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Taxing the Bandit Kings

The rise of significant inbound capital flows originating from sovereign wealth funds (SWFs) has occasioned a debate over the appropriate regulatory and tax treatment of these funds.[1] In particular, it has been argued that the tax exemption currently enjoyed by SWFs confers an advantage on these entities as providers of capital to U.S. firms relative to private foreign investors, and that a tax should be imposed on SWFs to restore fairness.[2] This essay argues that the distinctive nature of the portfolio choices facing SWFs negates this fairness argument. Indeed, changing the tax treatment of SWFs as has been proposed would distort choices that are otherwise efficient and would handicap U.S. firms and workers.

Fiscal instruments, such as taxes on inbound capital flows, are a tempting dimension of the regulatory response to SWFs because they promise revenues and deterrence of capital flows which seem ominous to some. Imposing such taxes is all the more tempting when that choice is coupled with the promise of

1. *See, e.g.*, 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), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1095023.

2. *See* Victor Fleischer, *A Theory of Taxing Sovereign Wealth*, 84 N.Y.U. L. REV. (forthcoming 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1234410. The tax treatment of SWFs has received considerable attention. *See* Ruth Mason, *Efficient Management of the Wealth of Nations*, TAX NOTES (forthcoming 2008); *Prof Suggests Review of Sovereign Wealth Funds' Tax Breaks*, DOW JONES NEWSWIRES, Mar. 6, 2008, at 1 (discussing, in part, Victor Fleischer, *Taxing Sovereign Wealth Funds*, The Conglomerate, Mar. 4, 2008, http://www.theconglomerate.org/2008/03/taxing-sovereig.html); Andrew Ross Sorkin, *Should Sovereign Funds Be Taxed?*, DealBook, N.Y. TIMES, Mar. 5, 2008, http://dealbook.blogs.nytimes.com/2008/03/05/blackstone-bill-professors-new-focus-sovereign-funds/.

rectifying some underlying unfairness or asymmetry. Under current law,[3] SWFs are exempt from taxation of their portfolio investment income under the doctrine of sovereign immunity.[4] In practice, the § 892 exemption applies only to withholding taxes that would otherwise be levied by the United States on dividends paid by U.S. firms to SWFs.[5] As such, a clear asymmetry exists between the tax treatment of, for example, the Norwegian SWF (which faces a zero withholding tax rate on U.S. dividends) and a Swedish mutual fund (which faces a 15% withholding tax rate on U.S. dividends). This asymmetry, it has been argued, confers a tax advantage on SWFs as purchasers of U.S. equities. The implication that seems to follow is that imposing withholding taxes on SWFs can restore symmetry and "fairness."[6] Interest in these issues has led to calls from Congress for a clarification of the nature of the taxation of SWFs.[7]

TAXATION AND THE PORTFOLIO CHOICES OF SWFS

In order to investigate the effects of a proposed tax on SWF passive income originating in the United States, it is important to frame the portfolio choice problem of an SWF and to consider the nature of the asset market equilibrium. To do so, it is critical to note that the doctrine of sovereign immunity is not peculiar to U.S. law. The passive income earned by SWFs around the world is generally tax-exempt, either through the application of the doctrine of sovereign immunity or through provisions in bilateral tax treaties. SWFs are also, by definition, tax-exempt at home.[8]

Consider the following example in which the parties are the two funds introduced above: the Norwegian SWF and the Swedish mutual fund. Imagine for the purpose of the example that U.S. and U.K. stocks bearing the same risk

3. I.R.C. § 892 (2000).

4. *See* Fleischer, *supra* note 2, at 13.

5. Alternative forms of returns to capital earned by non-residents are taxed in distinct ways by source countries. Typically, capital gains are taxed by the source country while dividends are subject to withholding taxes. The United States does not impose withholding taxes on interest. The withholding taxes on dividends are typically set at fifteen percent for investors from countries that have tax treaties with the United States and at thirty percent for other investors. *See, e.g.*, Raymond F. Wacker, *US Taxation of International Dividends Under JGTRRA*, 30 INT'L TAX J. 19, 23-24 (2004).

6. *See* Fleischer, *supra* note 2, at 25.

7. JOINT COMM. ON TAX'N, ECONOMIC AND U.S. INCOME TAX ISSUES RAISED BY SOVEREIGN WEALTH FUND INVESTMENT IN THE UNITED STATES, JOINT COMM. REP. NO. 49-08 (2008).

8. *See id.* at A-2 (finding that the majority of countries surveyed allow some form of tax exemption).

offer a 10% return after corporate taxes but before personal taxes.[9] The Swedish mutual fund faces a 15% withholding tax on dividends imposed by the United States. Assume that the personal tax rate facing investors in the Swedish mutual fund is 50%, and that Sweden allows a foreign tax credit for withholding taxes paid to the United States. Then, the effective personal tax rate on the Swedish mutual fund's income is 50%. The claim that this asymmetric treatment leads to an inequity rests on the answer to the following question: Does the Norwegian SWF's tax-exempt status make it a privileged provider of capital to U.S. firms relative to the Swedish mutual fund?

Imagine that the Norwegian SWF and the Swedish mutual fund could make one of two investments. The first is in a U.S. firm that issues equity at time 0 and is expected to liquidate at time 1, paying out $11 per share to its shareholders. The alternative opportunity is to invest at time 0 in a British firm that will pay a return of 10%, after corporate taxes but before personal taxes, as described above. The argument for a special tax on SWFs would seem to be premised on the notion that such funds would be preferred providers of capital to the U.S. firm. To investigate this claim, consider the price each fund would be willing to pay for the U.S. firm's stock.

The Swedish mutual fund will receive a return of 5% (after personal taxes) from the British firm and will thus demand the same return from the U.S. firm. This entails a return of 10% as well (before personal taxes) and so the Swedish mutual fund will be willing to pay $10 per share to buy the U.S. firm's stock. The Norwegian SWF will receive a return of 10% (which is not subject to taxation) from the British firm and will thus demand the same return from the U.S. firm. This entails a return of 10% (also not subject to taxation) and so the Norwegian SWF will also be willing to pay $10 per share.[10]

This example demonstrates that neither the Norwegian SWF nor the Swedish mutual fund is a privileged provider of capital to the U.S. firm. Of course, this does not mean that the after-personal-tax rates of return are the same for the two investors. The Norwegian SWF enjoys a higher after-personal-tax return of 10% relative to the 5% after-personal-tax return received

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9. This equality of returns is a requirement of market equilibrium. Any differences in the corporate tax rates of the United States and the United Kingdom must be reflected in share prices (and hence returns); otherwise, investors would only hold equities issued in the country with the lower corporate tax.

10. The return to the Swedish mutual fund after personal taxes is 5% because the 10% return is taxed at 50%. A price of $10 per share for the U.S. firm's stock entails a dividend of $1 per share at time 1 (with a nontaxable return of capital of $10 per share at time 1). The Swedish mutual fund faces a 50% tax on the dividend, and so earns $0.50 per share after tax. This represents a 5% return (identical to that available after tax from the British firm). The Norwegian SWF faces no tax, and so earns $1 per share; this represents a 10% return (identical to that available from the British firm).

by the Swedish mutual fund. This difference, however, does not distort the pattern of investment as long as each investor faces the same tax rate wherever it invests. Indeed, as long as a given investor faces the same tax rate across all investments, her choices will be undistorted relative to a no-tax equilibrium, which is the classic benchmark for assessing efficiency.[11]

To illustrate this point, consider two alternative scenarios: (1) that all countries impose taxes on SWFs and (2) that the United States alone imposes taxes on SWFs. In our example, if *both* the United States and the United Kingdom impose a 15% withholding tax on dividends paid to the Norwegian SWF, then the after-personal-tax return for the SWF will fall to 8.5% wherever it invests. Accordingly, the price it is willing to pay for the U.S. firm's stock will be unchanged and the pattern of investment will be undistorted.

Suppose instead that the United States unilaterally imposes a 15% withholding tax on dividends paid to the Norwegian SWF while the United Kingdom respects sovereign immunity. The Norwegian SWF can still obtain a 10% return from its British investment, so it will demand the same (after-personal-tax) return from the U.S. firm. This requires that the U.S. firm provide an 11.8% pre-personal-tax return; equivalently, the Norwegian SWF would only be willing to pay $9.84 for a share of the U.S. firm's stock at time zero.[12] In contrast, the Swedish mutual fund is still willing to pay $10 per

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11. There is, to some extent, an analogy with the long-standing debate concerning the Unrelated Business Income Tax (UBIT) imposed on nonprofits, especially with the question of whether, absent the UBIT, nonprofits would be in a tax-advantaged position relative to for-profits in undertaking business activity. *See, e.g.*, Henry B. Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 VA. L. REV. 605 (1989); Michael S. Knoll, *The UBIT: Leveling an Uneven Playing Field or Tilting a Level One?*, 76 FORDHAM L. REV. 857 (2007); Susan Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, 34 STAN. L. REV. 1017 (1982). Fleischer challenges the analogy to the UBIT by noting "for profit foreign portfolio investors and nonprofit foreign portfolio investors can both invest in portfolio debt on a tax-free basis, suggesting that they would use the same hurdle rate in evaluating investments." Fleischer, *supra* note 2, at 28 n.91. This observation pertains only to taxation by the United States. While both types of investors face similar U.S. tax treatment (a zero tax rate, as the United States does not impose withholding taxes on interest income), private foreign portfolio investors, unlike SWFs, face home country taxes on U.S.-source interest. In terms of the example, both the Norwegian SWF and the Swedish mutual fund can hold U.S. bonds free of U.S. withholding taxes (as an alternative to buying stock in the U.S. firm). The Swedish investors in the mutual fund will face a 50% tax (imposed by Sweden) on the interest income, however, while the Norwegian SWF faces no tax. Thus, the basic conclusion from our example is unaffected by the possibility of investing in bonds.

12. A price of $9.84 per share entails a dividend of $1.16 per share at time 1 (with a nontaxable return of capital of $9.84 per share at time 1). As the United States imposes a withholding tax of 15%, the after-tax dividend is approximately $0.984 per share. This represents a 10% return (identical to that available from the British firm). The pretax return of 11.8% is computed as a (pretax) dividend of $1.16 on an investment of $9.84.

share. Thus, the unilateral imposition of U.S. withholding taxes on the Norwegian SWF does not restore fairness but actually handicaps the SWF and makes the Swedish mutual fund a preferred provider of capital to U.S. firms.

POTENTIAL NEGATIVE CONSEQUENCES OF TAXING SWFS

Recent evidence on the sensitivity of foreign portfolio investment to taxes indicates that the behavioral responses to the repeal of § 892 could be considerable. The 2003 U.S. tax reform reduced taxes on dividends paid from some, but not all, foreign countries.[13] In effect, this raised the tax rate on a subset of assets for American investors (investments in companies based in the countries excluded from the tax cut), much like a repeal of § 892 would raise the tax rate on U.S. assets for an SWF.

The evidence suggests that the 2003 tax cut led to a substantial reallocation of outbound U.S. foreign portfolio investment towards the tax-favored countries.[14] By analogy, the repeal of § 892 also might engender a considerable response from SWFs as they would demand a higher (pretax) rate of return to invest in U.S. firms, as described in our example. Such a response would make it more difficult for U.S. firms to raise capital for investment. Given the complementary relationship between capital and labor, this reduction in investment would likely reduce demand for labor and harm American workers by reducing their wages.[15]

Taxing SWFs may also seem appealing as a means of addressing concerns regarding the potentially non-pecuniary motivations that may guide sovereigns in their investment decisions. Addressing such concerns through tax policy, however, is misguided. The use of tax policy to address these concerns would preclude the United States' ability to discriminate across industries and countries, leading to a rather blunt and imprecise approach to addressing such non-pecuniary motivations. The current regulatory approach, as embodied in

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13. *See, e.g.*, Hale E. Sheppard, *Reduced Tax Rates on Foreign Dividends Under JGTRRA: Ambiguities and Opportunities*, J. INT'L TAX'N, July 2004, at 14, 16-17.

14. *See* Mihir A. Desai & Dhammika Dharmapala, *Taxes and Portfolio Choice: Evidence from JGTRRA's Treatment of International Dividends* (Nat'l Bureau of Econ. Research, Working Paper No. 13,281), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1000680.

15. This mechanism is analogous to the channel through which the corporate tax is often argued to lower workers' wages. For empirical evidence that this channel is operative in reality, see Mihir A. Desai, C. Fritz Foley & James R. Hines Jr., Labor and Capital Shares of the Corporate Tax Burden: International Evidence (Dec. 2007) (unpublished manuscript), *available at* http://www.people.hbs.edu/mdesai/PDFs/Labor%20and%20Capital.pdf.

the Committee on Foreign Investment in the United States (CFIUS), is better suited to address these concerns.

CONCLUSION

It is tempting to view SWFs as, in the words of Mancur Olson, bandit kings—sovereigns using their power to earn unfairly large returns.[16] This view leads many to seek a fiscal response, but such proposals overlook a critical dimension of this setting—the nature of the portfolio problem for nontaxable investors. Aside from the potential response to the repeal of § 892, it is worth noting that some have also argued that SWFs are hardly bandits. Their investment decisions appear, on average, to transfer wealth to, rather than from, Americans.[17] As such, the words of William Wordsworth may provide a cautionary coda: "Tax not the royal Saint with vain expense."[18]

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16. Mancur Olson, *Dictatorship, Democracy, and Development*, 87 AM. POL. SCI. REV. 567 (1993).

17. *See* Mihir Desai, *America the Difficult*, THE AMERICAN, May/June 2008, at 98.

18. WILLIAM WORDSWORTH, *Sonnet 43: Inside of King's College Chapel, Cambridge* (1822), *in* THE COMPLETE POETICAL WORKS OF WILLIAM WORDSWORTH 381 (Andrew George Jackson ed., 1919).