete.”).

156. *Supra* note 152.

their general tax-exemption. This charitable purpose rationale can then justify exempting the investment income of a non-profit from tax. However, there is no clear parallel to the charitable purpose of a non-profit entity in the case of a foreign government. Congress has not clearly identified foreign governments as deserving of a tax exemption, and therefore the investment income earned by a foreign government should be treated more like the investment income of a private entity than like the investment income of a non-profit.

International tax provides another example of the active/passive distinction in the income tax world. In determining whether or not a foreign individual has effectively connected income (“ECI”) for U.S. tax purposes, the Code looks to whether the taxpayer was actively engaged in the business, or was “merely” trading or investing.<sup>157</sup> In this case, trading or investing on their own do not constitute a trade or business for U.S. income tax purposes, so income generated by trading or investing will not be treated as ECI for a foreign investor. If a nonresident taxpayer *does* have ECI, that income is taxed at the rates in effect under § 1, making the nonresident taxpayer equivalent to the resident taxpayer, for federal tax purposes. The rationale for taxing ECI at resident tax rates again stems from a desire not to give tax preferences to foreign businesses that will advantage the foreign businesses as compared with their domestic counterparts. However, the tax preference given to trading and investment income cannot be justified on these same grounds. On the contrary, exempting investment income or income earned by trading for one’s own account from the definition of ECI, and thereby exempting it from the tax rates imposed by § 1, can give a significant competitive advantage to non-U.S. investors. Therefore, the same rationale that justifies exempting the investment income of non-profit entities from tax does not apply in this context.

While it is true that this active/passive distinction is present throughout the Code, in the sections mentioned above, as well as others,

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157. § 871(b) imposes a tax on income earned by a non-resident in a trade or business. “A nonresident alien individual engaged in trade or business within the United States during the taxable year shall be taxable as provided in section 1 [establishing resident tax rates] . . . .” § 871(b)(1). “Trade or business” is defined in § 864, which states that “the term ‘trade or business within the United States’ . . . does not include . . . (2) . . . [t]rading in . . . stocks or securities through a resident broker, commission agent, custodian, or other independent agent . . . [or] trading in stocks or securities for the taxpayer’s own account, whether by the taxpayer or his employees or through a resident broker, commission agent, custodian, or other agent . . . .” § 864(b)(2)(A)(i)-(ii).

a larger discussion of this distinction and its ramifications is outside of the scope of this Article. Given the changing nature of the economy, and the increasing presence of passive investors, it may be time to re-evaluate the tax preferences available for passive investment income. Amending the active/passive distinction (in the form of the commercial/investing distinction) for foreign governments and SWFs does not necessitate a full re-evaluation of the active/passive distinction in other parts of the Code. The language describing “commercial” in the context of § 892 can easily accommodate investment activity, without implicating the definition of “active” or “passive” in other Code sections. This narrow focus is part of what makes the foreign sovereign tax exemption so ripe for change. Any alteration of the law can be done narrowly, without necessarily implicating other Code sections, where Congress is not yet prepared to change the law.

#### VII. TAX EXEMPTION AS NEGOTIATION TOOL

An additional problem with the current form of the foreign sovereign tax exemption is the universality of the statutory structure. Since the United States offers a statutory tax exemption to *all* foreign sovereigns who invest in the United States, there remains no negotiation tool to ensure that the United States and its controlled entities and integral parts receive the same treatment in other countries.<sup>158</sup> Under current law, the United States offers a foreign sovereign tax exemption to a number of countries that do not offer the same exemption in return. A country need not have negotiated a tax treaty with the United States in order to benefit from the foreign sovereign tax exemption. Since it is provided as a statutory matter, even countries with whom the United States has never signed a tax treaty are beneficiaries of the provision. Many of these countries do not have statutory foreign sovereign tax

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158. One might argue that we do not always need to receive reciprocal treatment in order to make a policy decision. In other words, if the policy is good, the United States should offer it as a statutory matter, regardless of whether other countries provide the same benefits to the United States. This may be true in other circumstances where there are good policy justifications for the rule, but, as I have argued in this Article, there is no good justification for the foreign sovereign tax exemption, so, at a minimum, the United States should be getting something in return when it offers this subsidy to foreign governments investing in the U.S.

exemptions, and therefore the United States does not have the benefit of an exemption on income it earns in those countries. As a practical matter, since the United States does not currently have a federal SWF, there may be less pressure at the national level to seek such an exemption. However, there are U.S. entities that could benefit from a provision paralleling the current provision in Section 892. For instance, the Alaska Permanent Fund and CALPERS are both entities that would qualify for the benefits of a foreign equivalent of Section 892.<sup>159</sup>

Arguably, some good things do come out of the statutory provision of the foreign sovereign tax exemption. The United States primarily signs tax treaties with wealthier and more politically powerful nations.<sup>160</sup> A country with whom the United States has not yet signed a tax treaty might need the revenue it can generate by investing and earning income in the United States. That country might benefit tremendously, and possibly quite justifiably, from the exemption provided statutorily to foreign sovereigns by Section 892. However, the revenue lost through the unjustified provision of the exemption to the richest countries investing the largest amounts in the United States far outweighs the possible social justice gains at the margins. If the U.S. government elects to engage in international relief work, it will be much more effective to engage in the subsidies of foreign governments directly than to do so through the statutory provision of a tax exemption to all foreign governments investing and earning income in the United States.

As a foreign policy matter, there is no clear reason why the United States should offer tax benefits to foreign governments (and their integral parts and controlled entities) when these benefits are not available to the United States in return. Indeed, the fact that the exemption is offered as a statutory matter means that the United States also provides a tax exemption (and thereby financial support) to countries that it might not wish to support.<sup>161</sup> There is no good policy reason, neither foreign policy or tax policy, for providing such benefits while receiving nothing in return.

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159. For a discussion of the U.S. entities that would qualify as Sovereign Wealth Funds, see Fleischer, *supra* note 1.

160. See, e.g., note 49 for the list of countries with whom the United States has signed a tax treaty.

161. It is surprising, for instance, to think that at the same moment that we were at war with Iraq and Afghanistan, our Code was providing an exemption from tax on any income those governments might have earned in the United States.

### CONCLUSION

I have argued that the current tax treatment of SWFs, as an extension of the foreign governments that own them, is both unfair and incomplete. The current model is unfair, because it offers to SWFs an unjustified additional tax exemption beyond that offered to foreign private corporate investors. The lack of clear legislative intent authorizing such a tax preference makes this violation of horizontal equity indefensible. In addition to this inequity, the current statutory model is incomplete, as it does not actually achieve the underlying Congressional goals related to sovereign immunity. The principle of sovereign immunity aims to exclude foreign sovereigns from U.S. jurisdiction, including its taxing jurisdiction, when those sovereigns are engaged in governmental activities. However, the structure of the foreign sovereign tax exemption statute allows a foreign government to earn income from its governmental activities which, if that income is not income from investments, will be subject to tax in the United States. Therefore, the current statutory model fails on both counts.

In this Article I have proposed that Congress amend Section 892 to ensure that all income earned by a foreign government engaging in governmental activities will be exempt from tax in the United States. Simultaneously, Congress should remove the provision exempting foreign sovereigns (and, by extension, SWFs) from U.S. tax on investment income, and instead offer such exemptions, when they are desirable, through negotiation as a treaty provision. This change would allow the exemption to be more narrowly tailored to satisfy the goals of its original enactment, and would also ensure that the United States receives comparable tax treatment in return.