SHOULD THE UNITED STATES TAX SOVEREIGN WEALTH FUNDS?

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[C]ountries, like people, behave dangerously when their mood turns dark. If America fails to distinguish between what it needs to change and what it needs to accept, it risks hurting not just allies and trading partners, but also itself.[1]

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[1] *Unhappy America*, Economist, July 24, 2008, at 15.

I. Introduction

Devotees of free markets have a marked aversion to government entanglement in private enterprise. Aside from conceding the need for governmental action to ameliorate market failures, free market disciples believe that little good emanates from the government in matters economic. Moreover, free market advocates believe that barriers to the free flow of trade and capital between countries should be kept to a minimum and that any such barriers be justified on some policy ground, such as public health or national security. The participation of sovereign wealth funds in the U.S. capital markets has brought these two beliefs in conflict. On the one hand, foreign investment in the United States is welcome. On the other hand, government ownership of capital is viewed with skepticism.

Not surprisingly, during times of economic difficulty principles are often compromised. These are times of economic difficulty. The federal government has engineered the bailout of one investment bank, expanded the firms eligible for Federal Reserve Bank credit, and has recently taken control of the two federally chartered mortgage giants, Fannie Mae and Freddie Mac, pursuant to authority granted in recently enacted legislation.[2] These actions, in the words of S.E.C. Chairman Christopher Cox, "break with the norm that markets should decide which firms fail and which succeed . . . ."[3] It should come as no surprise that foreign enterprises are included among those to which blame for our economic troubles is fixed. Sovereign wealth funds have now come under

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[2] On July 30, 2008, President Bush signed into law the Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654 (2008). Section 1117 of the legislation provides authorization until December 31, 2009 for the U.S. Department of the Treasury to purchase the obligations and stock of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks in certain circumstances. These provisions have proven very controversial. *See* Editorial, *Housing Bill Hammers Taxpayers*, Wall St. J., July 24, 2008, at A14; Deborah Solomon et al., *Mortgage Bailout is Greeted with Relief, Fresh Questions*, Wall St. J., Sept. 9, 2008, at A1. In early September 2008 the federal government agreed to provide, if necessary, $200 billion of capital to the companies in exchange for preferred stock and warrants to acquire slightly less than 80% of the stock of the companies. Deborah Solomon, *U.S. Treasury Considers Buying Stakes in Banks*, Wall St. J., Sept. 9, 2008, at A1; David Ellis, *U.S. Seizes Fannie and Freddie*, CNNMoney.com, Sept. 7, 2008, http://money.cnn.com/2008/09/07/news/companies/fannie_freddie/index.htm?postversion=2008090711. Their new regulator, the Federal Housing Finance Agency, put both companies into conservatorship. A recent Wall Street Journal and NBC News poll indicates that a majority of Americans believe that government should take a more active role in the economy. Bob Davis et. al., *Unraveling Reagan: Amid Turmoil, U.S. Turns Away From Decades of Deregulation*, Wall St. J., July 25, 2008, at A1. Moreover, this view is held by an increasing number of Republican disciples of Ronald Reagan. *Id.*

[3] Christopher Cox, Op-Ed, *What the SEC Really Did on Short Selling*, Wall St. J., July 24, 2008, at A15.

scrutiny.[4] Although these funds have injected badly needed capital into firms that may otherwise have gone begging, the sheer size of their portfolios and the fact that they are owned by foreign governments have caused policy makers to take a close look at these funds.[5]

There is a general level of discomfort in the United States with foreign investment, particularly foreign government investment. There comes a point at which that discomfort tends to manifest itself in policy circles.[6] During the 1970s there was a great deal of hand-wringing over oil-fueled Middle-Eastern investment. The collective mood soured again in the late 1980s as a result of export driven Japanese investment. Today, sovereign wealth funds have our attention.[7] Adding to our discomfort is the fact that most sovereign wealth funds have grown in size due to the wealth generated by natural resource exports, particularly oil.[8] Much of the growth of these funds has been fueled by the steep prices that we pay at the gasoline pump.[9] We admire success but not at our expense.

These funds are entitled to a tax exemption, not available to private investors, because they are owned by foreign sovereigns.[10] Foreign governments have enjoyed some form of tax exemption in the United States for almost a century.[11] The exemption, informed by notions of sovereign immunity, has generated little controversy until recently.[12] This exemption, however, has now become a subject of debate by tax professionals.[13] More importantly, Congress has recently taken an interest in the taxation of sovereign wealth funds.[14]

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[4] Posting of Victor Fleischer to The Conglomerate, http://www.theconglomerate.org/2008/03/taxing-sovereig.html#c105883464 (Mar. 4, 2008).

[5] *Id.*

[6] *See* STAFF OF JOINT COMM. ON TAXATION, ECONOMIC AND U.S. INCOME TAX ISSUES RAISED BY SOVEREIGN WEALTH FUND INVESTMENT IN THE UNITED STATES (Comm. Print 2008) [hereinafter ISSUES RAISED BY SOVEREIGN WEALTH FUNDS], *available at* http://www.house.gov/jct/x-49-08.pdf.

[7] *See*, *e.g.*, Steven R. Weisman, *A Fear of Foreign Investments*, N.Y. TIMES, August 21, 2007, at C1, *available at* http://www.nytimes.com/2007/08/21/business/worldbusiness/21wealth.html?scp=1&sq=fear%20of%20foreign%20investment&st=cse.

[8] *See* ISSUES RAISED BY SOVEREIGN WEALTH FUNDS, *supra* note 6, at 25.

[9] *See, e.g.*, Heather Timmons and Julia Werdigier, *For Abu Dhabi and Citi, Credit Crisis Drove Deal*, N.Y. TIMES, Nov. 28, 2007, at C1, *available at* http://www.nytimes.com/2007/11/28/business/worldbusiness/28invest.html?scp=4&sq=growth+sovereign+wealth+funds+oil&st=nyt.

[10] ISSUES RAISED BY SOVEREIGN WEALTH FUNDS, *supra* note 6, at 1.

[11] *Id.*

[12] *See id.*

[13] *See, e.g.,* Posting of Lawrence Solum to Legal Theory Blog, http://lsolum.typepad.com/legaltheory/2008/03/fleischer-on-ta.html (last visited Mar, 4, 2008); Posting of Victor Fleischer to The Conglomerate, http://www.theconglomerate.org/2008/03/taxing-sovereig.html#c105883464 (last visited Mar. 4, 2008).

[14] *See generally* ISSUES RAISED BY SOVEREIGN WEALTH FUNDS, *supra* note 6; Press Release, U.S. Senate Comm. On Fin., Baucus, Grassley Seek JCT Analysis of

Part II of this article presents an overview of sovereign wealth funds and discusses the varying objectives of these funds and their effects on fiscal and monetary policies, both domestically and internationally. The criticisms leveled at the manner in which these funds operate and the reform efforts that have been undertaken as a result of such criticisms are also discussed. Finally, the national security concerns spawned by sovereign wealth fund investments are analyzed.

Part III provides a background on the doctrine of foreign sovereign immunity in which the tax exemption is rooted. The historical development of the doctrine and its current statutory manifestation, the Foreign Sovereign Immunities Act, are analyzed. Part IV provides an analysis of the tax framework applicable to foreign taxpayers in general and then proceeds to discuss the tax exemption for foreign governments.

Part V presents the argument for retaining the current exemption. Support for ending the tax exemption for sovereign wealth funds stems from the belief that U.S. tax policy should not provide these funds with a comparative advantage over their private sector counterparts. However, this comparative advantage is greatly exaggerated. The present statutory rules and income tax treaty provisions exempt significant categories of income earned by private sector investors. Moreover, non-sovereign investors often structure transactions to minimize or altogether avoid tax liability. To a great extent, public discomfort with sovereign wealth fund investment in the United States motivates efforts for tax reform. This discomfort stems largely from the opacity under which such funds operate and the concomitant fear that political, not economic, objectives may inform fund investment decisions.

Thus far, these fears have been misplaced. Moreover, adequate mechanisms are in place to directly address concerns that may yet arise. Significant reform efforts have been undertaken by the governments of capital-recipient countries, the funds themselves, and multilateral organizations. Ironically, the present tax scheme actually serves as a significant disincentive for sovereign wealth funds to gain control of investee enterprises. In any event, these issues are best addressed directly and not through the tax code. Finally, the tax exemption, almost a century old, is rooted in the doctrine of foreign sovereign immunity. Long standing principles of comity and mutual respect will be compromised by eliminating the exemption.

U.S. Taxation of Sovereign Wealth Funds (Mar. 13, 2008), http://finance.senate.gov/press/Gpress/2008/prg031308.pdf. On March 13, 2008 the U.S. Senate Committee on Finance requested this report that would describe and analyze the current U.S. tax treatment of foreign governments from the Joint Committee on Taxation. The report was issued on June 17, 2008. *See id.*

II. Sovereign Wealth Funds: An Overview

The participation of sovereign entities in financial markets is unremarkable and has, except for the occasional political hyperbole regarding exchange rates, generated little concern.[15] Public pension funds and state-owned enterprises have been active investors for some time.[16] On occasion, investments by state-owned enterprises have raised concerns in the target country. For example, the attempt by China National Offshore Oil Corporation to acquire California based Unocal drew intense political opposition.[17] Similar opprobrium was directed at the Dubai government's attempt, through its port operator, DP World, to acquire a U.S. port operator with terminals in New York and New Jersey.[18]

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[15] *See generally* Weisman, *supra* note 7. On occasion, a sovereign is accused of managing its currency in an effort to maintain or increase its current account position. China, for example, has been subjected to criticism for maintaining its currency at artificially low levels. *Lost in Translation*, Economist, May 19, 2007, at 80. As a consequence of the recent dramatic rise of the euro against the U.S. dollar, the United States has been subject to similar criticism by the euro-block countries. *Divine Intervention*, Economist, Mar. 27, 2008, at 100; *see* Sheryl Gay Stolberg & Steven R. Weisman, *Bush Talks Up Dollar as He Heads to Europe*, N.Y. Times, June 10, 2008, at C1, *available at* http://www.nytimes.com/2008/06/10/business/10bush.html#. The recent reductions in short term U.S. interest rates by the Federal Reserve Board, precipitated by the credit market crisis, have served to stoke further criticism. *See id.* Despite the fact that the dollar has declined approximately 25% against the euro since early 2002, the U.S. trade deficit, as a percentage of gross domestic product, has experienced only a modest decline. Tom Barkley, *IMF Says Imbalances Will Linger*, Wall St. J., July 23, 2008, at A10.

[16] Public pension funds traditionally have had minimal exposure to foreign investments. Robert M. Kimmitt, *Public Footprints in Private Markets*, FOREIGN AFF., Jan.-Feb. 2008, at 120, *available at* http://fullaccess.foreignaffairs.org/2008 0101faessay87109/robert-m-kimmitt/public-footprints-in-private-markets.html. However, these funds have begun to allocate an increasing portion of their portfolio to foreign investment. *Id.* State-owned enterprises are government owned operating companies. *Id.* These companies often invest in foreign enterprises. *Id.* Investments by state-owned enterprises are usually made for operational or strategic purposes. *Id.*

[17] Jonathan Weisman & Peter S. Goodman, *China's Oil Bid Riles Congress: Attempt to Take Over U.S. Firm Spurs Calls for Retaliation*, Wash. Post, June 24, 2005, at A01.

[18] Edward Alden et. al., *Dubai cedes control of U.S. ports*, Fin. Times, Mar. 10, 2006, at 1. Controversy over sovereign wealth fund investments is not unique to the United States. The ouster of Thailand's Prime Minister Thaksin Shinawatra in September 2006 was due, in part, to negative reaction over Temasek's acquisition of Shin Corp. Weisman, *supra* note 7. Nor is negative reaction to foreign investment limited to foreign government investment. For example, the purchase, by Mitsubishi Estate Co., of a controlling interest in the entity that owned the Rockefeller Center and Radio City Music Hall in 1989 was not universally applauded. *See* Claudia H. Deutsch, *A Group Without a Center; Rockefeller Investment Arm Trying Not to Look*

Various definitions of the term "sovereign wealth fund" exist. According to the U.S. Department of the Treasury, "sovereign wealth funds are government owned investment vehicles" that undertake the management of "foreign exchange assets separately from the official reserves of the sovereign's monetary authorities."[19] The International Monetary Fund has proposed the following definition:

> SWFs are special purpose public investment funds, or arrangements. These funds are owned or controlled by the government, and hold, manage, or administer assets primarily for medium- to long-term macroeconomic and financial objectives. . . . The funds are commonly established out of official foreign currency operations, the proceeds of privatizations, fiscal surpluses, and/or receipts resulting from commodity exports. These funds employ a set of investment strategies which include investments in foreign financial assets.[20]

Sovereign wealth funds have existed for some time but they have recently become increasingly influential participants in global financial markets.[21] Kuwait's fund, believed to be the first sovereign wealth fund, was formed in 1953, almost a decade before the country's independence from the United Kingdom.[22] The Alaska Permanent Reserve Fund, owned by the State of Alaska, was established in 1976 to manage the wealth derived from oil and mineral extraction.[23] The assets controlled

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Back, N.Y. Times, Dec. 1, 1999, at B1, *available at* http://query.nytimes.com/gst/fullpage.html?res=980CE7DC1E3FF932A35751C1A96F958260&sec=&spon=&&scp=24&sq=mitsubishi%20Reckefeller%20center&st=cse.

[19] *See* U.S. Dep't of the Treasury, Report on Int'l Econ. and Exchange Rate Policies, Appendix 3, 1 (Dec. 2007), *available at* www.treas.gov/offices/international-affairs/economic-exchange-rates/pdf/2007_FXReoprt.pdf.

[20] International Monetary Fund, Sovereign Wealth Funds—A Work Agenda 26 (2008), *available at* http://www.imf.org/external/np/pp/eng/2008/022908.pdf. Saudi Arabia does not have a separate sovereign wealth fund but manages its investments through its monetary authorities. *See id.* at 7. If the Saudis had a separate fund it would rank as one of the largest funds. *Id.* Botswana likewise manages it wealth through the central monetary authorities. *See id*. at 7.

[21] U.S. Dep't of the Treasury, Report on Int'l Econ. and Exchange Rate Policies, Appendix 3, *supra* note 19, at 1. Brazil has recently announced that it plans to launch a sovereign wealth fund to manage the wealth it has derived from agricultural and natural resource exports. Matt Moffett, *Brazil Joins Front Rank of New Economic Powers*, Wall St. J., May 13, 2008, at A1. In February 2008, Russia officially launched its sovereign wealth fund, the National Welfare Fund, with approximately $32 billion in assets. Stephen Jen & Oliver Weeks, *Currencies: Celebrating the Birth of Russia's SWF*, Morgan Stanley Global Econ. Forum, Feb. 1, 2008, www.morganstanley.com/views/gef/archive/2008/20080201-Fri.html (last visited June 9, 2008).

[22] *See* Kimmitt, *supra* note 16 at 119.

[23] Alaska Permanent Fund Corporation, http://www.apfc.org/home/Content/reportspublications/fundHistory.cfm (last visited July 22, 2008). The Alaska

by these funds have grown to enormous proportions. The International Monetary Fund estimates that sovereign wealth fund assets are between $2.09 trillion and $2.97 trillion and various projections have these assets growing to $15 trillion in less than a decade.[24] It has been estimated that the petroleum-exporting Gulf States cover their import bills with oil at $50 per barrel, implying that, at the present price levels, over $70 per barrel will be funneled into the acquisition of foreign assets.[25]

The growth of sovereign wealth funds has been fueled, in large part, by rising commodity exports. Governments maintain international reserves to manage currency shortfalls that may result from export-import imbalances or to intervene in currency markets in the event of a financial crisis.[26] In addition, governments often accumulate reserves generated from excess export revenue to stabilize the economy in the event that future commodity export declines jeopardize macroeconomic stability and to sterilize the effect of rapid increases in exports.[27] Increases in commodity prices, particularly oil, have led to a surge of government revenue, either directly in the case of direct government ownership of the export commodity, or indirectly through taxation.[28] The revenue bonanza has led

Permanent Fund was established by a state constitutional amendment shortly after oil from the North Slope fields began flowing through the Trans-Alaska Pipeline. *Id.* At least 25% of certain mineral sales and royalty income is set aside in the fund. *Id.* The state legislature determines how the fund income is spent. *Id.* The Fund is managed by the Alaska Permanent Fund Corporation. *Id.*

[24] INTERNATIONAL MONETARY FUND, *supra* note 20, at 7. It is estimated that hedge funds manage approximately $1.4 trillion in assets. The combined value of investments managed by insurance companies, pension plans, mutual funds, and other investment funds exceeds $100 trillion. *Sovereign Wealth Funds: Hearing Before the Subcomm. on Domestic and International Monetary Policy, Trade, and Technology and the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the Comm. On Financial Services,* 110th Cong. 2-3 (2008) [hereinafter *Alvarez Testimony*] (statement of Scott G. Alvarez, General Counsel of the Federal Reserve Board), *available at* http://www.federalreserve.gov/newsevents/testimony/alvarez20080305a.htm.

[25] Brad Setser & Rachel Ziemba, UNDERSTANDING THE NEW FINANCIAL SUPERPOWER – THE MANAGEMENT OF GCC OFFICIAL FOREIGN ASSETS 2, 7-8 (2007), http://www.cfr.org/content/publications/attachments/SesterZiembaGCCfinal.pdf (last visited June 3, 2008).

[26] *See* Kimmitt, *supra* note 16. The International Monetary Fund defines international reserves as "external assets controlled by and readily available to finance ministries and central banks for direct financing of international payment imbalances." *Id.* at 120. These reserves are highly liquid and are typically held in the form of highly rated government bonds. *Id.*

[27] *See* INTERNATIONAL MONETARY FUND, *supra* note 20, at 5. *See infra* note 41 for a discussion of currency sterilization operations.

[28] *See* Stephen Jen, *Currencies: How Big Could Sovereign Wealth Funds Be by 2015?,* MORGAN STANLEY GLOBAL ECON. FORUM, May 4, 2007, www.morganstanley.com/views/perspectives/files/sovereign_2.pdf (last visited May 27, 2008). Oil and gas

governments to extend their investment objectives beyond economic stabilization and exchange rate management to intergenerational savings and access to ideas and technology.[29] Persistently large non-commodity current account surpluses also account for a significant portion of sovereign wealth fund assets.[30] South Korea, Singapore, and China have used revenues generated from their trade surpluses to establish their funds.[31]

Sovereign wealth funds can have a number of objectives. A fund's objectives often dictate the type of investments held by the fund. In addition, the enormous amounts of wealth at government disposal have significant implications for governments' fiscal and monetary policies. The deployment of such wealth in the global capital markets also has international monetary effects. The following sections discuss the role a fund's objectives play in investment decisions and the domestic and international implications that arise from sovereign wealth fund investments. It is inevitable that aggressive investment of large concentrations of wealth by governments will generate criticism. These criticisms and the reform proposals they have generated will also be discussed. Finally, national security concerns emanating from sovereign wealth fund activities are described.

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exports account for approximately two-thirds of total assets held by these funds. *Id.* Some of the larger oil driven funds are the funds of the United Arab Emirates, Norway, Kuwait, Russia, and Canada. SWF Institute, Fund Rankings, http://www.swfinstitute.org/funds.php. Other commodity sourced funds include Chile's two funds, funded by income from copper exports. *Id.*

[29] *See* Chip Cummins, *GE Sets Abu Dhabi Partnership for $8 Billion*, WALL ST. J., July 23, 2008, at B1; Rob Cox & Jeff Segal, *GE's Imagination at Work*, WALL ST. J., July 23, 2008, at C18. G.E. has recently announced the formation of an investment partnership with Abu Dhabi's sovereign wealth fund. Cummins, *supra*, at B1. The fund has also indicated its plans to purchase a significant stake in G.E. *Id.* Part of the motivation for the transaction is the potential for access to G.E.'s technology and expertise. Critics of sovereign wealth funds assert that unstated objectives of some of these funds may be political and raise national security concerns. *See infra* notes 66-71 and accompanying text. China has recently formed a sovereign wealth fund, the China Investment Corporation. SWF Institute, Fund Rankings, http://www.swfinstitute.org/funds.php (last visited December 22, 2008) [hereinafter SWF Institute Rankings]. With an initial allocation of $200 billion, it immediately landed in the ranks of the largest funds. *Id;* Jen, *supra* note 28. The China Investment Corporation's highest profile investments to date are its $3 billion and $5 billion investments in the Blackstone Group and Morgan Stanley, respectively. Rob Cox, *Sovereign Funds Take Heat*, WALL ST. J., March 31, 2008, at C10 [hereinafter *Sovereign Funds Take Heat*]. These investments have caused the Chinese authorities much consternation at home. *See id.*

[30] SWF Institute Rankings, *supra* note 29.

[31] *Sovereign Wealth Funds*, *supra* note 24, at 2.

A. *Fund Objectives*

Sovereign wealth funds have long-term investment horizons and seek higher returns than the returns earned from the investment of official reserves.[32] Consequently, these funds are more risk tolerant and invest aggressively in foreign assets.[33] In contrast to regulated investment companies and most other U.S. institutional investors, information regarding the portfolio holdings of sovereign wealth funds is often opaque.[34] However, certain funds have made public their investment allocation targets.[35] Norway, for example, currently invests forty percent of its sovereign wealth fund portfolio in equities and seeks to increase its equity holdings to sixty percent of its portfolio by 2010.[36] Sovereign wealth funds are thought to hold significant investment stakes in emerging markets and have made forays into alternative investments such as private equity, hedge funds, and real estate.[37]

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[32] *See The World's Most Expensive Club*, ECONOMIST, May 26, 2007, at 94, *available at* http://www.financialexpress.com/news/The-worlds-most-expensive-club/200505/4. Singapore's fund, Temasek, was formed in 1974 and is credited with initiating the move into more diverse investments. *Id.* Previously, funds tended to invest in a manner akin to central banks. *Id.*

[33] *Id.*

[34] *Id.*

[35] *Id.*

[36] INTERNATIONAL MONETARY FUND, *supra* note 20, at 9.

[37] *Id.* at 9-10 (citing a Morgan Stanley research note and information from the McKinsey Global Institute). Smaller and more active funds, such as Qatar's, focus on alternative investments and employ leverage to enhance their returns. Setser & Ziemba, *supra* note 25, at 5. The Gulf Cooperation Council (GCC) is comprised of Saudi Arabia, the United Arab Emirates, Bahrain, Kuwait, Oman, and Qatar. *Id.* Overall, a significant majority of Gulf States' foreign assets are dollar denominated but emerging market investments are becoming increasingly important. *See id.* at 9-11. Equity allocations in the larger gulf state funds tend to hover between 50% and 60% of assets under management. *See id.* at 12-14. The persistent decline in the value of the U.S. dollar over the past several years has led to concern that foreign investors will unwind their dollar positions in favor of investments denominated in other currencies. *See* Jen, *supra* note 21. The dollar's steep decline has also led to speculation that central banks will intervene in the currency markets to bolster the value of the dollar. *Divine Intervention*, ECONOMIST, Mar. 27, 2008, at 100 (discussing the likelihood of success of currency interventions). The dollar serves three purposes. Jen, *supra* note 21. First, it serves as a unit of account. *Id.* In the government sector the dollar is the unit of account for countries that peg their currencies to the dollar. *Id.* In the private sector, the dollar serves as a unit of account in cases where trades in goods and services between two non-dollar partners are invoiced in U.S. dollars. *Id.* Second, the dollar serves as a medium of exchange. *Id.* The dollar is held for currency intervention purposes by central banks whose official currency is pegged to the dollar. In the private sector the dollar is used for exchange purposes. *Id.* Exchange rates are quoted bilaterally. *Id.* The liquidity of the dollar often results in the use of the dollar to convert one foreign currency into another. *Id.* For example, it

Funding sources affect fund objectives and investment strategies. Surpluses from commodity exports, particularly oil, are often a more durable funding source than surpluses from non-commodity current account surpluses.[38] Countries such as Russia and India have seen significant net capital inflows.[39] These types of inflows are generally more susceptible to the vagaries of foreign investor sentiment and are least durable.[40]

Sovereign wealth funds are often characterized according their objectives.[41] Stabilization funds attempt to insulate the government budget and the domestic economy from the effects of significant commodity price movements.[42] Typically, a portion of the revenue generated during good times is invested to provide a cushion for the arrival of the inevitable lean years. Savings funds seek to provide future generations with a more diversified source of income by reducing the domestic economy's dependence on income from nonrenewable asset sources.[43] In periods of very high commodity prices, revenues may exceed the funding requirements of stabilization funds and excess reserves are channeled into these savings funds. Reserve investment corporations seek to increase returns on official reserves.[44] Development funds attempt to increase the productivity of the domestic economy by funding projects or promoting policies that

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may be cost effective, in the conversion of currency X to currency Y, to convert currency X to the dollar and then convert the dollars to currency Y. *See id.* Finally, the dollar is a store of value. *Id.* It is here that that the dollar has performed poorly. *Id.*

[38] Stephen Jen, *Currencies: Spending SWF Money*, MORGAN STANLEY GLOBAL ECON. FORUM, Mar. 31, 2008, http://www.morganstanley.com/views/gef/archive/2008/20080331-Mon.html (last visited May 29, 2008).

[39] *Id.*

[40] *Id.*

[41] INTERNATIONAL MONETARY FUND, *supra* note 20, at 5. A particular fund may have several objectives. INTERNATIONAL MONETARY FUND, SOVEREIGN WEALTH FUNDS: IMF GLOBAL FINANCIAL STABILITY REPORT ANNEX 1.2. 47 (2007) [hereinafter IMF STABILITY REPORT], *available at* http://www.imf.org/external/pubs/ft/gfsr/2007/02/pdf/annex12.pdf. Structurally, such funds may seek to meet multiple objectives in various ways. *Id.* For example, a fund may have tiers of accounts with each tier seeking to meet a particular objective. *Id.* at 47, n. 54. In other cases, a fund may transfer assets to the central bank for management. *Id.*

[42] INTERNATIONAL MONETARY FUND, *supra* note 20, at 5.

[43] *Id.*

[44] *Id.* at 5-6. These funds are often considered part of the government's official reserves. *See* IMF STABILITY REPORT, *supra* note 41, at 46. Official reserves must be readily available to the monetary authorities and represent a liquid claim in foreign currency on nonresidents. *Id.* It is presumed that assets held by sovereign wealth funds that are carried "on the books of the central bank or a [government agency] that exercises control over the disposition of funds, then the presumption is that the assets are international reserves." *Id.* If the funds are held in a separately incorporated long-term fund then it is presumed that such funds are not included in reserves. *See* ANNEX 1.2. SOVEREIGN WEALTH FUNDS, INTERNATIONAL

will increase the country's growth potential.[45] Finally, contingent pension reserve funds are designed to fund governmental pension obligations.[46]

A particular fund's objectives will determine, in large part, its portfolio investment strategy.[47] Savings funds, for example, typically invest with a long-term perspective when compared to stabilization funds.[48] Accordingly, it is expected that savings funds will have a significantly different risk tolerance than stabilization funds.[49] Some funds may desire to hedge their local economy's dependence on commodity prices and, therefore, hold assets that are negatively correlated with the prices of particular commodities.[50]

Public sector investment managers have experience in fixed income investing.[51] Consequently, the movement of funds into other asset classes has been accompanied by a reliance on external money managers.[52] However, the tremendous growth of assets under management has made it economically feasible for some funds to reduce their reliance on external money managers and develop in-house investment management expertise.[53] Sovereign wealth funds have typically been passive investors with little desire to agitate corporate management.[54]

MONETARY FUND, at 46 citing to the draft 6th edition of the BALANCE OF PAYMENTS AND INTERNATIONAL INVESTMENT POSITION MANUAL.

[45] INTERNATIONAL MONETARY FUND, *supra* note 20, at 5.

[46] *Id.*

[47] *Id.* at 6.

[48] *See* IMF STABILITY REPORT, *supra* note 41, at 46-47.

[49] *Id.*

[50] *Id.* at 47.

[51] INTERNATIONAL MONETARY FUND, *supra* note 20, at 9.

[52] *See id.* at 50.

[53] *Id.* Norway, Singapore, and the United Arab Emirates provide examples of this trend. *See* INTERNATIONAL MONETARY FUND, *supra* note 20, at 9.

[54] Jason Kotter & Ugur Lel, FRIENDS OR FOES? THE STOCK PRICE IMPACT OF SOVEREIGN WEALTH FUND INVESTMENTS AND THE PRICE OF KEEPING SECRETS, Board of Governors of the Federal Reserve System, International Finance Discussion Papers, Number 940, 5 (August 2008), http://www.swfinstitute.org/research/ifdp940.pdf. China Investment Corporation's investment in Blackstone Group, a significant stake, was coupled with an express relinquishment of voting rights. *See* Andrew Ross Sorkin & David Barboza, *In Strategy Shift, China to Buy $3 Billion Stake in Blackstone,* N.Y. TIMES, May 21, 2007, at C1, *available at* http://www.nytimes.com/2007/05/20/business/worldbusiness/20cnd-yuan.html. Approximately one-third of China Investment Corporation's funds, however, were used to purchase the entity that controls China's major commercial banks. *China Investment Corporation Unveils Investment Plan*, XINHUA ECON. NEWS (Beijing), Nov. 7, 2007, *available at* www.china-embassy.org/eng/xw/t379014.htm. A recent study indicates that shareholder activism has yielded abnormally high returns for activist hedge funds. Alon Brav et.al., *The Returns to Hedge Fund Activism* European Corp. Governance Inst., Working Paper No. 098/2008, 2008, *available at* http://ssrn.com/abstract=1111778. Activist shareholders, for purposes of the study, sought to change a firm's capital

B. *Domestic Fiscal and Monetary Policy Implications*

The accumulation and management of staggering sums of wealth raise a host of domestic fiscal and monetary issues for policy makers.[55] Such wealth often allows policy makers to manage the economy more effectively.[56] On the other hand, such wealth may exacerbate political differences and create unexpected social problems.[57] Moreover, significant wealth can create difficulties in the execution of monetary policies and lead to debilitating inflation.[58]

Properly managed, these funds offer government financial authorities a powerful tool to stabilize the economy and avoid the all too frequent boom and bust cycles endemic to economies heavily reliant on natural resource or commodity exports. Moreover, prudent management of such wealth can ease the fiscal burdens of aging populations and provide for intergenerational transfers of wealth that may otherwise prove difficult to achieve for economies heavily reliant on nonrenewable resources. Sovereign wealth funds may also introduce, or improve upon, transparency and accountability within the government fiscal authorities.[59] Asset diversification also reduces the opportunity cost of holding reserves and reduces a fund's exposure to the risk that a capital recipient will inflate away its debt.[60]

These funds may also, however, exacerbate political differences. Various constituencies will inevitably have different preferences with respect to the uses of such wealth. These differences may be particularly acute with respect to investment time frames and intergenerational planning.[61]

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structure, alter its business strategy, sell the company, or improve the firm's governance practices. *See id*. at 5-6. To the extent that sovereign wealth funds invest in hedge funds it is quite possible that they will pursue activist strategies, albeit indirectly through the hedge fund.

[55] *See* INTERNATIONAL MONETARY FUND, *supra* note 20, at 11.

[56] *See id*; *see also* Kenneth M. Pollack, *Drowning in Riches*, N.Y. TIMES, July 13, 2008, at WK 14.

[57] *See id.*

[58] *See id.*

[59] INTERNATIONAL MONETARY FUND, *supra* note 20, at 11.

[60] Traditional holdings in fixed income instruments carry the risk that the borrower will inflate away the real burden of the debt. Persistent inflation will, in the long run, erode the value of the currency in which the debt is denominated.

[61] *See* Mariam Fam, *Nazif Wants Oil Money to Stay Put*, WALL ST. J., May 19, 2008, at A9. Egyptian Prime Minister Ahmed Nazif has questioned the wisdom of exporting vast amounts of capital and believes the Middle East would benefit from investing much of the region's petroleum wealth in the region. *Id.* A recent study has suggested that participation in the global economy will foster economic growth but also noted the desirability of heavy government spending on infrastructure and, in limited cases, on government subsidies to domestic industries. *See* Bob Davis, *Measuring the Ingredients of Economic Growth*, WALL ST. J., May 22, 2008, at A10 (reporting the findings of the Commission on Growth and Development, a panel

Poor investment performance may embolden critics of government policy – as it occurred in China in reaction to China's poorly timed investment in Blackstone Group.[62] Thus, the management of sovereign wealth in funds distinct from the central monetary authorities may result in more, not less, political accountability and shine light on conflicting agendas.

The accumulation of vast amounts of wealth may also have deleterious social effects.[63] Unfortunately, such vast sums are often an invitation to corruption.[64] Moreover, government largess may create a host of other, seemingly unrelated, issues such as public health problems. For example, four of the five highest rates of diabetes are found in the Gulf States.[65] Many of the petro-rich states are "hollowing-out in the non-oil sector"while the skilled labor to match the ambitions of government planners has been in short supply.[66] Such supply-side issues raise their own problems. The domestic economy may not have an adequately trained workforce or may have chronic shortages of certain forms of labor.[67] This brings into play immigration policies with their attendant political baggage.

Sovereign wealth fund operations also have significant effects on the conduct and efficacy of the government's monetary policies.[68] Discretionary authority to make significant adjustments in the portfolio's allocation between foreign and domestic investments can either enhance or undermine official monetary policy.[69] A significant reallocation of funds to either foreign or domestic investments will affect currency rates and add or reduce liquidity. For example, a significant shift to domestic assets could work at cross purposes with on-going sterilization operations.[70]

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funded by the World Bank, the Hewlett Foundation, and several nations). Political pressure has led the Saudi government to redistribute some its wealth through its domestic capital markets. Fiona Maharg-Bravo & Una Galani, *Sharing the Wealth*, WALL ST. J., May 21, 2008, at C16. The Saudi government has launched several initial public offerings of state-owned enterprises and has allowed retail investors to purchase the shares of these companies at substantial discounts. *Id.*

62 *See Sovereign Funds Take Heat*, *supra* note 29.

63 *See* Anders Aslund, *The Truth About Sovereign Wealth Funds*, FOREIGN POLICY, Dec. 2007, www.foreignpolicy.com/story/cms.php?story_id=4056.

64 *See id.* Russia's deputy minister of finance with responsibility for foreign asset management was recently arrested for embezzling $43 million. *Id.*

65 *How to Spend It*, ECONOMIST, Apr. 24, 2008, at 37 (noting rates of diabetes in United Arab Emirates, Saudi Arabia, Bahrain, and Kuwait are nearly 20%, 16.7 %, 15.2%, and 14.4%, respectively). Sedentary lifestyles and dietary changes resulting from prosperity are the suspected culprits. *Id.*

66 *Id.* at 37-38.

67 *Id* at 39.

68 INTERNATIONAL MONETARY FUND, *supra* note 20, at 10-11.

69 *Id.*

70 The pegging of a currency's value to the value of another currency requires that the monetary policy of the authority whose currency is pegged coordinate their

Failure of the sovereign wealth fund's managers and the monetary authorities to coordinate their actions could jeopardize the effectiveness of monetary policies.

Finally, sovereign wealth fund investments could exacerbate inflationary tendencies. Large infusions of funds into the domestic economy will add to aggregate demand leading to upward pricing pressures. Rapidly increasing export earnings are already putting upward pressure on prices in many nations.[71] This pressure is particularly acute with respect to non-

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policies with the monetary authorities of the pegged currency's country. *See generally* J. ORLIN GRABBE, INTERNATIONAL FINANCIAL MARKETS 24, 216 (2nd ed. 1991). Failure to do so will result in pressure on the peg due to supply and demand forces. *See id.* Moreover, in the event a currency is deemed under or over-valued, the monetary authorities will need to intervene in the currency markets to maintain the currency peg. *See id.* If, for example, there is excess demand for the pegged currency due to increases in export revenues, then the pegged currency, all things being equal, will rise in value. *See id.* In order to maintain the peg the central bank will need to purchase the currency to which its currency is pegged. *See id.* To do so the central bank will, in effect, sell domestic currency and thus increase the monetary supply and exacerbate inflationary tendencies. *See id.* To offset this effect the central bank may partially sterilize the effect of its currency intervention by selling other assets, such as domestic bonds, and thereby decrease the monetary supply. *Id.* at 216.

[71] *See generally An Old Enemy Rears Its Head*, ECONOMIST, May 24, 2008, at 91-93. Inflation is worrisome for many exporting countries due to the rise in world commodity prices, especially food. *Id.* Inflationary expectations may take root in many developing countries and precipitate a wage-price spiral. *See id.* Inflationary expectations in such countries could be stubbornly persistent because their central banks have neither the credibility nor, in some cases, the political independence, of other monetary authorities such as the U.S. Federal Reserve. *Id.* Moreover, the Gulf States, with the recent exception of Kuwait, peg their currencies to the U.S. dollar. Ambrose Evans-Pritchard, *Hedge Funds Target Currency Pegs*, Telegraph.co.uk, Dec. 2007, http://www.telegraph.co.uk/finance/comment/ambroseevans_pritchard/2817707/Hedge-funds-target-currency-pegs.html. The precipitous decline in the dollar has, consequently, raised the domestic price of imports that are not priced in dollars. *See How to Spend It, supra* note 65, at 38. One critic of sovereign wealth funds asserts that the vast reserves accumulated by exporting countries are the result of a chronically undervalued currency that cannot be sustained in the long-run. *See An Old Enemy Rears Its Head*, *supra*, at 91-93. By maintaining an undervalued currency these exporting countries, China in particular, are increasing foreign exchange reserves at the price of domestic inflation. *See* Aslund, *supra* note 63; Andrew Batson, *China Falters on Inflation Fight*, WALL ST. J., July 15, 2008, at A6. Some hedge funds and other institutional investors believe that the dollar pegs will end and that the pegged currencies will rise. Joanna Slater, *Investors Bet Persian Gulf Will Loosen Dollar Pegs,* WALL ST. J., May 27, 2008, at C1. Criticism of China's policy toward its currency is nothing new. China abandoned its official dollar peg in 2005 but does not allow the yuan to float freely. *Id.* Tensions with China have risen in recent months and the United States has filed a complaint against China over export subsidies with the World Trade Organization and has imposed tariffs on certain Chinese imports. *Lost in Translation*, *supra* note 15, at 80. Moreover, legislation was

tradable goods, such as housing and office space.[72] The law of supply and demand will ensure that economies that lack the productive capacity to absorb vast amounts of revenue will inevitably face upward pressure on prices. Oman, the United Arab Emirates, and Qatar are currently experiencing double digit inflation rates.[73] International Monetary Fund economists have estimated that the doubling of oil prices will eventually result in a "50% rise in the prices of non-tradable goods."[74] Countries that lack productive capacity, such as Russia, Saudi Arabia, and India, may encounter political pressure to spend a portion of their wealth domestically to increase their long-term productive capacity and diversify their economy.[75] Assuming a well functioning economy, such price increases will ultimately subside as supply catches up with demand and spending is diverted to less costly imports. The interregnum can prove painful, however.

C. *International Monetary Implications*

Sovereign wealth funds, by virtue of their size, have significant effects on the international financial system. International integration of markets began in earnest after World War II and has continued, albeit with some fits and starts, to this day.[76] The fall of the Berlin Wall, the demise

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proposed that would have imposed a steep tariff on Chinese imports to offset the alleged undervaluation of the yuan. *Id.* Failure to criticize the Gulf States, however, while continuing to badger China over its currency policy is becoming politically untenable. Domestic pressures, such as protests over food costs, are forcing leaders of the Gulf States to reconsider their dollar peg. Moreover, the recent decision by Ukraine to strengthen its currency against the dollar will provide further fodder for critics of the Gulf States' currency policies. *See* Joanna Slater & Lidia Kelly, *Ukraine Revises Currency Peg*, WALL ST. J., May 22, 2008, at C14. Saudi Arabia has recently dismissed calls to depeg their currency, however. *See* Landon Thomas Jr., *Gulf Countries Remain Tied to the Dollar*, N.Y. TIMES, Aug. 26, 2008, at C1.

[72] Non-tradable goods refer to goods which must be produced domestically.

[73] *See How to Spend It, supra* note 65, at 38; Mariam Fam, *Inflation to Cloud Mood at Mideast Forum*, WALL ST. J., May 17, 2008, at A2 (reporting that average annual inflation for the Middle East and North Africa is projected, according to the International Monetary Fund, to reach 10.4% this year and that annual inflation in Cairo and other urban centers in Egypt has hit 16.4%).

[74] *How to Spend It, supra* note 65, at 38.

[75] *Cf.* Pollack, *supra* note 56, at 14 (discussing the failures of many oil rich states to successfully invest their oil proceeds domestically during the 1970s and providing a somewhat pessimistic opinion of their likelihood of successfully investing their current windfall profits).

[76] WORLD TRADE ORGANIZATION, WORLD TRADE REPORT, xiii (2008), *available at* http://www.wto.org/english/res_e/booksp_e/anrep_e/world_trade_report08_e.pdf (offering detailed analysis of global trade, including its effects on various constituents). International integration of commodity, labor, and capital markets – globalization – is not a recent phenomenon. *Id.* A significant period of globalization began in the middle of the nineteenth century and ended with World War I. *Id.* We

of the Soviet Union, and rapid developments in information technology have led to an unprecedented globalization of financial markets during the past two decades.[77] Market forces began displacing government barriers and the world became awash in liquidity. These developments and their effects were described by Thomas Friedman and Daniel Yergin in two popular books.[78] For the most part, these developments have proved beneficial by increasing global liquidity, deepening financial markets, and facilitating political compromises.[79]

Basic economic principles inform us that an increase in the supply of capital will reduce the cost of such capital. In fact, the vast holdings of U.S. Treasury securities by foreign governments, especially China and Japan, have helped the U.S. economy sustain a relatively benign interest rate environment despite enormous budget and trade deficits.[80] As Warren Buffet put it "[t]his is our doing. . . . Our trade equation guarantees massive foreign investments in the U.S. . . . . When we force-feed $2bn daily to the rest of the world they must invest in something here."[81] The

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are in the midst of a period of globalization that began after World War II. *Id.* Political and technological developments in the past two decades have accelerated the integration process. *Id.* If not for the two World Wars and the period in between we could, arguably, be in a period of economic integration that began over a century and a half ago. Whether political liberalization results in increased trade or vice versa is a matter of some debate. President Bush believes that "[t]he case for free trade is not just monetary, but moral" because "[e]conomic freedom creates habits of liberty. And habits of liberty create expectations of democracy." ANDREW J. BACEVICH, AMERICAN EMPIRE: THE REALITIES AND CONSEQUENCES OF U.S. DIPLOMACY 202 (2002) (quoting Gov. George W. Bush during the 2000 presidential campaign). This issue is well beyond the scope of this work and the author's expertise, although I suspect that both processes reinforce each other.

[77] *See generally* DANIEL YERGIN & JOSEPH STANISLAW, THE COMMANDING HEIGHTS (1998).

[78] *See generally id*; *see generally* THOMAS FRIEDMAN, THE WORLD IS FLAT: A BRIEF HISTORY OF THE TWENTY-FIRST CENTURY (2005).

[79] *See generally* YERGIN, *supra* note 77; *see generally* FRIEDMAN, *supra* note 78.

[80] *See* Wayne M. Morrison & Marc Labonte, *China's Holdings of U.S. Securities: Implications for the U.S. Economy*, CRS Report for Congress (2008), *available at* http://fpc.state.gov/documents/organization/99496.pdf. The White House Office of Management and Budget has forecast that the budget deficit will be approximately $482 billion for the 2009 fiscal year. Robert Pear, David M. Herszenhorn & Stephen Labaton, *White House Predicts Bush Will Leave $482 Billion Deficit,* N.Y. TIMES, July 29, 2008, at C1 (reporting on the forecast made public by Jim Nussle, the White House Budget Director). This figure "does not include the full cost of military operations in Iraq and Afghanistan," nor does it include the potential costs associated with further declines in the housing market and additional economic stimulus packages that may be enacted. *Id.* The budget deficit for fiscal year 2007 was $162 billion and is projected at $389 billion for fiscal year 2008. *Id.*

[81] Francesco Guerrera & Justin Baer, *Buffet Defends Sovereign Wealth Funds*, FIN. TIMES, Feb. 29, 2008, www.ft.com/cms/s/0/025dc0c4-e719-11dc-b5c3-0000779fd2ac.

long-term nature of sovereign wealth fund investments tends to dampen volatility in the financial markets.[82] In contrast to the many private investment firms, both U.S. and foreign based, these funds are minimally leveraged.[83] Consequently, the snowball effect that often results from markets in crisis, due to margin calls, the inability to roll over debt, and other problems that surface from time to time in the debt markets, is less likely to impact these funds.[84]

Moreover, the long-term perspective of these investors often makes them a force of financial stability.[85] Their long-term focus allows them to make contrarian investments that exert a stabilizing influence on markets buffeted by negative sentiment. These vehicles, in contrast to highly leveraged hedge funds, are not susceptible to investor demands for the return of their funds and the concomitant disorderly liquidation of investments resulting from such demands. The on-going problems in the credit market, precipitated by the implosion of the mortgage market, are a case in point. In a world awash with liquidity the credit market seized as commercial lenders lost faith in their ability to properly price risk.[86]

During the credit crisis, sovereign wealth funds have channeled surplus funds to those in need of such funds.[87] Recent examples of these types of investments are the investments made by sovereign wealth funds in financial firms whose capital was precipitously eroded by billion dollar write-downs of mortgage securities.[88] In the past year – during the midst of one

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html (quoting Warren Buffet's remarks in his annual letter to shareholders of Berskshire Hathaway).

[82] Simon Willson, *Wealth Funds Group Publishes 24-Point Voluntary Principles*, IMFSurvey Magazine, Oct. 15, 2008, http://www.imf.org/external/pubs/ft/survey/so/2008/new101508b.htm (discussing the development and publication of the Santiago Principles to "reflect the governance and investment practices of SWFs").

[83] International Monetary Fund, *supra* note 20, at 8-9. Although leverage is not employed to any significant degree by sovereign wealth funds some smaller funds are, however, beginning to use leverage to a noticeable extent. *Id.* Sovereign wealth funds also invest in hedge funds, private equity funds, and real estate funds. Setser & Ziemba, *supra* note 25, at 5, 13-14. These funds are often highly leveraged.

[84] The recent turmoil in the credit markets was caused, in part, by the employment of significant leverage. When the investments that back the debt declined in value the reluctance of lenders to continue funding these investments caused investors to liquidate their positions to meet their debt obligations. This selling pressure further exacerbated the downward pressure on asset prices, creating a vicious, self-perpetuating circle.

[85] Willson, *supra* note 82.

[86] *See, e.g.,* Moises Naim, *Three Paradoxes of the Financial Crisis*, Foreign Policy, Feb. 2008, www.foreignpolicy.com/story/cms.php?story_id=4203.

[87] Allister Bull, *Fed Staffer: Sovereign Wealth Funds Boon to U.S. Firms*, Reuters, Mar. 5, 2008, http://www.reuters.com/article/idUSWAT00907520080305.

[88] *See Top Sovereign Wealth Fund M&A Transactions 2007-2008*, Gulfnews, Feb. 4, 2008, www.gulfnews.com/business/Investments/10187286.html; David Enrich et al., *How Wall Street Firms Reached out to Asia*, Asian Wall St. J., Jan. 17, 2008, at 19.

of the worst credit markets in memory - Citigroup, Merrill Lynch, Morgan Stanley, Barclays Bank, and UBS received multi-billion dollar capital infusions from sovereign wealth funds.[89] It appears unlikely that these capital infusions will prove to be one-off deals.[90] Japan is actively pursuing such investments to counter recent sell-offs by hedge funds and other private foreign investors.[91] These funds have also provided a bright ray of hope to an otherwise bleak commercial real estate market.[92]

Private money tends to be hot. In the absence of capital controls private investors exhibit a herd mentality. The experiences of several Asian economies with sudden shifts in investor sentiment in the late 1990s are still a painful memory for many of those affected by the destabilizing behavior of many market participants.[93] Ironically, the very opacity for

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[89] *See Top Sovereign Wealth Fund M&A Transactions 2007-2008*, *supra* note 88; David Enrich et. al., *How Wall Street Firms Reached out to Asia*, *supra* note 88. The reluctance of corporations to seek capital from existing shareholders is partly responsible for these infusions of capital. Many corporations believe, for example, that issuing rights to acquire shares to existing shareholders signals distress and, thus, stigmatize the corporation. *See, e.g.,* Hugo Dixon, *Demystifying Rights Issues*, WALL ST. J., May 19, 2008, at C12; Lauren Silva & Richard Beales, *Right Across the Pond . . .*, WALL ST. J., June 3, 2008, at C14; *see* Rob Cox, *Retro Ploy on Wall Street*, WALL ST. J., July 7, 2008, at C8.

[90] Louise Story, *Write-Down is Planned at Merrill,* N.Y. TIMES, July 29, 2008, at C1; Susanne Craig, Randall Smith & Serena Ng, *Merrill Aims to Raise Billions More*, WALL ST. J., July 29, 2008, at A1. Merrill Lynch has recently announced that it plans to raise $8.5 billion of capital, $3.4 billion of which will come from Singapore's sovereign wealth fund, Temasek Holdings. *Id.* at C1. The International Monetary Fund, in a recent report, stated that banks have raised enough capital to cover approximately 75% of losses related to bad debts but that conditions are deteriorating in heretofore stable areas of the credit market, such as the prime mortgage market. IMF STABILITY REPORT, *supra* note 41, at 5.

[91] Yuka Hayashi, *Japan Hopes to Lure Sovereign Investors*, WALL ST. J., Apr. 8, 2008, at C2.

[92] Alex Frangos, *Abu Dhabi Fund Acquires Most of Chrysler Building*, WALL ST. J., July 10, 2008, at C3 (reporting on the Abu Dhabi Investment Council's purchase of a 90% stake in the Chrysler Building in New York City).

[93] *Here We Go Again; Asia and the Crisis*, THE ECONOMIST, Oct. 18, 2008, at 51, *available at* http://www.economist.com/world/asia/displayStory.cfm?source=hptextfeature&story_id=12437723. In 1997 the currencies of Thailand, Malaysia, the Philippines, and Indonesia suffered precipitous drops in value. DICK K. NANTO, CONGRESSIONAL RESEARCH SERVICE REPORT FOR CONGRESS: THE 1997-98 ASIAN FINANCIAL CRISIS (1998), *available at* http://www.fas.org/man/crs/crs-asia2.htm. Subsequently, the currencies of Taiwan, South Korea, Brazil, Singapore, and Hong Kong came under significant downward pressure. *Id.* In an effort to stem the decline in their currencies the affected governments sold foreign currency reserves and raised interest rates. *Id.* These steps resulted in slowing economic growth throughout the region. *See Here We Go Again; Asia and the Crisis*, *supra*.

which sovereign wealth funds are roundly criticized may be a stabilizing attribute of these funds.[94]

International capital flows also have domestic implications for the capital- importing countries.[95] Cross-border capital flows affect exchange rates which, in turn, have implications for a country's trade balances and inflation.[96] Domestic securities laws and corporate governance regimes are also implicated.[97] However, except for the magnitude of investable funds they have at their disposal, sovereign wealth fund investors do not raise any concerns in this respect that would not similarly be applicable to other types of foreign investors.

D. *Criticism of Sovereign Wealth Funds*

For all the putative benefits derived from sovereign wealth fund investments, the control of vast amounts of national wealth by governmental entities is troubling to many people.[98] Anders Åslundis of the opinion that sovereign wealth funds, with certain exceptions, are indigenous to authoritarian regimes in semi-developed countries, the citizens of which are unable to demand better use of their national wealth.[99] They "reflect a paternalistic-and economically illiterate-notion that the ruler knows best while citizens are so irresponsible that they cannot be entrusted with their own savings."[100]

Ironically, the triumph of market forces over centralized governmental control has led to an enormous concentration of wealth by govern-

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[94] Disclosure of the funds' portfolio holdings and trading may, due to their immense size, "move the market" or result in copycat investment strategies – results that have occurred domestically with Warren Buffett and Berkshire Hathaway. For a discussion of the issue of sovereign wealth fund transparency, see *supra* notes 66-73 and accompanying text.

[95] *See Economics Focus: The Domino Effect*, THE ECONOMIST, July 5, 2008, at 86, *available at* http://www.economist.com/finance/displaystory.cfm?story_id=11667810.

[96] *Id.*

[97] *See, e.g.*, Graciela L. Kaminsky, *International Capital Flows, Financial Stability and Growth*, DESA Working Paper No. 10, 4, 20-21, *available at* http://www.un.org/esa/desa/papers/2005/wp10_2005.pdf.

[98] Aslund, *supra* note 63. Peter S. Goodman & Louise Story, *Overseas Investors Buy Aggressively in U.S.*, N.Y. TIMES, Jan. 20, 2008, at A1. A more cynical view is that these investments serve to entrench management because the investors are recruited by management and are expected to support management. *See* Holman W. Jenkins, Jr., *Sovereign Wimp Funds*, WALL ST. J., Jan. 23, 2008, at A24. Singapore's Temasek Holdings recent show of support for Merrill Lynch's management, despite multibillion dollar losses, lends support to Mr. Jenkin's viewpoint. *See* Rick Carew, *Temasek Throws Support to Merrill's Thain*, WALL ST. J., Aug. 27, 2008, at C3 (quoting Temasek Senior Managing Director Manish Kejriwal). "If anything, the [Merrill management] team has gotten stronger over the last eight months." *Id.*

[99] Aslund, *supra* note 63.

[100] *Id.*

ments.[101] What has emerged, in the words of two scholars, is a "new mercantilism" that reflects a form of state capitalism in which the unit of value to be maximized is the country.[102] State capitalism stands in stark contrast to market capitalism. The latter prevents the shifting of profits from private enterprise to the state – the very objective of state capitalism.[103] Some commentators believe that the global economy is fragmenting and that trade barriers and other wrenches in the machinery of the global economy are inevitable.[104] The hand-wringing over the influence of such large government controlled pools of capital is a manifestation of this trend. In general, the criticism of these funds is centered on their lack of transparency and the potential for political, as opposed to financial, considerations to exert influence over investment decisions.[105] The cacophony of criticism has led to several proposals for reform which are discussed subsequently. In addition, the assertion that sovereign wealth fund investments may, in certain cases, jeopardize national security is examined.

1. Opacity and Politicization of Investments

To an extent, the criticisms leveled at sovereign wealth funds' opacity echoes complaints that have been voiced about hedge funds and private equity funds. Effective disclosure enhances market discipline and may

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[101] Our own profligate ways and our failure to fully develop our own natural resources as a result of environmental concerns cannot be ruled out as contributing factors. *See* Russell Gold et. al., *Oil Industry, Lawmakers Aim to Lift Bans on Drilling*, WALL ST. J., May 23, 2008, at A5.

[102] Ronald J. Gilson & Curtis J. Milhaupt, *Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Merchantilism*, 60 STAN. L. REV. 1345, 1346 (2008).

[103] Criticism of state-owned capital does not stop at waters-edge. California's Public Employee Retirement System (CALPERS), a massive $259 billion dollar investment pool, is often criticized for its alleged politicization. *See, e.g.,* Benn Steil, *California's Sovereign Wealth Fund*, WALL ST. J., Mar. 7, 2008, at A14, *available at* http://online.wsj.com/public/article_print/SB120485294561618331.html. The news that the Pension Benefit Guarantee Corporation, created in 1974 by Congress to guarantee the obligations of defined benefit pension plans, plans to diversify its investment portfolio to include equities was not universally applauded. Press Release, Pension Benefit Guaranty Corp., PBGC Announces New Investment Policy (Feb. 18, 2008), http://www.pbgc.gov/media/news-archive/news-release/2008/pr08-19; *See* Editorial, *Uncle Sam Stocks Up*, WALL ST. J., March 26, 2008, at A14.

[104] *See* Bob Davis, *Rise of Nationalism Frays Global Ties*, WALL ST. J., Apr. 28, 2008, at A1, A16. Export barriers, patent violations, asset expropriations in the natural resource industries, and balkanization of the internet provide support for this view. *Id.* at A1, A16.

[105] *See, e.g.*, Posting of Victor Fleischer to The Conglomerate, http://www.theconglomerate.org/2008/03/taxing-sovereig.html#c105883464 (last visited Mar. 4, 2008).

help reduce systemic risk. Informational deficiencies are a contributing, if not a major, cause of the credit crisis gripping the United States. Losses on mortgage-backed securities and other sophisticated financial products whose risks were poorly understood by both investors and ratings agencies triggered the crisis. The inability to obtain credible valuations for significant classes of investments has led to widespread lack of confidence in the adequacy of many commercial and investment banks' levels of capitalization.

Unlike sovereign wealth funds, hedge funds and private equity funds are private sector entities driven exclusively by a profit motive. Mechanisms for achieving transparency in the private sector are available contractually as a result of information demands from investors, lenders, and counterparties to trades. If deemed necessary, better transparency is achievable by regulatory fiat. In any event, a concerted effort has been undertaken to improve the transparency of private capital pools.[106]

As public sector entities, however, sovereign wealth funds may be motivated by considerations other than profit.[107] Moreover, unlike hedge funds and private equity funds, these funds do not have sophisticated investors as a disciplinary force. Government pension funds and state owned enterprises are subject to constraints that do not apply to sovereign wealth funds. Pension funds' objectives are clearly defined – to fund large future liabilities to former employees and citizens.[108] This clarity serves as a constraint on the funds' investment policies.[109] State-owned

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[106] International Monetary Fund, *supra* note 20, at 25. The U.K. Hedge Fund Working Group has prepared a set of voluntary disclosure practices. *Id.* These disclosures would improve information provided to investors and counterparties, increase transparency in the valuation of assets, and tighten risk management policies. *Id.* In January 2008 fourteen large hedge funds accepted these practices. *Id.* A similar initiative was undertaken by the Private Equity Working Group on Transparency and Disclosure in 2007. *Id.* The voluntary standards would apply to firms that manage or advise funds that control large companies in the United Kingdom or have the ability to invest in such companies. *Id.* In the United States, the President's Working Group proposed a set of best practices for private pools of capital, including hedge funds and private equity funds. *Id.* These proposals, issued in 2007, are in the process of being finalized. *Id.* The European Union and the Organization for Economic Cooperation and Development have also undertaken efforts to improve the transparency and governance of private capital pools. *Id.* Hong Kong, Japan, and Singapore regulate these capital pools in a manner similar to their regulations of other issuers of securities. *Id.*

[107] *See* Andrew Ross Sorkin, *What Money Can Buy: Influence*, N.Y. Times, Jan. 22, 2008, at C1, *available at* http://www.nytimes.com/2008/01/22/business/22sorkin.html.

[108] Pension funds appear to be more transparent and accountable. Adrian Blundell-Wignall *et.al.*, *Sovereign Wealth and Pension Fund Issues*, Fin. Mkt. Trends, May 29, 2008, at 117, 130, *available at* http://www.oecd.org/dataoecd/27/49/40196131.pdf.

[109] *Id.*

enterprises exist to provide specific goods or services. Likewise, their investment discretion is constrained. Politicized investments by such entities tend to be noticeable.

The paucity of information regarding the operation, investment objectives, and portfolio composition of sovereign wealth funds has generated concern from policy makers and citizens of capital recipient countries.[110] The deployment of large pools of government-owned capital to purchase stakes in private enterprises has raised suspicions that investment decisions are motivated by motives other than profit.[111] Felix Rohatyn, a pillar of the Wall Street establishment, succinctly expressed a growing sentiment when he stated that if "[t]hey are making investments that they probably think are O.K. but not spectacular . . . there has to be a political objective over and above the rate of return."[112]

Government ownership of private enterprise is discomfiting in the United States as a general principle. Proposals for U.S. government investment in the private capital markets are very controversial.[113] The motives of large state-owned pension funds are often questioned when they undertake an activist role in corporate governance.[114] Investments by foreign governments, despite their purported benefits for the domestic economy, generate a great level of angst.[115] Foreign governments have

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[110] *See, e.g.,* Sorkin, *supra* note 107.

[111] *See id.*

[112] *Id.* (quoting Felix Rohatyn).

[113] *See* Sudeep Reddy & Michael R. Crittenden, *Paulson Defends Rescue Plan for Fannie and Freddie*, WALL ST. J., July 16, 2008, at A2; *see also* Damian Paletta & Sarah Lueck, *Congress Takes Up Plan to Stabilize Fannie, Freddie*, WALL ST. J., July 17, 2008, at A3. Recently enacted legislation temporarily authorizes the U.S. Department of the Treasury to bolster the capital of the federally chartered mortgage giants, the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corp. (Freddie Mac), and the Federal Home Loan Banks. *See supra* note 2 and accompanying text. This legislation authorizes the Treasury to purchase stock and obligations in these entities to prevent disruption in the capital and mortgage markets or to protect taxpayers. *Id.* The recent announcement by the Pension Benefit Guarantee Corp., the federal corporation that insures defined benefit plans, of its intent to diversify its investments into equities has also raised concerns. *See supra* note 103.

[114] *See, e.g.,* CALPERS, GLOBAL PRINCIPLES OF ACCOUNTABLE CORPORATE GOVERNANCE (2008), http://www.calpers-governance.org/principles/docs/2008-8-18-global-principles-accountable-corp-gov-final.pdf (last visited Oct. 3, 2008). CALPERS, the California Public Employees' Retirement System, is very active in the corporate governance movement. It has published a set of best practices and rates publicly held corporations on its governance practices. *See id.*

[115] *See supra* notes 80-94 and accompanying text; Kimmitt, *supra* note 16, at 119, 126 (noting that "foreign-owned firms in the United States employ 4.5% of the domestic workforce and account for 5.7% of national output . . . 13% of research and development spending, and 10% of" plant and equipment investment). Most of the concern centers on politically motivated investment. *See id.* at 123. Rapid

objectives and strategic interests apart from portfolio profit maximization. They have at their disposal security and intelligence apparatus that may offer them access to information not available to other market participants. As sovereign entities they may borrow more cheaply than non-sovereign investors. Their lack of transparency serves as fodder for those ready to believe the worst.

There has been little evidence of politically motivated investments by such funds. In fact, such funds have been long-term investors in prominent companies for years.[116] Moreover, funds vary in their governance practices and some funds have strong governance practices and a relatively high degree of transparency.[117] High profile capital infusions into U.S. financial services firms have come without voting rights.[118] Some funds have even issued public denials that investment decisions are politically motivated or have attempted to minimize, in the public's mind, their association with a foreign sovereign.[119] However, the explosive growth of assets under sovereign wealth fund management has heightened concerns

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disinvestment by such funds, however, can be a destabilizing force in the host country. Libya, for example, has threatened to avoid U.S. investment as a result of the disputes over terrorism-related legislation in the United States. Jay Solomon, *Libya Sours on U.S. Ties Amid Boom in Economy,* WALL ST. J., May 16, 2008, at A1. Libyan investments in the United States are not significant but this episode highlights the risk in question. *See id.*

[116] *Asset-backed Insecurity*, ECONOMIST, Jan. 19, 2008, at 78, *available at* http://www.economist.com/opinion/displaystory.cfm?story_id=10533428; Kuwait's fund has been an investor in Daimler-Benz since the late 1960's and a significant investor in British Petroleum since Prime Minister Margaret Thatcher's government privatized it in mid-1980s. *See generally id.*; Peter Gumbel, *Stop Whining About Sovereign Wealth Funds*, FORTUNE, Jan. 24, 2008, http://money.cnn.com/2008/01/24/magazines/fortune/gumbel_davosSWF.fortune/index.htm.

[117] *See, e.g.*, Una Galani & Simon Nixon, *Breakingviews Sovereign Wealth Fund Risk Index*, BREAKINGVIEWS, Jan. 24, 2008, www.breakingviews.com/2008/01/04/Sovereign%20wealth%20. Various rankings of fund governance and accountability exist. One ranking, by Edwin M. Truman of the Person Institute for International Economics, provides a composite ranking based on four factors – structure, governance, transparency and accountability, and behavior. *SOFAZ ranks 7th for management of assets among 32 sovereign wealth funds of 30 countries,* GEORGIAN TIMES, www.geotimes.ge/index.php?m=home&newsid=9135 (reporting on Mr. Truman's testimony before the House Committee on Banking, Housing and Urban Affairs) (last visited July 28, 2008). Out of 32 funds ranked, New Zealand's ranked highest and the United Arab Emirates ranked last. *Id.*

[118] *See supra* note 54 and accompanying text. Investees can, of course, insist on contractual protections, such as lock-up and standstill provisions, to reduce the influence of investors and jurisdictional provisions that provide the investee company with legitimate recourse in the event of disputes.

[119] *See, e.g.,* Yousef al Otaiba, *Our Sovereign Wealth Plans*, WALL ST. J., Mar. 19, 2008, at A16 (discussing the operation and objectives of Abu Dhabi's fund); Rick Carew, *Temasek Throws Support to Merrill's Thain*, WALL ST. J., Aug. 27, 2008, at C3

in capital recipient countries.[120] A recent study has found that half of the publicly reported equity investments by sovereign wealth funds since 2000 involved the purchase of majority interests in target companies.[121] Moreover, thirty-seven percent of the investments examined involved purchases of interests between ten and fifty percent.[122] It appears that the funds have been more cautious with respect to their acquisitions in the United States and Europe, probably out of fear of exacerbating concerns in these areas.[123] Failure to confront these concerns may lead to policies that restrict the flow of foreign capital and usher in a wave of deleterious protectionist measures.[124]

2. Reform Proposals

The International Monetary Fund, drawing on existing guidelines for fiscal, monetary, and financial transparency in reserve management, has suggested several themes for further consideration with respect to sovereign wealth funds.[125] The International Monetary Fund divides transparency into three categories: "transparency with respect to: (i) objectives; (ii) organizational structure and institutional arrangements; and (iii) investment portfolio (size, composition, returns, risk indicators).[126] Among the best practices recommended by the International Monetary Fund are the establishment of a "clear legal framework that

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(reporting that Temasek Holdings prefers to be referred to as a return driven, nonpolitical investor and not as a sovereign wealth fund).

[120] *See Lie Back and Forget the Maple Leaf*, ECONOMIST, Apr. 5, 2008, at 41 (discussing growing concerns in Canada about foreign investment); *Asset-backed Insecurity, supra* note 116 (noting opposition to the acquisition of certain Thai telecom companies by Singapore's Temasek fund in 2006); *Suspicion Lingers*, ECONOMIST.COM, Feb. 28, 2008, http://www.economist.com/daily/news/displaystory.cfm?story_id=10766365 (commenting on the suspicion about the motives of Qatar's fund in its rumored acquisition of a stake in the Royal Bank of Scotland).

[121] Bob Davis, *Sovereign-Wealth Funds Seek Control*, WALL ST. J., June 6, 2006, at C2 (reporting the results of a study conducted by the Monitor Group, a consulting firm).

[122] *Id.*

[123] *Id.*

[124] This process may already be underway. The Doha round of trade talks, seven years in the making, recently collapsed over disagreements about farm subsidies and tariffs by the United States and Europe. *See* John W. Miller, *Global Trade Talks Fail As New Giants Flex Muscle*, WALL ST, J., July 30, 2008, at A1; *The Doha Round . . . and Round . . . and Round*, ECONOMIST, July 31, 2008, at 71 (discussing conflicts in farm subsidy policy). *See also supra* note 71 (noting the complaint filed by the United States against China with the World Trade Organization).

[125] INTERNATIONAL MONETARY FUND, *supra* note 20, at 23-26.

[126] *Id.* at 26. The third category, dealing with portfolio disclosures, will require a balancing between the risk of disclosure of sensitive market data and the risk that disclosures are inadequate to verify a fund's stated objectives. *Id.*

specifies the institutional structure within in which the [fund] operates and ensures that itsobjectives, role, scope, and responsibilities" are clearly expressed.[127] A clear and publicly disclosed allocation of responsibilities and "mechanisms to ensure that [the fund] operates in a manner that is consistent with overall government objectives" is also recommended.[128] According to the International Monetary Fund, sovereign wealth funds should "clearly specify their risk management framework."[129] Also recommended is the regular and timely disclosure of comprehensive data on size, sources and uses of funds, operations, and asset holdings by type and class.[130] The International Monetary fund also recommends that "annual independent external audits . . . be published."[131]

The International Monetary Fund recommends that best practices be developed with input from the sovereign wealth funds and multinational institutions such as the Organization of Economic Co-operation and Development (OECD) and the World Bank.[132] The members of the International Working Group of Sovereign Wealth Funds met in early September 2008 with representatives of the European Commission and the OECD and reached a preliminary agreement on a draft set of principles, the Generally Accepted Principles and Practices for Sovereign Wealth Funds, that will be recommended to the members' respective governments for adoption.[133] The European Union has suggested a coordinated approach toward reform of sovereign wealth fund practices and has proposed reforms similar to those suggested by the International Mone-

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[127] *Id.* at 23.

[128] *Id.*

[129] *Id.*

[130] *Id.*

[131] *Id.*

[132] *Id* at 26.

[133] Press Release, Int'l Working Group of Sovereign Wealth Funds, Int'l Working Group of Sovereign Wealth Funds Reaches a Preliminary Agreement on Draft Set *Generally Accepted Principles and Practices*-"Santiago Principles" (Sept. 2, 2008), http://www.iwg-swf.org/pr.htm. The Convention on the Organization for Economic Co-operation and Development was signed on December 14, 1960 by various European countries, the United States, and Canada. Convention on the Organisation for Economic Co-operation and Development, Dec. 14, 1960, 12.2 U.S.T. 1961. Among the objectives of the organization are the achievement of "sustainable economic growth and employment" and "the expansion of world trade on a multilateral, nondiscriminatory basis." *Id* at Article 1(a),(c). At present, 30 countries are members of the organization. About OECD, Organisation for Economic Co-Operation and Development, http://www.oecd.org/pages/0,3417,en_36734052_36734103_1_1_1_1_1,00.html (last visited May 27, 2008). In May 2007, Chile, Estonia, Israel, Russia, and Slovenia were invited to open discussions for membership. Moreover, Brazil, China, India, Indonesia, and South Africa were offered enhanced engagement with the organization with a view toward possible membership. *Id.*

tary Fund.[134] The Organization for Economic Co-operation and Development held a conference on March 31, 2008 to address "steps that [both sovereign wealth funds] and [capital-recipient countries] can take to build mutual confidence and trust."[135] The U.S. Department of the Treasury, in addition to studying issues presented by sovereign wealth funds, has held discussions with officials of Singapore and the United Arab Emirates.[136] The parties issued a joint statement endorsing the work of the International Monetary Fund and the Organization for Economic Cooperation and Development in developing a voluntary set of best practices.[137]

Many of the proposals mentioned above have been echoed by others.[138] Some proposals, however, would go beyond the general gist of these proposals whose focus is principally on information availability and internal fund governance. One suggestion put forth is that "behavioral guidelines" be established that "create the presumption of consultation with the relevant countries with respect to the allocation [of] assets denominated in different currencies or located in different countries.".[139] Other suggestions include conditioning the ability of a foreign fund to invest in a host country on its country granting reciprocal investment rights to foreign funds.[140] Some commentators have suggested that funds

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[134] *See* COMM'N OF THE EUROPEAN CMTY., COMMC'N FROM THE COMM'N TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN ECON. AND SOC. COMM. AND THE COMM. OF THE REGIONS: A COMMON EUROPEAN APPROACH TO SOVEREIGN WEALTH FUNDS, 7-12 (2008), *available at* http://ec.europa.eu/internal_market/finances/docs/sovereign_en.pdf.

[135] Sovereign Wealth Funds in the Global Investment Landscape: Building Trust, http://www.oecd.org/dataoecd/13/0/40098596.pdf (outlining conference agenda).

[136] *See* Press Release, U.S. Dep't. of the Treasury, Treasury Reaches Agreement on Principles for Sovereign Wealth Fund Investment with Singapore and Abu Dhabi (March 20, 2008), www.treasury.gov/press/releases/hp881.htm.

[137] *Id.* Attempts to develop global standards are also evident in efforts by foreign governments and private enterprises to persuade U.S. regulators to allow the use of international accounting standards under U.S. securities laws instead of U.S. generally accepted accounting principles. U.S. Sec. and Exch. Comm'n, Concept Release on Allowing U.S. Issuers to Prepare Financial Statements in Accordance with International Financial Reporting Standards 5 (Aug. 7, 2007), *available at* http://sec.gov/rules/concept/2007/33-8831.pdf. The Securities and Exchange Commission has long resisted these efforts but has recently appeared to have had a change of heart. *See id.*

[138] *See, e.g.,* Edwin M. Truman, *Sovereign Wealth Funds: The Need for Greater Transparency and Accountability*, POLICY BRIEF NO. PB07-6 (Peter G. Peterson Inst. for Int'l Econ., Wash. D.C.), Aug. 2007, at 7-9, *available at* http://www.petersoninstitute.org/publications/interstitial.cfm?ResearchID=783 (last visited May 18, 2008); Kimmitt, *supra* note 16, at 127-28.

[139] Truman, *supra* note 138, at 8.

[140] *Fear of Foreigners*, ECONOMIST, Aug. 14, 2007, http://www.economist.com/business/displaystory.cfm?story_id=E1_JGQTJDG.

be limited to non-voting investments or be encouraged to invest in well-diversified index instruments such as the S&P 500 or the Wilshire 5000.[141] Two scholars have suggested that voting rights be suspended for investments held by foreign government controlled entities.[142] The suspended voting rights would become effective when the investments are transferred to a non-governmental investor.[143]

3. National Security Concerns

The fear that sovereign wealth funds will wield their massive portfolios for political gain raises legitimate national security concerns. Unfortunately, it is oftentimes difficult to distinguish legitimate national security concerns from protectionist sentiment masquerading as such. Reflexive national security fears appear unwarranted for several reasons. First, there is little evidence to date that would suggest sovereign wealth funds

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[141] Joshua Aizenman & Reuven Glick, *Sovereign Wealth Funds: Stumbling Blocks or Stepping Stones to Financial Globalization,* FRBSF ECON. LETTER NO. 2007-38 (Federal Reserve Bank of S.F., San Francisco, Cal.), Dec. 14, 2007, http://www.frbsf.org/publications/economics/letter/2007/el2007-38.pdf (last visited March 12, 2008). Voting rights may be divorced from economic ownership in a number of ways, the most straightforward of which is the issuance of a separate class of non-voting securities. However, equity swaps, other forms of derivatives, and other techniques are available to separate voting rights from other indicia of ownership. *See generally* Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions,* 156 U. PA. L. REV. 625, 628-54 (2008). Many of these techniques are employed by management to ensure that votes are in friendly hands or by investors accumulating a large interest in a takeover target. *Id.* at 643-45. Many of the methods employed attempt to avoid required securities law disclosures and have resulted in statutory or regulatory adjustments. *See id.* at 635. It appears that these techniques are not as popular in the United States as they are in Europe. *Id.* at 654-59. Large sovereign wealth fund investments in European and North American public companies may result in an increase in the use of such techniques. *Id.* at 659-60. CSX Corp. has argued, in a lawsuit against two hedge funds, that equity swaps should be treated similarly to direct stock investments for securities law reporting requirements. *See* Dennis K. Berman, *The Game: Will Judge Kaplan Open 'Swaps' to Disclosure? - Deal Makers Anxiously Await Ruling in CSX's Proxy Spat Against Hedge Funds*, WALL ST. J., June 3, 2008, at C1 (reporting on the status of litigation between CSX Corp. and hedge fund investors). The United States District Court of the Southern District of New York has issued a permanent injunction barring the funds from future securities law violations. Dennis K. Berman & Peter Eavis, *Funds Faulted in CSX Row,* WALL ST. J., June 12, 2008, at C3 (reporting on the federal district court's ruling that the equity swaps in question consciously allowed the investors to delay disclosure of their positions and that the SEC position on swaps exalted form over substance). The court's opinion is available at http://blogs.law.harvard.edu/corpgov/files/2008/06/csx_v_tci.pdf. *See also* Robert Cyran, *Policing Equity Derivatives*, WALL ST. J., June 7, 2008, at B14.

[142] *See* Gilson & Milhaupt, *supra* note 102, at 10, 21-25.

[143] *Id.* at 10.

have actively sought to pursue a political agenda.[144] More importantly, effective mechanisms have been in place for some time that address national security concerns.

The Committee on Foreign Investment in the United States (CFIUS) is charged with "monitoring the impact of foreign investment in the United States. . . ."[145] CFIUS, part of the executive branch, was created by an Executive Order issued by President Ford in 1975.[146] Prior to a recent legislative change, it was comprised of twelve members that included the Attorney General, the Chair of the Council of Economic Advisers, the Director of the Office of Management and Budget, and the Secretaries of State, Treasury, Defense, Commerce, and Homeland Security.[147] The role of CFIUS has been strengthened by various pieces of legislation since its inception. In 1988, the Exon-Florio Amendment authorized executive branch investigation of the national security effects of transactions that could result in foreign control of companies engaged in interstate commerce and sanctioned the suspension or prohibition of acquisitions that posed a national security threat:[148]

> Prior to the [Exon-Florio] Amendment, foreign acquisitions could be blocked if the President declared a national emergency or regulators found a violation of antitrust, environmental or securities laws . . . .

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[144] *Id.* at 21; *See supra* note 116 and accompanying text.

[145] Exec. Order No. 11,858, 40 Fed. Reg. 20,263 (May 7, 1975).

[146] *Id.* The International Investment Survey Act of 1976 provided a statutory imprimatur to CFIUS. *See* 22 U.S.C. §§ 3101-3108 (2006). The enactment of the Financial Investment and National Security Act of 2007, Pub. L. No. 110-49, 121 Stat. 246 (2007), statutorily established CFIUS, which had previously been created by executive order. George Stephanov Georgiev, *Comment: The Reformed CFIUS Regulatory Framework: Mediating Between Continued Openness to Foreign Investment and National Security*, 25 YALE J. ON REG. 125, 126 (2008); *see supra* notes 107-16 and accompanying text for a discussion of the changes made to the review process by this legislation. CFIUS review is initiated by a voluntary notice from a party to the transaction or on recommendation from a CFIUS member agency. *Id;* 50 U.S.C. § 2170(b) (2000). In practice reviews have been initiated by voluntary notification by a party to the transaction. Georgiev at 127. Generally, parties voluntary notify CFIUS thereby insulating them from post-transaction unwinding except in certain cases of misrepresentation. *See id.* at 127 (citing to a report by the U.S. Government Accountability Office). Voluntary filings also allow the filer, in many cases, to have issues addressed in a less defensive manner. *See id.* at 128.

[147] *See* JAMES K. JACKSON, THE COMMITTEE ON FOREIGN INVESTMENT IN THE UNITED STATES 6 (Cong. Research Serv., Rep. No. RL33388, 2007), *available at* http://www.fas.org/sgp/crs/natsec/RL33388.pdf. Recent legislation has altered the composition of CFIUS. *See infra* notes 161-63 and accompanying text.

[148] Omnibus Trade and Competitiveness Act of 1988, Pub. L. No. 100-418, § 5021, 102 Stat. 1107, 1425 (1988) (codified as amended at 50 U.S.C. app. 2158-2170 (2006)). Control is defined broadly and focuses on the ability of an acquirer to exercise powers over certain important business decisions. Recently issued proposed regulations define control in a similar fashion. *See infra* note 169 and accompanying text.

> [*M*]*andatory* investigations of transactions in which the acquirer is "controlled by, or acting on behalf of, a foreign government," and "seeks to engage in an acquisition that could affect national security" . . . [were legislated in 1992].[149]

CFIUS conducts a thirty day review of transactions to determine whether there is credible evidence to support a belief that the foreign person threatens to impair national security and whether other laws exist that would adequately protect national security interests.[150] If one or more of the CFIUS agencies determines that an investigation is warranted then a forty-five day investigation may be commenced.[151] In the event the transaction involves a foreign government and could affect national security the forty-five day investigation is mandatory.[152] After this investigation is complete CFIUS issues a report and recommendation to the President who, in turn, has fifteen days to decide whether to suspend or prohibit a proposed transaction or seek to unwind a completed transaction.[153]

Among the factors that CFIUS and the President may consider during this process are the "domestic production needs for projected national defense requirements, the capability and capacity of domestic [agencies] to meet . . . defense requirements . . . and the control of domestic industries . . . by foreign" entities and its effect on the United States' ability to meet its national security requirements.[154] Moreover, "the potential effects of the . . . acquisition on the sale of military goods, equipment, [and] technology to any country" that supports terrorism or present missile, chemical, and biological weapons proliferation concerns are considered.[155] The effects the transaction could have on U.S. technological

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[149] Georgiev, *supra* note 146, at 127; National Defense Authorization Act for Fiscal Year 1993, Pub. L. No. 102-484 § 837, 106 Stat. 2315, 2463-65 (1992) (codified as amended at 50 U.S.C. app. § 2170(b)(2006)).

[150] 31 C.F.R. § 800.501(b) (2007).

[151] Georgiev, *supra* note 146, at 128.

[152] 50 U.S.C. app. § 2170(a)-(b) (2006); 31 C.F.R. §§ 800.501(a), 800.503 (2007). Recent legislative changes have reduced the discretion of CFIUS in this respect. In order to excuse the 45 day review a joint finding that the transaction will not impair national security by the Secretary of the Treasury and the head of the lead agency within CFIUS is required. 50 U.S.C. app. 2170(b)(2)(D) (2006), as amended by The Foreign Investment and National Security Act of 2007, 50 U.S.C.A. app. § 2061 (2007).

[153] 50 U.S.C. app. § 2170(d) (2006); 31 C.F.R. §§ 800.504 (2007); 31 C.F.R. §§ 800.601 (2007). The President's decision and his explanation thereof, are not subject to judicial review and must be reported to Congress. 50 U.S.C. app. § 2170(e) (2006). Note that any information provided to CFIUS or the President is not subject to Freedom of Information Act disclosures. 50 U.S.C. app. § 2170(c), (g) (2006).

[154] 50 U.S.C. app. § 2170(f)(1)-(3) (2006); 31 C.F.R. § 800.702 (2007).

[155] *Id.*

leadership in areas affecting national security is also reviewed.[156] CFIUS has played a role in several recent high profile transactions including the IBM's sale of its personal computer business to Lenovo Group and China's state-owned oil company's bid for Unocal.[157]

The Foreign Investment and National Security Act of 2007[158] made several significant changes in the national security review process.[159] The Act provides that CFIUS have at least nine members.[160] The Attorney General and Secretaries of the Treasury, Homeland Security, Commerce, Defense, and State continue to be members of CFIUS.[161] The Secretary of Energy has been added as a member and the Secretary of Labor and the Director of National Intelligence have been added as *ex officio* members.[162] The President may designate other executive branch officers as members. By a recent Executive Order, the President has added the United States Trade Representative and the Director of the Office of Science and Technology Policy.[163]

The 2007 legislation also expanded the list of factors that CFIUS must consider in its evaluation. Among the additional factors are an acquisition's potential impact on critical infrastructure, long-term U.S. energy requirements, regional military threats, and cooperation with counterterrorism efforts.[164] The legislation also imposed additional Congressional reporting requirements on CFIUS, authorized CFIUS initiated reviews, increased the difficulty of withdrawing a CFIUS notice, and provided

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156 *Id.*

157 *See, e.g.*, Jonathan Peterson, *Panel Has a Big Say in Foreign Purchases: Security Clearance for a Chinese Bid for Unocal Would Hinge on an Obscure U.S. Committee*, L.A. TIMES, July 5, 2006, at C1, C4.

158 Pub. L. No. 110-49, 121 Stat. 246 (2007).

159 *See id.* Impetus for changes to the process was provided by DP World's acquisition of U.S. assets. Georgiev, *supra* note 146, at 125. CFIUS cleared the transaction but political pressure ultimately caused the transaction to unravel. *DP World's Long Shadow*, ECONOMIST, June 16, 2007, at 74-75. The political fallout resulted, by some estimates, in a decrease of United Arab Emirates investment in the United States of over one billion dollars in 2006 alone. *DP World's Long Shadow*, ECONOMIST, June 16, 2007, at 74-75.

160 50 U.S.C. app. § 2170(k) (2006) (as amended by the Foreign Investment and National Security Act of 2007, 50 U.S.C.A. app. § 2061 (2007)).

161 *Id.* The Secretary of the Treasury is to designate a lead agency to take responsibility for negotiating any agreements necessary with the parties to protect national security. *Id.*

162 *Id.*

163 Exec. Order No. 13,456, 73 Fed. Reg. 467, (Jan. 23, 2008). The President has also named several officials as observers. *Id.* Among these officials are the Director of the Office of Management and Budget and the Chairman of the Council of Economic Advisers. *Id.*

164 50 U.S.C. app. § 2170(f) (2006) (as amended by the Foreign Investment and National Security Act of 2007, 50 U.S.C.A. app. § 2061 (2007)).

authority to re-open a review and, in certain cases, to unwind a transaction.[165]

The Foreign Investment and National Security Act of 2007 also added the term "covered transaction" to describe the types of transactions subject to CFIUS review and investigation.[166] A "covered transaction" is defined as "any merger, acquisition, or takeover . . . by or with any foreign person which could result in foreign control of any person engaged in interstate commerce in the United States."[167] CFIUS's mandate extends only to control transactions. This limitation is a manifestation of the balance that is sought between welcoming foreign investment and preserving national security. Despite the fact that investments falling short of control may carry indicia of influence, the CFIUS process reflects a policy judgment that foreign investment is to be turned away in rather limited circumstances.

The Act does not define the term "control" but requires that the term be defined by regulation.[168] The U.S. Department of the Treasury recently issued proposed regulations that determine control based on analysis of several factors, none of which are inherently determinative. Under the proposed regulations control is defined as the:

> power, direct or indirect, whether or not exercised, through the ownership of a majority or a dominant minority of total outstanding voting interest in an entity, board representation, proxy voting, a special share, contractual arrangements, formal or informal arrangements to act in concert, or other means, to determine, direct, or decide important matters affecting an entity . . . ."[169]

The 2007 legislation provides greater transparency and clarity by providing a lead agency to shepherd the process and by increasing Congressional oversight of CFIUS. At the same time it enhances security

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[165] *See* Georgiev, *supra* note 146 at 131-133; 50 U.S.C. app. §§ 2071(b)(3); 2701(g); 2701(m); 2710(b)(1)(D); 2170(b)(1)(C); 2170(b)(1)(D) (2006) (as amended by the Foreign Investment and National Security Act of 2007, 50 U.S.C.A. app. § 2061 (2007)).

[166] Foreign Investment and National Security Act of 2007 § 2, Pub. L. No. 110-49, 121 Stat. 246 (2007).

[167] *Id.*

[168] *Id.*

[169] 73 Fed. Reg. 21,869 (proposed April 23, 2008) (to be codified at 31 C.F.R. pt. 800.203). The regulations also exempt acquisitions made for solely for investment purposes. *Id.* Included in such investments are acquisitions of less than 10% of the voting interests in the target entity. *Id.* Citigroup's and Morgan Stanley's recent capital infusions from sovereign wealth funds were structured in a very tax advantaged fashion. David B. Stewart, *Sovereign Wealth Fund Deals Take Advantage of IRS Ruling*, 118 TAX NOTES 993 (2008). In essence, the investments were structured as a combination of notes and forward contracts to purchase shares. *Id.* at 994. Some commentators believe that these complex structures may have been undertaken to avoid CFIUS review. *Id.*

protection by expanding the factors to be considered in the review and investigation process. Whether this legislation strikes the right balance between the enhancement of national security and the promotion of foreign investment remains to be seen. Politicized decisions can result in protectionist backlashes, particularly in the current economic environment.[170]

CFIUS, which provides a national security review on a transactional basis, is complemented by a host of industry-wide statutory and regulatory schemes. For example, marine ports, airports, nuclear power plants, and U.S. classified contract projects are subject to laws and regulations that impose a host of security measures on owners, operators, and employees of such facilities.[171] Acquisitions of telecommunication carriers are subject to Federal Communication Commission review and approval.[172] Federal Reserve approval is required, under the Bank Holding Company Act, when a company either acquires ownership or control of 25 percent or more of any class of voting securities, controls a majority of the board of directors, or obtains the ability to exercise a controlling influence over the management of a bank or bank holding company.[173] The Change in Bank Control Act requires federal approval of certain investments that do not meet the thresholds for Bank Holding Company Act review.[174] Recently, the Department of Homeland Security completed seventeen sector specific plans for protecting critical infrastructure assets.[175]

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[170] There appears to be a trend toward enhanced national security reviews of foreign acquisitions around the world. *See* Warren G. Lavey, *Telecom Globalization and Deregulation Encounter U.S. National Security and Labor Concerns*, 6 J. TELECOMM. & HIGH TECH. L. 121, 161 n.129 (quoting Canada's Minister of Industry in an address to a trade group). It is conceivable that this trend is, at least in part, a response to the greater weight the United States is giving national security concerns. *Id.*

[171] *See id.* at 165-71. The Customs-Trade Partnership Against Terrorism program allows port operators, importers, and common carriers to operate under reduced scrutiny in exchange for submission of a security plan that meets U.S. Customs and Border Protection's minimum standards. *See Supply Chain Security: U.S. Customs and Border Protection Has Enhanced Its Partnership with Import Trade Sectors, but Challenges Remain in Verifying Security Practices*, G.A.O. HIGHLIGHTS (U.S. Gov. Acc't. Office, Washington, D.C.), April 2008, *available at* http://www.gao.gov/highlights/d08240high.pdf. The parties must also allow periodic verification that their security measures are being followed. *Id.* A recent U.S. Government Accountability Office report has found problems with this program. *See id.* at 28.

[172] *See* Lavey, *supra* note 170, at 149-59.

[173] *Alvarez Testimony*, *supra* note 24, at 4-7.

[174] OFFICE OF THE COMPTROLLER OF THE CURRENCY, CHANGE IN BANK CONTROL, COMPTROLLER'S LICENSING MANUAL 1 (2007), *available at* http://www.occ.treas.gov/corpbook/group3/public/pdf/cbca.pdf.

[175] Lavey, *supra* note 170, at 172.

The collective mood of the polity is not good. Gasoline prices have surged to unprecedented levels, home values are decreasing in many parts of the country, the effects of the mortgage crisis continue to ripple through the economy, and the war in Iraq appears endless. Adding to our angst is the perception that other nations are becoming increasingly powerful. Oil exporting nations are accumulating wealth at an astonishing rate. One commentator succinctly captured the nation's anxiety when he noted that OPEC could "potentially buy Bank of America in one month worth of production, Apple computers in a week, and General Motors in just 3 days."[176] Russia has become increasingly belligerent toward the West as evidenced by its sale of arms to Iran and Syria and its repressive policies at home.[177] A palpable sense of unease over the United States' influence in the world has taken root – a sense that Pax-America is over.[178] Our diminished global image as a result of the war in Iraq, whether warranted or not, combined with the increasing assertiveness of other nations has created a profound sense of insecurity.[179] It is precisely such a sense of insecurity that often results in common-sense yielding to protectionist tendencies.

III. Sovereign Immunity

Sovereign wealth funds, by definition, are integral parts of a foreign sovereign. As such, the concept of sovereign immunity becomes relevant to the development of tax policy with respect to these funds. This section provides a historical background of sovereign immunity in general, the development of the doctrine of foreign sovereign immunity in the United States, and an analysis of the current incarnation of foreign sovereign immunity as manifested by the provisions of the Foreign Sovereign Immunities Act. As will become evident, the concept of foreign sovereign immunity is not a bar, as a matter of first principle, to the taxation of sovereign wealth funds. Instead, foreign sovereign immunity is granted by the host state by voluntarily ceding a portion of its territorial jurisdiction.

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[176] Thomas L. Friedman, *Imbalance of Power*, N.Y. Times, May 21, 2008, at A29 (quoting the Congressional testimony of Gal Luft).

[177] *The Big Chill*, Economist, May 19, 2008, at 55-56.

[178] For an excellent analysis of the changing role of the U.S. in the world see Fareed Zakaria, The Post-American World (2008).

[179] A sense of unease has also filtered into global institutions. Changes in the global economic landscape, which includes the growth of sovereign wealth funds, have called into question the efficacy and relevance of well established international institutions, including the United Nations Security Council, the International Monetary Fund, and the World Bank. *See Wrestling for Influence*, Economist, July 5, 2008, at 33.

A. *Historical Background*

1. Sovereign Immunity in General

The "generally accepted principle that one government does not tax another"[180] is derived from the broader concept of sovereign immunity. Although the United States has exempted income of foreign governments for almost a century, this exemption has largely escaped public attention and has, until recently, generated little debate. Supported on a foundation of sovereign immunity the status quo has proven extremely resistant to change. The sheer enormity of sovereign wealth funds has brought the tax exemption into the public's consciousness and has made it, for the first time, a subject of debate.

Sovereign immunity is an ancient legal principle that places severe limitations on the use of the courts to control the government.[181] Based on the maxim that "the King can do no wrong," sovereign immunity precludes government liability for the torts of its officers or agents unless the immunity is waived by statute.[182] The notion that a sovereign cannot be hailed into court without her consent is a manifestation of the oft-times conflicting influences of Roman and Canon law, tribal customs, and feudal traditions.[183] Common law notions of sovereign immunity appear to be based more on practical considerations than on the fiction that the king is incapable of doing wrong or on the divine nature of royalty.[184]

The Justinian Code, rediscovered in 1076, contained ample support for the notion that the sovereign's power is absolute and unlimited.[185] Church authorities, while strongly supportive of monarchy, believed that secular monarchs derived their authority from God and were thus accountable to God's representatives on earth, the Pope and his bish-

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[180] David R. Tillinghast, *Sovereign Immunity From the Tax Collector: United States Income Taxation of Foreign Governments and International Organizations*, 10 LAW & POLICY IN INT'L. BUS. 495 (1978) (citing Taylor, *Tax Treatment of Income of Foreign Governments and International Organizations*, *in* ESSAYS IN INTERNATIONAL TAXATION (1976)).

[181] *See generally* Guy I. Seidman, *The Origins of Accountability: Everything I Know About the Sovereign's Immunity, I Learned from King Henry III*, 49 ST. LOUIS U. L.J. 393 (2005). A related doctrine, official immunity, provides immunity, in a somewhat more limited form, to individual government actors. *See generally* Seth P. Waxman & Trevor W. Morrison, *What Kind of Immunity? Federal Officers, State Criminal Law, and the Supremacy Clause*, 112 YALE L.J. 2195 (2003).

[182] *See* BLACK'S LAW DICTIONARY 1396 (6th ed. 1990). The earliest record of the maxim "that the king can do no wrong" is during the minority of King Henry III. This statement, not very controversial when applied to the acts of a minor, "grew 'by degrees . . . until it became a cardinal principle of the [English] Constitution.'" Seidman, *supra* note 181, at 430 (quoting A. LAWRENCE LOWELL, 1 THE GOVERNMENT OF ENGLAND 27 (1908)).

[183] *See* Seidman, *supra* note 181.

[184] *Id.*

[185] *See id.* at 412-17.

ops.[186] The Church's position weakened the case for absolute immunity because if the sovereign was accountable to Rome then further accountability could not be ruled out as a matter of principle. Tribal customs also precluded claims that a monarch was above the law.[187]

Feudal institutions provided the strongest claim to immunity.[188] The Normans established a version of feudalism in England that was, in many ways, based in contract or mutual obligation.[189] "[F]eudal overlords granted rights [to their tenants] in return for food, military service, or religious support."[190] Disputes were resolved in the courts of the overlord.[191] Consequently, the king, with no overlord, was not subject to suit.[192] As Professor Seidman noted:

> The king was immune before his courts not because he was not under the law, but because royal courts were not a forum that could act against the king's interest. Any attempt to hold the king accountable before his own courts against his will was simply impractical. It was also legally unacceptable, for it would make the king the judge of his own case . . . . [T]he feudal origins of the royal courts gave rise to the doctrine of sovereign immunity. The king could not be sued in his central courts of law, "for no feudal lord could be sued in his own court.[193]

At early common law, kingship was personal. This caused a great deal of difficulty upon the death of the monarch because such death ended legal acts taken during the deceased's reign.[194] A distinction began to be drawn between the government as an entity and the persons wielding power.[195] Over time, and as a result of power struggles between the Crown and Parliament, limitations were placed on the sovereign's immunity.[196] A distinction was made between a monarch's absolute powers that derived from his political capacity as head of state and that were

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[186] *Id.* at 409-13. The Church, which consecrated coronation ceremonies, lent legitimacy to the monarchy and expected fealty. Kings, quite naturally, did not always agree with the Church's position. *Id.* at 411.

[187] *Id.* at 418-20. Tribal leaders ordinarily owed their rank to an act of the community and hereditary positions took some time to develop. *Id.* Many tribal codes clearly made the ruler accountable to the law. *Id.*

[188] *See id.*

[189] *Id.* at 422.

[190] *Id.* at 421.

[191] *See id.* at 423.

[192] *Id.* at 398.

[193] *Id.* at 427 (quoting W.S. HOLDSWORTH, A HISTORY OF ENGLISH LAW 465 (3d ed. 1923)).

[194] *See id.* at 427-28. For example, the Magna Carta, signed by King John in 1215, had to be reissued and reconfirmed by later rulers. *Id.* at 428.

[195] *See id.* at 428-29.

[196] *See id.* at 437-49. Limits on royal power could be indirectly effectuated by holding the King's ministers personally accountable. *See id.* at 437-49. These

inseparable from the person of the king and his ordinary powers that involved the day to day conduct of the government.[197] The former powers were subject to immunity.[198] The ruler could, however, be held to account for the latter acts.[199] Thus, at common law, sovereign immunity developed more from practical exigencies than divine right. As the Supreme Court has noted, the peculiarities of the English feudal system, more than anything else, gave birth to the doctrine of sovereign immunity.[200]

Scholars have debated whether the doctrine of federal sovereign immunity was accepted as an underlying premise in the ratification of the U.S. Constitution. Sovereign immunity was publicly endorsed by several prominent delegates, among them Hamilton, Madison, and Marshall, during the ratification debates.[201] In contrast, some commentators believe that the Constitution's extension of judicial power over "[c]ontroversies to which the United States shall be a party" belies the notion that federal sovereign immunity was an accepted premise at the ratification.[202] Moreover, despite disagreements over the doctrine's justification and application the Supreme Court accepted federal sovereign immunity as a well-established premise by the end of the nineteenth century.[203] By 1962 the Court made it clear that the United States could not be sued absent a statutory waiver of immunity.[204]

The United States has waived sovereign immunity to a limited extent. Under the Federal Tort Claims Act the U.S. government may be called to account for the negligent acts of its employees performed within the

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attempts reflect the distinction between sovereign immunity and official immunity. *See* Seidman, *supra* note 181.

[197] *See id.* at 437.

[198] *Id.* at 455.

[199] *Id.*

[200] Nevada v. Hall, 440 U.S. 410, 415 (1979).

[201] Gregory C. Sisk, *A Primer on the Doctrine of Federal Sovereign Immunity*, 58 OKLA. L. REV. 439, 443 (2005).

[202] U.S. Const. Art. III, § 2; Sisk, *supra* note 201, at 445 (citing to Susan Randall, *Sovereign Immunity and the Uses of History*, 81 NEB. L. REV. 1, 38 (2002)). Justice Story believed that this provision was designed to allow the United States to sue as a plaintiff. *Id.* at 444 (citing to JOSEPH STORY, FAMILIAR EXPOSITION OF THE CONSTITUTION OF THE UNITED STATES § 332 (American Book Co., 1840)). State sovereign immunity was also debated at the constitutional convention. *Id.* at 443. The Supreme Court was influenced by the ratification debates and held that the concept of state sovereign immunity was critical to ratification. *Id.* at 443 (citing to Welch v. Texas Dep't of Highways & Pub. Transp., 483 U.S. 468 (1987)). State sovereign immunity issues are implicated by the Eleventh Amendment. *See infra* note 210.

[203] Sisk, *supra* note 201, at 446.

[204] *Id.* at 455.

scope of employment.[205] The Act draws on the public-private distinction made at common law and limits the waiver to "circumstances where the United States, if a private person, would be liable to the claimant in accordance with the law of the place where the act or omission occurred."[206] Generally, immunity is waived neither for conduct that is uniquely governmental nor for most intentional torts.[207] Moreover, the waiver does not extend to an action, or lack of action, that relates to the exercise of discretionary government functions.[208] The Supreme Court has provided a two-part test to determine whether a function is discretionary. In general, an action will be discretionary if there exists no specific prescribed course of action pursuant to a statute, regulation, or other government policy and the action related to the making of social, economic, or political policy.[209] Similar issues are raised with respect to waivers of immunity by a state government. Whether a state may be sued in federal court, however, implicates issues of federalism and its attend-

[205] Federal Tort Claims Act, ch. 754, Title IV, Stat. 842 (1946) (codified as amended at 28 U.S.C. §§ 1346(b), 2671-2680 (2006)). The Tucker Act, ch. 359, 24 Stat. 505 (1887) (codified as amended at 28 U.S.C. § 1491 (2006)), provides a waiver of immunity for actions that arise out of contracts to which the government was a party and for constitutional claims. The Tucker Act does not provide a waiver for tort claims. Note that under the Federal Tort Claims Act liability may fall exclusively upon the government. The employee is removed as a defendant upon certification by the Attorney General that the employee was acting within the scope of his office or employment. 28 U.S.C. § 2679(d)(1) (2006). Government liability for the actions of an independent contractor requires that the government had the authority to control detailed aspects of the contractor's performance and exercised substantial supervision over the contractor's activities. *See* U.S. v. New Orleans, 425 U.S. 807, 814 (1976). The liability of the government is to be determined in "accordance with the law of the place where the act or omission occurred." 28 U.S.C. § 1346(b)(1) (2006). Consequently, under the Federal Tort Claims Act, a court must apply the law that a state court would apply in a similar tort action. *See* Caban v. U.S., 728 F.2d 68, 72 (2d Cir. 1984).

[206] 28 U.S.C. § 1346(b) (2006).

[207] The government is not liable for the torts of "assault, battery, false imprisonment, false arrest, malicious prosecution, abuse of process, libel, slander, misrepresentation, deceit, or interference with contract rights . . . ." 28 U.S.C. § 2680(h) (2006). However, the government is not immune if certain of the aforementioned acts are committed by a law enforcement officer. *Id.*

[208] 28 U.S.C. § 2680(a) (2006).

[209] *See* Berkovitz v. U.S., 486 U.S. 531, 536 (1988); U.S. v. Gaubert, 499 U.S. 315, 322-23 (1991). The Supreme Court has also ruled that the United States "is not liable under the Alien Tort Claims Act for injuries" to members of the armed forces that are sustained while on active duty resulting from the negligence of members of the armed forces. Feres v. U.S., 340 U.S. 135, 135, 146 (1950).

ant undertones of sovereign immunity as well as federal constitutional issues.[210]

2. Foreign Sovereign Immunity

The doctrine of foreign sovereign immunity, the application of sovereign immunity to foreign sovereigns, is a long-established fixture in international law.[211] The United States has applied the doctrine since its birth.[212] The rationale for such immunity, the extent of such immunity, and its evolution to the present time in many ways parrot the controversies surrounding general sovereign immunity. The question of whether sovereign immunity was rooted in the divine right of kings or had its genesis as a pragmatic response to the institutional infrastructure of feudal England is echoed in the question of whether foreign sovereign immunity is a matter of first principle or is grounded in utilitarian rationales. One theory, based on the maxim *par in parem non habet imperium*,[213] posits that foreign sovereign immunity is a fundamental state right.[214] This view of foreign sovereign immunity generally held sway in the eighteenth and nineteenth centuries:[215]

> In this period, the state was generally conceived of as a juristic entity having a distinctive personality and entitled to specific fundamental rights, such as the rights of absolute sovereignty, complete and exclusive territorial jurisdiction, absolute independence and legal equality within the family of nations. Consequently, it appeared as a logical deduction from such attributes to conclude that as all sovereign states were equal in law, no single state should be subjected to the jurisdiction of another state.[216]

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[210] The U.S. Constitution provides that "[t]he Judicial power of the United States shall not be construed to extend to any suit . . . against one the United States by Citizens of another State, or by Citizens or Subjects of any Foreign State." U.S. CONST. Amend. XI. This provision has spawned a significant amount of litigation; a discussion of its application to various fact patterns is beyond the scope of this work. For an excellent analysis of the constitutional issues, see MELVYN R. DURCHSLAG, STATE SOVEREIGN IMMUNITY: A REFERENCE GUIDE TO THE UNITED STATES CONSTITUTION (Praeger Pub. 2002).

[211] *See* RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES: INTRODUCTORY NOTE TO PART IV(5)(A) (1987).

[212] *See, e.g.,* Moitez v. The South Carolina, Bee 422, 17 F.Cas. 574, No. 9,696 (Admiralty Court of Pa., 1781); U.S. v. Peters, 3 U.S. 121 (1795).

[213] The term, translated literally, means "an equal has no power over an equal." Lee M. Caplan, *State Immunity, Human Rights, and Jus Cogens: A Critique of the Normative Hierarchy Theory*, 97 AM. J. INT'L. L. 741, 748 (2003) (citing to BLACK'S LAW DICTIONARY 1673 (7th ed. 1999)).

[214] *Id.*

[215] *See id.*

[216] *Id.* (quoting THEODORE R. GIUTTARI, THE AMERICAN LAW OF SOVEREIGN IMMUNITY: AN ANALYSIS OF LEGAL INTERPRETATION 5 (1970)). Not surprisingly,

The competing view posits that foreign sovereign immunity is not a fundamental right but exists out of practical considerations and a desire to foster comity among nations. Chief Justice Marshall, in the seminal case of *Schooner Exchange v. McFadden,*[217] while seemingly endorsing an absolute view of sovereign immunity, articulated a more pragmatic foundation for the doctrine. The Chief Justice noted the "mutual benefit" accruing to nations by relations with each other.[218] Moreover, Marshall viewed such immunity as a relaxation of the principle of a sovereign's absolute and complete jurisdiction over its territory.[219] Marshall stated that "[a]ll exceptions . . . to the full and complete power of a nation within its own territories, must be traced up to the consent of the nation itself."[220] In effect, the Marshall Court viewed foreign sovereign immunity as a waiver, by the host state, of its sovereignty and not as a fundamental right of the foreign sovereign. Although the Court conferred absolute immunity in the case, it arguably did so based more on principles of comity than on fundamental right grounds. The Court revisited the issue twice about a decade later in *The Santissima Trinidad* and *Planters' Bank* cases.[221] The Court, in both cases, pointedly distinguished between the public acts of a foreign sovereign and acts that a sovereign undertakes that are of a private commercial nature.[222]

When seen in this context foreign sovereign immunity is subservient to the principle of territorial jurisdiction and must be justified.[223] States are equally free to engage in certain official acts such as the formulation of economic and foreign policies, but international law allocates sovereignty in accordance with national borders. A state's power is paramount when applied to its citizens in its own territory but such power is substantially diminished when it is applied to citizens of a foreign sovereign within the latter's territorial jurisdiction.[224]

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communist regimes strongly supported an absolutist view of foreign sovereign immunity. *See id.* at 760. Immunity is not constitutionally required. The U.S. Constitution extends federal judicial power to all cases between a state or its citizens and a foreign state or its citizens or subjects. U.S. CONST. art. III, § 2.

[217] 11 U.S. 116 (1812) [hereinafter The Schooner Exchange].

[218] *Id.* at 136.

[219] *Id.*

[220] *Id.*

[221] The Santissima Trinidad, 20 U.S. (7 Wheat) 283, 352-53 (1822); Bank of the U.S. v. Planters' Bank of Georgia, 22 U.S. (9 Wheat) 904, 907-08 (1824).

[222] The Santissima Trinidad, *supra* note 221, at 352-53; Planters' Bank of Georgia, *supra* note 221, at 907-08.

[223] This view has been posited by various scholars. *See* Caplan, *supra* note 214, at 750 (citing Ian Sinclair and Sir Robert Jennings).

[224] *See id.* at 751-52. Whether immunity should extend to all acts of a sovereign against its own citizens on its own soil is by no means resolved. Sovereign immunity and human rights abuses implicate a clash of fundamental principles that are often difficult to resolve. Some scholars view sovereign immunity as a right that may be

The conference of absolute immunity in the eighteenth and nineteenth centuries is attributable to the nature of the intercourse among states during that period. By today's standards interaction among sovereign nations during peacetime was extremely limited and conducted principally by diplomatic and military personnel.[225] Consequently, most disputes among states involved sensitive foreign policy matters.[226] Broad grants of immunity can be seen as a manifestation of the preference to resolve such disputes by diplomatic means as opposed to litigation.[227] Absolute sovereign immunity was merely a tool of a simpler time.

As noted in *The Schooner Exchange*, it was customary international law for states to waive jurisdiction and grant immunity to protect a foreign sovereign from arrest and detention, to protect diplomats, and to allow passage of friendly troops and warships.[228] Technological improve-

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trumped by other rights that are hierarchically superior under international law. Certain international norms, known as *jus cogens*, are thought to be peremptory. One judge aptly captured this notion when she stated that "*[j]us cogens* norms are by definition nonderogable, and thus when a state thumbs its nose at such a norm, in effect overriding the collective will of the entire international community, the state cannot be performing a sovereign act entitled to immunity." Princz v. Federal Republic of Germany, 26 F.3d 1166, 1182 (Wald, J. dissenting). Other scholars disagree with this view and frame the conflict of norms as occurring between *jus cogens* and the principle of adjudicatory jurisdiction. Thus, a state's decision to protect human rights is strictly a domestic decision to exercise their right of jurisdiction. *See generally* Caplan, *supra* note 213, at 771-72.

225 Caplan, *supra* note 213 at 754 (citing MALCOLM N. SHAW, INTERNATIONAL LAW 494 (4th ed. 1997)).

226 *Id.*

227 *Id.*

228 The Schooner Exchange, 11 U.S. at 137-41. "Customary international law arises from international practice rather than treaty. It is recognized where states consistently follow a rule out of a sense of legal obligation ("*opinio juris*") rather than mere practicality." Harlan Grant Cohen, *Supremacy and Diplomacy: The International Law of the U.S. Supreme Court*, 24 BERKELEY J. INT'L L. 273, 283 n.49 (citing to Art. 38 of the Statute of the International Court of Justice). Mr. Cohen's article provides a thoughtful analysis of the role international law has played in recent Supreme Court decisions. Whether "customary international law "is binding in a fashion similar to common law and should be afforded the same status as treaty law or is merely a reference point for political decisions has stirred much debate. One scholar that has studied the issue has concluded that the elevation of "customary international law" to treaty status has not taken place in general nor has such elevation occurred in cases involving foreign sovereign immunity in particular. *See generally* Phillip R. Trimble, *A Revisionist View of Customary Law International Law*, 33 U.C.L.A. L. REV. 665 (1986). The author makes a forceful argument that there are qualitative differences between "customary international law" and treaties. The principle qualitative difference lies in the fact the former is created largely outside the political process while the latter is created pursuant to well-established politically accountable processes. *See id.* at 727-31. Note that foreign sovereign immunity is, for

ments in transportation and communication in the twentieth century led to a rapid expansion of trade and commerce among nations and their citizens.[229] As a consequence, private actors and sovereign nations interacted much more frequently and the concomitant increase in the number of disputes led to a marked shift by the courts away from absolute immunity and toward a restrictive application of the doctrine that was predicated on the distinction between a sovereign's public and private acts.[230]

During the middle of the twentieth century, the courts often deferred to the State Department when questions of foreign sovereign immunity presented themselves. The Supreme Court, in *Republic of Mexico v. Hoffman*, noted that it is "not for the courts to deny an immunity which our government has seen fit to allow, or to allow an immunity on new grounds which the government has not seen fit to recognize."[231] In 1952 the restrictive application of foreign sovereign immunity became the express position of the State Department via the Tate Letter.[232] State Department involvement in immunity decisions – and the courts' deference to State – led to politicization of immunity decisions. In cases where the State Department did not weigh in on the issue of immunity, the courts were left to their own devices in applying the private-public dichotomy expressed in the Tate Letter. "Thus, sovereign immunity determinations were made in two different branches, subject to a variety of factors, sometimes including diplomatic considerations. Not surprisingly, the governing standards were neither clear nor uniformly applied."[233]

3. Foreign Sovereign Immunities Act

In 1976, in an effort to depoliticize immunity decisions and minimize attendant foreign relations problems, the Foreign Sovereign Immunities

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most countries, not subject to treaty obligations. There is only one comprehensive multilateral agreement that covers state immunity, the European Convention on State Immunity, and this agreement has been ratified by only Austria, Belgium, Cyprus, Germany, Great Britain, Luxembourg, the Netherlands, and Switzerland. Caplan, *supra* note 213, at 757.

[229] International integration of commodity, labor, and capital markets increased dramatically after World War II after a more than thirty year respite brought on by the start of World War I. *See supra* note 76.

[230] *See, e.g.*, Berizzi Brothers v. The Pesaro, 271 U.S. 562 (1926); Mexico v. Hoffman, 324 U.S. 30 (1945). One commentator has noted that common law countries tend to regulate immunity through domestic legislation while civil law countries tend to view immunity as a customary international practice that must be applied by their domestic courts. *See* Caplan, *supra* note 213, at 762-64.

[231] Hoffman, 324 U.S. at 35.

[232] Jack B. Tate was U.S. Department of State Acting Legal Advisor to Acting Attorney General Philip B. Perlman. The letter, written on May 19, 1952, is reprinted in 26 Dept. State Bull. 984-85 (1952) and in Alfred Dunhill of London, Inc. v. Cuba, 425 U.S. 682 (1976) (App.2 to opinion of White, J.).

[233] Verlinden B.V. v. Cent. Bank of Nigeria, 461 U.S. 480, 488 (1983).

Act (FSIA) was enacted.[234] This legislation codified the restrictive application of foreign sovereign immunity.[235] "FSIA is the sole basis for obtaining jurisdiction over a foreign [sovereign]. . . ."[236] It provides a comprehensive set of legal standards that contain a general presumption of immunity and that cover subject matter and personal jurisdiction, venue, procedural issues, exceptions to immunity, liability determinations, and rules of execution upon a foreign sovereign's property.[237] Despite the fact that sovereign immunity is not considered a fundamental right and must be justified on some utilitarian rationale, FSIA establishes a presumption of immunity and requires a plaintiff to prove that one of the statutory exceptions to immunity is applicable.[238]

The threshold issue in the application of FSIA is whether the entity claiming immunity is a foreign state.[239] A foreign state is defined to include "a political subdivision of a foreign state or an agency or instrumentality of a foreign state. . . ."[240] "An agency or instrumentality of a foreign state" is defined as "a separate legal person, corporate or otherwise, that is an organ of a foreign state or political subdivision thereof, or a majority of whose shares or other ownership interest is owned by a foreign state . . . which is neither a citizen of a state of the United States . . . nor created under the laws of any third country."[241] The legis-

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[234] H.R. REP. NO. 94-1487, at 7 (1976); Foreign Sovereign Immunities Act, Pub. L. No. 94-583, § 4(a), 90 Stat. 2892 (1976).

[235] *See* H.R. REP. NO. 94-1487, at 9 (1976). By the mid-1950s almost all Western European countries had adopted a restrictive view of sovereign immunity. *See id.*

[236] Argentina v. Amerada Hess Shipping Corp., 488 U.S. 428, 443 (1989); *see* 28 U.S.C. §§ 1330(a), 1602 (2006). Foreign state immunity claims are justiciable in either federal or state court. 28 U.S.C. § 1602 (2006).

[237] *See* 28 U.S.C. §§ 1330-1332, 1391, 1441, 1606-1611 (2006). In the event immunity is not applicable liability determinations are made as if the state actor in question were a private individual. However, punitive damages, except under very limited circumstances, are not awardable. 28 U.S.C. § 1606 (2006).

[238] 28 U.S.C. § 1604 (2006). In a recent case involving the immovable property exception to immunity discussed at *infra* note 244, the Supreme Court held that U.S. courts had jurisdiction over New York City's claim of property taxes on India's United Nations headquarters. Permanent Mission of India to the United Nations v. City of New York, 127 S.Ct. 2352 (2007). The Court, despite international law precedents, held that property ownership is not an inherently sovereign act and refused to hold that the power of taxation falls outside FSIA's statutory exception to immunity with respect to immovable property. *Id.*

[239] This is also a threshold issue for the application of I.R.C. § 892, the statute granting a tax exemption to foreign governments. *See infra* notes 338-430 and accompanying text.

[240] 28 U.S.C. § 1603(a) (2006).

[241] 28 U.S.C. § 1603(b) (2006); 28 U.S.C. §§ 1332(c)-(d) (2006). The Supreme Court has held that majority ownership must be held directly by the sovereign state and not indirectly through tiered structures. *See* Dole Food Co. v. Patrickson, 538 U.S. 468 (2003). In determining whether an entity is a separate legal person the

lative history of FSIA indicates an intent that the term "agency or instrumentality" be interpreted broadly. Such entities "could assume a variety of forms, including state trading corporation, a mining enterprise . . . a steel company, a central bank, an export association . . . or a department or ministry . . . ."[242]

The determination of whether a particular entity is an organ of a foreign state or political subdivision thereof can be somewhat muddled. The various economic and political systems that exist inevitably result in entities whose structures and functions differ radically from what we, in the United States, would deem appropriate for a government-owned entity. The courts have developed several factors to determine whether an entity is an organ of a foreign state or political subdivision thereof. Among the factors considered are the ownership and management of the entity; whether the entity performs a public activity; whether the foreign state created the entity for a national purpose; whether such entity is actively supervised by the state; whether the foreign state requires the entity to employ public employees; whether the entity holds some exclusive national right or rights; and the entities treatment under the foreign state's law.[243]

The restrictive theory of foreign sovereign immunity is manifested through the statutory exceptions to immunity. FSIA provides exceptions to immunity in a variety of circumstances.[244] The most significant excep-

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courts have applied a legal characteristics test to inquire whether an entity can function legally independent of the state. Hyatt Corp. v. Stanton, 945 F. Supp. 675, 683-84 (S.D.N.Y. 1996). An individual employed by a foreign state and acting in her official capacity within the scope of her authority may also qualify for immunity. *See id.* at 679.

[242] H.R. Rep. No. 94-1487, at 15-16 (1976).

[243] *See* Michael A. Granne, Defining "Organ of a Foreign State" Under The Foreign Sovereign Immunities Act of 1976 (2008) (unpublished manuscript, *available at* http://works.bepress.com/cgi/viewcontent.cgi?article=1000&context=michael_granne).

[244] Under the FSIA statute immunity is vitiated by a waiver by the foreign state, whether expressly or by implication. 28 U.S.C. § 1605(a)(1) (2006). According to the courts, for an express waiver to have been given, proof of a foreign state's subjective intent to waive immunity is required. Generally such waivers will be found in cases where contract language indicates an intent to waive immunity or a government decree waives immunity. *See* Drexel Burnham Lambert Group, Inc. v. Committee of Receivers for A.W. Galadari, 12 F.3d 317, 327 (2d Cir. 1993); Eaglet Corp. v. Banco Central De Nicaragua, 839 F.Supp. 232, 234, (S.D.N.Y. 1993); Paul v. Avril, 812. F.Supp. 207, 210 (S.D. Fla. 1993). Courts have construed implied waivers narrowly and have found such waivers in agreements by a foreign state to arbitrate disputes, in agreements that U.S. law will govern disputes, and in failures to raise the immunity defense in a responsive pleading. *See* Maritime Ventures Int'l. v. Caribbean Trading & Fidelity, Ltd., 689 F.Supp. 1340, 1351 (S.D.N.Y. 1988); Eckerd Intern, Inc. v. Fiji, 32 F.3d 77, 79 (4th Cir. 1994); Foremost-McKesson, Inc. v. Iran, 905 F. 2d 438, 443-44 (D.C. Cir. 1990). Immunity also does not apply to actions that take property rights in

tion is the commercial activity exception. A foreign state is not immune if the cause of action is based either "on a commercial activity carried on in the United States by the foreign state; or upon an act performed in the United States in connection with a commercial activity of the foreign state elsewhere; or upon an act outside the . . . United States in connection with a commercial activity of the foreign state elsewhere and that caused a direct effect in the United States."[245]

Under FSIA a commercial activity is circularly defined as a "regular course of commercial conduct or a particular commercial transaction or act."[246] In determining whether an activity is commercial, FSIA does not attempt to divine whether the foreign sovereign is acting in a public or private capacity. Instead, the nature of the activity itself, not its purpose or the sovereign's motivation in carrying on the activity, is determinative.[247] The Supreme Court, in *Republic of Argentina v. Weltover, Inc.*, held that if a foreign government acts as a private market participant and not as regulator then the foreign government's actions are commercial in

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violation of international law, certain tortuous acts, enforcement of certain arbitration awards, and certain admiralty and ship foreclosure actions. *See* 28 U.S.C. §§ 1604-1605 (2006). The Supreme Court held, in a case involving Nazi expropriation of artwork, that the FSIA applied retroactively to acts that occurred prior to its enactment and, for that matter, to acts that occurred prior to the writing of the Tate Letter. *See* Arjun Gupta, *A Portrait of Justice Deferred: Retroactive Application of the FSIA and Its Implications for Holocaust Era Art Restitution, Republic of Austria v. Altman, 124 S.Ct. 2240 (2004),* 30 U. DAYTON L. REV. 373 (2005). Finally, an exception to immunity is provided for actions based on immovable property located in the U.S. or property located in the U.S. acquired by gift or succession. 28 U.S.C. § 1605(a)(4) (2006). The Supreme Court has recently held that this exception may encompass taxation of immovable property. *See supra* note 238. The application of the statutory exceptions is subject to existing international agreements such as Status-of-Forces agreements. 28 U.S.C. § 1604 (2006); H.R. REP. NO. 94-1487, at 21 (1976). A Status-of-Forces agreement is an agreement between a country and a foreign nation that stations military forces in that country. These agreements deal with legal issues associated with military individuals and property. Among the issues generally covered by these agreements are taxation issues and issues concerning civil and criminal jurisdiction over the military bases and base personnel. *See generally* GlobalSecurity.org., Status-of-Forces Agreement (SOFA), http://www.globalsecurity.org/military/facility/sofa.htm (last visited July 10, 2008).

[245] 28 U.S.C. § 1605(a)(2) (2006).

[246] 28 U.S.C. § 1603(d) (2006). Describing the statute's definition of "commercial activity" as circular may be kind. One court has called it "remarkably obtuse" and a "constant bane of the federal judiciary." Callejo v. Bancomer, S.A., 764 F.2d 1101, 1107 (5th Cir. 1985).

[247] 28 U.S.C. § 1603(d) (2006). Other countries, in applying their own exceptions to immunity, may look to the purpose of the actions as opposed to their nature. *See* Caplan, *supra* note 213, at 761 (discussing the French approach to commercial activities).

nature.[248] At issue in this case was the extension of the due date of bonds issued by Argentina to satisfy existing debts – an action deemed necessary to support the country's currency and economy. The Court was unmoved by the unarguable public purpose of the transaction and instead focused on the nature of the transaction and found such a transaction, the issuance of debt, to be one that private persons would engage in for profit.[249] In *Saudi Arabia v. Nelson*, the Court held that the Saudi government was immune from suit for the alleged torture by police of a state hospital employee whistleblower.[250] The action's purpose, to discourage employee whistleblowing, had commercial overtones.[251] Nevertheless, the Court viewed the alleged actions as falling within the police power, a peculiarly sovereign activity.[252]

With respect to the exception for commercial activity carried on in the United States by a foreign state, FSIA requires that the commercial activity have substantial, not isolated, contact with the United States.[253] FSIA's legislative history provides examples of activities that would fall within this exception. Among transactions that would not be insulated by immunity are commercial transactions performed in whole or in part within the United States, import transactions involving sales to a U.S. buyer, export transactions involving sales by a U.S. seller, negotiation or execution of loans in the United States, and receipt of financing from a U.S. lending institution.[254]

The second commercial activity exception, acts performed in the United States in connection with a foreign commercial activity, requires less of a nexus with the United States but still requires that the act upon which the claim is based occur in the United States. Among acts that may fall within this exception are wrongful termination in the United States of an employee who works in a commercial activity that is carried on outside the United States, and violations of federal securities laws as a result of actions taken in the United States.[255]

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[248] 504 U.S. 607, 614 (1992).

[249] *Id.* at 614-17.

[250] *See* 507 U.S. 349 (1993), *rev'g.* 923 F.2d 1528 (11th Cir. 1991).

[251] *See* Saudi Arabia, 507 U.S. at 362.

[252] *Id.* at 361.

[253] 28 U.S.C. § 1603(e) (2006).

[254] H.R. Rep. No. 94-1487, at 17 (1976).

[255] *Id.* at 19. Note that the term "commercial activity" for purposes of the FSIA is much broader than the tax concept of conducting a trade or business in the United States. For tax purposes, a distinction is made between passive types of investment activities and active trades or businesses. The FSIA, on the other hand, focuses on the nature of the activity itself and whether it is an activity that a private actor would undertake. The Supreme Court did state that commercial activities are those actions by which a private party engages in "trade and traffic or commerce." Republic of Arg. v. Weltover, Inc., 504 U.S. 607, 614 (1992). The "trade or traffic" language seems to imply the active conduct of some business. The term "commerce" however, can,

The third prong of the commercial activity exception does not require a nexus between a specific act or acts and the United States. Instead, acts performed in a commercial activity outside the United States with some direct effect in the United States fall within this exception. In *Republic of Argentina*, the Supreme Court refused to read into the statute that the direct effect caused by the act at issue be substantial or foreseeable.[256] The Court merely required that the effect follow "as an immediate consequence of the defendant's . . . activity" and, accordingly, found that the defendant's failure to make a payment in New York satisfied the direct effect criteria.[257] Courts have interpreted the direct effect exception in confusing and oftentimes contradictory rulings. But the mere fact that an action caused a loss or financial hardship to a U.S. party is, by itself, not sufficient to fall within the direct effect exception. The Tenth Circuit, in deciding a case that involved a claim of lost profits by a U.S. company due to a breach of contract in Kazakhstan, stated that:

> The requirement that an effect be "direct" indicates that Congress did not intend to provide jurisdiction whenever the ripples caused by an overseas transaction manage eventually to reach the shores of the United States. . . . [The company's] allegation that it lost profits and suffered other harm in the United States as a result of the defendant's actions does not meet the requirements of § 1605(a)(2). . . . Appellant would have us interpret § 1605(a)(2) in a manner that would give the district courts jurisdiction over virtually any suit arising out of an overseas transaction in which an American citizen claims to have suffered a loss from the acts of a foreign state.[258]

The current statutory scheme clearly expresses a restrictive view of foreign sovereign immunity. Under FSIA's commercial activity exception, the nature of a foreign sovereign's actions will determine whether the presumption of immunity will stand or whether it is overcome. Moreover, the territorial nexus required between the act or acts in question and the United States to defeat immunity is extremely loose. The distinction between commercial and non-commercial activities is also critical under the tax law. This distinction determines how foreign taxpayers, in general, are taxed and whether foreign governments are taxed at all. Although the tax rules make this distinction somewhat differently than FSIA, the principles underlying the tax law would be recognizable to someone versed in FSIA jurisprudence.

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and has been, interpreted to include all sorts of transactions that would not arise to the conduct of a trade or business. See *infra* notes 284-305 and accompanying text for a discussion of the tax consequences of conducting a trade or business in the United States.

[256] Republic of Arg., 504 U.S. at 618.

[257] *Id.*

[258] United World Trade, Inc. v. Mangyshlakneft Oil Prod. Ass'n, 33 F.3d 1232, 1238, 1239 (10th Cir. 1994).

IV. Taxation of Foreign Governments

The United States, unlike many countries, taxes its citizens and residents on their worldwide income.[259] Tax jurisdiction over foreign taxpayers, however, is exercised under a source-based scheme.[260] Such taxpayers are subject to tax only on income derived from sources within the United States.[261] Moreover, unlike U.S. citizens or residents, the tax schedules to which foreign taxpayers are subject depend on the nature of their U.S. source income. This section discusses the tax rules applicable to foreign taxpayers in general. A discussion of the tax rules applicable to foreign governments then follows. Although the principles of foreign sovereign immunity have informed U.S. tax policy for almost a century,

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[259] Mechanisms to avoid double taxation include tax treaties and the foreign tax credit. This credit allows U.S. citizens or residents to credit, within statutorily defined limits, foreign taxes paid against their U.S. income tax liability. *See generally* I.R.C. §§ 901-08 (2008).

[260] The disparity in the tax schemes applicable to citizens and residents of the United States and non-resident alien taxpayers has led to various attempts by U.S. taxpayers to engage in transactions that avoid U.S. taxation of worldwide income. For example, corporate inversion transactions had as their objective the replacement of the U.S.-based parent of a corporate group with a foreign corporation based in a low tax jurisdiction. These and other "earnings stripping" transactions have resulted in recent legislative changes. *See generally* U.S. Dept. of the Treasury, Report to the Cong. on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties (2007) [hereinafter Treasury Rep. on Earnings Stripping], *available at* http://www.treas.gov/offices/tax-policy/library/ajca2007.pdf.

[261] Foreign investment in the United States takes many forms. For example, foreign investors may invest in the United States though branches of a foreign corporation, through controlling stakes in U.S. corporations, and through passive portfolio investments. According to the latest relevant information compiled by the I.R.S. there were 61,820 domestic corporations controlled by a foreign person that filed income tax returns in 2005. James R. Hobbs, *Foreign-Controlled Domestic Corporations, 2005*, *in* 28 No.1 S.O.I. Bulletin, 4 (2008), *available at* http://www.irs.gov/pub/irs-soi/08rpsumbul.pdf. Although these corporations accounted for approximately 1% of all domestic corporations that filed returns they represented 14.7% and 15.7% of domestic corporation receipts and assets, respectively. *Id.* During the ten year period between 1996 and 2005 the number of income tax returns filed by foreign controlled domestic corporations remained relatively constant but the revenues of such corporations more than doubled during this period. *Id.* at 6. These corporations were active in nineteen industrial sectors with the majority of such firms active in wholesale trade, real estate, manufacturing, and professional services. *Id.* at 6-8. Residents of forty countries accounted for ownership of approximately 90% of these corporations. *Id.* at 10. Residents of the United Kingdom, Japan, Germany, the Netherlands, Canada, France, and Switzerland were the largest holders, by revenue, of these corporations. *Id.* The I.R.S. does not compile statistics with respect to foreign portfolio investment. *See infra* note 284 for the most recently compiled statistics concerning branch operations of foreign corporations.

the comparative advantage enjoyed by foreign governments over their private counterparts is less than what is commonly imagined.

A. *Taxation of Foreign Taxpayers in General*

Foreign nonresident alien individuals and corporations are subject to U.S. income tax on their income from sources within the United States.[262] The tax scheme varies considerably depending on whether the U.S. source income is effectively connected with the conduct of a trade or business in the United States. The net income connected with such trade or business is taxed at graduated tax rates.[263] Otherwise, absent a statutory exemption or contrary treaty provision, a flat thirty percent tax is levied upon the gross income generated from certain specified classes of U.S. source income.[264] A threshold requirement for subjecting foreign taxpayers to U.S. income tax is the existence of income from sources within the United States.

1. U.S. Source Income

Income from sources within the United States includes interest from the United States, the District of Columbia, and interest and dividends from domestic corporations.[265] Income from personal services performed

[262] I.R.C. §§ 871(a)-(b), 881(a), 882(a) (2006). The remaining discussion will focus on the taxation of foreign corporations. A foreign government, if subject to tax, is treated as a corporate resident of its country. A foreign government is similarly treated for income tax treaty purposes if such government grants equivalent treatment to the U.S. government. I.R.C. § 892(a)(3) (2006).

[263] I.R.C. § 882(a) (2006). Gain from the disposition of a U.S. real property interest is treated as income that is effectively connected with the conduct of a U.S. trade or business. U.S. real property interests are broadly defined to include fee ownership interests, co-ownership interests, leaseholds, options, and interests in certain corporations, partnerships, trusts, and estates. *See* I.R.C. §§ 897(c), (g) (2006).

[264] I.R.C. § 881(a) (2006). The tax is generally withheld at the source. *See* I.R.C. §§ 1441-42 (2006). If the President finds that the laws of a foreign country impose discriminatory or extraterritorial taxes on citizens or corporations of the United States then the President shall, by proclamation, double the rates of tax to which citizens and corporations of the foreign country are subject. I.R.C. § 891 (2006). Treaty provisions often provide for reduced rates of tax on such income. *See infra* note 336 and accompanying text.

[265] I.R.C. § 861(a) (2006). Interest received from a domestic corporation that derives at least 80% of its gross income from the active conduct of a trade or business in a foreign country or U.S. possession is not deemed to be from U.S. sources. I.R.C. §§ 861(a)(1)(A), (c) (2006). Dividends received from foreign corporations are treated as U.S. source income if the foreign corporation in question derived at least 25% of its gross income for a three year testing period from the conduct of a trade or business in the United States. I.R.C. § 861(a)(2)(B) (2006). The amount of the dividends treated as U.S. source income is the portion of the dividends that bears the same ratio to the

in the United States,[266] rental and royalty income from property located in the United States,[267] income from the disposition of U.S. real property interests,[268] and gains from the sale of inventory that was purchased outside the United States but sold within the United States are also U.S. source income.[269] Income from the sale of personal property, other than inventory, is U.S. sourced if the sale was made by a U.S. resident.[270] Otherwise, such income is not deemed U.S. source income.[271] Therefore, gains derived by foreign taxpayers from the sale of exchange or personal property held for investment are not subject to tax unless such income is effectively connected with the conduct of a U.S. trade or business.[272]

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total dividends as the income effectively connected with the conduct of a U.S. trade or business bears to the corporation's gross income from all sources. *Id.*

[266] I.R.C. § 861(a)(3) (2006). Certain limited exceptions apply. *See* I.R.C. §§ 861(a)(3)(A)-(C) (2006).

[267] I.R.C. § 861(a)(4) (2006). Royalties for the use of U.S. patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and similar property are included under this provision.

[268] I.R.C. § 861(a)(5) (2006). This type of income is deemed effectively connected with the conduct of a trade or business in the United States. *See supra* note 263.

[269] I.R.C. § 861(a)(6) (2006). Inventory property purchased within the United States and sold outside the United States is foreign source income. I.R.C. § 862(a)(6) (2006). Income from the sale of inventory that is produced in the United States and sold outside the United States or produced outside the United States and sold within the United States is sourced, in part, to the United States. I.R.C. § 863(b)(2) (2006). The regulations provide that such income is sourced based on independent factory or production prices charged to independent third party buyers. The income so determined is sourced to the country in which the production activities took place. The remaining income is sourced under the general sourcing rules. In the absence of independent factory or production prices the regulations allocate 50% of the income based on the location of the taxpayer's property and the other 50% based on business activity using certain defined metrics. *See generally* Treas. Reg. § 1.863-3A (1996).

[270] I.R.C. § 865(a)-(b) (2006).

[271] *Id.* In the event the property sold or exchanged was subject to depreciation, a portion of the gain – in essence, a form of depreciation recapture – may be sourced in the United States. I.R.C. § 865(c) (2006). Moreover, the proceeds from sales of certain intangible assets that are contingent on productivity, use, or disposition of the intangible asset are treated, for sourcing purposes, as royalties. I.R.C. § 865(d) (2006).

[272] *See infra* note 289 and accompanying text. However, if the income from certain sales of personal property by a foreign taxpayer is attributable to an office or other fixed place of business maintained in the United States then such income is U.S. sourced. I.R.C. § 865(e)(2)(A) (2006). This provision is targeted at foreign entities operating in a jurisdiction that does not impose tax on foreign source income. These entities often established sales offices in the United States to avoid taxation in their country of domicile. Consequently, this rule does not apply to the sale of inventory property for use, disposition, or consumption outside the United States if a foreign office or other foreign fixed place of business materially participated in the sale. I.R.C. § 865(e)(2)(B) (2006). A similar rule applies to treat income from sales of

Special rules are provided to determine the source of transportation income, income derived from oceanic and space activities, and international communications income.[273] Moreover, rules are provided to source income derived partly in the United States and partly outside the United States and in allocating and apportioning deductions to U.S. and non-U.S. source income.[274]

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personal property as foreign source income when made by a U.S. resident through an office or fixed place of business in a foreign country and a foreign income tax of at least 10% is imposed. I.R.C. § 865(e)(1) (2006). The existence of an office or other fixed place of business in the United States will also cause rents and royalties derived from the use of intangible property outside the United States to be sourced as U.S. income provided the intangible assets originated from the U.S. trade or business. Also, certain financial income derived from a U.S. banking business or an active securities investment business will be sourced to the United States. I.R.C. § 864(c)(4)(B)(ii) (2006). *See infra* note 295 and accompanying text for a brief discussion of the rules regarding the maintenance of an office or other fixed place of business.

[273] *See generally* I.R.C. § 863(c)-(e) (2006).

[274] I.R.C. § 863(a)-(b) (2006). The rules for sourcing income that is partly from U.S. and non-U.S. sources and the rules allocating and apportioning deductions among U.S. and foreign sources are beyond the scope of this work. The allocation of income and deductions between foreign and domestic sources has significant consequences for U.S. taxpayers. Elaborate and complex rules exist for the allocation of certain expense items. *See e.g.,* Temp. Treas. Reg. §§ 1.861-8T-13T (2006) (providing rules for allocation of interest expense); Treas. Reg. § 1.861-17 (1995) (providing rules for the allocation of research and experimental expenses). Allocation issues have also resulted in significant disputes between taxpayers and the I.R.S., particularly with respect to income from intangible assets. U.S. taxpayers often seek to shift as much income as possible to foreign subsidiaries based in low tax rate countries. I.R.C. § 482 requires that income from transfers of intangible property among controlled taxpayers be commensurate with the income attributable to the intangible. The foreign source income earned by such foreign subsidiaries will generally not be subject to U.S. tax until they are repatriated to the U.S. parent corporation. This general rule is, however, subject to numerous exceptions. *See generally* I.R.C. §§ 951-965 (2006). Generally accepted accounting principles allow domestic corporations to avoid accruing income taxes on the unrepatriated earnings of foreign subsidiaries if certain conditions are met. *See generally* ACCOUNTING FOR INCOME TAXES, Statement of Fin. Accounting Standards No. 109 (Fin. Accounting Standards Bd. 1992), *available at* http://www.fasb.org/pdf/aop_FAS109.pdf. The combination of tax deferral and financial statement treatment provides an incentive for U.S. corporations to retain their foreign subsidiaries' earnings outside the United States, thus preventing the reinvestment of such earnings in the United States. In an effort to encourage the repatriation of foreign earnings, the American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 422(a), 118 Stat. 1514 (2004) (codified as amended at I.R.C. § 965 (2006) enacted a temporary deduction of 85% of cash dividends received from controlled foreign corporations. The amount of dividends taken into account under this provision was subject to several limitations but in no event could they exceed $500 million.

Beginning in 1984, portfolio interest received from U.S. sources is exempt from tax.[275] In general, portfolio interest is interest on a debt obligation, in registered form, held by a foreign person that does not arise from the lender's active business activities.[276] Prior to 1984, U.S. borrowers often employed a finance subsidiary domiciled in the Netherlands Antilles to obtain foreign funding.[277] The Netherlands Antilles subsidiary borrowed money from foreign sources and loaned the proceeds to the U.S. parent.[278] The United States–Netherlands Antilles tax treaty exempted interest paid by the U.S. parent to the Netherland Antilles subsidiary from tax.[279] Congress created the portfolio interest exemption to allow domestic borrowers to tap foreign funding sources without the expense of effectuating the borrowings through a Netherlands Antilles subsidiary.[280] Interest, for this purpose, includes original issue discount but excludes contingent interest.[281] In addition, portfolio interest does not include interest received by ten percent shareholders or interest received by a controlled foreign corporation from a related person.[282] This exemption is lost if the interest is deemed effectively connected with the conduct of a U.S. trade or business.[283]

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[275] *See* I.R.C. § 881(c) (2006).

[276] *See id*. Interest on certain obligations not in registered form will also qualify as portfolio interest. Generally, such obligations must be reasonably designed to ensure that they are sold to non-U.S. persons and that interest is payable outside the United States and its possessions. *See* I.R.C. §§ 881(c)(2)(A), 163(f)(2)(B) (2006).

[277] *See* James P. Holden, Note & Comment, *Repeal of the Withholding Tax on Portfolio Debt Interest Paid to Foreigners: Tax and Fiscal Policies in the Context of Eurobond Financing*, 5 VA TAX REV. 375, 384-86 (1985).

[278] *Id.* at 384.

[279] *Id.* at 385.

[280] *Id.* at 393.

[281] I.R.C. §§ 881(c)(2), 881(c)(4) (2006). Contingent interest is any interest the amount of which is determined by reference to, among other factors, sales, receipts, cash flow, profits, property values, or dividends of the debtor or related person. I.R.C. §§ 881(c)(4), 871(h)(4) (2006).

[282] I.R.C. § 881(c)(3)(B)-(C) (2006). A 10% shareholder is any person who owns 10% or more of the total combined voting power of all classes of stock entitled to vote or, in the case of a partnership obligation, any partner who owns 10% or more of the capital or profits interest in the partnership. Attribution rules apply in determining ownership. For example, stock owned by a corporation or partnership is attributed to the shareholders and partners, respectively. I.R.C. §§ 318(a)(2)-(3), 871(h)(3)(B)-(C) (2006). Also excluded from the definition of portfolio interest is interest received by a bank pursuant to an extension of credit made in the ordinary course of its trade or business. I.R.C. § 881(c)(3)(A) (2006).

[283] *See infra* note 289 and accompanying text.

2. Tax Consequences of Conducting a Trade or Business in the United States

If a foreign corporation conducts a trade or business in the United States, all its income is deemed effectively connected with the conduct of such trade or business unless such income falls within a specific statutory exception.[284] Although the conduct of a trade or business in the United States is not necessary to confer taxing jurisdiction, the conduct of such a business serves to attract income that would otherwise not be subject to tax or that would otherwise be subject to tax at a flat rate. Certain classes of income that are generally subject to tax at a flat rate are, if deemed effectively connected with the conduct of a U.S. trade or business, subject to tax at graduated rates along with other effectively connected income.[285] Moreover, certain foreign source income may be treated as effectively connected with the conduct of a trade or business in the United States.[286]

The statutory classes of U.S. source income that are subject to a flat rate of tax – termed fixed or determinable annual or periodic income – include interest, dividends, rents, annuities, and gains from the sale of certain intangible assets the proceeds of which are contingent on produc-

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[284] I.R.C. § 864(c)(3) (2006). The current taxing scheme was introduced by the Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, 80 Stat. 1539 (1966). Prior to the enactment of this legislation, foreign taxpayers that were not conducting business in the United States were subject to a flat rate of tax on certain defined classes of income. If, however, the foreign taxpayer did conduct a trade or business in the United States then all its U.S. source income, including income not attributable to the conduct of the business, was subject to tax at graduated rates. This regime tended to discourage foreign taxpayers from investing in the United States. *See generally* Harvey P. Dale, *Effectively Connected Income*, 42 TAX L. REV. 689, 690-91 (1987). During 2002, the most recent year for which such information is available, 12,705 foreign corporations filed U.S. income tax returns that reported income effectively connected with a U.S. trade or business. Lissa Redmiles, *Statistics of Income Studies on International Income and Taxes*, *in* 26 No. 1, S.O.I. BULLETIN, 150 (2006), *available at* http://www.irs.gov/pub/irs-soi/intertax.pdf. These corporations reported approximately $3.3 billion of gross receipts attributable to U.S. trades or businesses and paid approximately $646 million in U.S. income taxes. *Id.* During the period 1986 to 2002 the number of returns of foreign corporations with effectively connected income remained relatively constant as a percentage of corporate tax returns filed – between 0.2% and 0.3%. *Id.*

[285] I.R.C. 881(a) (2006). In certain cases, income would be exempt from taxation were it not considered effectively connected with the conduct of a U.S. trade or business. *See also* I.R.C. § 881(c) (2006) (exempting portfolio interest from taxation but defining portfolio interest as interest that would otherwise be subject to tax at a flat rate).

[286] For example, rents or royalties derived from property located outside the United States are deemed effectively connected with the conduct of a U.S. trade or business if such income is attributable to an office or other fixed place of business in the United States. *See* I.R.C. § 864(c)(4)(B)(i) (2006).

tivity, use, or consumption.[287] However, if such income is effectively connected with the conduct of a trade or business in the United States it is not subject to the flat tax regime.[288] Moreover, certain classes of income, otherwise not subject to tax, are taxable if such income is effectively connected with the conduct of a trade or business in the United States. For example, gains or losses from the sale of capital assets and portfolio interest, if effectively connected with the conduct of a U.S. trade or business, will be subject to tax.[289]

The statute links income to the conduct of a U.S. trade or business in two ways. First, three categories of U.S. source income are automatically treated as effectively connected to the conduct of a U.S. trade or business if such income is attributable to an office or fixed place of business in the United States. Income, gain, or loss consisting of rents or royalties for the use, or the privilege of using, certain intangible property will be captured under this rule.[290] Likewise, dividend and interest income derived in the active conduct of a banking, financing, active investment, or similar business is subject to this rule.[291] Finally, the sale of inventory property outside the United States will be subject to this rule unless a foreign

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[287] *See* I.R.C. § 881(a) (2006). Gains from the sale of intangible assets that are not contingent on productivity, use, or consumption are not U.S. source income. *See supra* note 21 and accompanying text. The term "fixed or determinable annual or periodic income" is somewhat misleading. The regulations make clear that the payments need not be periodic but may be received in a lump sum. Moreover, so long as the payments may be received from time to time, whether or not at regular intervals, they are deemed periodic. *See* Treas. Reg. § 1.1441-2(a) (2006). *See also* Comm'r. v. Wodehouse, 337 U.S. 369 (1949). The statute includes salaries and wages as fixed and determinable annual or periodic income. However, U.S. source salaries and wages will invariably be deemed connected to the conduct of a U.S. trade or business.

[288] I.R.C. § 881(a) (2006).

[289] I.R.C. § 864(c)(2) (2006). Income from the sale of personal property, other than inventory, by foreign taxpayers, is sourced outside the United States with few exceptions. *See supra* note 270 and accompanying text. Portfolio interest is exempt from tax. *See supra* notes 276-83 and accompanying text. The statutory language regarding capital gains and losses is somewhat sloppy. The statute determines whether "gain or loss *from sources within the United States* from the sale or exchange of capital assets" is effectively connected with a U.S. trade or business. *Id.* (emphasis.added). However, this provision does not determine the source of income. It merely determines whether such income is effectively connected with the conduct of a U.S. trade or business. Because gains from the sale of capital assets by foreign taxpayers are foreign source income, it appears that the language allows such gains to escape taxation unless the gains are attributable to an office or other fixed place of business in the United States and sourced in the United States pursuant to I.R.C. § 865(e)(2). The regulations, however, make clear that capital gains can be captured under this rule. *See* Treas. Reg. § 1.864-4(c)(2)(v), ex. 2 (2005).

[290] I.R.C. § 864(c)(4)(i) (2006).

[291] I.R.C. § 864(c)(4)(ii) (2006).

office or fixed place of business materially participated in the sale.[292] In determining whether a taxpayer has an office or other fixed place of business in the United States, the offices of a dependent agent are disregarded unless the agent has "the authority to negotiate and conclude contracts" on behalf of the taxpayer or regularly fills orders from a stock of merchandise held in the United States.[293] Offices or other places of business of independent agents are disregarded unless they operate as exclusive agents.[294] The exercise of managerial functions, such as general supervision and policy making, out of a U.S. office or other place of business will not, by itself, trigger the application of this rule.[295]

In addition to the aforementioned automatic rules, fixed or determinable annual or periodic income and capital gains may be deemed effectively connected to the conduct of a U.S. trade or business pursuant to two fact and circumstances based tests. The first test, the asset use test, focuses on whether the income in question is derived from assets used, or held for use, in the conduct of a trade or business in the United States.[296] This test has its principle application in the case of passive types of income where the trade or business does not give rise to the realization of such income directly. In general, income generated from assets held for the principal purpose of promoting the conduct of a trade or business, acquired and held in the ordinary conduct of the business, or in direct relationship to the trade or business will be deemed effectively connected to the trade or business under this test.[297] For example, interest earned on temporary investments of working capital will be captured by this rule.[298] Likewise, capital gains realized from the investment of excess funds generated by the business will be deemed effectively connected to the conduct of the business pursuant to this test.[299]

The second test, the business activities test, will characterize fixed and determinable annual or periodic income as effectively connected with the conduct of an active trade or business if such business activities were a

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[292] I.R.C. § 864(c)(4)(iii) (2006). Note that such income, although generally not treated as U.S. source income, is deemed U.S. source income by virtue of I.R.C. § 865(e)(2).

[293] Treas. Reg. § 1.864-7(d) (1972).

[294] *Id*. at 1.864-7(d)(2), (3).

[295] *See generally* Treas. Reg. § 1.864-7 (1972).

[296] I.R.C. § 864(c)(2)(A) (2006); Treas. Reg. § 1.864-4(c)(1) (2005).

[297] *See* Treas. Reg. §§ 1.864-4(c)(1)-(2) (2005). In determining whether an asset is in direct relationship with the business, primary consideration is given to whether the asset is needed in the trade or business. A rebuttable presumption of such direct relationship exists if the asset was acquired with funds generated by the business, the income from the asset is retained or reinvested in the business, and operating personnel maintain management and control over the asset. Treas. Reg. § 1.864-4(c)(2)(iv)(b) (2005).

[298] *See* Treas. Reg. § 1.864-4(c)(2)(iv)(b) (2005).

[299] *See* Treas. Reg. § 1.864-4(c)(2)(v) ex. 2 (2005).

material factor in the realization of such income.[300] This test will capture income of a passive variety that arises directly from the operation of the business.[301] For example, this test would be met in the case of interest and dividends generated by a dealer in securities, capital gains derived by an investment company, and royalties derived from an active business of licensing intangible property.[302]

In unusual circumstances other income may also be deemed to be effectively connected with the conduct of a U.S. trade or business.[303] Section 864(c)(3) is a catchall provision that treats all categories of U.S. source income not mentioned in section 881(a) as effectively connected with the conduct of a U.S. trade of business.[304] This provision may serve to attract income from the sale of inventory in the United States that is not connected to the conduct of a trade or business in the United States because the foreign taxpayer conducts another trade or business in the United States.[305] For example, assume a foreign taxpayer performs services in the United States and that this is an activity that would constitute an active trade or business. The taxpayer also sells goods via the internet and maintains no office or other fixed place of business with respect to such sales activities. The operation of the service business would attract the income from the sales operation. Most treaties would prevent this result, however.[306]

3. Trade or Business in the United States

Whether a foreign taxpayer conducts a trade or business in the United States is critical to the taxing scheme to which such taxpayer's U.S. source income will be subject. As discussed above, the conduct of such trade or business will result in the income generated from the trade or business to

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[300] I.R.C. § 864(c)(2)(B) (2006); Treas. Reg. § 1.864-4(c)(1) (2005). Note that a factor in applying both the asset use and business activities tests is whether the asset and the income generated from the asset are accounted for on the books of the trade or business. This factor is not controlling, however. Treas. Reg. § 1.864-4(c)(4) (2005).

[301] Treas. Reg. § 1.864-4(c)(3) (2005).

[302] Treas. Reg. § 1.864-4(c)(3)(i) (2005).

[303] Note that gains from transactions in properties that are not effectively connected to the conduct of a U.S. trade or business, but were in the preceding ten years, will be treated as effectively connected to the conduct of the business. A similar rule applies to gains recognized from deferred payment sales. *See* I.R.C. §§ 864(c)(6)-(7) (2006).

[304] *See* Treas. Reg. § 1.864-4(c)(3) (2005).

[305] Sales of inventory are not included in I.R.C. § 881(a) as fixed or determinable annual or periodic income. Income from the sale of inventory property in the United States is U.S. source income and, therefore, could be captured under this rule.

[306] Treaty provisions generally require that a foreign taxpayer maintain a permanent establishment in the United States in order to be subject to tax from such transactions. *See infra* notes 327-33 and accompanying text.

be taxed at graduated rates. Moreover, the conduct of such trade or business may serve to attract income that is otherwise taxed at a flat rate, or altogether exempt from taxation, to the graduated tax rate scheme. A foreign corporation is also subject to the branch profits tax, a second level of taxation imposed on effectively connected earnings and profits.[307] The statute and related regulations provide little guidance on the determination of whether a taxpayer's activities constitute a trade or business.

The performance of personal services within the United States, subject to a minor exception, constitutes the conduct of a trade or business within the United States.[308] Trading in stock, securities, or commodities for the taxpayer's own account will not, unless the taxpayer is a dealer in such stock, securities, or commodities, constitute a trade or business.[309] This result holds regardless of whether the taxpayer trades on her own, through employees, or through independent agents. Trading in stock, securities, or commodities, including trading as a broker or dealer through a resident broker, commission agent, custodian, or other independent agent is also not considered a trade or business unless the taxpayer maintains an office or other fixed place of business in the United States through which such trading is directed at any time during the tax year.[310]

The statutory exemption of stock, securities, and commodities trading activities from trade or business status reflects a long-standing notion that a trade or business must involve activities other than mere passive investment. The Supreme Court, in *Higgens v. Comm'r.* held that the taxpayer's activities in managing a large securities portfolio did not rise to the level of a trade or business.[311] The assets in question were financial assets that entitled the taxpayer to income but gave him neither the right

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[307] The branch profits tax is a 30% tax on the "dividend equivalent amount" of a foreign corporation in each taxable year. The details of this tax are beyond the scope of this work. In effect, this tax is imposed on the repatriation of earnings of the branch as measured by the disinvestment of accumulated earnings by the U.S. branch. This disinvestment is measured by the net change in the net equity of the branch. The tax does not apply in the tax year in which the branch is permanently ended. *See generally* I.R.C. § 884 (2006).

[308] I.R.C. § 864(b) (2006). An exception is provided for personal services performed in certain circumstances by nonresident alien individuals who are present in the United States for a period not exceeding ninety days and whose compensation does not exceed $3,000. I.R.C. § 864(b)(1) (2006).

[309] I.R.C. §§ 864(b)(2)(A)(ii), (b)(2)(B)(ii) (2006); Treas. Reg. § 1.864-2(c)(2) (1975). For this rule to apply to commodity trading the commodities traded must be of a kind customarily traded on an organized commodity exchange. I.R.C. § 864(b)(2)(B)(iii) (2006).

[310] I.R.C. §§ 864(b)(2)(A)(i), (b)(2)(B)(i), (b)(2)(C) (2006); Treas. Reg. § 1.864-2(c)(1) (1975).

[311] 312 U.S. 212 (1941).

to participate in managing the operations of a business nor any liability exposure beyond his investment.[312]

Under *Higgens*, direct ownership of property, with its concomitant right to management and exposure to liability, is required for trade or business status.[313] Moreover, in addition to direct ownership the taxpayer must have a profit motive and engage in regular and considerable levels of activity with respect to the enterprise.[314] For example, real estate holdings may or may not represent a trade or business.[315] Speculative holdings in raw land for eventual sale, rental real estate subject to long-term net leases, and royalty interests in natural resources probably would not rise to the level of a trade or business.[316] Manufacturing, construction, and other production activities, on the other hand, invariably are trades or businesses.[317] Similarly, the purchase and sale of goods will constitute a trade or business.[318]

Courts have refused to impute the trade or business of a corporation to its shareholders.[319] However, trade or business status is imputed to part-

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[312] *Id.* at 214.

[313] *Id.* at 218.

[314] The issue of whether the taxpayer has a profit motive may be a significant issue for U.S. individual taxpayers. If the activity is found to lack a profit motive then deductions attributable to such an activity are limited to the gross income derived from the activity. These so-called hobby loss rules contain a presumption that an activity is engaged in for profit if the activity generates net income for a certain number of years in a defined testing period. *See generally* I.R.C. § 183 (2006).

[315] Note, however, that gains from the disposition of U.S. real property interests are treated as effectively connected with the conduct of a U.S. trade or business. *See supra* note 263 and accompanying text. Rental real estate is treated, with some exceptions, as a passive activity under the passive activity loss rules. This treatment should not be confused with whether or not the rental real estate operation in question is a trade or business. The passive activity loss rules are designed to prevent losses from certain defined passive activities from offsetting income from other sources. *See generally* I.R.C. § 469 (2006).

[316] *See* Pinchot v. Comm'r., 113 F.2d 718 (2d Cir. 1940); Rev. Rul. 73-522, 1973-2 C.B. 226.

[317] *See, e.g.,* Treas. Reg. § 1.864-4(b), Ex. 1 (2005).

[318] *See, e.g.,* Treas. Reg. § 1.864-4(b), Ex. 2 (2005). The status of an activity as a trade or business has significant domestic implications also. For example, whether an activity is a trade or business or merely an investment impacts the deductibility of expenses incurred in that activity. *See, e.g.*, I.R.C. §§ 162, 212 (2006). The deductibility of interest expense, in particular, is significantly impacted depending on whether the interest is allocable to a trade or business or to an investment activity. *See* I.R.C. § 163(d) (2006) (limiting, for non-corporate taxpayers, the deductibility of interest expense attributable to investment activities to net investment income).

[319] *See* Whipple v. Comm'r., 373 U.S. 193 (1963) (refusing to hold that a taxpayer's majority ownership of several corporations which he actively managed constituted a trade or business). *See also* Neuman De Vegvar v. Comm'r., 28 T.C. 1055 (1957).

ners from partnerships and to beneficiaries from estates and trusts.[320] Whether the operation of a trade or business through agents will be imputed to the principal depends primarily on the nature of the principal-agent relationship. The conduct of business through employees, due to the principal's control over the agents, invariably will result in the imputation of such conduct to the principal. If the business is conducted through non-employee agents, whether the conduct of the agents is imputed to the principal depends on the degree of control available, or in some cases, exercised by the principal over the agents.[321]

In order to trigger the statutory rules discussed above, the foreign taxpayer operating the trade or business must conduct that trade or business in the United States. Typically, where a trade or business is conducted is determinable without difficulty. However, transactions regarding the sale goods have raised issues. Mere on-line or mail order solicitation of sales, without any degree of physical presence in the United States will not constitute the conduct of a trade or business within the United States.[322] Likewise, without any further action in the United States, neither promotional activities alone in the United States nor purchases of goods in the United States for resale elsewhere are likely to constitute the conduct of a trade or business within the United States.[323]

4. Treaty Provisions

The statutory framework for inbound U.S. investment is often varied by treaty. Tax treaties between the United States and foreign govern-

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[320] I.R.C. §§ 875(1)-(2) (2006).

[321] *See, e.g.*, Comm'r. v. Spermacet Whaling & Shipping Co., 281 F.2d 646 (6th Cir. 1960); Di Portanova v. United States, 690 F.2d 169 (Ct. Cl. 1982); Neill v. Comm'r., 46 B.T.A. 197 (1942); Rev. Rul. 58-166, 1958-1 C.B. 324 (1958); Rev. Rul. 55-617, 1955-2 C.B. 774 (1955).

[322] Income from such sales are treated as U.S. source income pursuant to I.R.C. § 861(a)(6). I.R.C. § 864(c)(3) causes such income to be treated as effectively connected to the conduct of a trade or business within the United States. However, treaty provisions generally ameliorate the effect of these provisions. *See infra* notes 327-35 and accompanying text. Analogous issues are raised with respect to whether a state may exercise tax jurisdiction over an out of state person who has no physical presence in the state and merely solicits business in the state. The Supreme Court has ruled that it is constitutionally impermissible for a state to impose a duty to collect use taxes on non-domiciliary taxpayers if such taxpayers' only connection, or nexus, with the state is the sale of goods by mail. *See* Quill Corp. v. North Dakota, 504 U.S. 298 (1992). This case has presented barriers to states attempting to impose taxes on internet sales by merchants with no physical presence in the state.

[323] The income generated from the purchase of inventory in the United States and the sale of that inventory without the United States is treated as foreign source income. I.R.C. § 862(a)(6) (2006). The failure of such purchases to constitute a trade or business will, however, preclude the attraction of other income into the category of effectively connected income. *See supra* notes 290-306 and accompanying text.

ments serve several functions.[324] In general, treaties attempt to prevent double taxation, apportion tax revenues among the signatories, establish enforcement mechanisms to prevent tax evasion, and facilitate commerce among the residents of the signatory nations.[325] The details of particular treaties vary as a result of the negotiations that occur between the parties. However, several common themes are present in most tax treaties. The U.S. Department of the Treasury has issued the United States Model Income Tax Convention of November 15, 2006 (U.S. Model Treaty), whose provisions are a starting point for negotiations with foreign nations.[326] With respect to the taxation of business profits, the U.S. Model Treaty provides that the profits earned by a foreign enterprise are not taxable by the source country "unless the enterprise carries on business . . . through a permanent establishment situated" in the source country.[327] The requirement that the business be conducted through a permanent establishment raises the jurisdictional bar for taxation of U. S. source business profits earned by a foreign taxpayer and reflects a policy preference that tax jurisdiction should lie with the country of domicile rather than the country of source.

The U.S. Model Treaty defines a permanent establishment as "a fixed place of business through which the business of an enterprise is wholly or partly carried on."[328] A permanent establishment includes a place of management, branch, office, factory, workshop, mine, oil and gas wells, and construction sites that last for more than twelve months.[329] The use

[324] As of November 2007 there were fifty-eight income tax treaties, covering sixty-six countries, to which the United States is a party. TREASURY REP. ON EARNINGS STRIPPING, *supra* note 260, at 74.

[325] Double taxation may arise if the signatories assert taxing jurisdiction over the same income by virtue of inconsistent tax bases or if their taxing systems have fundamentally different tax bases. Tax treaties apply to residents of the contracting states. U.S. MODEL INCOME TAX CONVENTION, art. 1(1) (2006) [*hereinafter* U.S. MODEL TREATY], *available at* http://www.treas.gov/press/releases/reports/hp16801.pdf. A resident of a contracting state is defined as any person who, under the laws of that state, is liable to tax therein by reason of domicile, residence, citizenship, place of management, place of incorporation, or similar criteria. Residents do not include persons subject to tax only by reason of income sourced to the state or by reason of profits attributable to a permanent establishment in the state. *Id.* at art. 4(1). Treaty provisions, in an effort to limit treaty shopping, attempt to limit the benefits of the treaties to residents that have a substantial connection to a signatory.

[326] The text of the U.S. Model Treaty is available at http://www.treas.gov/office/tax-policy/library/model006.pdf. The previous U.S. Model Treaty was issued in 1996. The Organization for Economic Cooperation and Development, discussed at *supra* note 106, has also issued a model treaty. *See* ARTICLES OF THE MODEL CONVENTION WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL (2005), *available at* http://www.oecd.org/dataoecd/50/49/35363840.pdf.

[327] U.S. MODEL TREATY, art. 7(1) (2006).

[328] U.S. MODEL TREATY, art. 5(1) (2006).

[329] U.S. MODEL TREATY, arts. 5(2)-(3) (2006).

of facilities solely to store, display, deliver goods, or maintain a stock of goods for such purposes does not constitute a permanent establishment.[330] Likewise, the maintenance of a fixed place of business solely for purchasing goods, collecting information, or engaging in preparatory or auxiliary activities does not constitute a permanent establishment.[331] Moreover, a permanent establishment will not be imputed to a foreign taxpayer from an independent agent.[332] The high threshold created by the U.S. Model Treaty will allow, in contrast to the statutory scheme, the income from the sales of property in the United States from either locations outside the United States or from storage facilities in the United States to avoid U.S. taxation.[333]

In the event a foreign taxpayer operates through a permanent establishment, treaties generally do not operate to attract income to the permanent establishment in the broad way the statutory structure attracts effectively connected income.[334] Moreover, interest income and dividend, unless attributable to the permanent establishment, are exempt and subject to reduced rates of tax, respectively.[335] The U.S. Model Treaty does not prevent the imposition of the branch profits tax. However, such tax is imposed at a reduced rate of five percent for qualified foreign cor-

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[330] U.S. MODEL TREATY, art. 5(4) (2006). Moreover, any combination of the aforementioned activities will not constitute a permanent establishment. *Id.*

[331] *Id.* Moreover, any combination of the aforementioned activities will not constitute a permanent establishment. *Id.*

[332] U.S. MODEL TREATY, art. 5(6) (2006).

[333] I.R.C. § 861 sources income derived from such sales to the United States. *See supra* note 269 and accompanying text.

[334] U.S. MODEL TREATY, art. 7(2) (2006). *See supra* notes 290-306 and accompanying text for a discussion of income attracted to the conduct of a trade or business in the United States. Moreover, for older treaties that may attract income broadly if a permanent establishment in the United States is present, I.R.C. § 894(b) provides relief. Under the U.S. Model Treaty profits attributable to a permanent establishment are determined based on the profits that a separate and distinct enterprise engaged in the same or similar activities under the same or similar circumstances might be expected to make. *Id.* This standard differs from certain statutory and regulatory prescribed methods of allocating items. For example, interest expense and research and experimental expenses are allocated pursuant to methods specified in the regulations. *See supra* note 274 and accompanying text. The Court of Federal Claims has held that a taxpayer could determine its allocation of interest expense under an arms length method pursuant to the treaty provision rather than using the method of allocation provided for in the regulations. *See* National Westminster Bank v. United States, 44 Fed. Cl. 120 (1999).

[335] U.S. MODEL TREATY, arts. 11(1), 10(2) (2006). The exemption for interest in the U.S. Model Treaty is somewhat broader than the statutory exemption for portfolio interest discussed at *supra* notes 276-83 and accompanying text. The tax rate on dividends imposed by the U.S. Model Treaty is 15%. If the dividend recipient owns at least 10% of the voting stock of the payor corporation, the tax rate is reduced to 5%. U.S. MODEL TREATY, art. 10(2) (2006).

porations.[336] Moreover, in certain circumstances, the branch profits tax is not imposed.[337]

There are no special statutory rules that govern the taxation of foreign governments. Instead, a specific statutory exemption exists. Unlike foreign taxpayers in general, for all practical purposes, whether a foreign government engages in commercial activity is a jurisdictional issue.

B. *Taxation of Foreign Governments – Section 892*

Some form of exemption for income earned by foreign governments has been in place almost since the enactment of the income tax. The scope of this exemption, in certain respects, parallels the application of sovereign immunity in general. At its inception, the exemption was extremely broad and, over time, has been narrowed by various exceptions. This section provides a brief history of the exemption and discusses the present statutory exemption in detail.

1. Historical Background

Internal Revenue Code section 892 provides an exemption for certain classes of income earned by a foreign government and international organizations.[338] The predecessor of section 892 was enacted in 1917 and exempted the income of foreign governments received from investments in U.S. stocks, bonds, other domestic securities, and bank deposits.[339] The following year the statute was amended to exempt income from any other source within the United States.[340] Until a major revision was made in 1986, the only statutory change was made in 1945 to exempt international organizations in addition to foreign governments.[341]

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[336] U.S. MODEL TREATY, art. 10(8) (2006); I.R.C. § 884(e)(2) (2006). Qualified corporations are corporations of treaty countries of which at least 50% of the stock is owned by individual residents of the treaty country or individual citizens or residents of the United States. I.R.C. § 884(e)(4)(A) (2006).

[337] If the foreign corporation is chartered in a country whose treaty with the United States exempts dividends from taxation then no branch profits tax is imposed. Treas. Reg. § 1.884-1(g)(1) (2006).

[338] Compensation income of certain foreign government or international organization employees and income derived by foreign central banks from U.S. obligations or bank deposits are also exempted under separate statutory provisions. *See generally* I.R.C. §§ 893, 895 (2006).

[339] An Act to Provide Revenue to Defray War Expenses and for Other Purposes, Pub. L. No. 50, § 1211, 40 Stat. 300, 337 (1917).

[340] An Act to Provide Revenue and for Other Purposes, Pub. L. No. 254, § 213(b)(5), 40 Stat. 1057, 1066 (1918).

[341] An Act to Extend Certain Privileges, Exemptions, and Immunities to International Organizations and to the Officers and Employees Thereof, and for Other Purposes, Pub. L. No. 291, 59 Stat. 669 (1945). The impetus for this legislation was the end of World War II and the birth of the various international organizations in the war's aftermath, particularly the United Nations.

The 1918 amendments were not a model of clarity. The statutory language continued to delineate classes of investment income for exemption and then provided an exemption for income from any other source.[342] A broad interpretation of this language would lead to the conclusion that all income of a foreign government was exempt.[343] An alternative interpretation would only exempt other, non-specified, types of investment income.[344] Proponents of this interpretation argued that if the 1918 amendments exempted all classes of income then the statute's enumeration of specified classes of income was superfluous.[345] Instead, according to this interpretation, the 1918 amendments were intended only to expand the class of investment income that was exempt from tax.[346]

The Internal Revenue Service initially interpreted the statutory language broadly and then narrowed its application considerably – reminiscent of the judicial and statutory movements toward a restrictive theory of sovereign immunity in general.[347] For decades, the Internal Revenue Service interpreted the foreign government exemption to include income from commercial activities.[348] In 1920 the exemption was extended to corporations wholly owned by a foreign government.[349] The Internal Revenue Service did a complete about-face on this issue in 1946 and for approximately thirty years applied differing tests to corporations wholly owned by a foreign government that focused on the entity's commercial activities.[350] Ironically, one of the more liberal tests may have been moti-

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[342] *See* Robert A. Berquist, *U.S. Taxation of Foreign Governments and their Controlled Entities*, 39 TAX NOTES 115, 117 (1988).

[343] Tillinghast, *supra* note 180, at 536.

[344] *Id.*

[345] *Id.*

[346] *See id.* (supporting a narrower interpretation by analogy to the restrictive theory of foreign immunity in the FSIA). Support for a narrow interpretation of a statutory provision enacted in 1918 by reference to a statute enacted in 1976 is questionable.

[347] The Internal Revenue Service was formerly named the Bureau of Internal Revenue. Although the name "Internal Revenue Service" appeared on tax forms from time to time the official name of the agency was not changed until 1953. *See* T.D. 6038, 1953-2 C.B. 443. For sake of simplicity all references to the Internal Revenue Service include references to the Bureau of Internal Revenue.

[348] O.D. 182, 1 C.B. 90 (1919) (ruling that income from raw material sales was exempt); O.D. 515, 2 C.B. 96 (1920) (ruling that income from commercial shipping operations was exempt). These ruling were declared obsolete in 1968. *See* Rev. Rul. 68-575, 1968-2 C.B. 603. *See also* I.T. 4082, 1952-1 C.B. 69 (ruling that the income from the operation of a railroad was exempt). This ruling was declared obsolete in 1970. *See* Rev. Rul. 70-293, 1970-1 C.B. 282.

[349] O.D. 628, 3 C.B. 124 (1920). This ruling was revoked in 1946. *See infra* note 350.

[350] In 1946 the I.R.S., in revoking the Australian Central Bank's tax exemption, ruled that the statutory exemption cannot be extended to a corporation wholly owned by a foreign government. I.T. 3789, 1946-1 C.B. 100, *revoking* O.D. 628, 3 C.B. 124

vated to attract funds that were being amassed by OPEC countries during the oil shocks of the 1970s.[351]

In 1980, final regulations were issued that denied the tax exemption for income from any commercial activity in the United States, whether derived directly by a foreign government or by a controlled entity of that government.[352] Generally, for this purpose, an activity that did not constitute the conduct of a trade or business in the United States under Internal Revenue Code section 864 was not a commercial activity.[353] Moreover, the regulations provided that investments in stock and securities, mere purchases of goods, amateur athletic performances and certain cultural events, and net leases of real property were not commercial activities.[354] These regulations did not distinguish between a foreign government *per se* and an entity controlled by the government.[355] The Tax Reform Act of 1986 amended the statute to its present, significantly narrowed, form.[356]

2. Section 892

Section 892 enumerates specific classes of income that are exempt from taxation and defines the entities that are eligible for the exemption.[357] In

(1920). The Tax Court held that a corporation created by a public statute, with no private owners, that performs governmental functions and is publicly funded is a foreign government for tax exemption purposes. Vial v. Comm'r., 15 T.C. 403 (1950). *Vial* dealt with a statutory tax exemption for employees of foreign governments. The I.R.S. acquiesced in this decision. 1952-1 C.B. 4. In 1966 the I.R.S. ruled that a corporation wholly owned by a foreign government was exempt if its purposes, functions, and activities were not those which, in the United States, are customarily carried on by a for profit private enterprise. Rev. Rul. 66-73, 1966-1 C.B. 174. In 1975 the I.R.S. revoked this ruling and developed a *de minimis* commercial activity test that would exempt corporations that earned passive investment income and engaged in no more than *de minimis* commercial activity in the United States. Rev. Rul. 75-298, 1975-2 C.B. 290.

[351] The 1975 ruling, discussed at *supra* note 350, was motivated in part by this factor. *See* Tillinghast, *supra* note 180, at 518.

[352] Treas. Reg. § 1.892-1(a)(3)(i) (1981). This regulation was part of an extensive set of regulations issued under I.R.C. § 892. *See* 45 Fed. Reg. 4882 (1980). For a detailed analysis of these regulations, see Berquist, *supra* note 342.

[353] Treas. Reg. § 1.892-1(c)(2)(iv) (1981).

[354] *See generally* Treas. Reg. § 1.892-1(c)(2) (1981).

[355] Treas. Reg. § 1.892-1(b) (1981).

[356] Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986). Minor technical corrections to the statute were made by the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3730 (1988).

[357] The tax exempt status of the income also benefits U.S. issuers. U.S. issuers have devised complex equity flavored instruments that allow the issuer to treat a significant portion of the investment returns paid to the foreign government holder as deductible interest expense. These transactions were given I.R.S. imprimatur by Rev. Rul. 2003-97, 2003-2 C.B. 380. This ruling involved the issuance of units comprising of

both respects, the 1986 changes narrowed the eligibility for exemption. With respect to the types of income that are exempt, the statute limits its application to traditional passive investment income.[358] Income from stocks, bonds, other domestic securities, financial instruments held in the execution of governmental financial or monetary policy,[359] and interest on U.S. bank deposits are exempt.[360] "Other securities," for this purpose, includes notes, annuities, mortgages, bankers acceptances, and commodity forwards, futures, and options contracts if the commodities in ques-

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notes and equity forward contracts. If certain requirements are met the notes and the forward contracts can be separated by the issuer and the interest on the notes deducted by the issuer. A tax exempt holder would be indifferent to the classification made by the issuer. Citigroup and Morgan Stanley used variations of this technique in structuring their deals with sovereign wealth funds. *See* Stewart, *supra* note 240.

[358] The exemption for international organizations is broader, covering similar passive types of income and income "from any other source within the United States." I.R.C. § 892(b) (2006). An international organization is a public international organization "entitled to enjoy the privileges, exemptions, and immunities under the International Organizations Immunity Act." I.R.C. § 7701(a)(18) (2006). Such organizations are comprised of foreign governments, have the United States as a participant, and must be designated as such by the President. The United Nations, the World Bank, and the International Monetary Fund are examples of such organizations. *See* BRETT R. DICK, U.S. INCOME TAXATION OF FOREIGN GOVERNMENTS, INTERNATIONAL ORGANIZATIONS AND THEIR EMPLOYEES A19-A20 (2005).

[359] Temp. Treas. Reg. § 1.892-4T(c)(1)(i) (1988). It would appear that this language would subject derivatives and other financial arrangements that are not stocks, bonds, or securities to the condition that they be held in the execution of some official government function. Generally, such income would not be U.S. sourced, so the effect of this provision is to make it more difficult to avoid the controlled commercial activity label. It is not clear why, as a policy matter, such instruments should be subject to conditions not applicable to more traditional investment securities. Whether a financial instrument is held to effectuate financial or monetary policy is determined based on the primary purpose of holding the instrument. Temp. Treas. Reg. § 1.892-3T(a)(5)(i) (1988). *See infra* note 442 and accompanying text for a discussion of derivatives.

[360] I.R.C. § 892(a)(1)-(2) (2006). A financial instrument includes forward, futures, and options contracts, derivatives, and precious metals, such as gold. Temp. Treas. Reg. § 1.892-3T(a)(4) (1988). Income from U.S. real property interests is not exempt. However, the regulations appear to exempt income and gains derived from stock in a U.S. real property holding corporation that is not controlled by the foreign government. *See* Temp. Treas. Reg. § 1.892-3T(b), Ex. 1 (1988). Whether I.R.C. § 892(a) provides an exemption for capital gain distributions from a real estate investment trust is unclear. The I.R.S. has announced its position that real estate investment trust distributions that relate to the underlying sale of U.S. real property interests are not exempt. *See* Notice 2007-55, 2007-27 I.R.B. 13. A discussion of the taxation of real estate investment trusts and the interplay of such vehicles with I.R.C. § 892 is beyond the scope of this work. For a detailed analysis of this issue *see* Dick, *supra* note 358, at A11-A14.

tions are customarily traded on an organized exchange.[361] Interests in publicly traded partnerships are also other securities for this purpose.[362] However, interests in other partnerships are not treated as other securities. Under general Subchapter K principles, the income derived from such interests will retain the same character as it had in the hands of the partnership.[363] Consequently, the partner's allocable share of income from an investment partnership will, assuming it falls within the enumerated statutory classes, be exempt.[364] However, any gain from the sale of the partnership interest will not be exempt.[365]

Income from the aforementioned sources will not, however, be exempt from tax if it is either "derived from the conduct of any commercial activity[, whether in the United States or not,] received by a controlled commercial entity, or derived from the disposition of any interest in a controlled commercial entity."[366] A controlled commercial entity is "any entity engaged in commercial activities whether or not in the United States [in which the foreign government] holds directly or indirectly, any interest which . . . is fifty percent or more of the total of such interests in the entity or [in which the foreign government] holds any other interest that provides [it] with effective control of such entity."[367]

The regulations also contain several rules of attribution which will impute the commercial activity of an entity onto another entity. The commercial activities of a parent corporation and partnership "are attrib-

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361 Temp. Treas. Reg. § 1.892-3T(a)(3) (1988).

362 *Id.* Publicly traded partnerships, with certain exceptions, are taxed as corporations. *See generally* I.R.C. § 7704 (2006).

363 *See generally* I.R.C. §§ 702, 703 (2006); Treas. Reg. § 1.702-1(a)(8)(ii) (2005).

364 *See* I.R.S. Priv. Ltr. Rul. 96-43-031 (July 29, 1996). Note that if the partnership engages in commercial activity then such income is not exempt. *See infra* note 368 and accompanying text.

365 *Id.* This result is questionable and is not expressly called for by the statutory language. As a consequence of this rule the income from the sale of an interest in an investment partnership would be taxable but income from the sale, by the partnership, of the underlying investment assets, even when followed by a liquidating distribution from the partnership, would be, for all practical purposes, exempt. In certain circumstances, liquidating distributions from partnerships could generate capital gain. This gain is deemed to arise from the sale or exchange of a capital asset – the partnership interest that was liquidated. *See* I.R.C. § 741 (2006). In such cases, I.R.C. § 892 would not serve to exempt this gain. However, the gain from the underlying sale of assets by the partnership that is passed through to the partners is exempt.

366 I.R.C. § 892(a)(2)(A) (2006).

367 I.R.C. § 892(a)(2)(B) (2006). "The regulations provide that "effective practical control may be achieved through [ownership of a sufficiently large minority interest] or through [a combination of minority ownership and] creditor, contractual, or regulatory relationships." For example, a significant creditor with a minority equity stake may have effective practical control over an enterprise. Temp. Treas. Reg. § 1.892-5T(c)(2) (2002).

uted to its subsidiary and partners, respectively."[368] However, the activities of a subsidiary or brother corporation are not attributed to its parent and sister corporation, respectively.[369] These provisions are extremely important for parent corporations that do not engage in any commercial activity and for structuring operations in situations where commercial activities will be undertaken. Commercial activities and investment activities should be isolated in separate brother-sister subsidiaries. This structure will prevent the commercial activities of one subsidiary from tainting the income of the either the parent corporation or the other subsidiaries.[370]

Any interest owned "by an integral part or controlled entity of the foreign sovereign [is] deemed owned by the foreign sovereign."[371] The regulations also provide that if a foreign government has effective practical control over an entity such entity will be deemed a controlled entity.[372] Effective practical control can be attained, for example, through a minority ownership stake combined with creditor rights, control of strategic supplies, or contractual or regulatory relationships.[373]

Eliminating the tax exemption for income derived from a commercial activity reflected a Congressional desire for tax neutrality between nationalized entities and private enterprise.[374] Moreover, subjecting to tax both the income received from a controlled commercial entity or from the disposition of an interest in such entity stemmed from a belief that such income, although passive in form, is, in substance, a return on the commercial investments made by the controlled entity.[375] Neither the statute nor the regulations thereunder discuss how the determination of whether income is derived from a commercial activity is to be made. Consequently, it would appear the rules discussed previously for deter-

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[368] Temp. Treas. Reg. § 1.892-5T(d)(2)(ii), (3) (2002).

[369] Temp. Treas. Reg. § 1.892-5T(d)(1), (2)(i) (2002).

[370] The dividends the parent receives from the subsidiary that does engage in commercial activity will not be exempt, but the dividends paid by the parent to its shareholders will be exempt provided that less than 25% of the parent corporation's gross income for the prior three years was effectively connected with the conduct of a U.S. trade or business. In such case the parent dividend is not U.S. source income. I.R.C. § 861(a)(2)(B) (2006). A central bank or pension trust could be deemed a controlled entity under certain circumstances. *See* Temp. Treas. Reg. §§ 1.892-5T(b)(2)-(3) (2002).

[371] Temp. Treas. Reg. § 1.892-5T(c)(1) (2002).

[372] Temp. Treas. Reg. § 1.892-5T(a) (2002).

[373] *Id.* at (c)(2).

[374] S. Rep. No. 99-313, at 416 (1986).

[375] *Id.* If a controlled entity engages in any commercial activity, all income received by or from such entity or received upon disposition of an interest in such entity is taxable. The tainting of all income presents significant issues for pension arrangements and may impact whether pension funds are held in separate trust or other entity or merely held as a separate fund. *See* Dick, *supra* note 358, at A-6.

mining whether income is derived from the active conduct of a trade or business in the U.S. should apply by analogy.[376]

The regulations define the term "commercial activities" as "all activities (whether conducted within or outside the United States) which are ordinarily conducted by the taxpayer or by other persons with a view towards the current or future production of income or gain."[377] The regulations also state that an activity may be deemed commercial "even if such activity does not constitute the conduct of a trade or business in the United States. . . ."[378] It is not entirely clear what the regulations mean by this statement. It could be interpreted to mean that activities that would constitute a trade or business conducted outside the United States are commercial activities. However, this interpretation would render the earlier parenthetical language in the regulations – within or outside the United States – superfluous.

Alternatively, the regulation could be interpreted to expand the definition of commercial activities beyond those activities that would constitute a trade or business.[379] This interpretation is plausible for three reasons. First, Congress chose the term "commercial activity" for use in the statute when it could have used the term "trade or business" as it did in the statutory provisions governing foreign taxpayers in general. A trade or business is necessarily a commercial activity, but a commercial activity does not necessarily rise to the level of a trade or business – a fact that, one would assume, would have been known to Congress.[380] Secondly, prior regulations expressly defined commercial activities with reference to the conduct of a trade or business.[381] The current regulations do quite the opposite. Finally, the conduct of a trade or business in the United States is not a threshold jurisdictional issue for the imposition of tax on foreign taxpayers in general. Instead, the conduct of such trade or business merely changes the tax scheme imposed on foreign taxpayers or, in limited circumstances, draws in income that would be otherwise exempt. However, with respect to foreign governments, the commercial activity exception is, for practical purposes, a threshold issue. Consequently, the fact that income from a range of activity that is broader than a trade or

[376] *See supra* notes 290-306 and accompanying text.

[377] Temp. Treas. Reg. § 1.892-4T(b) (1988).

[378] *Id.* Note that this definition also applies to determine whether an entity is a controlled commercial entity. Temp. Treas. Reg. § 1.892-4T(a) (1988).

[379] *See supra* notes 308-23 and accompanying text for a discussion of activities that constitute the conduct of a trade or business. At least one commentator believes that this interpretation goes too far in expanding the definition of commercial activity. *See* Dick, *supra* note 358, at A-16.

[380] Trade or business status requires activities performed with some regularity. *See supra* note 228 and accompanying text.

[381] *See supra* note 353 and accompanying text.

business falls outside the purview of section 892 seems quite unremarkable.

As a practical matter, this issue should not pose much difficulty. As discussed subsequently, the regulations eliminate the most common types of activities that would not be trade or business activities from being labeled "commercial activities" under the statute.[382] Moreover, in many cases, income from commercial activities that do not comprise a trade or business would not be sourced in the United States and, therefore, would not be subject to tax.[383]

The regulations provide a list of activities that are not commercial in nature. Investments in stocks, bonds, and other securities, loans, investments in financial instruments held in the execution of governmental financial or monetary policy, the holding of net leases on real property or land which is not producing income, and the holding of bank deposits are not commercial activities.[384] Moreover, such activities will not be tainted by income from unrelated activities nor will they morph into commercial activities solely by reason of the volume of such transactions.[385] The trading of stock, securities, or commodities for a foreign government's own account does not constitute a commercial activity regardless of whether such trading is effectuated through employees, brokers, or other independent agents.[386] In addition, unless the trading activities are undertaken as

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[382] *See infra* notes 384-93 and accompanying text.

[383] The commercial activity exception in the FSIA is quite broad. *See supra* notes 246-58 and accompanying text. Drawing inferences from the FSIA, however, may not be appropriate. The FSIA is designed to limit a foreign state's immunity to claims made by private actors. Much of the FSIA's focus falls on commercial activities of a tortuous nature and not income earning activities – wrongful termination claims, for example.

[384] Temp. Treas. Reg. § 1.892-4T(c)(1)(i) (1988). However, investments made in a banking, financing, or similar business are commercial activities whether or not the income from such investments is deemed effectively connected to the active conduct of a trade or business in the United States. Temp. Treas. Reg. § 1.892-4T(c)(1)(iii) (1988). Consequently, income derived from a banking or similar business is considered derived from a commercial activity whether or not it is attributable to an office or other fixed place of business in the United States. A banking, financing, or similar business is defined as the carrying on of at least one of a number of specified activities, such as taking deposits and making loans with the general public or on a regular basis. *See* Treas. Reg. § 1.864-4(c)(5)(i) (2005). The I.R.S. has, in a private ruling, determined that making loans to customers to finance exports did not constitute a banking, financing, or similar business. *See* I.R.S. Priv. Ltr. Rul. 92-35-061 (June 5, 1992).

[385] Temp. Treas. Reg. § 1.892-4T(c)(1)(i) (1988).

[386] *Id.* at (ii).

a dealer, such activities are not commercial activities regardless of whether such activities constitute or trade or business.[387]

"Performances and exhibitions . . . of amateur athletic events and events devoted to the promotion of the arts by cultural organizations are not commercial activities."[388] Although income derived from such activities is not statutorily exempt, this provision will prevent an entity from being deemed a controlled commercial entity solely because of these activities.[389] "Activities that are not customarily . . . carried on by a private enterprise for profit are also not commercial activities."[390] Activities that constitute governmental functions, determined under U.S. standards, are not commercial activities.[391] Governmental functions include activities performed for the general welfare or that "relate to the administration of some phase of government."[392] The regulations specify, by way of example, that the operation of libraries, toll bridges, and postal services are governmental functions.[393]

Section 892 applies to foreign governments, a term left undefined by the statute. The regulations treat a foreign government as a part of a foreign sovereign and limit which parts of the sovereign will qualify. The regulations define a foreign government as "only the integral parts or controlled entities of a foreign sovereign."[394]

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[387] A dealer is defined as "a merchant of stock or securities [who is] regularly engaged . . . in [the buying of stock and] securities and selling them to customers." *See* Treas. Reg. § 1.864-2(c)(2)(iv)(a) (1975).

[388] Temp. Treas. Reg. § 1.892-4T(c)(2) (1988).

[389] I.R.C. § 892 exempts specific classes of income. Income from the aforementioned activities is not enumerated in the statute. *See supra* notes 358-66 and accompanying text.

[390] I.R.C. § 892 exempts specific classes of income. Income from the aforementioned activities is not enumerated in the statute. *See supra* notes 358-66 and accompanying text.

[391] Temp. Treas. Reg. § 1.892-4T(c)(4) (1988).

[392] *Id.*

[393] *Id.*

[394] Temp. Treas. Reg. § 892-2T(a)(1) (1988). The statute does not define the term "foreign government." One court noted that the regulations define the term expansively. The court looked to the ordinary meaning of the term "government" and found that a government is "the organization, machinery, or agency through which a political unit exercises authority and performs functions and which is usually classified according to the distribution of power within it." Qantas Airways Ltd. v. United States, 62. F.3d 385, 388 (Fed. Cir. 1995), *rev'g.* 30 Fed. Cl. 851 (1994) (*quoting* WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 982 (1971)). The court then held that the regulation that carved out controlled entities from the definition of foreign government, to the extent of their commercial activities, provided a reasonable interpretation of the statute. *Id.* at 389. This case was decided under the statute prior to its 1986 amendment and under previous regulations. The current regulations include all controlled entities within the definition of a foreign

Sovereign wealth funds qualify as a foreign government under the regulatory definition without controversy. An "integral part" of a foreign sovereign is broadly defined as "any person, body of persons, organization, agency, bureau, fund, instrumentality, or other body, however designated, that constitutes a governing authority of a foreign country."[395] In addition, the "earnings of the governing authority must be credited to its own account or to other accounts of the foreign sovereign," and no portion of the earnings of such governing authority may inure to the benefit of any private person.[396] As noted above, many sovereign wealth funds have turned over a portion of their investment management functions to third parties.[397] It is common for compensation arrangements with these third parties to contain incentive-based provisions that determine a significant portion of the compensation as a percentage of the profits earned from the funds under management.[398] Arguably, provided that the compensation arrangement in question is within industry norms, such compensation schemes should not run afoul of the prohibition against private inurement. However, the regulations' ambiguity has led the New York State Bar Association to propose that this result be made express.[399]

The regulations create a presumption against private inurement of income if the persons benefiting by the income are the intended beneficiaries of a governmental program the activities of which constitute governmental functions as defined in Treasury Regulation § 1. 892-

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government but remove the tax exemption for controlled commercial entities. *See supra* note 366 and accompanying text.

[395] Temp. Treas. Reg. § 892-2T(a)(2) (1988).

[396] *Id.*

[397] *See supra* note 53 and accompanying text.

[398] The fund manager, usually a limited partnership or limited liability company, receives an annual management fee based on a percentage of the fund's capital in exchange for managing the fund. This fee is typically between one and three percent. Dow Jones & Co. estimates that approximately 57% of private equity managers charge a 2% fee and approximately 31% charge between 1.5% and 2%. Tennille Tracy, *It's the Fees, Not the Profits,* WALL ST. J., Sept 13, 2007, at C1, C2 (*citing* to the PRIVATE EQUITY ANALYSTS TERMS AND CONDITIONS REPORT (Dow Jones 2007)). In addition, the fund manager receives a share of future profits generated by the fund, commonly 20%. This latter element of compensation – the so-called "carried interest" – has generated significant controversy in tax circles. Funds are structured so that the "carried interest" represents a distributive share of partnership profits. Accordingly, this compensation is often subject to tax at very favorable capital gain rates. Tax exempt investors are generally indifferent about the classification of the carried interest. *See generally* STAFF OF THE J. COMM ON TAXATION, PRESENT LAW AND ANALYSIS RELATING TO TAX TREATMENT OF PARTNERSHIP CARRIED INTERESTS 37 (Comm. Print 2007), *available at* http://www.house.gov/jct//x-41-07.pdf.

[399] N.Y. BAR ASSOC. TAX SECT., REPORT ON THE TAX EXEMPTION FOR FOREIGN SOVEREIGNS UNDER SECTION 892 OF THE INTERNAL REVENUE CODE, 36-37 (2008), *available at* http://www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1157rpt.pdf [hereinafter N.Y. STATE BAR ASSOC. REPORT].

4T(c)(4).[400] Thus, the fact that income is used to provide housing, food assistance, or medical care to individuals under a government program will not cause the income to be considered inuring to the benefit of a private individual.[401] However, the use of a governmental entity as a conduit for personal investment or the diversion of income from its intended purpose through the exercise of influence or control will constitute private inurement.[402]

An individual acting in a private or personal capacity is not an integral part of the foreign sovereign.[403] Determining whether an individual is acting in a private or personal capacity rather than in an official capacity can prove vexing. Foreign economic, legal, and political systems may be organized and operated in ways that are significantly different than that to which we in the United States are accustomed. Moreover, in many countries, particularly many oil-rich Middle-Eastern countries, the distinction between the activities of ruling class individuals and the government may not be so clear. The I.R.S. has had trouble in the past with this issue and will probably continue to do so.[404]

In addition to integral parts of a foreign sovereign, a foreign government also includes a controlled entity of a foreign sovereign. A "controlled entity" is an entity that is either separate in form from a foreign sovereign or otherwise constitutes a separate juridical entity.[405] In addition, the entity must meet four requirements.[406] First, the entity must be wholly owned and controlled by the foreign sovereign, either directly or

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[400] Temp. Treas. Reg. § 892-2T(b) (1988). *See supra* notes 391-93 and accompanying text for a discussion of Temp. Treas. Reg. § 1.892-4T(c)(4) (1988).

[401] The I.R.S. ruled that three trusts established by a country's Parliament whose proceeds were to be used to provide housing for residents of the country, to restore and rehabilitate natural resource rich lands that were depleted, and to provide for the general welfare of the public and fund government operations were integral parts of the foreign sovereign. However, income of a fourth trust, earmarked for landowners whose properties had been nationalized, was not exempt because such income inured to the benefit of private persons. *See* I.R.S. Priv. Ltr. Rul. 91-20-031 (Feb. 22, 1991).

[402] Temp. Treas. Reg. § 892-2T(b)(1), (2) (1988).

[403] *Id.* The determination of whether an individual is acting in a private or personal capacity is based on all the facts and circumstances. *Id.*

[404] *See* Dick, *supra* note 358, at A-3, A-4 (discussing various, often contradictory rulings).

[405] Temp. Treas. Reg. § 1.892-2T(b) (2000).

[406] Temp. Treas. Reg. § 1.892-2T(a)(3) (1988). Prior regulations issued under the statute before the 1986 amendments included controlled entities in the definition of a foreign government only to the extent that such entities did not engage in commercial activities in the United States. *See* Treas. Reg. § 1.892-1(b)(1) (1982). Under the prior regulations a controlled commercial corporation's income would be subject to tax only to the extent such income was commercial. *See supra* note 352 and accompanying text; Qantas Airways Ltd. v. United States, 62 F.3d 385, 389 (Fed. Cir. 1995). The current regulations provide no exemption for the income of a controlled commercial corporation. *See supra* note 366 and accompanying text.

indirectly through controlled entities.[407] The tax regulations' allowance of indirect ownership through tiered entities to count toward ownership differs from the approach taken by the Supreme Court in interpreting the application of FSIA.[408] Second, the entity must be organized "under the laws of the foreign sovereign."[409] Third, "the net earnings of the entity [must be] credited to its own account or other accounts of the foreign sovereign [and] no portion of its income [can inure] to the benefit of any private person."[410] Finally, upon dissolution, the entity's assets must vest in the foreign sovereign.[411] The regulations treat any business entity that is wholly owned by a foreign government or integral part of a foreign government as a corporation.[412] Consequently, wholly owned entities that would be disregarded under general tax rules, such as limited liability

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[407] Temp. Treas. Reg. § 1.892-2T(a)(3)(i) (1988). A partnership or any other entity owned and controlled by more than one foreign sovereign is not a controlled entity for this purpose. Temp. Treas. Reg. § 1.982-2T(a)(3) (1988). Therefore, such entities, to qualify under I.R.C. § 892, must meet the definition of an international organization, discussed at *supra* note 358, or be a transnational entity, as defined in the regulations. *See infra* notes 424-27 and accompanying text.

[408] For FSIA purposes the majority ownership requirement must be held directly by the sovereign state and not indirectly through tiered structures. *See* Dole Food Co. v. Patrickson, 538 U.S. 468 (2003). *See also supra* note 241 and accompanying text.

[409] Temp. Treas. Reg. § 1.892-2T(a)(3)(ii) (1988).

[410] Temp. Treas. Reg. § 1.892-2T(a)(3)(iii) (1988). Whether income inures to the benefit of a private person is determined under the same rules applicable for determining whether a governing authority is an integral part of a foreign sovereign. *See supra* notes 395-404 and accompanying text.

[411] Temp. Treas. Reg. § 1.892-2T(a)(3)(iv) (1988). A central bank can qualify as a controlled entity. Moreover, it can also qualify as a controlled commercial entity if it engages in commercial activities within the United States. Temp. Treas. Reg. § 1.892-5T(b)(2) (2002). If a central bank does not qualify as a controlled entity certain classes of its income may, nonetheless, be exempt under I.R.C. § 895. A central bank may be owned by various countries which would disqualify it from being classified as controlled entity. In general, income from bank deposits, U.S. government obligations, and obligations of U.S. agencies or instrumentalities will be exempt from tax. Classification as a controlled entity will entitle the central bank to qualify for the broader exemption afforded by I.R.C. § 892 and qualify its employees to obtain the benefits of a tax exemption for their compensation. *See* I.R.C. § 893(a) (2006) (applying the exemption only to employees of a foreign government or international organization).

[412] Treas. Reg. § 301.7701-2(b)(6) (2006). This regulation was originally adopted with state governments in mind and was amended in 2002 to include entities owned by foreign governments. In effect, this rule serves to classify more entities as controlled commercial entities and thereby potentially taint all the income of the entity. *See* N.Y. STATE BAR ASSOC. REPORT, *supra* note 399, at 31-33.

companies, would be treated as corporations when owned by a foreign sovereign.[413]

A separately organized pension trust is a controlled entity if the trust is established exclusively to provide retirement, disability, or death benefits for current and former employees of the foreign government or non-governmental employees who perform or have performed services for the foreign government.[414] Moreover, the pension funds must be managed by employees of the foreign government or by persons appointed by the foreign government.[415]

The distinction between an integral part of a foreign sovereign and a controlled entity is not entirely clear. Under the regulations a controlled entity may be either an entity separate in form from the foreign sovereign or an otherwise separate juridical entity.[416] The term "an entity separate in form" begs the question of whether it must be a legally distinct person.[417] One would assume that the term "controlled entity" would be defined consistently with the term "controlled commercial entity," but it is not. A controlled commercial entity is defined as "any entity" that engages in commercial activities the control of which is defined in terms of "interests" in the entity.[418] This language appears to imply a separate legal entity or person.

The definition of controlled entity, however, merely requires that it be wholly owned, without reference to any "interests" in the entity.[419] As one commentator has noted, distinguishing between an integral part of a foreign sovereign and a controlled entity "is further complicated in the foreign context because many foreign governmental agencies are different from virtually anything in the U.S. experience."[420] The distinction can be important. If a foreign government's operation is considered a

[413] Single member limited liability companies and other non-partnership entities owned by a single person that are not otherwise classified as corporations are disregarded for federal income tax purposes unless an election is made to treat such entities as corporations. *See* Treas. Reg. § 301.7701-3(b)(1), (2) (2006).

[414] Temp. Treas. Reg. §§ 1.892-2T(c)(1)(i), (iii) (1988).

[415] Temp. Treas. Reg. §§ 1.892-2T(c)(1)(ii) (1988). The income of the pension trust must be used to satisfy the foreign government's obligation to plan participants and cannot inure to the benefit of a private person. Temp. Treas. Reg. §§ 1.892-2T(c)(1)(iv) (1988).

[416] Temp. Treas. Reg. § 1.892-2T(b) (2000).

[417] FSIA, for purposes of determining whether an entity is an agency or instrumentality of a foreign state, expressly requires such entity to be a separate legal person. *See supra* note 241 and accompanying text. Whether an entity is a separate legal person depends on whether, based on its legal characteristics, the entity can function legally independent of the state. *See* Hyatt Corp. v. Stanton, 945 F. Supp. 675, 683-84 (S.D.N.Y. 1996).

[418] *See supra* note 367 and accompanying text.

[419] *See supra* note 407 and accompanying text.

[420] Dick, *supra* note 358, at A-5.

controlled commercial entity then the commercial taint permeates all its operations.[421] If the operation in question is merely a part of a broader governmental function then the commercial taint is limited to the income derived from the commercial operation.[422] The difficulty in making this distinction, coupled with the significant consequences associated with rather formalistic niceties, has led some commentators to propose the treatment of controlled commercial entities in a manner comparable to the treatment afforded the activities conducted directly by foreign government.[423]

The rules that apply to foreign sovereigns also apply to political subdivisions of a foreign sovereign and to transnational entities.[424] A transnational entity is an "organization created by more than one foreign sovereign that has broad powers over external and domestic affairs of all participating countries that go beyond" economic issues.[425] The Internal Revenue Service ruled that the European Communities constituted a foreign government but that organizations established to foster economic, financial, and technical cooperation did not.[426] Classification as a transnational entity allows entities that do not qualify as international organizations, perhaps because the United States is not a participant, to obtain the benefits of section 892.[427]

The definition of a foreign government for purposes of section 892 and the definition of a foreign state for purposes of FSIA are closely related but not identical. In certain respects the section 892 definition of a for-

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[421] *See supra* note 366 and accompanying text. *See also* Rev. Rul. 87-6, 1987-1 C.B. 179 (ruling that none of the income of a foreign government controlled airline was exempt).

[422] *See supra* note 370 and accompanying text. *See also* Rev. Rul. 87-6, 1987-1 C.B. 179 (ruling that only the commercial income of a Ministry of Tourism was subject to tax).

[423] *See* N.Y. STATE BAR ASSOC. REPORT, *supra* note 399, at 33-35. One consequence of this rule is the use of "blocker" entities to quarantine the commercial taint within that entity and avoid the commercial taint from infecting other entities. *See* Peter Guang Chen, *Investments by Sovereign Wealth Funds in the United States: Tax Issues and Challenges*, 37 TAX MGM'T INT'L J. 388 (2008), *available at* http://www.deloitte.com/dtt/cda/doc/content/us_fsi_Im_BNATaxMgtIntlJournalSec892ArticleChenJuly%202008.pdf.

[424] Consequently, integral parts or controlled entities of political subdivisions or transnational entities will qualify as foreign governments. In most cases whether an entity is a political subdivision is readily apparent. However, because of differences in governmental structures, whether an entity is a political subdivision is not always clear. *See* Dick, *supra* note 358, at A-7.

[425] Temp. Treas. Reg. § 1.892-2T(d) (2000).

[426] *See* Rev. Rul. 68-309, 1968-1 C.B. 338; Rev. Rul. 77-41, 1977-1 C.B. 226. The European Union would appear to qualify as a transnational entity.

[427] International organizations obtain their tax exemption through a separate statutory provision. *See supra* note 358 for a discussion of international organizations.

eign government is both broader and narrower than the definition of a foreign state under FSIA. For example, under FSIA a corporation that is majority owned by a foreign state qualifies as a foreign state.[428] Under section 892, only wholly owned entities qualify as a foreign government.[429] On the other hand, FSIA has been interpreted to require direct majority ownership while section 892 expressly provides for indirect ownership of controlled entities.[430] Because both FSIA and section 892 serve to exempt foreign governments or foreign states from burdens imposed on other parties, one would expect that the persons entitled to the exemptions are closely related. For the most part, they are.

V. An Argument for the Status Quo

In broad terms, the possibility of subjecting sovereign wealth funds to taxation can be supported on neutrality grounds. The tax exemption enjoyed by these funds provides them with a competitive advantage in comparison to private enterprise. Also underpinning calls to end their tax exemption is a distrust of such funds and a desire to end the tax inducements for such funds to invest in the United States. However, whatever benefits may attend to ending the tax exemption for these funds must be weighed against the cost such a change will impose on the United States. The benefits of such a change would be marginal and would be outweighed by the damage such a change would cause.

Note that the following discussion examines the prospect of ending the tax exemption for sovereign wealth funds under the existing federal income tax architecture. Proposals for altering the system of taxing foreign investors in general are beyond the scope of this work. Whether the U.S. tax system should be source-based or residence-based and whether the tax system can be made to more effectually allow foreign profits to be repatriated to the United States are important questions. Systemic reform would probably change the analysis of the tax status of foreign governments in general and sovereign wealth funds specifically. These questions, however, are best left to others.[431]

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[428] *See supra* note 241 and accompanying text.

[429] *See supra* note 407 and accompanying text. For purposes of determining whether an entity is a controlled commercial entity, only majority ownership or effective practical is required. This lower threshold will cause income received from enterprises in which the foreign government owns a majority interest or over which the foreign government exercises effective practical control to be taxable. *See supra* note 367 and accompanying text.

[430] *See supra* notes 241 and 407 and accompanying text.

[431] An extensive body of literature exists on these subjects, which I will not attempt to list. For an excellent discussion of some of the issues presented by our system of international taxation, see William McLure & Herman Bouma, *The Taxation of Federal Income from 1909 to 1989: How a Tilted Playing Field Developed,* 43 Tax Notes 1379 (1989); Michael J. Graetz, *Taxing International Income:*

The term "tax neutrality" is multi-faceted. It could refer to a tax system that conforms to a pre-defined ideal. The term is also occasionally used to refer to a tax system that does not provide incentives for taxpayers to choose one investment or activity over another. A closely related use of the term is a tax system that does not create a bias over the form of enterprise that a taxpayer chooses to conduct activities.[432] It is the latter use of term that is invoked in the discussion of sovereign wealth funds' tax exemption. With respect to the types of activities undertaken by foreign investors the tax code is not neutral and the revocation of the tax exemption for sovereign wealth funds would not impact this form of neutrality. Significant differences will continue to exist in the taxation of certain types of income – for example, business income, interest, and dividends – in the event sovereign wealth funds lose their tax exemption.[433]

To be sure, sovereign wealth funds, due to the application of I.R.C. section 892, have a competitive advantage in the investment marketplace when compared to foreign-based private enterprise.[434] Moreover, sovereign participants in the marketplace may enjoy other advantages over their private counterparts. Better access to information, lower cost structures due to sovereign immunity, and gilded credit ratings are examples of the advantages of sovereignty. In the case of the tax advantage enjoyed by sovereign wealth funds, however, there is less than meets the eye.

As discussed above, sovereign wealth funds enjoy no tax advantage over private enterprise with respect to income generated from commercial activities.[435] Such income will be taxed to the funds in the same man-

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Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies, 54 TAX L. REV. 261 (2001).

[432] For a detailed discussion of the concept, see Douglas A. Kahn, *The Two Faces of Tax Neutrality: Do They Interact or are They Mutually Exclusive*, 18 N. KY. L. REV. 1 (1990).

[433] Tax neutrality, in this sense, is observed more in the breach under the Internal Revenue Code. Tax provisions favor housing, education, retirement savings, capital assets, charitable giving, and a plethora of other activities.

[434] The Internal Revenue Code very often violates this form of tax neutrality. The choice of entity is often dictated, in great part, by tax considerations. For example, limited liability companies are often the entity of choice because such entities are taxed as partnerships. Moreover, the taxation of compensation often differs depending on the form of entity from which it is paid. *See, e.g.*, Matt Richtel, *Entrepreneurs Defend a Tax Benefit Despite a Dubious Congress*, N.Y. TIMES, Sept. 22, 2007, at C6 (discussing the debate about the taxation of income received in the form of a share of partnership profits).

[435] *See supra* note 366 and accompanying text. In fact, an argument can be made that the scope of commercial activities for foreign governments is broader than the scope of trade or business activities conducted by private enterprises. *See supra* notes 379-81 and accompanying text.

ner that it would be taxed had the income been earned by a private enterprise.[436] Two very broad categories of passive investment income, portfolio interest and capital gains from the disposition of stock and securities, are, as a general rule, exempt from tax for all foreign investors, governmental or otherwise.[437] The exemption applicable to foreign taxpayers for portfolio interest is inapplicable to interest received from a corporation in which the recipient is a ten percent shareholder.[438] Consequently, section 892 does provide a comparative advantage to sovereign wealth funds for interest received from corporations in which the fund is a ten percent, but not controlling, shareholder.[439] This advantage could surface in the context of private equity fund investments held by sovereign wealth funds.[440]

Sovereign wealth funds do enjoy the advantage of receiving dividends from non-controlled corporations tax-free. However, two factors mitigate this advantage. First, the significant reduction in tax rates provided to many private investors by treaty reduces the comparative advantage enjoyed by sovereign wealth funds.[441] Second, equity investments can be, and often are, structured to avoid dividend tax withholding. It is not uncommon for foreign taxpayers to structure an equity investment as an equity swap, a form of derivative contract, to avoid the tax on divi-

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[436] A foreign government is taxed as a foreign corporation. *See supra* note 262 and accompanying text.

[437] *See supra* notes 272, 275-83 and accompanying text.

[438] Similar rules apply to interest received from partnerships. *See supra* note 282 and accompanying text.

[439] If the corporation is controlled by the sovereign wealth fund then the controlled commercial entity rules will apply and the exemption will be lost. In general, a 50% stake will trigger the controlled commercial entity rules, but control could exist at lower ownership levels if coupled with other control features. *See supra* note 367 and accompanying text.

[440] Private equity funds are generally structured as partnerships or limited liability companies. For purposes of the portfolio interest exemption whether a person is a 10% shareholder is determined after the application of certain attribution rules. A partner is deemed to own her proportionate share of the interests owned by the partnership. I.R.C. § 318(a)(2) (2006). Accordingly, a sovereign wealth fund will be deemed to own its proportionate share of the private equity fund's stake in the entity in question. To the extent that this ownership interest reaches the 10% threshold, section 892 does provide an advantage to the fund that would not have been applicable to a non-sovereign foreign taxpayer.

[441] Sovereign wealth funds also enjoy other tax advantages over private investors. For example, a sovereign wealth fund would not incur tax on income derived from most commodity investments or from the sale of stock in U.S. real property holding corporations that is does not control. *See supra* notes 360-61 and accompanying text. However, income derived from such activities is generally not significant in comparison with the more traditional types of passive income earned by the funds.

dends.[442] For example, a foreign investor may enter into a contractual arrangement with a financial institution as a counterparty under which the foreign investor agrees to make payments to the counterparty equal to the sum of the amount of depreciation of an underlying stock and an amount determined by applying an agreed upon interest rate applied to the value of the underlying stock. The counterparty, in turn, agrees to pay the foreign investor an amount equal to the sum of the appreciation of the underlying stock and any dividends paid on such stock. This transaction mimics the results that would have been achieved had the foreign taxpayer executed a leveraged purchase of the stock. However, none of the payments received by the foreign investor are taxed as dividends and the income derived from the transaction is characterized as foreign source income.[443]

The relative difference between the taxation of foreign sovereigns and non-sovereigns is much less than the relative difference between the taxation of domestic sovereigns –states and Indian tribes – and domestic non-sovereigns.[444] Moreover, various domestic entities, such as pension

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[442] A derivative contract is an agreement under which the parties bind themselves to deliver an amount of property or money determined by reference to the price of an underlying item, such as stocks, commodities, interest rates, or currency values. In an equity swap the underlying item is a particular stock or group of stocks. Derivatives include traditional option and forward contracts as well as more esoteric instruments. *See generally* Kevin Dolan & Carolyn DuPuy, *Equity Derivatives: Principles and Practices*, 15 VA. TAX L. REV. 161 (1996).

[443] An equity swap is treated as a notional principal contract under I.R.C. § 446. *See* Treas. Reg. § 1.446-3(c)(1)(i) (1994). Unlike many derivatives, the character of the income and loss generated by the termination of a swap is not determined by reference to the underlying item. *See generally* I.R.C. § 1234A (2006). Income from notional principal contracts is generally sourced by reference to the residence of the taxpayer unless such income is effectively connected with the conduct of a trade or business in the United States. Treas. Reg. § 1.863-7(b)(2)-(3) (1991). A detailed analysis of the tax rules applicable to derivatives is beyond the scope of this work. For a succinct overview of these rules, see STAFF OF THE J. COMM. ON TAXATION, PRESENT LAW AND ANALYSIS RELATING TO THE TAX TREATMENT OF DERIVATIVES (Comm. Print 2008), *available at* http://www.house.gov/jct/x-21-08.pdf. These transactions have come under criticism and investigation by the Senate and the Internal Revenue Service. *See* Jesse Drucker, *Street Firms Accused of Tax Scheme*, WALL ST. J., Sept. 11, 2008, at C1.

[444] The Internal Revenue Code's income tax provisions apply to individuals, corporations, trusts, estates, and other specified persons. States are not subject to income tax. *See generally* David M. Richardson, *Federal Income Taxation of States*, 10 STETSON L. REV. 411 (1990). Moreover, income accruing to states, political subdivisions of states, and the District of Columbia on income derived from any public utility or the exercise of any essential government function is exempt from tax. I.R.C. § 115(1) (2006). The exemption for U.S. possessions is broader. *See* I.R.C. § 115(2) (2006). Federally chartered tribal corporations are also not subject to income tax. *See* Rev. Rul. 67-284, 1967-2 C.B. 55; Rev. Rul. 94-16, 1994-1 C.B. 19.

trusts, 401(k) plans, and university endowments, invest on a tax-exempt basis and very little protest has been heard about the competitive advantages enjoyed by these entities.[445] Protests concerning these entities, when they arise, tend to focus on their operations and not on any competitive advantage they enjoy in the capital markets.[446] The relatively modest tax exemption enjoyed by sovereign wealth funds and the lack of neutrality objections in analogous domestic settings lead one to question the tax neutrality justification put forth by opponents of the tax exemption. After all, no one seriously contemplates removing the tax exemption for foreign governments *in toto*. Perhaps tax neutrality is a chimera and the impetus for change lies with a distrust of these vehicles.

Discomfort about the rapid growth of assets controlled by sovereign wealth funds is based principally on the perceived lack of transparency of these funds and the resultant potential that political considerations will drive the funds' investment decisions. Fears of political machinations are most pronounced in equity investments made by the funds. Debt holdings offer much less potential for policy intervention in the investee entity than equity holdings. In certain circumstances creditors can exert a great deal of influence over the debtor's operations and, in cases where the level of debt holdings is significant, the potential for such influence can be worrisome. Ironically, perhaps the best example of this is the anxiety caused by the multi-trillion dollar U.S. government debt, much of it held by foreign governments. However, in the typical case, equity holdings by foreign sovereigns are the investments that generate the most angst among policy makers and the public at large.

As previously noted, the present tax system provides sovereign wealth funds a tax advantage over private foreign investors with respect to dividends, which are returns on equity investments.[447] In essence, the very types of investments that create the most discomfort are tax-favored. However, the fears surrounding such investments are exaggerated. Existing non-tax mechanisms are in place to prevent foreign governments from exercising undue political influence. Attempts by foreign acquirers to obtain control of a domestic enterprise are extensively vetted by

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For other purposes, such as the deductibility of charitable contributions and issuance of tax-exempt bonds, Indian tribes are treated as states. *See generally* I.R.C. § 7871(a) (2006).

[445] *See, e.g.*, I.R.C. §§ 401, 501 (2006). Certain tax exempt organizations are taxable on the income earned from unrelated business income. *See generally* I.R.C. §§ 511-15 (2006).

[446] Universities have come under Congressional scrutiny recently concerning the use of their rapidly growing endowments. The scrutiny centers on the use of endowments to provide financial aid. *See* Press Release, United States Senate Comm. on Fin., Baucus, Grassley Write to 136 Colleges, Seek Details of Endowment Payouts, Student Aid, (Jan. 24, 2008), *available at* http://www.finance.senate.gov/press/Gpress/2008/prg012408f.pdf.

[447] *See supra* note 359 and accompanying text.

CFIUS.[448] Recently issued proposed regulations define the term "control" expansively to include indirect control and dominant minority interests, contractual arrangements, and informal mechanisms that enable the exercise of influence over important matters.[449] A CFIUS review is mandatory whenever the foreign acquirer is a foreign government.[450] Moreover, recent legislative changes have expanded the scope of CFIUS reviews to include a variety of politically sensitive industries.[451]

Complementing the transaction-based CFIUS process are various industry-wide statutory and regulatory regimes designed to protect U.S. national interests. Transportation, telecommunications, nuclear power, and banking are examples of industries for which such protection exists.[452] Finally, diplomatic efforts have been undertaken to address source country concerns with inbound investments by sovereign wealth funds. These efforts have begun to bear fruit, as evidenced by the work done by the International Monetary Fund and other multi-lateral organizations in addressing the areas of concern to capital-recipient countries.[453]

In addition to CFIUS, industry-wide procedures, and diplomacy, the tax code discourages controlling investments by sovereign wealth funds. Although returns on equity investments are tax-favored as a general matter, such returns are fully taxable if generated from a controlled commercial entity.[454] Similar to the definition of control for CFIUS purposes, the tax regulations define control very broadly for this purpose. Any direct or indirect interest of fifty percent or more in the commercial entity is deemed controlling.[455]

Moreover, the regulations also provide that effective practical control over a commercial entity will cause investment returns from such entity to be subject to tax. Effective practical control can be evidenced by a minority equity stake coupled with creditor rights, contractual arrangements, or control of strategic resources.[456] In essence, the tax code provides a disincentive to control. Assuming, *arguendo*, that the criticisms directed at sovereign wealth funds are warranted, amending the tax code will do little to rectify the problems that are perceived to emanate from the funds' investments. Transparency issues and the political and national security concerns they may generate are best dealt with directly and not through the back door of tax policy.

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[448] *See supra* notes 144-170 and accompanying text.
[449] *See supra* note 169 and accompanying text.
[450] *See supra* note 152 and accompanying text.
[451] *See supra* note 164 and accompanying text.
[452] *See supra* notes 171-75 and accompanying text.
[453] *See supra* notes 125-37 and accompanying text.
[454] *See supra* note 366 and accompanying text.
[455] *See supra* note 367 and accompanying text.
[456] *See supra* note 367 and accompanying text.

This article presumes that foreign investment in the United States is desirable and that barriers to the free flow of capital, if necessary to satisfy other national interests, should be kept to a minimum. Sovereign wealth funds will continue to invest in the U.S. regardless of whether they are taxed as foreign governments. The United States attracts foreign investment due its deep, liquid, well-regulated, and transparent capital markets. United States capital markets continue to represent an area of significant comparative advantage despite assertions that provisions of the Sarbanes-Oxley Act of 2002 have eroded such advantage.[457] Moreover, provided the U.S. economy employs a well-trained workforce and remains a technological leader, foreign investment will continue to seek a home here. To that extent, our attractiveness to foreign investors is a measure of our success.

The United States has experienced a trade deficit for several decades. Our paltry domestic savings rate combined with an ever growing imbalance between imports and exports has resulted in an explosion of foreign investment in the United States.[458] Sovereign wealth funds will, most likely, continue to amass investable funds. These funds will seek a home and the belief that a relatively modest tax advantage plays a significant role in sourcing investments to the largest economy in the world is misguided.[459]

That said, if the tax advantage enjoyed by sovereign wealth funds is modest and is not a significant motivating factor in the funds' investment decisions, why retain the exemption? Amending the tax law to carve out sovereign wealth funds from the definition of a foreign government runs contrary to over two centuries of sovereign immunity jurisprudence and

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[457] Pub. L. No. 107-204, 116 Stat. 745 (2002). Among the provisions of the Sarbanes-Oxley Act of 2002, enacted in the aftermath of the Enron and Worldcom scandals, are provisions that made significant changes to the relationship between independent auditors and their clients, mandated certification of financial statements by certain officers, and require public companies to assess their internal controls and for the independent auditors to opine on such assessment. For an analysis of the effects of this legislation on the capital markets, see Donald Nordberg, *Waste Makes Haste: Sarbanes-Oxley, Competitiveness and the Subprime Crisis* (unpublished working paper, *available at* http://ssrn.com/abstract=1131674). *See also* Craig Doidge et. al., *Has New York Become Less Competitive in Global Markets? Evaluating Foreign Listing Choices Over Time* (Fisher College of Business, Working Paper No. 2007-03-012, 2007), *available at* http://ssrn.com/abstract=982193.

[458] Net foreign investment in the United States has grown from 6.1% of gross domestic investment in 1993 to 27.5% of gross domestic investment in 2007. Gross foreign investment in the United States totaled $ 2.59 trillion in 2007. Issues Raised by Sovereign Wealth Funds, *supra* note 6, at 13 (citing to U.S. Department of Commerce, Bureau of Economic Analysis information).

[459] Australia, Canada, Great Britain, and Japan exempt foreign governments from taxation on sovereign immunity principles. Many continental European countries do not, however. *See id*., App. 1, at A-1 to A-4.

almost a century of tax policy. The effect in dollars and cents to sovereign wealth funds and the U.S. Treasury would be inconsequential in comparison to the harm such a change would cause to the international political and financial reputation of the United States.

The application of foreign sovereign immunity in the United States has changed to reflect the realities of modern commerce. A more or less absolute view of immunity has given way to a restrictive theory of immunity that is exemplified by the exceptions to immunity contained in FSIA.[460] The tax code has similarly restricted immunity over time and its application of foreign sovereign immunity is, in most respects, analogous to FSIA's. As noted long ago by the Supreme Court, grants of immunity are not a fundamental right of a foreign sovereign but a consensual waiver of territorial jurisdiction by the host nation.[461] As a policy matter we have chosen to exercise territorial jurisdiction in matters commercial.[462] Otherwise, principles of comity and good relations with sovereign equals have dictated that immunity be granted.

U.S. tax policy has always granted an exemption for passive investments. Investment of government funds is, quite unremarkably, an activity in which governments engage. Perhaps we are uncomfortable with the fact that sovereign wealth funds are a manifestation of state capitalism. State ownership of vast swatches of an economy has never sat well with the U.S. polity. Perhaps we welcome foreign government investment in the form of debt but oppose sovereign ownership of private enterprise. However, the creation of an exception to tax policies that have existed virtually since the inception of the income tax due to these objections would be anathema to principles of comity and sovereign equality.

How a foreign sovereign chooses to structure itself is none of our concern. How it chooses it invest its funds is also none of our concern provided such investments do not infringe on our own policy goals. Our aversion to U.S. government participation in the equity markets should not be projected overseas. The potential for conflicts of interests and politicization of investment decisions as a result of U.S. government investment in domestic enterprises is a legitimate concern due to the fact that the U.S. government has regulatory jurisdiction over such enterprises. This is not the case with respect to foreign government investment. Long-standing principles of comity and mutual respect dictate that the tax exemption for income generated by the passive investment of foreign government wealth remain intact. To do otherwise would send a clear message to the world that we are not as amenable to foreign investment as was believed and that, when it suits our needs, we will embrace parochial notions of foreign sovereignty.

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[460] *See supra* notes 244-45 and accompanying text.

[461] *See supra* notes 220-21 and accompanying text.

[462] Several other exceptions to immunity apply under FSIA. *See supra* note 244.

VI. Conclusion

To the adage "bad facts make bad law" can be added the corollary "bad economies make bad policy." Knee-jerk reactions to economic threats, whether real or perceived, seldom result in the consequences desired. Sovereign wealth funds have grown to enormous proportions. This growth has occurred, in part, at our expense. However, these funds have also served as a stabilizing financial force in turbulent financial markets. Investor attraction to the United States reflects the strength, not the weakness, of the U.S. economy. National security and political considerations are adequately addressed by existing policies. The tax advantages offered by the tax exemption granted to sovereign wealth funds are considerably less than commonly perceived. Violating long-standing principles of sovereign immunity should require greater justification than that put forth by proponents of ending the tax exemption for sovereign wealth funds.