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VICTOR FLEISCHER

# Should We Tax Sovereign Wealth Funds?

Important characteristics distinguish sovereign wealth fund investment, which is often troubling, from private foreign investment, which is generally beneficial. Allowing sovereign wealth funds to own equity stakes in American companies encroaches on the autonomy of U.S. industrial and foreign policy in a way that private investment does not. Moreover, because some sovereign wealth fund investment is politically motivated, this new form of investment impairs the efficient allocation of economic resources. Given these effects, one might expect U.S. tax policy to discourage state-controlled investment and encourage private investment. Instead, tax policy does just the opposite, subsidizing sovereign wealth funds that invest in the equity of U.S. companies.

In this Essay, I sketch out a few tax reform alternatives that could complement other regulatory proposals regarding sovereign wealth. First, and most modestly, the U.S. could strive for sovereign tax neutrality, eliminating the unwarranted tax subsidy that sovereign wealth funds enjoy under current law. A second, more aggressive, alternative would impose an excise tax on sovereign wealth. Additional reform alternatives are more fine tuned, linking the tax rate to a fund's compliance with best practices or other measures of transparency, accountability, and professionalization. I fully develop the case for taxing sovereign wealth elsewhere in a longer paper.[1] For present purposes, I merely wish to convince the reader that regardless of how one feels about regulating sovereign wealth funds, the tax exemption under current law deserves reconsideration.[2]

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1. *See* Victor Fleischer, *A Theory of Taxing Sovereign Wealth*, 84 N.Y.U. L. REV. (forthcoming 2009), *available at* http://ssrn.com/abstract=1234410.

2. The Joint Committee on Taxation recently issued a report, JOINT COMM. ON TAXATION, 110TH CONG., ECONOMIC AND U.S. INCOME TAX ISSUES RAISED BY SOVEREIGN WEALTH FUND INVESTMENT IN THE UNITED STATES, REP. No. 49-08 (2008). The Joint Committee Report is measured, but concludes that "it is difficult to conceive of any reasonable justification for

To date, analysis of sovereign wealth funds has mostly focused on a variety of non-tax issues, generating a scatterplot of policy prescriptions. Professors Gilson and Milhaupt propose limiting the voting rights of funds that purchase the common stock of U.S. companies.[3] Professor Rose looks to encourage compliance with best practices.[4] Professor Davidoff notes the possibility of simply relying on Committee on Foreign Investment in the United States (CFIUS) review, backed by existing securities law disclosure.[5]

The problem with these minimalist approaches is that they assume that the current regulatory scheme, which broadly welcomes sovereign investment as if it were private investment, is the appropriate baseline. In fact, we have stumbled into the status quo by historical accident, and it is not self-evident that current law, including the tax subsidy, advances U.S. economic and foreign policy goals of promoting freedom, democracy, and capitalism at home and abroad. Indeed, the risks associated with sovereign wealth fund investment create a possible case for Pigouvian taxation (or some other form of regulation).[6]

## THE EXISTING TAX SUBSIDY FOR SOVEREIGN WEALTH

Under current law, tax policy plays an unintended role in shaping and encouraging sovereign wealth investment in U.S. equity rather than debt. Specifically, our tax system provides a hidden subsidy, albeit a small one, for sovereign wealth funds. Under current law, Section 892 of the tax code grants sovereign wealth funds an exemption from tax.[7] This anachronistic provision offers an unconditional tax exemption when a foreign sovereign holds portfolio

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modifying the existing rules to treat SWFs, or foreign governments more generally, less favorably than foreign corporations." *Id.* at 73.

3. *See* Ronald J. Gilson & Curtis J. Milhaupt, *Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism* (Stanford Law & Econ. Olin Working Paper No. 355, 2008).

4. See Paul Rose, *Sovereigns as Shareholders*, N.C. L. REV. (forthcoming 2008), *available at* http://ssrn.com/abstract=1102254.

5. *See* Steven M. Davidoff, *Telling Friend from Foe in Foreign Investments*, DealBook, N.Y. TIMES, Apr. 2, 2008, http://dealbook.blogs.nytimes.com/2008/04/02/telling-friend-from-foe-in-foreign-investments.

6. A Pigouvian or corrective tax is designed to make the person who engages in an activity with negative externalities or public harms internalize the costs associated with that activity. *See generally* ARTHUR CECIL PIGOU, THE ECONOMICS OF WELFARE 192-93 (Transaction Pubs. 2002) (1952) (discussing corrective taxes on alcoholic drinks, building in crowded areas, and petrol duties and motor vehicle license taxes).

7. I.R.C. § 892(a)(1) (2008).

investments in the United States. Because sovereign wealth funds generally hold non-controlling investments, these investments are exempt from tax, even if the funds acquire a substantial equity stake as a strategic investment. The original rationale for the tax exemption was based on an expansive view of sovereign immunity which the United States (and other countries) discarded fifty years ago.[8] The current debate over sovereign wealth presents us with an opportune moment to revisit these tax rules.

Because we typically tax foreign capital with a light touch, the existing tax subsidy for sovereign wealth funds is not as large as it might seem.[9] When private foreign investors receive capital gains and portfolio interest, that income is typically treated as foreign source income and not taxed in the United States.[10] The tax advantage for sovereign wealth funds is therefore limited to dividends, royalties and other periodic income, and certain real estate-related income.

This is not to say that the tax advantage is trivial. The disparate tax treatment creates the possibility of a clientele effect, drawing sovereign wealth funds to dividend-paying stocks where they hold a tax advantage over taxable investors.

## WHAT IS THE OPTIMAL TAX RATE ON SOVEREIGN WEALTH?

To simplify things a bit, consider the three basic possibilities: (1) taxing sovereign wealth funds more favorably than private foreign investors, (2) taxing sovereign wealth funds the same as private foreign investors, and (3) taxing sovereign wealth funds at a higher rate than private foreign investors.

The case for subsidizing sovereign wealth funds is weak. When sovereign wealth funds invested in these financial services firms following last year's subprime mortgage crisis, the investments were thought to help stabilize the jittery capital markets.[11] But the case for systematically granting a tax preference would require a long-term policy rationale for preferring state-controlled investment over market-based investment. It is hard to imagine what that rationale might be.

A more sensible starting point for tax policy is a norm of sovereign tax neutrality, which would treat state-controlled investment vehicles no better and no worse than private corporations. A norm of sovereign tax neutrality

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**8.** *See* Fleischer, *supra* note 1, at 13-19.

**9.** *Id.* at 19-22 .

**10.** *See* I.R.C. §§ 871(h), 881, 882.

**11.** *See* Fleischer, *supra* note 1, at 37-38.

would not eliminate politically motivated investment entirely: If foreign governments seek both political and financial gains through their foreign investment policy, they may be willing to accept lower financial returns than private investors because they judge the success of an investment not just by measuring its financial return, but also by whether it achieves political objectives. Eliminating the subsidy under current law would at least allow financially motivated private investors to compete on a level playing field with financially motivated state-controlled investors. Private investment promotes the efficient allocation of resources, protects the autonomy of American industrial foreign policy and discourages U.S. companies from unnecessarily partnering with autocratic regimes.

Lastly, one could go further and impose an excise tax, which could help address the risk associated with politically motivated investment. The most powerful rationale for an excise tax is that strategic investment by sovereign wealth funds may be a Trojan horse, allowing foreign governments to shape and influence American enterprise in a manner inconsistent with our economic and national security interests. Even if the professional managers of these funds are currently acting in a manner consistent with other, nongovernmental institutional investors, there is no guarantee that they will continue to do so in the future in circumstances in which the financial interests of the fund and the political interests of the government that controls the fund diverge.

Tax need not be a blunt instrument; we can tailor tax policy to complement other policy aims. For example, imposing an excise tax on equity investments could shift investments from equities to debt instruments, where policy concerns are less troubling. Similarly, we could consider distinguishing between voting and non-voting investments, along the lines of what Gilson and Milhaupt suggest.[12] It is also possible that we may not need to tax all funds alike. If some funds comply with best practices that accord with proper financial motives, professional management, and minimize the risk of improper political motives, then perhaps they should be taxed at a lower rate similar to private investors.

## CONCLUSION

Ultimately, the case for taxing sovereign wealth depends not just on the presence of negative externalities but also on whether the political institutions that would design, implement, and enforce an excise tax on sovereign wealth have a comparative advantage over the political institutions that would design, implement, and enforce non-tax regulatory controls. As with the carbon tax

12. *See* Gilson & Milhaupt, *supra* note 3.

versus cap-and-trade debate, I am not sure that tax is the better approach. What I am sure about is that we should re-evaluate the tax subsidy that exists now. Tax neutrality is defensible; a tax subsidy is not.

*Victor Fleischer is an Associate Professor and Thomas Mengler Faculty Scholar at University of Illinois, College of Law.*

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