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“A Theory of Taxing Sovereign Wealth”

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A Theory of Taxing Sovereign Wealth

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ABSTRACT

Sovereign wealth funds enjoy an exemption from tax under section 892 of the tax code. This anachronistic provision offers an unconditional tax exemption when a foreign sovereign earns income from non-commercial activities in the United States. The provision, which was first enacted in 1917, reflects an expansive view of the international law doctrine of sovereign immunity that the United States (and other countries) discarded fifty years ago in other contexts. The Treasury regulations accompanying section 892 define non-commercial activity broadly, encompassing both traditional portfolio investing and more aggressive, strategic equity investments. Because section 892 was not written with sovereign wealth funds in mind, the policy rationale for this generous tax treatment has not been closely examined before.

This Article provides a framework for analyzing the taxation of sovereign wealth. I start from a baseline norm of “sovereign tax neutrality,” which would treat the investment income of foreign sovereigns no better and no worse than private investors’ income. Nor would it favor any specific nation over another. Whether we should depart from this norm depends on several factors, including the external costs and benefits created by sovereign wealth investment, whether tax or other regulatory instruments are superior methods of attracting investment or addressing harms, and which domestic political institutions are best suited to implement foreign policy. I then consider whether we should impose an excise tax that would discourage sovereign wealth fund investments in the equity of U.S. companies. If desired, the tax could be designed to complement nontax economic and foreign policy goals by discouraging investments by funds that fail to comply with best practices for transparency and accountability.

The case for repealing the existing tax subsidy is strong. We should tax sovereign wealth funds as if they were private foreign corporations; there is no compelling reason to subsidize sovereign wealth. My analysis also shows that imposing a special excise tax may not be the optimal regulatory instrument for managing the special risks posed by sovereign wealth funds, although a carefully-designed tax would be more effective than the status quo.
I. INTRODUCTION .............................................................................1

II. CURRENT LAW ...........................................................................11
   A. What Are Sovereign Wealth Funds? ........................................ 11
   B. Historical Background ......................................................... 13
   C. Taxing Inbound Foreign Investment ...................................... 19
   D. Section 892 .......................................................................... 22

III. A THEORY OF TAXING SOVEREIGN WEALTH ............................25
   A. Sovereign Tax Neutrality ....................................................... 25
   B. The Case for an Excise Tax on Sovereign Wealth ................. 30
      1. Literature Review: Costs and Benefits ............................. 32
      2. Positive Externalities ....................................................... 36
      3. Negative Externalities .................................................... 41
      4. Summary ........................................................................ 49
   C. What Is The Right Regulatory Instrument? ......................... 50
      1. Instrument Choice .......................................................... 50
      2. Domestic Political Institutions ......................................... 53

IV. REFORM ALTERNATIVES...........................................................58
   A. Tax Sovereign Wealth Funds as Private Corporations .......... 58
   B. Excise Tax on Sovereign Wealth Funds ............................... 59
   C. Conditional Tax Exemption .................................................. 60

V. CONCLUSION ..............................................................................60

APPENDIX.........................................................................................61

I. INTRODUCTION

Prologue. Morgan Stanley, the storied New York investment bank, was navigating treacherous waters in late 2007. The white-shoe firm held billions of dollars worth of exposure to subprime mortgages. It had already taken $5 billion of losses on its income statement, and more losses were expected. Bear Stearns had not yet collapsed, but Wall Street was plenty worried that the credit crunch

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could induce the death spiral of a major investment bank. Morgan Stanley needed additional equity to shore up its balance sheet.¹

Like many of its investment banking rivals, Morgan Stanley turned to a sovereign wealth fund for assistance. On December 19, 2007, Morgan Stanley announced the sale of a 9.9% equity stake to the China Investment Corporation (CIC), a sovereign wealth fund controlled by the Chinese government.² Just a few years ago, this kind of financing deal between a New York investment bank and a foreign government was virtually unheard of. An investment bank in dire straits would likely have turned instead to a private investor, such as a private equity fund in the United States, or perhaps a private investor in Europe, Japan, or the Persian Gulf. By 2007, however, sovereign wealth funds had appeared on the scene as ready suppliers of equity capital. These state-controlled investment funds, which had historically invested primarily in Treasury bonds and other government obligations, were eagerly buying up the common stock of financial services firms like Morgan Stanley, Citigroup, Blackstone, Carlyle, and Merrill Lynch.

It’s easy to understand why Morgan Stanley sold equity to China: It needed the money, and China was an appealing counterparty. China offered the best price, agreed to be locked in to the stock for several years, and was willing to take equity without the control rights or board seats a hedge fund or private equity fund might have demanded. The deal was structured using a tailored financial product that avoids CFIUS review, counts as Tier 1 capital for bank regulatory purposes and receives some equity credit from the rating agencies, but generates a tax deduction for Morgan Stanley when it makes dividend-like quarterly contract payments to China.³ (Because China’s sovereign wealth fund is tax-exempt, it pays no tax on the receipt of those payments.) From Morgan Stanley’s point of view, there was little downside.

The challenge is figuring out why China was willing to make the investment on these terms. It’s naïve to assume that China bought the stock purely for financial reasons. China did not suddenly become the Warren Buffett of the global capital markets, divining intrinsic value in Morgan Stanley stock that other financial investors failed to unearth. It’s more plausible, I think, that China bid a higher price for the stock because it had other, nonfinancial motives

² See id.
³ CFIUS stands for Committee on Foreign Investment in the United States, an inter-agency committee chaired by the Secretary of the Treasury that reviews certain cross-border deals for national security considerations.
as well. The problem with sovereign wealth funds is that it’s not entirely clear what these motives are. The best we can do is infer China’s objectives from the available evidence.

To be sure, the managers of China’s state-controlled investment vehicles have a financial motive to achieve good investment returns. But as a sovereign nation, China also has a range of other political and strategic interests that shape its investment policy. In fact, the structure of CIC ensures that the fund is sensitive to the political and strategic influence of China’s ruling party. CIC reports directly to the State Council (the equivalent of the U.S. President’s Cabinet), and nearly all of CIC’s board of directors hold Party-appointed jobs within China’s financial bureaucracy. The investment advances China’s geopolitical agenda; investing in firms like Morgan Stanley, Blackstone, Visa and Barclays embeds the Chinese in Western financial networks. This isn’t necessarily bad: China can learn from its relationships with Western financial institutions as it continues to modernize its financial system. More ominously, by investing directly in U.S. equities, China expands its influence over American economic and foreign policy.

Our understanding of sovereign wealth funds is limited by the funds’ lack of transparency. What we do know for sure, after observing the string of investments by sovereign wealth funds in U.S. financial institutions, is that sovereign wealth funds were willing to pay more for the equity of these financial institutions than private investors were willing to pay. In corporate finance terms, the funds had a lower “hurdle rate” for these target investments; their managers count strategic and political gains as well as financial gains in evaluating the success of an investment. The political dynamics of investments by countries like Abu Dhabi, Saudi Arabia, and Singapore differ from China, but all share the potential for mixed-motive investments.

The ambiguity of mixed-motive investment has fed a broad anxiety about sovereign wealth funds. Fifty-five percent of registered voters think investments made by foreign governments in U.S. companies have a negative effect on U.S. national security, while only ten percent see a positive effect. Voters favor investment by Australia, Norway, and Europe generally, but strongly oppose investment by Kuwait, Russia, China, Saudi Arabia, and Abu

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Dhabi. Nor is the negative reaction strictly populist, protectionist, or xenophobic. Top leaders in Europe share the American public’s skepticism, and a few high-profile American observers, like Senator Evan Bayh and former Treasury Secretary Larry Summers, have joined in.

The administration has not rushed to curtail investment by sovereign wealth funds. There is a yawning gap between the public’s apprehension and the administration’s welcome mat. Consider the upbeat comments of Robert Kimmett, Deputy Secretary of the Treasury: “SWFs may be considered a force for financial stability — supplying liquidity to the markets, raising asset prices, and lowering borrowing yields in the countries in which they invest.” Foreign investment in U.S. companies is a key element of our future economic growth, and the Treasury Department has embraced open access to U.S. capital markets by foreign investors as the dominant principle driving our public policy in this area. What the administration has sought—and what other academics have offered—is a set of modest regulatory responses that will sprinkle holy water on these state-controlled investments, allowing state-owned capital to seamlessly flow across borders without scraping up geopolitical concerns.

Tax policy offers stronger medicine that Congress and policymakers in the new administration might consider in addressing the risks posed by sovereign wealth. Tax policy also provides a useful framework for distilling and clarifying the relevant policy goals. As a tax law professor, I study how tax policy affects the framework of institutional investment, such as how tax policy affects venture capital firms and private equity firms, the companies they own, and the institutional investors they partner with. Sovereign wealth funds, after all, claim to be just another group of financial investors. Through the lens of institutional analysis,

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1 See id. at 2 (question 11).
4 In addition to tax and public finance scholarship, this Article draws insight from New Institutional Economics, a methodology which applies transaction costs economics to institutions (as opposed to organizations, firms, or individuals). Institutions are the set of formal and informal law, rules, and norms that
however, sovereign wealth funds differ both conceptually and in practice from their institutional investor counterparts in the private sector. The institutional differences lead me down two interconnected paths in constructing a theory of taxing sovereign wealth.

First, thinking about sovereign wealth funds as institutional investors exposes a striking tax policy discrepancy. On the one hand, sovereign wealth funds expect to be treated like private financial investors for purposes of corporate law, banking law, and national security law. They promise to invest for purely financial purposes. On the other hand, for tax purposes we unilaterally treat them as sovereigns acting to further political, diplomatic or humanitarian agendas, and we therefore exempt them from taxation as if it were a matter of international comity. It is hardly obvious that we should allow sovereign wealth funds to enjoy the best of both regulatory worlds. As sovereign wealth funds become powerful players in the capital markets, the more logical presumption is that they should pay tax like other financial institutions. There is no compelling reason to favor state-controlled investment over private capitalism.

Second, paying attention to institutional detail surfaces critical differences between sovereign wealth funds and other financial institutions. Many sovereign wealth funds are not mature, experienced financial institutions. They have not yet adopted the norms of professionalization that led to the flourishing of other potentially politically-sensitive institutional investors, like U.S. state pension funds and university endowments. History suggests that we should not encourage investment by financial institutions that have not yet internalized these important norms. Indeed, we may even want to impose an excise tax to actively discourage investments by sovereign wealth funds. On the other hand, institutional analysis also reveals striking differences among funds. China, Singapore, and Abu Dhabi, for example, each have different goals, and each has adopted different governance structures for its various funds in order to achieve those goals. Tax policy may not be the optimal regulatory tool to address the disparate risks created by each fund, particularly as those funds evolve over time.

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determine the behavior of individual actors. See Douglass C. North, Institutions, 5 J. ECON. PERSP. 97, 97 (1991).

- 5 -

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Summary of the Argument. This Article provides a framework for analyzing the taxation of sovereign wealth. I start from a baseline norm of “sovereign tax neutrality,” which would treat the investment income of foreign sovereigns no better and no worse than private investors’ income. Nor would it favor any specific nation over another. Whether we should depart from this norm depends on several factors, including the external costs and benefits created by sovereign wealth investment, whether tax or other regulatory instruments are superior methods of attracting investment or addressing harms, and which domestic political institutions are best suited to implement foreign policy. I then consider whether we should impose an excise tax that would discourage sovereign wealth fund investments in the equity of U.S. companies. If desired, the tax could be designed to complement nontax economic and foreign policy goals by discouraging investments by funds that fail to comply with best practices for transparency and accountability.

The case for repealing the existing tax subsidy is strong. We should tax sovereign wealth funds as if they were private foreign corporations; there is no compelling reason to subsidize sovereign wealth. My analysis also shows that imposing a special excise tax may not be the optimal regulatory instrument for managing the special risks posed by sovereign wealth funds, although a carefully-designed tax would be more effective than the status quo.

Following this lengthy Introduction, Section II of this Article reviews current law. The tax treatment of sovereign wealth has been ignored by academics in recent years. Under current law, portfolio

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There is a small literature from the 1960s and 1970s on section 892, discussed infra at Section II.B. The articles mainly focus on the distinction between commercial and non-commercial activity. Because sovereign wealth funds had not yet emerged, there is little attention paid to the portfolio investment activity of sovereigns. Even as sovereign wealth funds drew scrutiny in Congress in 2007 and 2008, the tax treatment was overlooked.

investments by foreign state-owned entities, including strategic equity investments, are categorically exempt from U.S. tax. By contrast, portfolio investments by private foreign individuals and foreign corporations are taxed at rates as high as 30%, although this rate is often reduced by treaty, or, in the case of most capital gains or portfolio interest, exempt from U.S. tax. The tax preference makes the biggest difference with respect to equity investments in dividend-paying stocks. For example, when Morgan Stanley pays a dividend to a private foreign investor, a 30% tax is imposed and withheld at the source, unless a treaty rate applies. By contrast, when Morgan Stanley pays a dividend to the China Investment Corporation, the dividend is not taxed at all, so long as China provides a simple form certifying that it is a foreign sovereign within the meaning of section 892. The favorable tax treatment of sovereign investments allows sovereign investors to achieve a significantly higher after-tax return on equity investments than private investors.

Section III provides a normative framework for taxing sovereign wealth. It starts from a baseline of sovereign tax neutrality, which would tax sovereign investment vehicles as if they were private foreign corporations. The case for eliminating the tax preference that exists under current law is strong. But because our tax system looks favorably on private foreign portfolio investment, the practical impact of treating sovereign wealth funds like private investors would be modest. So, while repealing section 892 is a worthy policy goal that Congress should pursue, Section III.B addresses the more


See Form W-8EXP, Certificate of Foreign Government or Other Foreign Organization for United States Tax Withholding.
difficult question of whether we ought to go further and impose a higher tax on sovereign wealth than on private investment.

An excise tax on sovereign wealth might be justified in two ways. First, it could help correct for the fact that sovereign wealth funds invest with mixed motives, pursuing both financial and geopolitical gains. Mixed motives lead funds to use a lower hurdle rate when evaluating potential investments, thus raising the possibility of crowding out private investment from target companies with important geopolitical value, including financial institutions. A tax on sovereign wealth fund investment could help level the playing field between private and state-controlled investment.

Second, a tax on sovereign wealth could, if imposed at a higher rate, affirmatively discourage investment in U.S. equities. If we believe that sovereign wealth funds—or certain types of investments by sovereign wealth funds—cause harm to the general public, a “Pigouvian” tax is one way to correct for the harm, in much the same way that a carbon tax might be used to control greenhouse gas emissions or a cigarette tax might be used to discourage smoking.

Section III.C of this Article then considers whether tax is the optimal regulatory instrument to address the risks posed by sovereign wealth funds. The academic literature on corrective taxes has largely focused on issues where externalities are relatively uniform regardless of who conducts the activity. Each additional unit of pollution is harmful to the environment, to roughly the same degree, regardless of who emits it. In the sovereign wealth fund context, however, the negative externalities derive from the risk that investments will be made for political purposes that run contrary to our own economic and foreign policy agenda; this political risk varies depending on the country and the institutional characteristics of the vehicle making the investment. Put another way, a sovereign wealth fund is not simply a rational financial actor, or, for that matter, an irrational or strategic political actor. Rather, a sovereign wealth fund is a financial organization embedded within a sovereign—a complex political institution that changes and develops over time. In the Appendix, I examine several prominent funds to illustrate what I mean by the heterogeneity, or non-uniformity, of this political risk. An excise tax on sovereign wealth would likely discourage investment by professionalized funds with strong separation from politics and strong financial motives—precisely the sort of investment we may want to welcome. Conversely, sovereign
wealth funds that lack separation from politicians and bureaucrats pushing a geopolitical agenda might invest anyway.\textsuperscript{12}

In a world with perfect political institutions, it’s possible that we could design a tax that was fine-tuned enough to account for the variations among foreign sovereigns who invest here. But I am less confident that our existing domestic political institutions are well-suited for this difficult task. Countries with strong attachments to the United States outside of the tax policy context—such as Saudi Arabia and Abu Dhabi—may well be able to influence legislation to achieve favored status over other countries that pose less of a geopolitical risk, such as Canada. If a treaty mechanism is used, small, developing countries that pose little geopolitical risk (such as Botswana) may be left out. Neither the tax writing committees nor the tax treaty process is well positioned to evaluate geopolitical risk, negotiate with foreign sovereigns, and update the law accordingly as foreign financial institutions develop over time. Thus, I conclude that tax may not be the optimal regulatory instrument to address the risks posed by sovereign wealth funds, although it may be preferable to the status quo.

Section IV of this Article offers policymakers three concrete reform alternatives. The first alternative, which I favor, is to repeal section 892 and replace it with a simple code section that taxes sovereign wealth funds as if they were private foreign corporations. This alternative would dampen any clientele effect that may result from the current tax preference for sovereign wealth fund equity investments. Because of the potential for non-financial motives to lower the hurdle rate for sovereign wealth funds, however, taxing sovereign wealth funds at the same rate as private investors may still leave in place a systematic preference for state-controlled investment. This alternative would therefore rely on other regulatory instruments to seek appropriate behavior by sovereign wealth funds.

A second reform alternative would go further and impose an excise tax intended to discourage investments in U.S. companies that are most likely to generate external harms. This reform alternative would make a populist statement in favor of private investment over state-controlled investment. It would twist the arms

\textsuperscript{12} In more formal economic terms, the supply of financially-motivated sovereign wealth is elastic, while the supply of politically-motivated sovereign wealth is more inelastic. While the inelasticity of politically-motivated sovereign wealth makes a tax promising from a revenue standpoint, the tax may not shape behavior in a manner consistent with our long-term policy goals.
of autocratic regimes to allow more private foreign direct investment in the United States in place of state-controlled investment. This reform alternative should appeal to policymakers concerned about the creeping influence of sovereign wealth, and those who want to make a strong statement in favor of private capitalism over state capitalism.

Finally, a third alternative would impose an excise tax on equity investments by sovereign wealth funds, but would treat the funds as if they were private corporations on the condition that they comply with specified best practices related to disclosure, investment goals, and accountability. In other words, we would tax sovereign wealth funds as financial investors only if they act like financial investors. This reform alternative should appeal to groups who favor a more technocratic policy response, shifting some of the policymaking power away from CFIUS and the executive branch and into the hands of the tax writing committees and Treasury Department lawyers who would draft the legislation and implementing regulations. It may also appeal to policymakers who want to do something about sovereign wealth funds, but who worry that relying on international organizations to design and enforce standards may be unrealistic without offering additional political leverage in the form of a conditional tax increase. I favor this approach only if other regulatory approaches, such as the multilateral coordination led by the OECD and IMF, continue to languish.

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Contributions to the Literature. This Article makes three principal contributions to the academic literature. First, the Article contributes to the tax policy literature by providing a theory of taxing sovereign wealth. While the tax literature on private foreign investment is substantial, this is the first Article in thirty years to focus on sovereign investment, and the first to focus on sovereign wealth funds. Section 892 is outmoded and in need of reform: This Article provides policymakers and academics with a strategy for how to think about taxing sovereign wealth.13

Second, the Article advances the broader debate on sovereign wealth funds by integrating tax policy into the discussion. Articles by leading academics provide policy prescriptions without considering either the tax subsidy under current law or the possibility that tax law

13 While the Joint Committee on Taxation and the New York State Bar Association each has issued helpful reports on section 892, neither group addressed whether tax should be used to tackle nontax policy concerns.
might be used to discourage investment going forward. Tax offers our regulators a powerful nightstick.

Third, this Article illustrates the importance of integrating institutional detail into tax policy analysis. Examining sovereign wealth funds as complex political and economic institutions rather than simply as firms (market actors) or sovereigns (state actors) underscores the fact that the risks associated with sovereign wealth are non-uniform. Because the harms are non-uniform, taxing sovereign wealth funds at a uniform rate that is higher or lower than the rate for private investment is a bad policy fit. A more carefully tailored tax would be appropriate. Institutional analysis also suggests that fine-tuning the tax rules to a level of detail that reflects the institutional variations among funds may be asking a lot of our own domestic political institutions. Whether it is worth the effort depends on the alternatives, and the strength of the political will to regulate sovereign wealth.

II. CURRENT LAW

Before considering the relevant policy questions, a brief review of current law regarding the taxation of sovereign wealth may be necessary for many readers. In this Section, I provide historical background, review the taxation of inbound private foreign investment generally, and then compare the taxation of sovereign investment under section 892. I make two key points necessary to move the discussion forward: (1) the international law doctrine of sovereign immunity does not limit Congress’s ability to impose a tax on sovereign wealth fund investment, and (2) under current law, the active/passive income distinction that pervades international tax treats most sovereign wealth fund investment as passive income, notwithstanding the strategic value of such investment.

A. What Are Sovereign Wealth Funds?

Sovereign wealth funds are investment vehicles funded and controlled by foreign governments. The largest funds are owned by Abu Dhabi (part of the United Arab Emirates), Saudi Arabia, Norway, Singapore, and China.14 Altogether sovereign wealth funds

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command about $3 trillion in capital. By contrast, the U.S. private equity industry has about $800 billion under management. Abu Dhabi’s main fund, the Abu Dhabi Investment Authority (ADIA), commands nearly $1 trillion in capital, or approximately 1% of the total securities holdings worldwide. Sovereign wealth funds are expected to grow to over $10 trillion within the next decade.

A few sovereign wealth funds, like ADIA, have existed for many years. Many countries that rely on oil or other natural resources for a large portion of their economic well-being have created state-managed stabilization funds to hedge against future declines in energy prices. In recent years, developing countries have come to view sovereign wealth funds as an alternative method of pursuing economic development. Rather than investing additional dollars domestically in infrastructure or distributing money to citizens, developing countries set up sovereign wealth funds to amass resources, achieve higher financial returns, and gain a foothold in global capital markets.

Sovereign wealth funds invest more aggressively now than in years past. Historically, foreign sovereigns would take excess funds generated from oil or trade surplus and invest in Treasury bonds or other governmental obligations. In recent years, however, these governments have diversified their holdings, seeking to increase financial returns and to further strategic political objectives. From the U.S. perspective, the most salient change is the desire of sovereign wealth funds to invest directly in U.S. companies. For many years, to the extent that sovereign wealth funds invested in equities at all, they did so indirectly by becoming limited partners in buyout funds operated by U.S.-based private equity firms like

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15 Because many funds are not transparent, estimates vary. For a thoughtful, conservative estimate of the size of these funds, see Truman, Blueprint, supra note 14, at 2. Mr. Truman’s estimate rises to $5.3 trillion if one includes state-directed pension funds. I agree with Mr. Truman that state-directed pension funds should be treated the same as other state-controlled funds only to the extent that the state, rather than individual participants, make investment decisions regarding the assets of the fund.
17 See Truman, Blueprint, supra note 14, at 2.
19 For a discussion of sovereign wealth funds’ impact on international economic development, see Patrick Keenan, Sovereign Wealth Funds and Social Arrears: Should Debts to Citizens be Treated Differently than Debts to Other Creditors? (forthcoming).
Carlyle and TPG. Now, of course, direct equity investments have become commonplace.

For tax purposes, the definition of “foreign government” is very broad, encompassing not only the “integral parts” of a sovereign like governmental departments or agencies but also separate legal entities controlled by the foreign sovereign that may or may not have counterparts in the United States. Entities that benefit from section 892 include:

1. state-owned or state-operated pension funds like Japan’s Government Pension Investment Fund (which has no U.S. federal analogue, but is somewhat analogous to California’s CalPERS),

2. sovereign wealth or stabilization funds (somewhat analogous to Alaska’s Permanent Fund), and

3. state-owned enterprises, like Russia’s government-controlled energy giant Gazprom (which has no U.S. analogue).

Central banks are addressed separately in section 895 of the tax code, although the principles discussed in this Article generally apply to central banks.

B. Historical Background

Current tax law reflects an anachronistic view of the jurisdictional doctrine of sovereign immunity. The tax exemption for sovereign investors dates back to the origins of our income tax. The original provision exempting income of foreign governments

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21 Private equity funds facilitate a significant portion of the investment activity that sovereign wealth funds conduct in the United States. SWF investments are normally structured as passive limited partnership interests, which offer little ability to influence the operations of the fund. More recently, rather than investing on a purely passive basis, funds are acquiring direct equity stakes in private equity sponsors or investing directly in portfolio companies.

22 See § 892.

23 For a listing of various funds, see Truman, Blueprint, supra note 14, at 2.

24 The distinction between central banks and sovereign wealth funds has been blurred by recent deals, including the investment by China’s SAFE (State Administration of Foreign Exchange) in a private equity fund operated by TPG, a U.S. private equity firm. See Henny Sender, Chinese in $2.5bn TPG Move, FINANCIAL TIMES, June 11, 2008. For present purposes, however, it is helpful to set aside definitional line-drawing questions until later in the discussion.
was enacted as part of the War Revenue Act of 1917. While additional subsections have been added, the language of section 892(a)(1) today still closely tracks the original language:

(a) Foreign Governments
   (1) In General. —The income of foreign governments received from—
      (A) investments in the United States in—
         (i) stock, 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.

The tax exemption was originally grounded in the international law principle of sovereign immunity. The idea was that so long as a foreign sovereign was acquiring property, like bank deposits or a consulate building, to further governmental purposes and not for commercial purposes, the doctrine of sovereign immunity would apply. The doctrine was rarely tested in the courts.

26 See § 892(a)(1). The original 1917 language provided:
   That nothing in Section II of the Act approved October third, nineteen hundred and thirteen, entitled “An Act to reduce tariff duties and to provide revenue for the Government, and for other purposes,” or in this title, shall be construed as taxing the income of foreign governments received from investments in the United States in stocks, bonds or other domestic securities, owned by such foreign governments, or from interest on deposits in banks in the United States of moneys belonging to foreign governments.

See War Revenue Act, supra note 25.
27 See NYSBA Report, supra note 10.
28 See Wm. W. Bishop, Jr., Immunity from Taxation of Foreign State-Owned Property, 46 AM. J. INT’L L. 239, 240 (1952) (“An examination of American practice leads to the conclusion that there is a growing tendency to exempt foreign state-owned property from taxation, and that this exemption is coming to be regarded as required by international law.”); id. at 256-57 (“It is by no means clear, however, that the same result is either probable or desirable when we are dealing with property used for purposes which seem more commercial than governmental.”).
In the middle of the twentieth century, the rise of the Soviet empire caused commercial activities of foreign governments in the United States to increase, forcing the IRS to engage in a difficult exercise of sifting out commercial activities, which were subject to tax, from governmental and other non-commercial activities, which were exempt from tax. The Service had little statutory guidance to work with, and the task was challenging: In dealing with autocratic or communist regimes, it’s hard to say where the private sphere ends and the public sphere begins. At the time, the Service based its rulings on whether the organization conducting the activity resembled a private U.S. business enterprise. Eventually this test was replaced with a more specific inquiry into the commercial or non-commercial nature of the activity conducted by the foreign sovereign rather than the organization conducting the activity.

This gradual narrowing of the section 892 exemption paralleled a broader legal development in the twentieth century concerning the jurisdictional doctrine of sovereign immunity. Until the middle part of the twentieth century, U.S. courts tended to take an expansive view of sovereign immunity. As the business activities of foreign governmental entities increased, however, the United States publicly adopted a more restrictive view of sovereign immunity reflected in an oft-cited 1952 letter from Jack Tate, a legal adviser at the State Department, known as the “Tate letter.”

In a 1959 Revenue Ruling, for example, the IRS held that payments from a U.S. distribution company to the Soviet Ministry of Culture were exempt from tax because Sovexport Film, the seller of the film, was deemed to be an integral part of the Soviet government. See Ruling dated May 21, 1959; David R. Tillinghast, Sovereign Immunity from the Tax Collector: United States Income Taxation of Foreign Governments and International Organizations, 10 LAW & POL’Y INT’L BUS. 495, 507 (1978) One could just as easily imagine the IRS ruling that because the films were shown commercially in the U.S., the activity was commercial.

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30 See Bernard Fensterwald, Jr., Sovereign Immunity and Soviet State Trading, 63 HARV. L. REV. 614, 627-28 (1950) (discussing organization of Soviet foreign trade before and after World War II). See also Dick, supra note 25, at A-4 (“[I]n certain socialist and OPEC countries, all or most of the country’s economic endeavors emanate from the government. When such governments invest their money in the United States perplexing conceptual and practical problems with respect to the § 892 exemption are created. This troublesome situation is further complicated by the fact that in many countries it is difficult to separate investment by the ruling class, as individuals, from investment by a foreign government.”)
31 See Tillinghast, supra note 30, at 514.
33 See Letter from Jack B. Tate, Acting Legal Adviser, Department of State, to Philip B. Perlman, Acting Attorney General, 26 DEPT. STATE BULL. 984 (1952). The Tate letter was viewed by practitioners as a method of minimizing political
called restrictive view of sovereign immunity, not all actions by a foreign sovereign are immune from jurisdiction in the United States. Rather, only governmental actions, or *acta jure imperii*, are entitled to immunity, while *acta jure gestionis*, or commercial actions, are not immune. The restrictive view of sovereign immunity was eventually codified in the Foreign Sovereign Immunities Act (FSIA) of 1976.

The codification of the restrictive view of sovereign immunity in the FSIA dispenses with the notion that all income received by a foreign government should be immune from tax simply because the income may be used to further public goals. If the nature of the activity is commercial, like operating a business or investing in securities, there is no argument for an exemption based on the jurisdictional doctrine of sovereign immunity. Rather, the scope of the tax exemption is purely a matter of tax policy, and may be

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34 See Tillinghast, supra note 30, at 530.

35 While the FSIA provides no explicit guidance on tax issues, the statute reflects an approach to distinguishing between commercial and governmental activities that proves useful in the tax context. Specifically, in determining whether an activity is commercial or governmental, the FSIA provides that the character of the activity shall be determined by reference to the nature of the activity rather than by reference to its purpose. See Foreign Sovereign Immunities Act of 1976, Pub. L. No. 94-583, codified at 28 U.S.C. § 1603(d) (“The commercial character of an activity shall be determined by reference to the nature of the course of conduct or particular transaction or act, rather than by reference to its purpose.”). See also Tillinghast, supra note 30, at 531 & n.167 (“When Congress enacted the 1976 sovereign immunity legislation, it came down clearly and expressly on the side of making the determination on the basis of the nature of the transaction, rather than its purpose.”) See Foreign Sovereign Immunities Act of 1976, Pub. L. No. 94-583, codified at 28 U.S.C. § 1603(d) (“The commercial character of an activity shall be determined by reference to the nature of the course of conduct or particular transaction or act, rather than by reference to its purpose.”).  

36 Conducting an active trade or business in the United States, for example, is an activity that would not be immune from jurisdiction, even if the profits were used to support a sovereign function, like supporting retirement benefits for government workers. As Mr. Tillinghast noted thirty years ago:

Even if one concedes that the OPEC countries, for example, are investing funds in the United States for the public purpose of preserving or enhancing the national patrimonies for the day when their hydrocarbon reserves run out, this should not require a finding of immunity since the reference is to the purpose rather than the nature of the income-producing activity.

See Tillinghast, supra note 30, at 534-35.
International law as such imposes no restrictions on our ability to tax sovereign wealth funds.\textsuperscript{37} Portfolio investment poses difficult analytic challenges under section 892, and while the scope of the exemption has narrowed over time, the Treasury and the IRS have tiptoed around portfolio investment. It was inferred from the language of section 892 that, insofar as investment income was concerned, the exemption applied only to portfolio investments.\textsuperscript{38} In Revenue Ruling 75-298, the Service held that a foreign central bank, or any other governmental organization, would be exempt from tax so long as it was wholly-owned or controlled by a foreign government, its income did not inure to a private person, its investments produce passive income, and it was not engaged in commercial banking. This ruling clarified that what matters for U.S. tax purposes is the nature of the activity in the United States, not the nature or function of the foreign governmental organization.\textsuperscript{39} The plain language of section 892, however, would presumably not allow the IRS to tax passive portfolio investment in “stocks, bonds, or other domestic securities,” even if such investment is not related to public or humanitarian goals.\textsuperscript{40}

Congress revamped section 892 as part of the Tax Reform Act of 1986. According to the legislative history, Congress was concerned, among other things, about the application of the exemption to quasi-commercial entities controlled by foreign governments.\textsuperscript{41} The Senate Report explained that it was not

\textsuperscript{37} In a few cases, Congressional discretion is bounded by treaties already in force.  
\textsuperscript{38} See \textit{Qantas Airways Ltd. v. United States}, 62 F.3d 385 (1995) (upholding regulatory authority to tax income derived from commercial activity by government-owned entity).  
\textsuperscript{39} See Tillinghast, supra note 30, at 508.  
\textsuperscript{40} See Rev. Rul. 75-298 (setting forth requirements); Tillinghast, supra note 30, at 519. Thus, even if the foreign governmental organization was engaged in an activity that would ordinarily be private in the United States, like the provision of health care or insurance, its investment activities would be exempt in the United States so long as it did not conduct any commercial activity here. The ruling was somewhat more generous towards state-controlled investment than one might have expected. According to Mr. Tillinghast, writing in 1978, the ruling was “motivated, no doubt, by a felt need to be flexible in an effort to attract petro-dollar investment in the United States.” See Tillinghast, supra note 30, at 519-20. Then, as now, the taxing authorities were wary of closing the door to foreign investment driven by trade imbalances, at least absent Congressional direction.  
\textsuperscript{41} See § 892(a)(1).  
\textsuperscript{42} The Senate Report explains:

The committee’s examination of current law’s tax exemption for investment income of foreign governments has revealed several problems. First, the exemption extends to entities, even business
appropriate to favor nationalized industries over privately owned industries.\textsuperscript{43} Congress was similarly concerned that dividend and interest payments to foreign governments with a controlling interest in U.S. corporations were inappropriately escaping tax.\textsuperscript{44} At the same time, Congress did not see any reason to treat a foreign government “worse than comparable private investors from the government’s country.”\textsuperscript{45} The revisions to Section 892 provided that income derived from the direct conduct of commercial activity, whether conducted within or outside the United States, would not be exempt from tax.\textsuperscript{46} Similarly, income received by or from a controlled commercial entity would not be exempt from tax.\textsuperscript{47} At the same time, the revisions clarified that a foreign government would be treated as a corporate resident of that country, allowing the government to enjoy any treaty benefits extended to foreign private residents.\textsuperscript{48}

The 1986 revisions did not address sovereign wealth funds, which were not yet making significant equity investments in the capital markets. The history of revisions to section 892 shows that Congress has been willing to amend the section to make sure that state-sponsored investment is not favored over private investment. International law leaves ample room for Congress to tax commercial corporations, wholly owned by foreign governments. This treatment tends to favor, for example, nationalized industries over privately owned industries. Under current law, the United States taxes U.S. source investment income received by a privately-owned foreign business corporation but not similar income received by a state-owned business corporation. The committee does not believe that this difference in treatment is appropriate.


\textsuperscript{43} See id.

\textsuperscript{44} The Senate Report explains:

[Current law provides an exemption for income (such as interest and dividends) derived by foreign governments or governmental entities from U.S. businesses that they control. For example, a foreign government may buy a controlling interest in a U.S. corporation. Dividend and interest payments from that corporation to the foreign government escape U.S. shareholder level tax. While an exemption for income from passive investments may be appropriate in some cases, payments to a controlling entity, in the committee’s view, are not passive investment income. The committee does not believe that exemption is appropriate in this case.]

Id. at 416-17.

\textsuperscript{45} See id. at 417 (“The committee sees no reason to treat a foreign government worse than comparable private investors from the government’s country.”).

\textsuperscript{46} See § 892(a)(2)(A)(i).

\textsuperscript{47} See § 892(a)(2)(A)(ii). See also § 892(a)(2)(A)(iii) (providing that income derived from the disposition of any interest in a controlled commercial entity is not exempt from tax).

\textsuperscript{48} See § 892(a)(3). Before 1986, there had been considerable confusion about the entity status of a foreign government, as it lacks some of the characteristics associated with private corporations or associations.
investment (and sovereign activities that resemble commercial investment).

C. Taxing Inbound Foreign Investment

A brief review of how foreign private investors are taxed may be helpful before examining the section 892 exemption more closely. Cross-border investing gives rise to a single stream of income with two potential tax claimants: the source country where the business activity takes place and the residence country of the foreign investor. The chief task of international tax policy is dividing this income into two parts: (1) the portion that should be taxed at the source of the business activity and (2) the portion that should be taxed at the residence of the investor. Broadly speaking, the United States, in accordance with international tax norms, only taxes foreign investors on active income that arises from a U.S. source.\(^49\) To distinguish between U.S. and foreign source income, the tax rules determine whether a foreign investor’s income is effectively connected with a U.S. trade or business (ECI). If it is, then the foreign investor is taxed in the same fashion, and at the same rates, as a U.S. investor. If a foreign corporation has a branch that operates an active business in the United States, the U.S. activities are taxed here as if they were being conducted by a United States resident.

When foreign investors invest in the U.S. capital markets, they derive income from business activities that take place in the United States. In the case of passive portfolio investments, however, the United States does not always treat such income as arising from a U.S. source. Rather, most income from passive portfolio investments—such as portfolio interest and capital gains—is treated as foreign-source income and is not taxed in the United States.\(^50\)


\(^50\) See, e.g., Yaron Z. Reich, Taxing Foreign Investors’ Portfolio Investments in the U.S.: Developments & Discontinuities, 16 TAX NOTES INT’L 1975, 1975-76 (1998) (“This review demonstrates that the U.S. tax system strongly encourages the investment by foreigners in the U.S. capital markets, virtually all material categories of portfolio investment income of foreign investors are exempt from U.S. taxation, with the exception of dividend income (and, increasingly, dividend surrogates).”).
To encourage foreign portfolio investment in the United States, the tax code gives wide berth to the activity of portfolio investing.\(^\text{51}\) Capital gains received by nonresident individuals and foreign corporations are treated as foreign-source income so long as the gains are not effectively connected with a U.S. trade or business.\(^\text{52}\) A foreign investor can therefore make an equity investment in a U.S. business and pay no tax on the appreciation in its stock. Not all investment income is treated generously, however. Sections 871 and 881 impose a flat 30% tax on certain types of U.S. source income if it is not effectively connected with a U.S. trade or business.\(^\text{53}\) Forms of what is often called FDAP income—which stands for “fixed or determinable, annual or periodic” income—are subject to withholding on a gross receipts basis at a 30% rate. These FDAP items (such as interest, dividends, rents and royalties) are subject to withholding under sections 1441 and 1442.\(^\text{54}\)

U.S. tax policy also encourages foreign investment in the debt securities of U.S. companies. As noted above, interest is one of the types of FDAP income that is subject to the 30% tax.\(^\text{55}\) Sections 871(h) and 881(c), however, exempt “portfolio interest” from the FDAP regime.\(^\text{56}\) Thus, a foreign investor holding debt securities that are not effectively connected with a U.S. trade or business typically does not have to recognize interest income or face withholding of any amount paid.\(^\text{57}\)

The definition of portfolio interest is broad.\(^\text{58}\) Interest paid by U.S. issuers typically meets the definition so long as the issuer complies with obligations designed to ensure that the bonds are not sold (or re-sold) to U.S. persons.\(^\text{59}\) The exemption does not extend

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\(^{51}\) See generally Avi-Yonah, supra note 49.

\(^{52}\) See §§ 881, 882.


\(^{54}\) See §§ 1441, 1442.

\(^{55}\) See §§ 871(a)(1)(A), 881(a)(1).

\(^{56}\) See §§ 871(h), 881(c). Before the portfolio interest exemption was enacted, U.S. corporations accessed the international debt markets through the use of Netherlands Antilles finance subsidiaries, relying on a treaty exemption and IRS rulings then in effect. See Reich, supra note 50, at 1985. The portfolio interest exemption simplified access to the “Eurobond” market by reducing the costs of structuring those deals. See id.

\(^{57}\) For a critique of international tax policy, including the portfolio interest exemption, see Charles I. Kingson, The Coherence of International Taxation, 81 COLUM. L. REV. 1151, 1283-87 (1981) (questioning reasoning underlying then-proposed portfolio interest exemption).

\(^{58}\) See §§ 871(h), 881(c).

\(^{59}\) See §§ 163(f)(2) (discussing obligations for bearer bonds); 163(f)(1) (discussing obligations for registered bonds).
to a 10% shareholder or partner in the U.S. issuer.\textsuperscript{60} Thus, a private investor who holds a major stake in a U.S. business will not receive tax-free interest, even if the investment is a non-controlling stake.\textsuperscript{61}

There are other exceptions to the general approach of lightly taxing foreign capital investment, most notably in the real estate context. In 1980, Congress enacted The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) to address the concern that the U.S. investors could not compete with their more lightly taxed foreign counterparts.\textsuperscript{62} Before FIRPTA, foreign investors often paid no tax at all on the disposition of U.S. real property, so long as the gains were not effectively connected with a U.S. trade or business. FIRPTA created section 897, which requires a foreign investor to pay U.S. income tax on the net gains derived from the disposition of a U.S. real property interest.\textsuperscript{63} Mechanically, section 897(a) achieves this result by treating a disposition of a U.S. real property interest as if it were effectively connected with a U.S. business, even if it would not normally fit within the usual meaning of the term.\textsuperscript{64} Indirect holdings in real property may be taxed as well, depending on whether the U.S. business is considered a U.S. real property holding corporation.\textsuperscript{65}

Dividends are the most significant source of income to foreign portfolio investors that the U.S. taxes. Dividends paid by U.S. corporations are normally sourced in the United States and treated as FDAP income subject to a 30% tax rate. In many cases, this rate

\textsuperscript{60} See § 871(h)(3)(A); § 881(c)(3)(B).
\textsuperscript{61} The portfolio interest exemption is further limited to avoid giving foreign banks a competitive edge over U.S. banks. If a foreign bank, in the “ordinary course of its trade or business,” enters into a loan agreement with a U.S. issuer, then interest paid pursuant to that agreement do not qualify as portfolio interest, even if the debt securities would otherwise meet the definition of portfolio interest. See § 881(c)(3)(A).
\textsuperscript{62} See S. Rep. No. 504, 96th Cong., 1st Sess. 6 (1979), cited and discussed in Kuntz & Peroni, supra note 53, at ¶ C1.06[1]: The committee believes that it is essential to establish equity of tax treatment in U.S. real property between foreign and domestic investors. The committee does not intend by the provisions of this bill to impose a penalty on foreign investors or to discourage foreign investors from investing in the United States. However, the committee believes that the United States should not continue to provide an inducement through the tax laws for foreign investment in U.S. real property ... [by] effectively exempting [such foreign investors] from U.S. tax on the gain realized on disposition of the property.
\textsuperscript{63} See § 897.
\textsuperscript{64} See § 897(a).
\textsuperscript{65} See § 897(c)(1)(A)(ii).
is reduced by treaty, but with few exceptions, the rate is not lowered below the 15% rate provided in the OECD model treaty.\footnote{See Reich, supra note 50, at 1986. Mr. Reich identifies Mexico, China, and Romania as exceptions to this rule, where our treaties offer a 10% rate. See id. n.69.}

To recapitulate, foreign investors are generally taxed lightly on their portfolio investments in the United States.\footnote{It is worth emphasizing that the generous rules related to foreign investment only apply if the income is not effectively connected with a U.S. trade or business. If the income is effectively connected, then sections 871(b) and 882 tax such activity at the usual U.S. tax rates even if the income would otherwise be exempt or taxed at a lower rate. For example, if a foreign individual owns and operates a U.S. corporation and sells her stock in that corporation, generating capital gain, the gain will be taxed in the United States as if the foreign individual were a United States person. While the question of whether a foreign investor is engaged in a U.S. trade or business requires a facts-and-circumstances analysis, investing in U.S. securities is not in and of itself considered a U.S. trade or business. See § 864(b)(2); Kuntz & Peroni, supra note 53, at ¶ C1.04[4][a].} Foreign investors do face significant taxes on some types of income, such as dividends from U.S. corporations and certain real estate investments. The withholding tax on dividends affects investment behavior, particularly because borrowing expenses associated with the investment cannot be deducted from the dividend income, which is calculated on a gross, not net, basis.\footnote{For an illustration using preferred stock, see Reich, supra note 53, at 1989. As a result, foreign investors often seek to invest through equity-like “surrogates,” such as derivatives that offer an equity-like return, in order to avoid the withholding tax. See id. at 1989-90. The IRS has challenged many of the strategies used to circumvent the withholding tax.}

D. Section 892

Section 892 follows the conceptual divide in international tax between commercial activity, which is taxed at the source, and passive portfolio investing, which is generally taxed at the residence. Section 892(a)(1) thus provides that the income of foreign governments received from investments in “stocks, bonds, or other domestic securities owned by such foreign governments,” financial instruments held in the execution of governmental financial or monetary policy, and bank deposits.\footnote{See § 892(a)(1)(A), (B).} Section 892(a)(2) addresses commercial activities, which are taxed in the same manner as foreign non-state investors. Specifically, section 892(a)(2)(A)(i) provides that section 892(a)(1) shall not apply to any income “derived from the conduct of commercial activity.” To address situations where a holding company or other controlled entity conducts the commercial activity, section 892(a)(2)(A)(ii) provides that any

\footnote{See § 892(a)(1)(A), (B).}
income received by or received from, directly or indirectly, a “controlled commercial entity” is not exempt from tax.\textsuperscript{70}

The regulations provide some clarification of the distinction between commercial and non-commercial activities. The regulations start with a broad definition, defining as commercial activities “all activities” that are conducted “with a view towards the current or future production of income or gain.”\textsuperscript{71} The regulations then specify that investments in stocks, bonds, and other securities are not commercial activities unless one is a “dealer” in securities\textsuperscript{72} or engaged in an active banking, financing, or similar business.\textsuperscript{73} While there is some question about whether mezzanine lending funds are engaged in a financing business, it is generally accepted that private equity funds are not engaged in a “financing business” within the meaning of the current regulations.\textsuperscript{74}

Two related code sections should also be mentioned, sections 893 and 895. Section 893 provides a tax exemption for employees of a foreign sovereign. As with section 892, the tax exemption does not extend to employees of a controlled commercial entity, or if the employee’s services are primarily in connection with a commercial activity of a foreign government.\textsuperscript{75}

Section 895 provides a tax exemption for foreign central banks of issue investing in obligations of the United States. The section

\textsuperscript{70} See § 892(a)(2)(A)(ii). Similarly, income derived from the disposition of any interest in a controlled commercial entity is not exempt under 892. In either case, income from a controlled commercial entity may still be exempt under some Code section other than 892.

\textsuperscript{71} See Treas. Reg. § 1.892-4T(B).

\textsuperscript{72} The threshold for becoming a “dealer” is high: Trading securities for one’s own account does not make one a dealer. See Treas. Reg. § 1.892-4T(c)(1)(vi) (cross-referencing the definition in § 1.864-2(c)(2)(iv)(a)).

\textsuperscript{73} Tax practitioners are most concerned with issues that arise when clients engage in commercial activities but also wish to take advantage of section 892. Under the “all or nothing” rule, an entity which engages in commercial activity anywhere in the world may be treated as a controlled commercial entity. While the commercial activities of a subsidiary are not generally attributed to the parent, issues can arise when a sovereign wealth fund invests in a limited partnership, like a hedge fund, which engages in commercial activities. See NYSBA Report, supra note 10, at 40. Securities trading is not generally treated as a U.S. trade or business, but may nonetheless be treated as a commercial activity for purposes of section 892, at least the way the regulations are currently drafted. Id. To avoid tainting the U.S. source income of an entire sovereign wealth fund as that of a controlled commercial entity, tax lawyers set up blocker entities to isolate limited partnership investments. See NYSBA Report, supra note 10, at 34.

\textsuperscript{74} See Dick, supra note 25.

\textsuperscript{75} See Dick, supra note 25, at A-2.
was enacted in 1961 to ensure that central banks organized as separate entities controlled by the sovereign (rather than an integral part of the sovereign) would be exempt from tax. A 1920 revenue ruling that gave rise to the uncertainty was declared obsolete in 1969, and today there is no question that central banks investing in U.S. securities are entitled to a tax exemption. Because section 895 only applies to investments in obligations of the United States, such as Treasury bonds, the section offers no guidance as to the treatment of sovereign wealth fund investment in U.S. businesses.

This description of current law raises two conceptual issues that policymakers may wish to address. One problem with the current approach of section 892 is the overbreadth of what is considered passive investment. Even if an investor becomes the company's largest shareholder and wields substantial influence over a target, so long as the shareholder does not acquire formal control by itself or through a related party, our tax system will treat the investment as passive. As I discuss below in more detail, this model may be a poor fit for sovereign investors. While, for political reasons, sovereign investors may not acquire formal control over a target such as a U.S. financial institution, investments in large blocks of equity confer substantial influence that goes beyond what true portfolio investors acquire.

A second, more fundamental problem with the current approach is the assumption that passive portfolio investment by a foreign sovereign should not be taxed. Even assuming, for the sake of argument, that inbound foreign portfolio investment by private investors should not be taxed, the myriad differences between private investors and foreign sovereigns begs for closer analysis. To justify current law, one would have to identify a reason for the preferential treatment of foreign sovereigns with respect to dividends and real estate investments. Of course, to justify a higher tax on foreign sovereigns, distinguishing their treatment from the general approach of lightly taxing inbound foreign investment, one would have to identify specific harms that may accompany inbound foreign investment by foreign sovereigns. I now turn to that task.

76 See NYSBA Report, supra note 10, at 10-11.
77 See § 895.
78 Another problem with the current approach is with the overbreadth of what we consider commercial activity: because of how the mechanics of the section work, a government investment vehicle that is engaged in a commercial activity anywhere in the world may be taxed as a private corporation in the United States, even if there is no commercial activity in the United States. See NYSBA Report, supra note 10.
III. A THEORY OF TAXING SOVEREIGN WEALTH

The twentieth century development of the restrictive view of sovereign immunity opens up a new opportunity to consider how we tax investments by entities controlled by sovereigns. The investments are clearly commercial in the sovereign immunity sense—the investments are made for profit. But freed from the historical baseline of leaving all sovereign actions untaxed, one must stake out a new, normative baseline for taxing the investments of foreign governments. This Section begins by making the case for a theory of taxing sovereign wealth based on the principle of sovereign tax neutrality: Absent special circumstances, we should tax sovereign wealth funds and other state-controlled investment vehicles as if they were private foreign corporations.

A. Sovereign Tax Neutrality

A useful starting point in tax policy is the concept that equals should be taxed equally.\(^79\) In the context of cross-border investment, sovereign investments compete with commercial investors: Sovereign tax neutrality is therefore neutral in the sense that it treats sovereign wealth fund investors no better and no worse than private foreign investors.\(^80\) The main benefits of the approach of sovereign tax neutrality are that it comports with widely-shared beliefs of equity and fairness and protects against unintended subsidies or penalties in the capital markets that could distort the allocation of economic resources.

There are certainly circumstances in which departure from a neutrality norm might be warranted. For example, because politically-motivated sovereign wealth funds have a lower hurdle rate for investments, tax neutrality could lead to larger-than-optimal amounts of sovereign wealth fund investment in sectors with strategic value even in the absence of a tax subsidy for sovereign

\(^{79}\) Taxing equals equally furthers the traditional tax policy goal of horizontal equity. Taxing similar persons at the same rate also furthers efficiency goals by minimizing the distortion that tax can have on the allocation of resources. If two parties face the same tax rate with respect to the expected rate of return from an asset, the party that values the asset higher because it can put the asset to a more productive use will bid the higher price for the asset, thereby placing the asset in the hands of the party that will maximize economic output.

\(^{80}\) Broadly speaking, international tax policy distinguishes investors based on whether they are active or passive, treating investors equally within those categories. It does not generally distinguish among foreign investors based on the country of origin.
investors. More generally, if the negative externalities from sovereign wealth fund investment outweigh the positive externalities, we may want to impose a higher tax on sovereign wealth funds. Conversely, of course, if the positive externalities outweigh the negative externalities, we may wish to subsidize sovereign wealth funds. Because lawmakers may find the externalities question indeterminate, and because tax policy is not the only regulatory instrument available, I focus first on setting forth the rationale for a policy of sovereign tax neutrality.

First, sovereign tax neutrality comports with a general view that, all else equal, we should not use tax policy to discriminate against investors based on geographic or ethnic origins, or other characteristics unrelated to legitimate tax policy norms like ability to pay. This is no less true in the international context than in the domestic context. The main exception to this rule is the treaty mechanism, which allows the United States to conditionally offer lower tax rates here in exchange for lower tax rates for U.S. investors doing business abroad. The treaty mechanism has nothing to do with ability to pay or horizontal equity, but rather promotes cross-border investment, reciprocity, and avoidance of double taxation. As a general matter, however, there is no obvious reason to subsidize sovereign wealth.

Second, taxing sovereign wealth funds as private corporations is consistent with broader international tax policy norms as reflected in the current practice of other countries. The United States is alone among its OECD peers in granting categorical, unilateral immunity

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81 Whether tax neutrality would have this effect depends on the availability of other regulatory and institutional constraints that may discourage politically-motivated investment.

82 There are other, limited exceptions to the rule: We sometimes subsidize particular cross-border investments, such as U.S. companies investing in Puerto Rico.

83 Writing in 1978, David Tillinghast noted that “As a matter of tax policy alone, however, there is nothing which argues that the government-owned investors are more entitled to exemption from withholding taxes than private investors.” See Tillinghast, supra note 29, at 538-39.

84 The great “compromise” of international tax, broadly followed among OECD countries, is to allocate active business income to the source jurisdiction, and to allocate passive or portfolio income to the residence of the capital-supplying investor. See Michael J. Graetz & Itai Grinberg, Taxing International Portfolio Income, 56 TAX L. REV. 537, 541 (discussing compromise); Avi-Yonah, supra note 49, at 1034-06. Source countries, however, typically tax dividends to portfolio investors at a higher rate, sometimes reducing that rate through treaty negotiation just as the United States does. See Graetz & Grinberg, supra, at 541. Taxing dividends paid for foreign sovereigns at the current 30% rate, unless reduced by treaty, thus fits cleanly into normal international practice.
from taxation for sovereign wealth funds. While some OECD countries grant an exemption from tax for foreign governments receiving passive income, the exemption tends to be conferred by administrative practice, not through legislation. Other countries simply treat foreign governments as if they were private entities, and if exemptions are made, they are administered through treaties.

A Joint Committee Report identified a broad divide between Japan and the Commonwealth countries of Australia, Canada, and the United Kingdom on the one hand and Continental Europe on the other. Japan and the Commonwealth countries generally grant an exemption for passive income, administered on a case-by-case basis. European practice confirms that international law confers no obligation to exempt passive income. In Germany, Norway, Poland, and Switzerland, foreign governments are treated like private foreign entities, enjoying exemption from tax only to the extent that private corporations from the country making the investment enjoyed such benefits as a result of treaty negotiations.

While the practice of other countries is hardly dispositive, it shows that the United States would not be out of step with international tax norms in following the Continental model of treating sovereign wealth funds as if they were private foreign corporations. Moreover, a default rule treating sovereign wealth funds as private corporations would provide the United States with improved leverage in treaty negotiations, where the baseline

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85 See Taylor, supra note 29, at 154 (“Few foreign governments explicitly exempt other foreign governments from tax on income generated in their country. Countries that do provide such exemptions generally do so on a reciprocal basis only.”)
88 Even compared to the Commonwealth countries, the United States is an outlier in providing an unconditional tax exemption for commercial sovereign wealth funds. In Australia, a sovereign wealth fund seeking an exemption must establish, through a private ruling process, that its portfolio income results from the performance of a governmental function. See JCT Report, supra note 10, at A-4, A-8. In Canada, the fund must establish that its portfolio income serves a “truly governmental” function with a public or humanitarian non-commercial purpose. See JCT Report, supra note 10, at A-4. Chinese state-owned banks, for example, have been denied exempt status. See JCT Report, supra note 10, at A-4. The United Kingdom broadly exempts foreign governments from tax on portfolio income by administrative practice, in accordance with their view of international customary law. See JCT Report, supra note 10, at A-49-50.
withholding rate of 30% on dividends is typically bargained down to a lower rate.\footnote{Unilaterally exempting dividends from tax is little more than an anachronism, chiseled into the tax code before sovereign immunity was restricted to exclude commercial activities. This was evident even 30 years ago, as Mr. Tillinghast explained: “Dividends, however, are a different issue. Until such time as the United State becomes a less developed country, it is difficult to hypothesize a case in which dividend income would result from the conduct of inherently governmental operations, unless Congress wished to ratify the view that the investment of public pension funds is a governmental operation.” See Tillinghast, supra note 29, at 542.}

Third, sovereign tax neutrality is also an appropriate baseline norm because it dampens the potential of a clientele effect that can occur when particular groups of investors are tax-advantaged. Under current law, the subsidy for sovereign wealth fund investment creates the potential to crowd out private investment.\footnote{In a recent paper, Professor Knoll argues that the tax-exemption for nonprofits should not produce a competitive advantage, even absent application of the Unrelated Business Income Tax (UBIT). See Michael S. Knoll, The UBIT: Leveling an Uneven Playing Field or Tilting a Level One?, 76 FORDHAM L. REV. 857, 868-69 (2007). Knoll’s finding depends on an assumption that nonprofits have a higher discount rate because nonprofit investors, unlike for profit investors, could invest in other assets tax-free. Here, unlike the UBIT context, for profit foreign portfolio investors and nonprofit foreign portfolio investors can both invest in portfolio debt on a tax-free basis, suggesting that they would use the same hurdle rate in evaluating investments. Thus, Knoll’s findings do not suggest that there would not be a clientele effect caused by a higher tax rate on dividends.}

Because dividend yield is tax-exempt to sovereign bidders, but not to private bidders, sovereign bidders can bid a higher price for the same asset.\footnote{Because the capital markets are relatively efficient, there is abundant evidence of tax-favored investors crowding out other investors. We already observe a parallel kind of crowding-out effect in the debt markets. Nearly all the debt obligations of U.S. companies is held by tax-exempt investors, such as pension funds and university endowments, or by foreign investors, who are exempt from tax on portfolio interest. These investor may pay an implicit tax on the investment; an issuer may be able to offer debt at, say, 8% instead of 10% because the interest is exempt from U.S. tax. Because taxable investors would bear both the implicit tax (i.e. receive a lower yield) and explicit tax, the tax-exempt investors tend to crowd out taxable investors.} The average dividend yield of S&P 500 stocks, as of mid-2008, was only 2.1%.\footnote{See http://www.indexarb.com/dividendYieldSortedsp.html [update source]} As the table below shows, and as one might expect given the tax effects, many of the largest cross-border sovereign wealth fund deals have involved firms paying a higher dividend yield.\footnote{See The New Global Wealth Machine, N.Y. TIMES, April 2, 2008, at H4 listing all seven of the U.S.-based deals as involving a financial services or private equity firm: Citigroup-Temasek Holdings & Kuwait Investment Authority, $12.5 billion, Citigroup-Abu Dhabi Investment Authority, $7.5 billion, Merrill Lynch-Korea Investment Fund & Kuwait Investment Authority, $6 billion, Merrill Lynch-} The table below shows the dividend yield of the
financial services firms that received large investments from sovereign wealth funds:

<table>
<thead>
<tr>
<th>Target</th>
<th>Buyers</th>
<th>Amount (b)</th>
<th>Dividend Yield (a)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Citigroup</td>
<td>Abu Dhabi (ADIA)</td>
<td>$7.5 billion</td>
<td>5.32%</td>
</tr>
<tr>
<td>Citigroup</td>
<td>Singapore (GIC)</td>
<td>$6.88 billion</td>
<td>5.32%</td>
</tr>
<tr>
<td>Citigroup</td>
<td>Kuwait</td>
<td>$3 billion</td>
<td>5.32%</td>
</tr>
<tr>
<td>Merrill Lynch</td>
<td>Singapore (Temasek)</td>
<td>$4.4 billion</td>
<td>3.03%</td>
</tr>
<tr>
<td>Merrill Lynch</td>
<td>Kuwait</td>
<td>$2 billion</td>
<td>3.03%</td>
</tr>
<tr>
<td>Morgan Stanley</td>
<td>China (CIC)</td>
<td>$5 billion</td>
<td>2.27%</td>
</tr>
<tr>
<td>Blackstone</td>
<td>China (CIC)</td>
<td>$3 billion</td>
<td>6.44%</td>
</tr>
<tr>
<td>Och-Ziff</td>
<td>Dubai (Dubai International)</td>
<td>$1.26 billion</td>
<td>23.99%</td>
</tr>
</tbody>
</table>

The tax treatment of the deals noted above is somewhat complicated. Several deals used financial products designed to take advantage of Revenue Ruling 2003-97, which allows issuers of certain mandatorily convertible securities (effectively, a debt instrument coupled with a forward contract) to enjoy a tax deduction on a portion of the payments to the securities holders. The securities holders receive dividend-like “contract payments” which, if held by private investors, would likely be subject to withholding. Because the sovereign recipients are shielded by section 892, however, the payments are free from tax, creating an arbitrage between the issuer (who enjoys a tax deduction) and the recipient (who is tax-exempt). Moreover, the sovereign’s tax preference for U.S. source dividends continues after the securities convert into equity. The tax preference is significant; based on a simple discounted cash flow basis, a $100 stock with an annual $3 dividend yield that is expected to be worth $200 in ten years would be worth

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95 For deal information, see Factbox: How Sovereign Wealth Investments Have Fared, INTERNATIONAL HERALD TRIBUNE, March 21, 2008. For information on the Och-Ziff/Dubai deal, see Alistair Barr, Dubai to Invest over $1 billion in Och-Ziff, available at http://www.marketwatch.com/news/story/dubai-invest-over-1-bln/story.aspx?guid=%7B66C78494-DFA2-4BD7-BFAA-FE5714943CF1%7D.

96 As of April 6, 2008 (information from Google Finance).
$134 in the hands of a sovereign investor, but only $127 in the hands of a private investor.\textsuperscript{97} Thus, it is possible that the ability of foreign sovereigns to receive a tax-exempt yield may increase their bids on the margins.\textsuperscript{98} Tax is not the only explanation for the pattern of investment, but the potential for a clientele effect to occur is an important reason to pursue sovereign tax neutrality.\textsuperscript{99}

In sum, sovereign tax neutrality is a sound baseline norm, but not necessarily the only appropriate tax policy. A higher or lower tax rate may be justified in terms of a corrective tax or subsidy, as discussed below.

B. The Case for an Excise Tax on Sovereign Wealth

This Subsection considers whether we should impose an excise tax on sovereign wealth funds. An excise tax would operate as a Pigouvian or corrective tax, which is a tax designed to make the person who engages in an activity with negative externalities or public harms internalize the costs associated with that activity.\textsuperscript{100} The goal is not necessarily to raise revenue, but rather to influence

\begin{itemize}
  \item \textsuperscript{97} [Insert Excel calculation here.]
  \item \textsuperscript{98} The categorical exemption under current law may also enable aggressive tax planning by U.S. private equity funds and hedge funds going public utilizing the “Blackstone”/Fortress PTP structure. See Fleischer, Taxing Blackstone, supra note 7. In the PTP structure, a firm like Blackstone or Och-Ziff must set up a “blocker” corporation to cleanse active income from management fees, deal monitoring fees, and the like. The blocker corporation reduces its corporate tax liability through the use of debt financing from the parent, and pays the parent partnership dividends which qualify as “passive income” under the current PTP rules. One apparent downside of this structure is that investors pay current tax on dividends—currently at a rate of 15% for qualifying dividends—while the blocker corporation receives no deduction for dividends paid. (The effective rate may be lower for corporations that can take the dividends received deduction under § 243, and higher for foreign investors subject to FDAP withholding at 30%). The character of the cash flow as a dividend payment is maintained as each investor in the PTP receives its distributive share of partnership income. Sovereign Wealth Funds who invest in this structure, however — such as China’s investment in Blackstone, Dubai’s investment in Och-Ziff, and Abu Dhabi’s investment in Carlyle — pay no tax on the dividend distributions.
  \item \textsuperscript{99} More likely, the rush into financial services firms is better explained by (1) the network benefits that sovereign wealth funds may acquire by establishing relationships with Western banks, see Katharina Pistor, Global Network Finance: Understanding East-West Linkages Between Sovereign Wealth Funds and Private Banks (2008) (working paper on file with the author), (2) the unwillingness of private equity investors to be regulated as bank holding companies, and, (3) more broadly, the lower hurdle rate of sovereign investors.
  \item \textsuperscript{100} See generally Arthur C. Pigou, THE ECONOMICS OF WELFARE, 4th ed. 192-93 (1932) (discussing corrective taxes on alcoholic drinks, building in crowded areas, and petrol duties and motor vehicle license taxes).
\end{itemize}
behavior. A properly designed carbon tax, for example, might encourage an optimal level of greenhouse gas emissions. To the extent that investments by sovereign wealth funds create negative externalities, then, we might consider a Pigouvian tax to correct for those public harms. Specifically, I consider the pros and cons of an excise tax on equity investments by sovereign wealth funds, as equity investments raise more troubling concerns than debt investments. If an excise tax on equity investments is not desirable, it seems implausible that we would want to impose an excise tax on debt investments.

Of course, sovereign wealth fund investments may also create public benefits. Generally speaking, cross border investment encourages economic growth both here and abroad. In a recent report to Congress, the Joint Committee on Taxation argued that taxing sovereign wealth funds might reduce aggregate investment, reducing future growth compared to that achievable in the absence of tax. "This analysis would argue," the Committee explained, “that restrictions on investments by SWFs cannot improve economic well being in the United States.”

The cursory analysis of the Joint Committee raises the question of whether investment by sovereign wealth funds confers the same costs and benefits of private foreign investment. Weighing the relative costs and benefits of sovereign wealth fund investment is ultimately a task for Congress and the committee staffs, not

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101 See, e.g., William J. Baumol, *On Taxation and the Control of Externalities*, 62 AM. ECON. REV. 307, 307 (1972) (arguing that, in practice, a modified Pigouvian approach of setting tax rate on the generator of an externality in order to reach “tolerable” level is superior to Coasean bargaining).


103 To be sure, there are situations where the tax code’s preference for issuing debt over equity raises troubling issues about how the tax code may distort financial structures and corporate governance generally. But it is unlikely that taxing debt investments by foreign sovereigns alone (without general repeal of the portfolio interest exemption for private foreign investors) would affect the cost of capital of U.S. companies. Because foreign sovereigns currently enjoy a preference with respect to dividend payments, it is possible that an excise tax could affect the cost of capital for U.S. companies raising equity. It seems more likely, however, that the excise tax would shape the clientele, not the cost, of raising equity; other tax exempt investors, like pension funds and endowments, could likely fill the gap now filled by sovereign wealth funds.

104 See JCT Report, supra note 10, at 73.

105 See JCT Report, supra note 10, at 73.
academics, lobbyists, or tax lawyers. In recent reports, both the Joint Committee on Taxation and the Tax Section of the New York State Bar Association declined to opine on the nontax policy concerns raised by sovereign wealth fund investment. Still, given the ability of tax law to affect investment incentives, a review of the costs and benefits is useful in thinking about the optimal tax policy.

1. Literature Review: Costs and Benefits

The existing debate on sovereign wealth funds generally views equity investments by sovereign wealth funds as a positive development in global finance. Our trade deficit pushes dollars into the hands of foreign governments who manage foreign exchange reserves, and those dollars must be recycled either by purchasing U.S. government obligations, or by purchasing the securities or assets of U.S. companies. Most commentators view the proper policy goal as ensuring that the inbound investments in U.S. equities are made in accordance with financial rather than geopolitical motives.

The leading approach to regulating sovereign wealth is the “best practices” model, which has been endorsed by both the Treasury and the IMF. Advocates of the best practices model, while not always dismissive of national security considerations, tend to view the free flow of capital as the paramount consideration. Edwin Truman, an economist at the Peterson Institute and a former Treasury official, has been a prominent voice in both recognizing the potential harms for sovereign wealth and in advocating a “best practices” approach to shaping their behavior. In making the case for greater transparency and accountability, Truman notes that strategies for managing sovereign wealth assets are often unclear to the managers of those assets, known to the managers but not the general public, or susceptible to political influence. Transparency promotes “horizontal accountability” among domestic and international stakeholders as well as “vertical accountability” within

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\(^{106}\) See JCT Report, supra note 10, at 2 (“[I]nvestments by SWFs or foreign governments more generally raise nontax policy concerns, but these fall largely outside the expertise of the Staff of the Joint Committee on Taxation.”); NYSBA Report, supra note 10, at 2-3 (“This report, however, does not make recommendations regarding how the tax laws might be used to address the deeper economic and political issues presented by SWFs or by other market developments over the last two decades.”)

\(^{107}\) See Truman, Blueprint, supra note 14; Edwin M. Truman, Sovereign Wealth Funds: The Need for Greater Transparency and Accountability, Peterson Institute for Institutional Economics Policy Brief PB07-6, August 2007 [hereinafter Truman, Transparency].

\(^{108}\) See Truman, Transparency, supra note 107, at 1 (discussing key issues raised by sovereign wealth fund investment).
the country’s political process. Only transparency can allow the home country’s citizens to hold funds accountable and alleviate the suspicion of the host country’s citizens. Mr. Truman sets out various benchmarks by which we might measure best practices, including governance structure, transparency, accountability, and investment behavior.

Professor Paul Rose argues that existing economic, and political factors mitigate the risks posed by sovereign wealth funds, and that the existing regulatory regime is sufficient to protect our interests. The greater risk, according to Rose, is not that sovereign wealth funds will make politically-motivated investments, but rather that politics will infect the regulatory process here, driving investment abroad. Rose argues that multilateral agreements concerning the regulation of sovereign wealth would provide certainty and stability, protecting sovereign wealth funds from political retribution by target countries. Given the practical difficulties with reaching multilateral agreement in short period of time, however, Rose advocates a best practices model that sovereign investors could adopt voluntarily.

One problem with the best practices model is the subjectivity involved in measuring compliance. One measure of transparency, for example, is whether we know what companies foreign sovereigns have invested in. But many sovereign wealth funds invest through other intermediaries, such as private equity funds, which are themselves not transparent and lightly regulated. Would disclosure of an investment in a private equity fund satisfy standards of transparency? A second problem with the best practices model is that a gap may arise between the stated practices of a fund and its

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109 See Truman, Transparency, supra note 107, at 7.
110 See Truman, Transparency, supra note 107, at 8.
111 See Truman, Transparency, supra note 107, at 17 (Appendix A) (listing factors).
113 See id. at 6.
114 See id. at 40-41 (describing ability of multilateral agreements to “provide additional certainty for SWF transactions to the benefit of both the sovereign and the host nation”).
115 See id. at 44-54.
116 See Truman, Transparency, supra note 107, at 6 (“Although we have tried to be comprehensive, rigorous, and objective in our evaluation of each fund, some degree of subjectivity necessarily is present.”).
117 Judging by past experience in the private equity context, institutional investors may fear losing access to high-performing funds, and thus may be reluctant to comply with high standards of transparency concerning which funds they invest in. Moreover they may lack the ability, let alone the desire, to disclose the identity of portfolio companies in which they have an economic interest.
actual practices, and it may be difficult to anticipate departures from best practices before they arise.\textsuperscript{118} It is not difficult to imagine, for example, that managers of China’s or Russia’s state-owned funds could find themselves subject to unofficial political pressure. A third problem with the best practices model is the lack of a method of enforcing compliance. While hortatory statements may help establish norms of behavior, many new funds from developing countries may have limited ability to resist the political demands of the sovereigns they serve. One the one hand, “naming and shaming” campaigns can be surprisingly effective.\textsuperscript{119} On the other hand, it is precisely those countries that have shown a pattern of resisting IMF policies that pose the greatest geopolitical risk to the United States.\textsuperscript{120}

Professors Ron Gilson and Curtis Milhaupt advocate a “minimalist” response that would promote sovereign investment but undercut the ability of sovereign wealth funds to accomplish strategic goals by limiting their influence over target companies.\textsuperscript{121} They suggest a targeted response that would “diffuse” the potential conflict between the foreign government (who may have a geopolitical agenda) and ordinary shareholders seeking financial returns without impairing the capital markets benefits that flow from recycling trade deficits.\textsuperscript{122} Under their approach, the equity shares of a U.S. company acquired by a foreign government controlled entity would

\begin{flushleft}
\textsuperscript{118} See Ronald J. Gilson & Curtis J. Milhaupt, Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism, 60 Stan. L. Rev. 1345, 1362 (“Could anyone genuinely believe that the investment managers of China Investment Corporation or Singapore’s Temasek would hang up the phone if a senior government (or in China’s case, Party) official called to offer advice on the fund’s handling of a particular investment to advance the country’s rather than the portfolio company’s, interests?”).

\textsuperscript{119} See Truman, Transparency, supra note 107, at 14 (“As is the case with compliance with existing standards subject to IMF and World Bank surveillance and oversight, the process of naming and shaming, combined with peer pressure from other SWFs that want to avoid the application of draconian restrictions to their activities, should contribute to a high level of compliance within a short period.”).

\textsuperscript{120} See Sen. Evan Bayh, Time for Sovereign Wealth Rules, WALL ST. J., Feb 13, 2008 (“Incentives for compliance and meaningful consequences for sovereign wealth funds that refuse to comply must be adopted. It would be a mistake to give a multinational organization like the International Monetary Fund responsibility for oversight, because the IMF lacks enforcement power and has proven ineffective in discharging many of its current responsibilities.”).

\textsuperscript{121} See Gilson & Milhaupt, supra note 118.

\textsuperscript{122} See Gilson & Milhaupt, supra note 118, at 9-10 (“Efforts to diffuse this tension between the benign and threatening faces of sovereign wealth fund equity investments requires a strategy of regulatory minimalism, one that does not spill over beyond addressing the potential conflict of interest between the foreign government and ordinary shareholders to impair the critical capital market benefits that flow from recycling large trade deficits.”).
\end{flushleft}
lose the voting rights normally associated with those shares, regaining those rights only when transferred to non-state ownership. Sovereign investors with purely financial motives will still invest; sovereigns seeking strategic benefits, however, “will find SWFs to be a less attractive vehicle by which to achieve their ends.” Specifically, Gilson & Milhaupt claim that a sovereign wealth fund’s formal and informal influence depends on its ability to vote its shares.

The problem with the “minimalist” approach is that it assumes that the strategic influence that foreign governments seek is derived directly or indirectly from their voting rights in individual companies. When a sovereign wealth fund is the largest shareholder in a publicly-traded firm, it need not vote its shares in order to influence corporate decisions. Moreover, as I discuss in more detail below, accumulating substantial equity positions in financial services firms increases the “soft power” of autocratic regimes seeking legitimacy in the capital markets.

Professor Katharina Pistor offers a descriptive model that is helpful in understanding the motivations of both sovereign wealth funds and the financial institutions seeking capital. She describes the advantages of these investments in terms of “network finance,” an emerging model of the global financial system that conceptually sits between the Anglo-American model and the relational finance model (such as Japan’s keiretsu model or Korea’s chaebol model). As more capital flows from East to West, sovereign wealth funds are emerging as nodes in a horizontal network of global finance, in contrast to the traditional model of finance flowing from West to East (or North to South). Pistor views sovereign wealth funds as a form of “institutional hedging,” employed by developing economies trying to figure out the optimal governance structure for their new role as financiers of Western capitalism, and by banks in developed countries seeking access to markets in developing countries. By taking minority stakes in Western financial institutions, sovereign wealth funds develop a network relationship where vertical

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123 See Gilson & Milhaupt, supra note 118, at 10 (outlining proposal).
124 See Gilson & Milhaupt, supra note 118, at 10.
125 See Gilson & Milhaupt, supra note 118, at 23 (“In the end, even the informal, non-legal elements operate in the shadow of the formal, legally dictated decision structures. ... [A] SWF’s informal influence depends on its formal influence – its ability to vote its shares.”).
126 See Pistor, supra note 99, at 5-6.
127 Developed economies have become net importers of capital for the first time since the 19th century. See Pistor, supra note 99, at 29-30.
128 See Pistor, supra note 99, at 33.
integration is neither politically feasible nor desirable, but where
one-off market transactions are inefficient.\textsuperscript{129} China gains more from
investing in Blackstone equity, in other words, than from making a
one-time loan to Blackstone.\textsuperscript{130}

In sum, the existing literature generally views sovereign wealth
fund investment as an inevitable consequence of global financial
trends. Academics and policymakers have, for the most part,
advocated minimalist responses to the risks posed by sovereign
wealth funds, including equity investments.

2. Positive Externalities

Many of the benefits from inbound sovereign wealth fund equity
investment inure to the benefit of the target company and its
shareholders. When Morgan Stanley sells securities to China for a
higher price than private investors offer, that transaction benefits
existing Morgan Stanley shareholders, who are less diluted than they
otherwise would have been. The benefit to Morgan Stanley
shareholders, however, does not necessarily justify a lower tax rate
on sovereign wealth investment.

To justify a Pigouvian subsidy, one must believe that investment
by sovereign wealth funds generates positive externalities above and
beyond the benefits to the parties involved. While several possible
positive externalities can be identified, close analysis suggests the
overall positive externalities are likely outweighed by the negative
ones, which I discuss further below in Part 3 of this Section.

Lowering the Cost of Capital. In defending equity investments
by sovereign wealth funds, Wall Street lobbyists have argued that
sovereign wealth funds may lower the cost of capital for U.S.

\textsuperscript{129} See Pistor, supra note 99, at 35.
\textsuperscript{130} See Pistor, supra note 99, at 47-48 (“It is still too early to identify the purpose of
networking in this instance, although some inferences can be drawn from parallels
to networking in the 1970s when Western banks expanded into Latin America.
One possible explanation is insurance against future losses. ... A more likely
explanation is institutional hedging. The transactions create links among major
players from different governance regimes at a time when doubts have emerged
about the absolute dominance of the Western regime for global financial
markets.”).

Pistor’s account of this emerging model provides limited evidence of network
benefits. Pistor views the value primarily in terms of institutional hedging—as a
method for both Western financial institutions and the autocratic regimes of
developing economies to deal with the uncertainties of a financial system in flux.
Other advantages that might support Pistor’s account include traditional relational
advantages. China’s investment in Blackstone, for example, might offer the
opportunity to lend to Blackstone-controlled portfolio companies in the future, or
to participate directly in equity investments of Blackstone’s targets.
companies seeking equity, which may in turn promote economic growth.\textsuperscript{131} Absent tax advantages, however, there is little reason to think that sovereign wealth funds are the marginal investors in the equity market. Because aggregate sovereign wealth fund investment, while growing, remains small in comparison to aggregate investment by other institutional investors, in the usual case other investors would step in to substitute for sovereign wealth fund investment at the same marginal cost of capital to the issuer.\textsuperscript{132} While it seems unlikely that reduced sovereign wealth fund investment would affect the cost of capital generally in the United States, reduced deal activity from sovereign wealth funds could reduce advisory fees from those clients. The fees are substantial, and advisors to sovereign wealth funds have weighed in accordingly.\textsuperscript{133}

The Bush Administration has emphasized the role of sovereign wealth funds in “stabilizing jittery markets.” The argument is that sovereign wealth funds are capital suppliers of last resort; they supplied equity capital to struggling U.S. banks when no one else would. One problem with this argument is that there is little

\begin{footnotesize}
\begin{enumerate}
\item One initial reaction to the argument set forth in this Article is that “any hint that sovereign funds may have their tax status questioned would be one more reason for them to take their business elsewhere.” See Landon Thomas, Jr., To Court or Shun the Wealth of Nations, N.Y. TIMES, April 2, 2008, at H1, H11. Professor Steven Davidoff, who also writes as a journalist for the New York Times, suggested that disclosure backed by CFIUS review, rather than taxation, might serve as a better incentive to encourage compliance with a code of conduct. See Steven M. Davidoff, Telling Friend From Foe in Foreign Investments, N.Y. TIMES, April 2, 2008, at H11 (referring to academic proposals by myself, Ronald Gilson & Curtis Milhaupt, and Paul Rose, and concluding that ‘a firm monitoring and disclosure process’ would be preferable).
\item The Joint Committee explains, “[I]nvestment by SWFs is small relative to aggregate U.S. investment and even smaller relative to aggregate worldwide investment. If SWFs are not the marginal investor in the United States, that is if investments made by SWFs would be readily substituted by other funds at little or no change in the cost of capital, restrictions on the investments of SWFs would have little or no effect on future economic growth in the United States.” See JCT Report, supra note 10, at 73.
\item The Joint Committee noted that legislation curtailing sovereign wealth could be perceived as protectionist, in which case private foreign investors could also shy away. See id. at 73 (“However, restrictions on some foreign investors may be interpreted by other potential investors as an indication that the United States is inhospitable to foreign investors. Such a perception could make foreign investment funds more expensive and reduce aggregate investment.”).
\item I do not intend to cast aspersions on the NYSBA Report. The tax section of the bar has historically, on occasion, been willing to take positions that are inconsistent with client interests. Rather, I refer to reports by Wall Street investment banks and certain law firms which are better viewed as lobbying statements, not disinterested analysis. See, e.g., Stephen Schwarzman, Reject sovereign wealth funds at your peril, FINANCIAL TIMES, June 19, 2008, available at http://www.ft.com/cms/s/0/403b8888-3df1-11dd-b16d-0000779fd2ac.html.
\end{enumerate}
\end{footnotesize}
evidence that sovereign wealth funds were, in fact, capital suppliers of last resort. Rather, they offered a higher price than other investors. Capital markets are generally flexible, and when public investors shy away from a sector, institutional investors such as private equity funds, hedge funds, and pension funds are often willing to step in.134

To be sure, in 2007 sovereign wealth funds played the role of contrarian investor, buying equity in U.S. financial institutions when others were unwilling. But this is not credible evidence that sovereign wealth funds are uniquely suited to the role of lender of last resort. Private equity firms shied away from investments in banks in part because of regulatory considerations.135 Specifically, if a private equity fund acquires more than 25% of the voting shares of a bank, or owns more than 9.9% of the voting shares of a bank and acquires a board seat, the fund would be treated as a bank holding company for regulatory purposes. Among other things, bank holding company status would subject the fund to the “source of strength” doctrine, which could require additional infusions of capital in the future. If policymakers want to expand the pool of available investors and lower the cost of capital for troubled banks, relaxing the restrictions of the bank holding company act would be more effective than using the tax code to subsidize sovereign wealth funds.136 Moreover, it appears that notwithstanding banking laws, private equity remains willing to step in when the price is right.137

In any event, the value of sovereign wealth funds as equity-suppliers-of-last-resort is unproven. In the one clear case where an investment bank was in truly deep trouble, sovereign wealth funds passed. China’s CITIC, a brokerage firm controlled by the Chinese government, had engineered a deal to buy an equity stake in Bear Stearns. As Bear Stearns’ financial position weakened, China sought a bigger investment, but then ultimately walked away from

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134 Other investors have emerged as sovereign wealth funds have slowed their investment in financial services firms. The New Jersey Investment Board, for example, purchased ...
136 For a discussion of the purpose of the bank holding company rules, see Howell E. Jackson, The Expanding Obligations of Financial Holding Companies, 107 HARV. L. REV. 507 (1994) (positing “hungry wolf” hypothesis and “regulatory deterioration” hypothesis and finding empirical support for the latter, suggesting that enhanced capital requirements are appropriate); Eric J. Gouvin, Of Hungry Wolves and Horizontal Conflicts: Rethinking the Justifications for Bank Holding Company Liability, 1999 U. ILL. L. REV. 949 (suggesting that parent holding companies should be liable in very limited circumstances).
137 TPG-WaMu.
the deal. According to two people with direct knowledge of the deal, political pressure affected negotiations. Nor is there any evidence that sovereign wealth funds will act again to stabilize markets, even if we assume that they served this role in 2007.

Finally, while some sovereign wealth funds may act as long-term investors who can help stabilize markets, others may not. Newly formed funds subject to political pressure may be even more fickle than experienced financial investors. Certain funds’ lack of transparency may fuel the market’s concern that state-controlled investors may not be trustworthy when push comes to shove.

**Hostage Argument.** Richard Posner has argued that equity investments by sovereign wealth funds enhance national security by effectively taking a “hostage” (in game theory terms). Posner explains: “It does not undermine our national security just because the purchaser is a foreign government, but on the contrary enhances our security because the investment is a hostage. It’s as if to guarantee China's good behavior the president of China sent his family to live in the United States.”

Putting the point more broadly, economic interdependence allows gains from trade and is alleged to decrease the likelihood of armed conflict. Giving foreign sovereigns an economic stake in U.S. companies may better align their economic incentives with our own. When Abu Dhabi partners with GE, it may be less willing to act in ways that harm GE, and in many cases, what is good for GE is good for America. The problem is that foreign sovereigns are not committed to acting only according to economic motives. Returning

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138 See George Chen, *China Seeks Bigger Share of Bear Stearns*, REUTERS, February 15, 2008, available at [http://www.iht.com/articles/2008/02/14/business/citic.php](http://www.iht.com/articles/2008/02/14/business/citic.php). Mr. Chen quotes two people with knowledge of the deal: “Chinese regulators will not feel happy if they see Citic Securities buying the stake of Bear Stearns at the original price,” one of the people said. ... “Beijing is also facing domestic concerns that Chinese firms are probably paying too much for foreign assets,” he added, citing recent investments in U.S. companies by China Investment Corp., the country’s sovereign wealth fund, as an example.


140 See id.

141 See Gilson & Milhaupt, supra note 121, at 18 (“Indeed, because equity investments reflect long term values, these investments leave SWFs hostage to the health of the economies in whose corporations they invest.”)
to Judge Posner’s hostage analogy, if the hostage is expendable, the hostage takers have less leverage than they might expect.142

The critical concern is that one of these strategic investments by sovereign wealth funds will turn out to be a Trojan horse, allowing foreign governments to shape and influence American enterprise in a manner inconsistent with our economic and national security interests. Even if the professional managers of these funds are currently acting in a manner consistent with other, non-governmental institutional investors, there’s no guarantee that they will continue to do so in the future in circumstances where the financial interests of the fund and the political interests of the government that controls the fund diverge.143 A country with a ruling monarchy friendly to the United States today may not be so friendly following a revolution.

Monetary Policy. Some argue that allowing sovereign wealth funds to invest in U.S. equities is part of a sensible monetary policy that encourages the free trade of goods and services across borders, which in turn fuels economic growth. The weak dollar makes investments in U.S. Treasury bonds less appealing to foreign sovereigns than it once was. But it may not be necessary to subsidize equity investments in order to achieve the monetary policy

142 Shoot the Hostage is a familiar strategy in popular culture. Like Judge Posner’s hostage analogy, its relevance to actual international relations is entirely speculative. See http://tvtropes.org/pmwiki/pmwiki.php/Main/ShootTheHostage; SPEED (Jack (Keanu Reeves) shoots hostage Harry (Jeff Daniels) to confuse the bad guy); DIE ANOTHER DAY (Bond shoots M in simulator program); USUAL SUSPECTS (Verbal recounts Keyser Söze’s shooting his own family).

143 There is some concrete evidence to back up the concern about mixed financial and political motives. First, the historical track record of government sponsored funds is poor. Second, even funds that have performed well display political motives that are inconsistent with pure financial goals. For example, Carlyle’s Mideast investment fund avoids investments in Israel out of respect for its Arab partners, no matter how attractive the investment opportunity. See Nathaniel Popper, As Dubai Heats Up, Is Israel Frozen Out?, FORWARD, Dec. 5, 2007. Persian Gulf countries, sensitive to the political fallout following the Dubai Ports controversy, turned to strategic investments in financial services firms, rather than controlling investments in operating firms. These non-controlling investments, at least when they amount to less than 10% of the equity of the target, were thought to avoid review by the CFIUS, the Committee on Foreign Investment in the United States. (The Treasury Department has since clarified that it may review deals below the 10% level.) Policymakers have begun sorting out what, if anything, we ought to do about sovereign wealth funds. Most of the debate has focused on caps—limiting the ownership percentage in domestic companies—and/or requiring increased disclosure. Congress recently passed FINSA, which tightened the operations of CFIUS, the Committee on Foreign Investment in the United States. CFIUS reviews both governmental and private foreign investment in U.S. assets with national security implications. Broadly speaking, CFIUS focuses on transactions in which the foreign investor acquires a controlling stake in the U.S. target.
benefits of having foreign sovereigns recycle dollars into U.S. assets. Foreign sovereigns can achieve higher returns through indirect investments in U.S. assets by investing in financial intermediaries, like hedge funds and private equity funds, that invest in U.S. assets. And foreign sovereigns can invest in the debt of U.S. companies to increase returns above the risk-free rate.

**Increased Professionalization.** Lastly, sovereign wealth funds are becoming increasingly sophisticated investors, and this can have a positive impact on economic development. Encouraging funds to act more like private equity funds, hedge funds, and other financial institutions, including making equity investments in the United States as part of a diversified portfolio, normalizes the capital markets activity of foreign countries. There is little doubt, for example, that Singapore’s experience in the capital markets over the last fifty years has helped it develop its own financial infrastructure. The United Arab Emirates has developed highly sophisticated financial institutions that increase the general welfare. In the case of the UAE, however, the ruling families enjoy welfare gains that outpace the improvements of everyone else involved, such as the population outside the wealthy Emirates of Dubai and Abu Dhabi or the foreign laborers who work in the construction industry.

**Summary.** In sum, the positive externalities from equity investment by sovereign wealth funds are significant but not overwhelming, at least if distinguished from a broader overall economic policy of open access to capital markets and monetary policy that allows foreign sovereigns to recycle dollars in one form or another.

### 3. Negative Externalities

A higher tax rate on equity investments by sovereign wealth funds is justified if sovereign wealth funds cause harm to third parties (such as the American public generally), or if some other factor leads to more of the activity than is socially optimal.

**Threatening American Foreign Policy Interests.** Perhaps the most troubling aspect of sovereign wealth fund investment is the potential leverage it gives those sovereigns in foreign policy negotiations. Former Treasury Secretary Lawrence Summers has

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144 Cf. North, supra note 8, at 108-11 (discussing importance of development of institutions that encourage impersonal market exchange).
145 There does appear to be some effort to improve conditions for foreign workers and for the poorer Emirates.
identified a couple of examples. A sovereign investor, in exchange for supporting U.S. military operations, could press for a tax break in a company in which it has invested.\textsuperscript{146}\textsuperscript{146} Pressure might also be more subtle: What might it mean for the U.S. government, asks Summers, “when a decision has to be made about whether to bail out a company, much of whose debt is held by an ally’s central bank?”\textsuperscript{147}

Professor Summers also suggests the possibility that sovereign investors may want to extract industrial technology.\textsuperscript{148} While minority shareholders do not enjoy special access to company technology as a matter of state corporate law, management might be willing to grant its largest shareholders a tour of the facilities, plans for expansion, or access to other nonpublic information.

Equity investments by sovereign wealth funds also increases what international law scholars call the “soft power” of those sovereigns. Soft power is the ability to get what you want through attraction rather than coercion.\textsuperscript{149} We often think of extending the soft power of the United States through investment abroad: When Americans invest or donate abroad, residents of the target countries are influenced by U.S. norms.\textsuperscript{150} But the process can work in

\textsuperscript{147} See \textit{id.}. The latter concern came to fruition in July 2008, a year after Summers’ column appeared, when the Treasury announced a bailout plan for Fannie Mae and Freddie Mac. China is the largest holder of debt in both companies. The Administration’s desire to cultivate good relations with China could affect its decision to bail out the mortgage companies. Admittedly, a bailout of Fannie Mae and Freddie Mac was inevitable. But if another investment bank—say, Morgan Stanley—were to fail, how would that affect the government’s decision whether to bail out the bank, and the terms of the bailout? The Treasury already dodged one bullet in early 2008. China had planned an investment in Bear Stearns, but did not close the transaction before the firm collapsed.

\textsuperscript{148} See \textit{id.} (“They may want to see their national companies compete effectively, or to extract technology or to achieve influence.”).
reverse as autocratic regimes invest here: Doing business with China arguably legitimizes Chinese investment and may be read as tacit approval of their political system. More precisely, accepting sovereign wealth fund investment establishes a norm that whatever the policies of the foreign sovereign may be, our disagreements do not rise to a level worthy of rejecting their money.

To be sure, China, Singapore, the Gulf States and other countries with prominent sovereign funds, as major trading partners with the U.S., already possess some soft power over U.S. foreign policy. After all, it is the trade imbalance with the United States that creates the opportunity to form sovereign wealth funds in the first place. And so the incremental gain in soft power through minority equity investments in U.S companies may not be vast.

_Inefficient Allocation of Resources._ Capitalism relies on companies and their shareholders seeking financial returns on their investments. The price signal is a valuable mechanism for reducing agency costs; as shareholders learn of good or bad decisions that managers have made, shareholders on the margin buy or sell stock accordingly, pushing the price of the stock up or down. Introducing governments as shareholders makes noise which interferes with the price signal.

Suppose, for example, that Morgan Stanley is considering expanding either its office in Beijing or Taiwan. China’s presence as the company’s largest shareholder may influence its managers towards Beijing, even if, in the absence of China’s influence, it would have chosen Taiwan. Even if managers do not explicitly seek the approval of their sovereign shareholders, they might shy away from actions that would offend those shareholders. Political influence on such decisions, in the aggregate, may create significant loss of efficiency for the company.

In the absence of transaction costs, the presence of China as a large shareholder might be irrelevant to managers. If managers offend Chinese officials, who in turn pressure CIC to sell the stock, China would be swiftly replaced by other investors who would see that the managers had made a wise business decision. But China’s sale of shares could also be interpreted as a signal of bad management. After all, China may be presumed to have better information about Morgan Stanley than non-shareholders.

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151 See, e.g., Summers, supra note 146 (“The logic of the capitalist system depends on shareholders causing companies to act so as to maximize the value of their shares.”).
In a context where information costs are high, such as in the venture capital-portfolio company context, it is well accepted that existing shareholders exert powerful influence over the ability of companies to secure future equity financing. Because information is asymmetric—the selling company and its existing shareholders have better information about future prospects than potential new shareholders—the refusal of an existing shareholder to participate in a new round of equity financing can be taken as a negative signal by the market. This familiar extension of the “lemons” problem means that potential new shareholders shy away. As a result, the participation of existing, non-controlling shareholders in future rounds of financing gives them influence separate and apart from any voting rights they may have. If, however, transaction costs are assumed to be low, the influence of a minority shareholder might be trivial.

At a higher level of abstraction, the presence of investors with non-financial motives can result in the mispricing of securities. The

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153 Similarly, antitrust scholars believe that passive investment in a rival firm can have an anticompetitive effect, at least under certain conditions. See generally David Gilo, The Anticompetitive Effect of Passive Investment, 99 MICH. L. REV. 1, 10 (2000) (discussing how passive investment facilitates tacit collusion, and, even in the absence of collusion, tends to reduce output and raise prices). See also Daniel P. O’Brien & Steven C. Salop, Competitive Effects of Partial Ownership: Financial Interest and Corporate Control, 67 ANTITRUST L. J. 559, 571 (2000) (“In simplest terms, when a firm acquires a partial financial interest in a rival, the acquiring firm’s unilateral pricing incentives to compete are reduced at the margin. What about the unilateral competitive incentives of the acquired firm? If the acquiring firm has no control or influence over the rival, acquired firm, that rival’s incentives to compete may be unaffected. However, if the acquiring firm also has control over the rival, then the rival’s incentives to compete are affected.”). Although the competitive effect of passive investment is outside the scope of this Article, the fact that antitrust scholars recognize the possibility that passive shareholders can sometimes influence the behavior of firms puts the formalist approach of Gilson & Millhaupt in jeopardy.

The MasterCard IPO is illustrative. In the MasterCard IPO, the member banks shed voting control of MasterCard, retaining influence through a passive economic stake in the company and a relationship maintained through a nonprofit foundation, which became a block shareholder in the newly public company. See Victor Fleischer, The MasterCard IPO: Protecting the Priceless Brand, 12 HARV. NEGOT. L. REV. 137 (2007). In evaluating the structure, Professor Wright correctly points out that the value of the structure depends on both the reduced regulatory exposure from a “single entity strategy” and on MasterCard retaining some control over merchant banks’ use of the MasterCard brand. See Joshua D. Wright, MasterCard’s Single Entity Strategy, 12 HARV. NEGOT. L. REV. 225, 223 (2007). In other words, the capital markets view the indirect influence of the member banks, without a formal vote, as a powerful factor in the governance of the organization going forward.
invisible hand of the marketplace relies on the aggregation of preferences of individual actors. Here, rather than individuals or private organizations acting independently, sovereign vehicles aggregate preferences on behalf of their citizens (or perhaps party officials). There is no reason to believe that Chinese party officials are better at identifying good investments—firms that will put capital to its highest and best use—than private investors. Some sovereign wealth funds might prove to be excellent investors; the wealth funds of Gulf States closely resemble the family offices of wealthy individuals. But not all sovereign wealth funds are so well-managed.

There is already substantial evidence that some sovereign wealth funds may have a lower hurdle rate for certain investments. For example, the China Investment Corporation has a “fairly clear floor” on its rate of return goal of about 5%, which is necessary to service the cost of the bonds issued to CIC by China’s Ministry of Finance. Even adjusting for risk, this relatively low floor leaves ample room to make inefficient investments, whether to achieve political goals or merely out of poor investment decisions.

Finally, it is useful to consider the historical evidence. Pension funds and endowments have succeeded in the U.S., indeed worldwide, only as they have become professionalized and institutionalized as financial actors. While empirical data on sovereign wealth funds is scant, there is powerful anecdotal and statistical evidence that pension funds sensitive to political influence underperform peers that are insulated from political influence.

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155 There is little empirical data on the performance of sovereign wealth funds. But the early returns are poor. See Veljko Fotak et al., The Financial Impact of Sovereign Wealth Fund Investments in Listed Companies, working paper available on SSRN (finding average abnormal returns of negative 40% over 480 trading days following sovereign wealth fund investment).

Contagion Effect. The lack of transparency of sovereign wealth funds produces another, more subtle harm. Unlike private investors, who are generally driven by profit motive, we do not generally know why sovereign wealth funds invest as they do. This uncertainty can destabilize markets because it is harder to anticipate how investors will respond to economic or political changes, and more difficult to assess systemic risk. The lack of transparency can lead to destabilizing rumors.\(^1\) Because the investment strategy of many sovereign wealth funds is unknown, and because the potential for investment for geopolitical or monopolistic gain is a concern, sovereign wealth fund investment can increase market volatility.\(^2\)

That sovereign wealth fund investment might increase market volatility may seem counter-intuitive, as they tout themselves as long-term investors. But they are a subset of portfolio investors. Foreign portfolio investment, unlike foreign direct investment, reacts quickly to changes, sometimes producing a “contagion effect.” Portfolio capital “flees when the milk goes sour.”\(^3\) Financial turmoil in the U.S. may be magnified, not dampened, by the presence of portfolio investment in the markets.\(^4\) Sovereign wealth funds may also be subject to political control, which may make them even more likely to overreact to financial turmoil and rapid changes in the value of their portfolio. The fact that sovereign wealth funds are so trendy now does not bode well for how they might react to bad news in the future.

Encroaching on the Autonomy of American Enterprise. Sovereign wealth fund investment in U.S. equities raises a concern that foreign governments might encroach on the autonomy of American enterprise. The United States is unnecessarily acting like a developing nation, giving up autonomy over our affairs in exchange for foreign direct investment.\(^5\) Among tax scholars, the concern about sovereign wealth funds brings to mind similar

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\(^1\) See Martin, supra note 154, at 7 (discussing volatility of Fortescue, an Australian iron ore company, and Rio Tinto, an Australian mining company, following rumors that the companies were targeted by CIC for investment).

\(^2\) See Martin, supra note 154, at 7 (discussing market concerns).

\(^3\) See Graetz & Grinberg, supra note 84, at 552.

\(^4\) Many economists advocate constraints on the flow of portfolio capital. See Graetz & Grinberg, supra note 84, at 553 (discussing proposals by Feldstein, Krugman, Stiglitz).

\(^5\) See Kingson, supra note 57, at 1162 (“The more a country must try to attract direct investment, the more that need conflicts with its independence; and the independence a country wants does not necessarily match the independence it can afford. A country may, therefore, simultaneously seek and selectively limit foreign ownership.”).
discussions a generation ago about foreign investment in U.S. real estate, which ultimately led to the enactment of FIRPTA.\footnote{See Foreign Investment in Real Property Tax Act of 1980, Pub. L. No. 96-499, §§ 1121-25, amending I.R.C. §§ 861(a)(5), 897, 6039C, 6652(g); see generally Richard L. Kaplan, Creeping Xenophobia and the Taxation of Foreign-Owned Real Estate, 71 GEOGETOWN L. J. 1091 (1983) (arguing that FIRPTA can only be understood as promoting xenophobia).}

Before FIRPTA, foreign investors could avoid all gains in U.S. real estate by holding the real estate through a corporate intermediary.\footnote{See S. Rep. No. 504, 96th Cong., 1st Sess. 6 (1979) ("[T]he committee believes that the United States should not continue to provide an inducement through the tax laws for foreign investment in U.S. real property ... [by] effectively exempting [the foreign investor] from U.S. tax on the gain realized on disposition of the property.").} When they sold the stock of the corporation that held the real estate, the gains were treated as capital gains and therefore were exempt from tax.\footnote{See id.} As foreign ownership of U.S. real estate rose during the 1970s, Congress began to investigate the tax loophole. Farmland was a particular concern; the idea of foreign investors crowding out domestic investors did not appeal to politicians in the heartland.\footnote{See Kaplan, supra note 162.} Similarly, urban politicians were alarmed by the possibility of “Japan Inc.” taking over the commercial real estate market. Many tax academics take a dim view of this chapter in American tax lawmaking. Law professor Richard Kaplan called the enactment of FIRPTA symptomatic of a “creeping xenophobia.”\footnote{See Kaplan, supra note 162.}

But one can be concerned about sovereign wealth funds without being xenophobic. Foreign governments pose a higher risk of making decisions based on political interests than foreign individuals. One concern is opportunism: There is some evidence of opportunistic behavior by sovereign wealth funds. In 2006, Norway's government-owned fund shorted the bonds of Iceland’s banks at a moment when the banks were particularly vulnerable at the tail end of a boom period.\footnote{See THE ECONOMIST, Asset-backed insecurity, Jan. 17th, 2008.} Perhaps the greater fear is that by becoming the largest shareholder in our public corporations, sovereign wealth funds may influence corporate decisions in a manner inconsistent with current practice. Politically-motivated sovereign wealth funds have encouraged companies to allocate resources in an objectionable fashion.\footnote{See Popper, supra note 143.} Financially-motivated funds have encouraged companies to adopt cost-cutting measures...
consistent with the well-being of shareholders but harmful to other
stakeholders. The Saudi Prince Al-Waleed Bin Talal, for example,
successfully (and publicly) pressured Citibank to fire thousands of
employees. While such influence may be efficient, not all
observers agree that what is best for shareholders is always best for
overall social welfare. Along similar lines, the current practices of
many sovereign wealth funds would be a step backward in terms of
expectations of gender diversity and racial tolerance within our
financial system.

**Supporting Autocratic Regimes.** Sovereign wealth fund
investment raises both moral and instrumentalist objections.
Accepting equity investments from foreign sovereigns makes U.S.
companies complicit in the actions of the foreign sovereign. Setting
aside, for the moment, both the efficiency and foreign policy (soft
power) implications discussed above, many find it morally
objectionable to partner with autocratic regimes, many of which
have poor human rights records. In the era of apartheid, for
example, activists pushed for divestment from South Africa not just
because divestment would hit South Africa in the pocketbook, but
because divestment symbolically distanced U.S. companies from
policies that we disagreed with. Similarly, partnering with China and
Gulf States imposes harm that, while not easily quantifiable,
onetheless counts as a negative externality.

Allowing direct investment by foreign sovereigns also raises
instrumentalist concerns. It may not be in our long-term interest to
support the status quo regimes in foreign countries, and interlocking
investments make it difficult to pursue a policy of regime change.
Furthermore, allowing equity investments by foreign sovereigns
makes it easier for those countries to maintain limited access to
capital markets for their own private investors. The creation of
sovereign wealth funds is not independent from overall trade policy
on inbound and outbound capital movements. Even given China’s
restrictive policy with respect to foreign direct investment in China,
more foreign direct investment flows into China than outward,
fueling the already staggering growth of its foreign exchange
reserves. While China has begun to allow certain “qualified”
Chinese nationals to invest abroad, the outbound investment is
limited by quotas.

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\textsuperscript{169} See Rose, supra note 112, at 34; David Wighton, \textit{Alwaleed Warns Citigroup

\textsuperscript{170} This is, obviously, a contested point in the literature.

\textsuperscript{171} See CRS Report for Congress, China’s Sovereign Wealth Fund, January 22,

\textsuperscript{172} See id. at 14.
Lastly, in many countries the benefits of sovereign wealth funds inure to the benefit of private individuals rather than the public at large. Particularly in the Gulf countries, it is hard to distinguish between benefits to the sovereign and benefits to the ruling family. While, in theory, the ruling families safeguard wealth for the citizens they represent, and the rising economic tide in the Gulf may eventually improve overall welfare, many observers remain troubled by the shape of progress in the region.

*Development Agenda.* Encouraging equity investments by sovereign wealth funds may be inconsistent with broader foreign policy goals with respect to development. Sovereign wealth funds concentrate financial resources in the hands of financial managers. In developing countries, these financial managers may be closely tied to political elites.\(^{173}\)

The conflict between our current sovereign wealth fund policy and development policy is clearest in the case of countries that received IMF aid. IMF aid dollars flow into the country, intended for domestic infrastructure. Meanwhile, dollars from the exploitation of natural resources are diverted away from domestic infrastructure into investments abroad. On a net basis, dollars flow from the United States to the IMF, from the IMF to the target country, and back from the target country to the United States. Sovereign wealth funds thus may undermine our general foreign policy approach of encouraging developing countries to improve their domestic infrastructure.

4. *Summary*

Neither the brightest promise nor the greatest fears of sovereign wealth funds has yet been realized. While it is impossible to quantify all the positive and negative externalities, policymakers could rationally conclude that the negative externalities outweigh the positive ones, making out a prima facie case for a Pigouvian tax. In my view, because the potential for negative harm is severe, the potential for positive benefit modest, and the capital supplied by sovereign wealth funds so easily replaced by private investors, there is a prima facie case for a Pigouvian tax.

Specifically, a tax on sovereign wealth could help encourage a broader policy of supporting private investment over state-controlled investment, protecting American foreign policy interests, and preventing foreign governments from increasing their power over us.

\(^{173}\) Insert more from Keenan here.
Welcoming foreign investment is generally in our own long-term interest, but there is little reason to encourage the accumulation of wealth by autocratic regimes hoarding the proceeds of international trade from their own citizens.

Setting the right tax rate depends on what we think the hurdle rate of sovereign wealth fund investors might be. Assuming that the goal is to tax sovereign wealth fund investors more heavily than private investors, this may require a tax rate in excess of 30%, which is the base rate for withholding on dividends paid to private foreign investors. As a placeholder for discussion purposes, assume an excise tax rate of 50% on all income received by sovereign investors.

An excise tax of 50% raises some difficult implementation questions, which I discuss in more detail below. Before turning to implementation questions, however, it is necessary to consider whether tax is the right regulatory instrument. Assuming that sovereign wealth fund is something we want to discourage, is taxing it the right policy tool for the task?

C. What Is The Right Regulatory Instrument?

There are advantages and disadvantages to using tax as a policy lever to address sovereign wealth. Tax might be an effective policy tool to encourage investment within institutional frameworks that are mutually beneficial to both the United States and foreign sovereign investors. For example, a Pigouvian tax on equity investments could help channel investment into debt securities, where the investment by a foreign government is less likely to contravene American industrial and economic policy. By channeling investment in this way, tax policy can enhance our ability to achieve both tax-related and broader economic policy objectives. At the same time, tax is likely to be less effective as a policy lever where taxing particular investment activities would test the institutional competence of tax institutions by forcing them to administer foreign policy directly.

1. Instrument Choice

- See infra at text accompanying notes xx – xx.
- In circumstances where a company is in financial distress, of course, holders of debt securities have considerably more influence than in the normal course.
- Tax is less likely to be effective as a policy lever where raising tax rates would be easily circumvented through wasteful gamesmanship techniques, or where taxing investment activities of foreign states would test the institutional competence of the tax administrators by forcing them to administer foreign policy directly.
Three ways of limiting activities that create external harms are conduct restrictions (command-and-control regulation), liability-based approaches (such as Pigouvian taxes), and property-based approaches (such as cap-and-trade). One could limit greenhouse gases, for example, by outlawing excessive emissions, taxing emissions, or granting (or auctioning off) carbon allowances and permitting trading of those property rights. The economics literature on instrument choice is extensive, but a few important threads are relevant here. In addressing greenhouse gas emissions—the context which has received the most academic attention—most economists view Pigouvian taxes as a superior instrument to either command-and-control regulation or cap-and-trade management. Professors Kaplow and Shavell, for example, have argued that even where the state is uncertain about the harm caused by an externality, corrective taxes are considered superior to quantity regulation. As one introduces complicating factors of political economy, however, it becomes less clear that Pigouvian taxes are superior. If it is exceedingly costly for the state to determine the amount of harm caused by an externality, for example, making a linear tax rate the only feasible schedule, then a corrective tax may be suboptimal.

The risk posed by sovereign wealth funds does not fit cleanly into the existing literature on instrument choice. In most models, it is assumed that externalities are uniform. Where the harms are not uniform, it may be difficult for policymakers to tailor tax legislation accordingly. If an equity investment by China’s CIC poses a threat to American foreign policy but an equity investment by Singapore’s Temasek does not, the tax rate may need to reflect

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177 Compare Martin L. Weitzman, Prices vs. Quantities, 41 REV. ECON. STUD. 477 (1974) (finding quantity regulation superior assuming linear tax rate) with Louis Kaplow & Steven Shavell, On the Superiority of Corrective Taxes to Quantity Regulation, 4 AM. L. ECON. REV. 1, 10-14 (2002) (finding superiority of corrective taxes even when state’s information about control costs is incomplete, based on state’s ability to impose nonlinear tax rate based on schedule of expected harm).

178 See Jeff Strnad, Conceptualizing the “Fat Tax”: The Role of Food Taxes in Developed Economies, 78 S. CAL. L. REV. 1221, 1244 (2005) (suggesting, in the context of a fat tax, that only feasible tax schedule may be linear, and that such a tax schedule would be suboptimal).

179 See also Louis Kaplow, Optimal Policy With Heterogeneous Preferences, at 2, 19 (working paper available on SSRN) (suggesting that where preference differences are not observable, Pigouvian prescription of complete internalization of externalities may not be optimal).

180 For another example of the difficulty of tailoring corrective taxes to non-uniform harms, see David S. Gamage, Taxing Political Donations: The Case for Corrective Taxes in Campaign Finance, 113 YALE L.J. 1283, 1290 (2004).
that fact; a uniform tax rate likely leads to a suboptimal level of investment by Singapore or excess investment by China, or both. Even if harms are not uniform, tax may be a useful instrument; the penalty increases as the size of the investment increases, and if the size of the investment (or, more precisely, the return on investment) is a good proxy for harm, tax may be an effective regulatory choice.

In a world with perfect political institutions, and where information costs and agency costs are assumed away or at least do not vary across political institutions, a Pigouvian tax with tailored rates could be equivalent to any other method of reducing exposure to the expected harms. In practice, the decision whether to control sovereign wealth fund risk through a corrective tax or some other regulatory instrument depends on institutional comparative advantage.\footnote{Cf. David A. Weisbach & Jacob Nussim, The Integration of Tax and Spending Programs, 113 YALE L.J. 955, 964 (2004) (suggesting that, like tax expenditure vs. direct spending decision, tax vs. regulation decision depends on institutional competence).} Discretion should be lodged with the decision-makers who have the best information about the risks posed by sovereign wealth funds, are best positioned to act in a manner consistent with the public interest, and are least subject to agency capture by the regulated industry.\footnote{Regarding the capture of tax-writing committees, see, e.g., Dhammika Dharmapala, Comparing Tax Expenditures and Direct Subsidies: The Role of Legislative Committee Structure, 72 J. PUB. ECON. 421 (1999); Edward A. Zelinsky, James Madison and Public Choice at Gucci Gulch: A Procedural Defense of Tax Expenditures and Tax Institutions, 102 YALE L.J. 1165 (1993); Daniel Shaviro, Beyond Public Choice and Public Interest: A Study of the Legislative Process as Illustrated by Tax Legislation in the 1980s, 139 PENN. L. REV. 1 (1999).} The choice of instrument may also be affected by realistic consideration of the legislation that would likely be enacted.\footnote{For example, in the absence of a global policymaker who can imposes taxes by unitary fiat, the necessity of attracting support from all countries suggests a preference for employing tradable allowances rather than taxes to control pollution. See Jonathan Baert Wiener, Global Environmental Regulation: Instrument Choice in Legal Context, 108 YALE L.J. 677, 780-83 (1999).} How we approach this question of institutional comparative advantage depends in part on the non-uniformity of harms posed by sovereign wealth funds. For readers interested in more detail on the sort of information regulators will need to assess and manage sovereign wealth fund risk, the Appendix to this Article discusses three different funds in some detail: China’s CIC, Abu Dhabi’s Mubadala Development Corporation, and Singapore’s Temasek Holdings. As the non-uniformity of risk is not likely to be a controversial point, I now turn to the question of which domestic political institutions are best suited to managing the myriad risks posed by sovereign wealth.
2. Domestic Political Institutions

In theory, tax legislation could be fine-tuned enough to account for the diversity among funds. In practice, however, the institutions that make tax law may not be well-suited for the task. To be sure, given the flaws of all political institutions, it is not outlandish to believe that our tax institutions may be comparatively better off than nontax institutions, and so I do offer two variations of a Pigouvian tax as reform alternatives below. On balance, however, there is good reason to think that Congress would struggle to write a tax law that appropriately distinguished good sovereign wealth funds from bad ones. Nor would the tax lawyers at the Treasury and IRS necessarily relish the task of evaluating and administering foreign policy.

Institutional analysis does not provide a clear answer about whether a corrective tax or some other regulatory instrument is optimal in regulating sovereign wealth, but it does show that implementing an excise tax would not be a simple matter. To begin with the obvious, public choice theory suggests that proposals that are appealing in terms of the traditional tax policy goals of equity, efficiency and administrability may not always survive the legislative process. According to the public choice model, optimal tax policy (in the public interest sense) is likely to be compromised both by the rent seeking of interest groups affected by the legislation and by the rent seeking of legislators who influence the process, who can extract political donations from interested parties. One can easily imagine the effect of interest group lobbying: Nations with better access to policymakers, like the Gulf States, are more likely to

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184 See infra Section IV.
emerge unscathed. By the time legislation emerges, there may be little relationship between the risks posed by a particular country and the tax rate imposed.

Making matters worse, an excise tax on sovereign wealth funds might offer an opportunity for legislators to shake down those who benefit from the status quo, including both foreign sovereigns and the investment bankers, lawyers, and other service providers who execute cross-border transactions. Like the proposal to raise the tax rate on carried interest, the issue carries high stakes to a small group of current beneficiaries, legislation is plausible, and the issue has low salience for general voters in comparison to issues like terrorism, climate change, and economic policy generally.

On the other hand, comparative institutional analysis offers some reason to think that refocusing legislation in the tax writing committees may be more likely to lead to an optimal policy outcome than the status quo. Tax institutions, after all, are not unique in their susceptibility to lobbying and their taste for rent seeking. The CFIUS process already offers ample opportunities for legislators to get involved with reviewing deals. In reviewing a deal, CFIUS reports to “(i) the majority and minority leaders of the House and Senate, (ii) the chair and ranking members of the Senate Banking Committee and the House Financial Services Committee, (iii) any House or Senate committee having oversight over the lead agency in the CFIUS review, (iv) Senators and Member of Congress from the district concerned, and implicitly (v) governors whose states ‘interact’ with the critical infrastructure involved.” While this structure ensures input from a wide variety of politicians, it also provides numerous opportunities to hold up the deal in exchange for political contributions.

Furthermore, experience shows that the public choice model does not always provide a descriptive account of how tax legislation actually works its way through the political process. Whether out of concern for the public interest or self-interested motivation for increased publicity, power, and prestige, politicians sometimes accomplish sound public policy. A tax on sovereign wealth has powerful symbolic value to voters and a political salience that could

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187 See McCaffery & Cohen, supra note 186, at 1177.
188 See McCaffery & Cohen, supra note 186, at 1177-78. The issue is also potentially two-sided, as groups such as the SEIU, AFL-CIO and other labor unions are likely to support a tax on sovereign wealth. Cf. Matthew Bodie, Mother Jones Meets Gordon Gekko: The Complicated Relationship between Labor and Private Equity, 79 Colo. L. Rev. (forthcoming 2008).
189 See Rose, supra note 112, at 28.
190 See Shaviro, supra note 182.
make it attractive on its own merits, potentially insulating it from standard public choice concerns. Politicians like Senators Bayh and Clinton, who have already voiced concerns about sovereign wealth, seem less likely to “sell” their votes to interest groups or waffle on the issue in an attempt to extract political donations. Even assuming self-interested behavior, politicians may be more interested in increasing their prestige by sponsoring legislation that puts them on a global stage rather than simply selling their vote to the highest bidder.

From the perspective of comparative institutional analysis, perhaps the greater lesson is not the danger of rent-seeking, but rather the importance of institutional competence. The executive branch is likely better suited to the task of managing the geopolitical risk posed by sovereign wealth funds than the tax writing committees. Nontax officials in the executive branch specialize in tailoring our foreign policy agenda. They are better positioned to coordinate sovereign wealth fund policy with other aspects of our policies on trade, development, and regime change. Under current law, the executive branch has the means to discourage unwanted sovereign wealth fund investment, and the fact that it has not done so reflects a lack of political will, not an absence of legal means.

A proposal to tax sovereign wealth could exacerbate a tug of war between the executive branch, which generally enjoys broad authority over national security and economic policy concerns, and

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191 See Shaviro, supra note 182 (discussing symbolic importance of legislation as important to voters, and salience as important to politicians).
192 See Shaviro, supra note 182.
193 See David A. Weisbach & Jacob Nussim, The Integration of Tax and Spending Programs, 113 YALE L.J. 955 (2004).
194 The executive branch is better positioned for managing sovereign wealth fund risk in part because these funds change and develop over time. Sovereign wealth funds are sprouting up rapidly, and existing funds continue to evolve and professionalize. Suppose Congress enacts an excise tax of 50% on sovereign wealth fund investment, and carves out exceptions for funds that comply with best practices. Who decides whether a country is in compliance?

Again, in theory, Congress could write legislation that was very specific, setting standards at a level of specificity that might distinguish among funds. But this approach creates several problems. Even assuming that Congress agrees that transparency is a worthy goal, it might be difficult to agree on how to define whether a fund is transparent. Similarly, it is generally agreed that funds should not pursue political goals. Assume for the sake of argument that China’s investment in Blackstone was made to achieve network benefits with Western banks. Is that a political goal, or a financial goal? The end result would be a complicated set of rules that would be difficult to administer and subject to various forms of regulatory gamesmanship.
Congress, which increasingly weighs in on sovereign wealth fund investment following notification through the CFIP process.\textsuperscript{195} Because of the tax writing committees influence over tax matters, tax policy would tilt power away from the executive branch and back towards the legislature.

Placing more power in the hands of the tax writing committees may improve matters over the status quo: If Congress is concerned about sovereign wealth, it may be more effective to address those concerns through tax policy rather than through the CFIP process, where the focus has been in recent years. After all, concerns about sovereign wealth go beyond national security concerns, which CFIP is designed to address. Furthermore, given the apparent pattern that Congress is more concerned about sovereign wealth fund risk than the executive branch, redundant programs might be optimal.\textsuperscript{196} Complementing CFIP with an excise tax—a belt-and-suspenders approach—may be further justified if the risks associated with sovereign wealth investments are of much greater magnitude than the benefits of investment, or if tax administrators bring a different, useful perspective to the problem.\textsuperscript{197} Finally, the tax-writing committees, which answer to heterogeneous interests, might better reflect the political will of the country than either other Congressional committees or a small group of people within the executive branch.\textsuperscript{198}

There are two lessons to extract from this discussion. First, there is much to be said for addressing the risks posed by sovereign wealth funds through other regulatory instruments. Second, if Congress moves forward with a tax on sovereign wealth, it should

\textsuperscript{195} See David Zaring, \textit{CFIP and National Security Exceptionalism}, forthcoming (draft on file with the author).


\textsuperscript{197} See Staudt, supra note 196, at 1222-24; Weisbach, supra note 196, at 1840-41 (discussing benefits of bureaucratic diversification); Michael M. Ting, \textit{A Strategic Theory of Bureaucratic Redundancy}, 47 AM. J. POL. SCI. 274, 276 (2003) (finding redundancy helpful where agencies’ policy preferences differ from principal’s preferences).

\textsuperscript{198} See Edward Zelinsky, \textit{James Madison and Public Choice at Gucci Gulch: A Procedural Defense of Tax Expenditures and Tax Institutions}, 102 YALE L. J. 1165, 1194-1207 (1997) (discussing tax-writing committees); id. at 1190 (“[T]ax subsidies ought to be preferred to direct expenditures when there is a need for detached administration and oversight by decisionmakers less susceptible to capture.”).
legislate in broad terms, leaving ample discretion to the Treasury Department, which would implement the rules through regulation, and the IRS, which would interpret and enforce the regulations.

One potential approach, for example, would be a “most-favored nation” methodology, with executive branch officials making the determination of whether a sovereign wealth fund has sufficiently adopted best practices or other indicia of professional investor norms worthy of a tax preference. This approach would avoid the most prickly challenge of demanding an understanding of foreign institutions that might be difficult for tax lawyers to achieve. Moreover, this approach would conform to the practice of granting tax preference as a matter of administrative discretion that appears to be followed in several other countries.

Yet another alternative is to set a high baseline tax rate and then reduce that rate through treaty negotiations. But treaty-making carries its own set of problems. Specifically, we tend to reach agreements for bilateral tax treaties with other developed countries, where foreign direct investment flows in both directions. Sovereign wealth funds, by contrast, mostly concern the relationship between the United States and developing countries. Relying on the treaty mechanism could cause long delays. It is not realistic to expect that we could negotiate treaties with the dozens of countries with sovereign wealth funds in an appropriate time frame.

Given the challenges associated with our domestic political institutions, there is a strong case for framing the question of taxing inbound sovereign wealth investment within the framework of cooperative tax norms among OECD countries. If Congress

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200 I am indebted to Professor Brennan for this suggestion.
201 See JCT Report, supra note 10, at pin.
202 See Tillinghast, supra note 29, at 540 (“As a practical matter, of course, relegating the exemption to the treaty-makers ensures long delays and exasperations in making it effective. ... On the whole, it seems preferable to legislate a properly constructed exemption and utilize the treaty-making process to cure uncertainties (for example, by recognizing particular entities as entitled to exemption) or to deal with special cases.”),
203 In comparison to domestic tax legislation, tax laws that impact cross-border investment tend to comply with broader norms of what constitutes appropriate tax legislation. As Professor Shaviro has explained, the United States may rationally aspire to a standard of worldwide welfare, rather than national welfare, as an appropriate standard in setting international tax policy. See Daniel Shaviro, Why Worldwide Welfare as a Normative Standard in U.S. Tax Policy?, 60 TAX L. REV. 155, 164-66 (2007) (discussing the role of cooperative norms). A normative standard of worldwide welfare may make not just altruistic sense, but makes sense as a strategic cooperative move within a framework of a prisoner’s dilemma game.
believes, however, that its policy preferences with respect to current law are not reflected in administrative policy, then complementing CFIUS and other administrative tools with an excise tax may be appropriate.

IV. REFORM ALTERNATIVES

In this Section, I briefly summarize three reform alternatives that Congress may wish to consider. The first alternative would tax sovereign wealth funds as if they were private foreign corporations. The second alternative would impose an excise tax on returns from equity investments by sovereign wealth funds. The third alternative would offer a continued tax exemption conditioned on compliance with specified best practices.

A. Tax Sovereign Wealth Funds as Private Corporations

The first reform alternative, which I favor, is replacing section 892 with a simple code section that would treat foreign governments as private foreign corporations. This alternative would follow the baseline norm of sovereign tax neutrality, conforming with the current practice of the European Union. Because the impact of this change would be modest, by implication it relies on other regulatory instruments to manage the geopolitical risk of sovereign wealth funds.

The principal advantage of this approach is eliminating an unwarranted subsidy for equity investments by sovereign wealth funds. This alternative would dampen any clientele effect that may result from the current tax preference for sovereign wealth fund equity investments. Eliminating the tax subsidy would also raise revenue. I am not aware of any current revenue estimates; in 1976 the Treasury estimated the annual revenue cost of the sovereign tax exemption at $630 million.

203 Congress could simply retain current § 892(a)(3), which states:

(3) Treatment as resident.—For 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.

See § 892(a)(3).

204 See Taylor, supra note 29, at 171. The estimate used lower treaty rates where applicable, and excluded interest on bank deposits, which are treated as foreign source income. See id. at 171 n.4. This calculation does not include an
The principal disadvantage of this approach is that it does not go far enough to address the risks posed by sovereign wealth funds. Because of the potential for non-financial motives to lower the hurdle rate for sovereign wealth funds, taxing sovereign wealth funds at the same rate as private investors may still leave in place a systematic preference for state-controlled investment. This alternative would therefore rely on other regulatory instruments to seek appropriate behavior by sovereign wealth funds.

B. Excise Tax on Sovereign Wealth Funds

A second reform alternative would impose an excise tax rate of 50% on income derived from equity investments in the United States. By taxing equity investments at a high rate, it would discourage those investments which are most likely to generate negative externalities.

The principal advantage of this approach is largely symbolic: it would make a powerful, populist statement in favor of private investment over state-controlled investment. But an excise tax would also achieve instrumentalist policy goals by protecting the integrity of the price signal in capital markets, improving the efficient allocation of resources, and encouraging foreign governments to promote private rather than sovereign investment. Nor would the proposal disrupt monetary policy, as foreign governments could still recycle dollars into the U.S. economy through tax-free investments in debt obligations of the U.S. government, private debt obligations, and possibly investments in private equity limited partnerships.\footnote{Although limited partnership interests are equity interests, I would be inclined to carve out a safe harbor for passive limited partnership investments, below a threshold of 10%, in investment funds. Because limited partners in investment funds have limited ability to influence the management of portfolio companies, many of the negative externalities discussed above in Section III are less problematic.}

The principal disadvantage of this approach is that the “hammer” of Pigouvian taxation would punish good and bad actors alike. As a result, the good actors (financially-motivated funds) might shift investments overseas, while the bad actors (politically-motivated funds) would continue to invest, notwithstanding the lower financial return. The tax is still better than the status quo, however, as it would both deter “bad” investment on the margins.
and raise revenue. A second disadvantage is that it would be administratively complex.\textsuperscript{206}

C. Conditional Tax Exemption

Finally, a third alternative would impose an excise tax on equity investments by sovereign wealth funds, but the tax would be waived if the investors met specified goals of transparency, accountability, and low political risk. To ease issues of institutional competence, this approach would require tax administrators to coordinate with other executive branch officials to generate a list of “most-favored nations” that would qualify for the tax exemption.\textsuperscript{207} In other words, we would tax sovereign wealth funds favorably, as private financial investors, if they provide evidence that they will act like private financial investors.

The principal advantage of this approach is that it would appeal to groups who favor a more technocratic policy response, shifting some of the policymaking power away from CFIUS and the executive branch and into the hands of the tax writing committees and Treasury lawyers who would draft the legislation and implementing regulations. It may also appeal to policymakers who want to do something about sovereign wealth funds, but who worry that relying on international organizations to design and enforce standards may be unrealistic without offering additional political leverage in the form of a conditional tax increase.

V. CONCLUSION

[to come]

\textsuperscript{206} Like FIRPTA, the tax would have to be withheld at the source.
\textsuperscript{207} A conditional exemption was suggested by David Tillinghast. See Tillinghast, supra note 29, at 540 (“An initial question is whether any exemption should be conditioned on reciprocity, either by making the exemption available only by treaty or by conditioning the operation of the Code provision.”).
APPENDIX

The Diversity of State-Controlled Investment Vehicles

Just as foreign states are governed by different political laws, traditions, norms, and institutions, the sovereign wealth funds they control operate differently. In this subsection, I briefly discuss China’s CIC, Abu Dhabi’s Mubadala, and Singapore’s Temasek. China’s CIC represents, at present, the clearest example of a fund that poses geopolitical risk to the United States and most warrants regulatory attention. Mubadala, while more professionalized than CIC, still raises valid concerns. Singapore’s Temasek is least threatening from a geopolitical perspective and represents a more promising model.

The China Investment Corporation. China announced plans to form the China Investment Corporation (CIC) in May 2007, and the fund was formally established in September 2007. As it is currently structured, CIC poses a greater threat to U.S. interests than most other funds, although there are signs that it is seeking greater legitimacy. According to researchers at the Oxford International Review, who conducted a careful review of Chinese-language commentary about CIC, the fund suffers from “an unresolved sense of mission.”

CIC floats between the political and financial arms of China’s administrative structure. There is some evidence that CIC is professionally managed. Many commentators believe CIC was formed to “shake up” China’s financial bureaucracy. CIC operates separately from SAFE, the State Administration of Foreign Exchange, which is the primary government agency managing China’s foreign exchange reserves. CIC was founded by the Ministry of Finance, funded with foreign exchange reserves from China’s central bank, and used approximately one-third of its initial capital infusion to acquire the Central Hunjin Investment Company,

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209 See Ashby Monk et al., A Review of Chinese-Language Literature on Sovereign Wealth Funds, OXFORD INTERNATIONAL REVIEW, at 4 (July 1, 2008), available at [link] (“Perhaps the most immediately evident theme in Chinese-language discourse on the CIC relates to its unresolved sense of mission and corporate character.”).

210 See Monk, supra note 209, at 4.
a government-controlled holding company which holds investments in several Chinese banks.\(^{211}\) CIC has also reportedly invested in two more Chinese banks (the Agricultural Bank of China and the China Development Bank), the China Railway Group, and its high-profile U.S. investments in Blackstone, Morgan Stanley, and Visa.\(^{212}\)

CIC’s president, Gao Xijing, is a Duke law school graduate with experience on Wall Street, where he worked for the now-defunct Mudge Rose.\(^{213}\) Gao suggested in a recent *60 Minutes* interview that CIC would strive for more transparency.\(^{214}\) At the same time, he called the idea of an IMF-issued code of conduct for sovereign wealth funds politically “stupid” and likely to raise problems “emotionally” by effectively singling out China as a potential threat.\(^{215}\) CIC’s Chairman Lou has dismissed calls for transparency, claiming that Western standards of transparency, governance, and accountability would place China at a competitive disadvantage. “I don’t want to show other people my cards,” Lou stated in a recent speech.\(^{216}\) CIC has made reassuring statements about adopting prudent accounting rules and disclosing completed transactions in compliance with foreign regulations, but it has offered no promise of tracking best practices.\(^{217}\)

There are signs that CIC is effectively tethered to China’s political administration. CIC reports directly to the State Council, which is analogous to the Cabinet in the United States.\(^{218}\) By contrast, other government investment organizations report to the Ministry of Finance.\(^{219}\) The Ministry of Finance has attempted to increase its influence over CIC, and it succeeded in appointing Jin Liqun, a former Vice President of the Asia Development Bank with experience dealing with overseas financial markets, to CIC’s Board of Directors.\(^{220}\)

\(^{211}\) See Monk, supra note 209, at 4 (discussing founding of CIC).
\(^{212}\) See Martin, supra note 208, at 2 (discussing investments by CIC).
\(^{215}\) See id.
\(^{216}\) See Monk, supra note 209, at 9.
\(^{217}\) See CRS Report, supra note 171, at 13 (“However, the degree and pace at which China will make the CIC transparent is uncertain. During a dinner at the mayor of London (England)’s mansion, Lou expanded on his previous statement, ‘We will increase transparency without harming the commercial interests of CIC. That is to say, it will be a gradual process. ... If we are transparent on everything, the wolves will eat us up.’”).
\(^{218}\) See Monk, supra note 209, at 5; Martin, supra note 208, at 1-2 (discussing Hunjin investments).
\(^{219}\) See Monk, supra note 209, at 5.
\(^{220}\) See Monk, supra note 209, at 5.
There is only limited separation between CIC’s governing board and the Chinese government. Its employees are mostly Chinese, notwithstanding the fund’s limited experience in global markets. None of CIC’s board members serve on the State Council. Of the eleven board members, however, ten are linked to the existing financial bureaucracy, with the last board member selected by CIC employees. Four board members are employed by the Ministry of Finance, two from the People’s Bank of China, two from China’s economic policy think tank, one from the Ministry of Commerce, and one from China’s pension fund. This structure bears the hallmarks of political compromise. As noted by Brad Setser, of the Council on Foreign Relations, “The CIC’s internal structure almost assures that its investment decisions will be far more politicized than the management of China’s formal reserves by the central bank. All parts of China’s bureaucracy are represented on its board – a legacy of the bureaucratic battles that accompanied its creation.”

CIC has a complex mandate that includes not just holding a diversified portfolio of investments, but also managing China’s domestic banks and supporting the expansion of Chinese firms into overseas markets. In fact, most of CIC’s investments have been made for non-commercial purposes, not the other way around. “For example,” explains the Congressional Research Service, “there are indications that the State Council, the PBoC [People’s Bank of China] and the NDRC [National Development and Reform Commission] insisted that the CIC provide help in the restructuring of these two state-owned banks as a condition of the CIC’s establishment.” Similarly, the report continues, CIC’s acquisition of Hunjin “may have been driven more by political considerations than economic ones.”

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221 See Monk, supra note 209, at 9.
222 See Martin, supra note 208, at 3; CRS Report, supra note 171, at 6.
223 See Brad Setser, What to Do with Over Half a Trillion a Year? Understanding the Changes in the Management of China’s Foreign Assets, COUNCIL ON FOREIGN RELATIONS Research Paper at 10, January 15, 2008, available at http://www.cfr.org/content/publications/attachments/Setser%20China%20Paper.pdf. Setser argues that because the board may be divided, many decisions “likely will be made by the top level of China’s government, not by the CIC.” Id. at 13. See also Cognato, supra note x, at 15 (“Throughout 2007, debate evidently grew very heated within the State Council over the proper structure and governance of the fund, with various arms of the Chinese government vying to take on a role in the fund’s decisionmaking.”).
225 See CRS Report, supra note 171, at 10.
226 See id. at 10.
There are also signs that CIC views its investment in U.S. banks as a method of entering the network of Western financial institutions. \(^{227}\) While integrating China into Western financial capital markets is a positive goal, it also signals a troubling willingness on the part of CIC to make investments based on strategic goals for China rather than seeking the highest available financial return. The goal of domestic financial reform, in other words, is inconsistent with the stated goal of achieving long-term financial returns through diversified holdings. \(^{228}\) Indeed, some Chinese commentators have advocated investing in companies like MasterCard and Wal-Mart to help facilitate the flow of Chinese goods to Western markets. \(^{229}\) China’s recent investment in Visa bears this out. While such investments are not necessarily inconsistent with financial motives, the pattern of investment suggests that CIC is simultaneously pursuing China’s geopolitical goals. A Congressional Research Service Report concluded, “China has handled the creation of the CIC in a fairly common Chinese fashion of combining reassuring statements with veiled warnings.” \(^{230}\)

In sum, it’s hard to dismiss concerns that CIC may invest for political motives. China has made reassuring statements that it will not acquire strategic stakes in American airlines, telecommunications, energy companies, or infrastructure. But CIC’s investment in Blackstone, Morgan Stanley and Visa show an interest in acquiring strategic positions in American financial infrastructure that would allow China to opportunistically press its advantage and, tellingly, shows little regard for financial returns or diversification from its existing financial assets.

**Mubadala Development Corporation (Abu Dhabi, United Arab Emirates).** Mubadala poses a different kind of geopolitical risk to the United States. In contrast to China, Abu Dhabi is adept at managing and massaging the U.S. political process, which raises more subtle concerns that its relationship with the United States may increase its soft power in the United States and lull us into complicity with a regime that has conflicts with our broader foreign policy and development agenda.

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\(^{227}\) See Pistor, supra note 99; see Monk, supra note 209, at 8 (“At least one such analyst, venture capital investor Gao Jianzhi, has interpreted the Blackstone investment as a way to gain access to Western financial institutional knowledge and has suggested that such “strategic partners” strengthen the CIC’s position both domestically and internationally.”)

\(^{228}\) See Monk, supra note 209, at 11 (discussing contradictory goals of CIC).

\(^{229}\) See Monk, supra note 209, at 11 (discussing comments of Cao Honghui, an economist at the Chinese Academy of Social Sciences).

\(^{230}\) See CRS Report, supra note 222, at 11.
Mubadala Development Corporation is a holding company owned by the Emirate of Abu Dhabi. Mubadala is organized as a “public joint stock” company, with the government as the sole shareholder. It is managed by a CEO, Kahldoon Khalifa al Mubarak, who holds an economics and finance degree from Tufts University. While the Abu Dhabi Investment Authority, the world’s largest sovereign wealth fund, overshadows Mubadala, Mubadala engages primarily in direct investment rather than portfolio investment, offering an instructive example of the risks noted above.

Mubadala primarily seeks strategic equity investments in both domestic and foreign corporations, often buying companies outright or obtaining controlling interests. It has made headlines for its purchase of an 8% stake in Advanced Micro Devices, an Austin-based chip manufacturer, a 7.5% stake in the private equity firm Carlyle Group, and entered into open-ended joint venture partnerships with gaming company MGM Mirage and commercial finance conglomerate GE. Rather than merely seek the highest financial returns, Mubadala concentrates its activities in sectors that complement Abu Dhabi’s economic advantage in aerospace, aviation, energy, real estate, and health care. Mubadala’s press office explains, “As well as ensuring its investments are financially rewarding, Mubadala also evaluates each opportunity based on other sustainable benefits it can provide for Abu Dhabi.” The chief advantage its investment strategy seeks appears to be ensuring access to deal flow in sectors in which it already has considerable expertise in evaluating investments. Thus, for example, its investment in AMD is evaluated not just on the basis of the financial returns of AMD stock, but also the financial and strategic value of accessing future deals in the semiconductor and computer technology sector.

Mubadala is a savvy manager of its corporate image. Recognizing the risk that political backlash could pose to its deal flow, Mubadala aggressively manages it image through nonprofit foundations, educational partnerships, and investments in Western entertainment ventures. Mubadala owns 5% of Ferrari, and in 2009

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231 See Mubadala website.
233 See Mubadala website.
234 Id.
235 Id.
will host a Formula 1 Grad Prix for the first time. Mubadala hosted Justin Timberlake’s final show of the Future Sex/LoveShow world tour. CEO Khaldoon is a member of the Board of Trustees of New York University, and he is overseeing the establishment of a satellite NYU campus in Abu Dhabi developed and funded by Mubadala. Its charitable activities include a vocational and career guidance program, a philanthropic foundation, and a music and arts foundation.

Mubadala’s experience extends into the political arena. It is no accident that Abu Dhabi has been more receptive than other countries to the idea of best practices. While Abu Dhabi may not strictly seek the highest financial returns for its investments, it still seeks to improve its long-term financial outlook by creating a global network of partners. More to the point, Abu Dhabi recognizes the symbolic value of cooperating with the United States and OECD countries concerned about the practices of Sovereign Wealth Funds. Mubadala has proven itself politically adept in the past, particularly in its completion of potentially sensitive investments in GE, AMD, and Carlyle. As noted by the consulting firm Monitor Group, Mubadala “paid close attention” to the U.S. domestic political process, “sounding out” key senators and congressmen informally and making clear that its investment would allow AMD to open a new chip fabrication facility in upstate New York. Mubadala’s lobbying expenditures, while still quite modest, have increased more than threefold from 2007 to 2008.

There is much to admire in Mubadala’s professionalism and political savvy, which in many ways outpaces the nascent lobbying efforts of the U.S. private equity and hedge fund industries. The concern is that the more effective Abu Dhabi becomes in managing its image, the more it masks underlying conflict concerning our development agenda in the Middle East. As Abu Dhabi successfully greases the wheels for economic investment in U.S. companies, it may reduce our ability to go against Abu Dhabi in the future concerning the Israeli-Palestinian conflict, terrorism or military concerns, or other diplomatic efforts.

While F1 has a modest following in the United States, its fan base in Europe equals or exceeds the NASCAR fan base in the United States.


See http://www.opensecrets.org/lobby/indusclient.php?lname=F07&year=a
Temasek Holdings (Singapore). Lastly, it is worth discussing Temasek Holdings, which many consider to be a model sovereign wealth fund. While Temasek is not free from political risk, nor does it invest in a fashion fully compliant with a professionalized institution, it provides a useful model to understand a relatively non-threatening fund.

[Insert Temasek research here]