# Sovereign Wealth Fund: More tax reforms needed to make it sleigh-ride!

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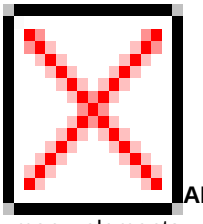
**THE POLICY LAB (TPL-16)**
**DECEMBER 30, 2022**

**By J B Mohapatra**

 **AMONG** many elements - market size and accessibility, opportunities for earnings and growth, predictable regulatory and legal regime including efficiency of dispute resolution framework, size and skill set of the labour market - that attracts FDI, tax policy is increasingly being seen as a vital catalyst in investment decisions and in respect of questions on where and how much to invest, as countries across the board are keeping apace with each other in removing non-tariff irritants. Sovereign Wealth Funds (SWF) and Public Pension Funds(PF) as state-owned investment vehicles leveraging a country's commodity export reserve or mineral royalties or government budget surplus or pension surplus or exchange reserve or direct transfer of assets and intending to invest cross-nationally ostensibly for the purpose of stabilising future government revenues and as a shield against future financial shocks, on the strength of a host country's tax policy are also emerging as strong policy instruments to catalyse efficiency and growth of the host economy and a bulwark to address to address resource gaps in national funding plans.

In essence, tax policy tailored for in-bound investments originating from SWF and PF follows the long established doctrine of foreign state immunity whereby barring purely commercial activities, a regime of restricted immunity with clear commercial exception is now being recognised for foreign state controlled investment entities. Thus while income from business or from pursuit of commercial projects or venture by the foreign sovereign is liable to be taxed in the host country, income by way of dividends or interest stands exempt from tax. Woven around this concept of restricted immunity are the specific tax provisions of various countries. For example, in section 892 of US IRC, while income from foreign governments received from investments in USA in stocks, bonds or domestic securities or financial instruments held in the execution of governmental financial or monetary policy or interest on deposits in banks in the USA are tax exempt, income received directly or indirectly from commercial activities, whether within or outside USA, received by controlled commercial entity (in essence an entity substantially controlled by the government) would be fully taxable. Australia has 2 regimes for exempting SWF and PF from domestic taxes- an investment management regime and an application process for private binding rules for sovereign immunity exemption. If otherwise tax exemption is not apparent under the domestic tax laws or under a treaty, sovereign immunity (provided that the entity is a foreign government or an agency of the foreign government; that the monies being invested perpetually remain that of the foreign government; that income being derived is of a non-commercial character) can be accessed through a private ruling application by the SWF. Under section 13v of Income Tax 1947 of Singapore, income of a prescribed sovereign fund or an approved foreign government owned entity arising from deployment of its funds that are managed in Singapore upon approval of the minister or an authorised body any time between 1-4-10 and 31-12-24 would be exempt from tax. Unlike restricted tax immunity in aforesaid countries, UK HMRC's International Manual of INTM 860180- "Income and gains arising to and in the sole direct beneficial ownership of the Head of a foreign independent state ( for example a reigning monarch or a president); the spouse of such a head of state; a foreign independent government are----normally immune from taxation"- makes it possible for all UK sourced income and gains including trading and property income, and income from commercial activities of sovereign immune persons exempt from direct taxes.

In India till 2020, a restricted form of sovereign immunity from tax on reciprocal basis was made available through the treaty/ DTAA route. For example Article 11 of DTAA in respect of USA/ UK/ South Africa provided that interest arising in a contracting state and derived and beneficially owned by the government of the other contracting state, a political subdivision or a local authority shall be exempt from domestic

taxes. It was only in Finance Act 2020 that exemption to SWF and PF through the tax statute route was introduced via insertion of section 10(23FE) in the Income Tax Act. Exemption is extended only to income in the nature of dividend, interest or long term capital gains arising from investments made in India. Conditions for exemption include (a) SWF to be wholly owned and controlled directly or indirectly by the government of a foreign country (b) SWF to have been set up and regulated under the law of such foreign country (c) earning of the SWF to be credited either to the account of the foreign government or an account designed by that government and no part of the earnings inures to the benefit of any private person (d) fund assets vest with the foreign government upon dissolution of the fund (e) SWF not to participate in the day to day operations of the investee (f) no part of the investments in India by the SWF or PF to have a direct or indirect nexus to any loans or borrowings (g) investments to be made in specified infrastructure business including infrastructure sub sectors mentioned in harmonised master list updated as on 13-8-18 (h) investments in India are made between 1-4-20 and 31-3-24 (i) an obligation to submit quarterly statements and to file annual ITR

It is a fact that in two years since the Finance Act 2020, 12 SWF (and 20 PF) have been notified under section 10(23FE) with SWFs geographically spread out from Saudi Arabia, Qatar, South Korea, UK, Norway and UAE letting out a clear signal among SWFs of the need for rebalancing their investment portfolio and relocating new investments to a desirable destination keeping in context the relative vulnerabilities among different jurisdictions concerning liquidity risk, credit risk, interest rate risk and political/market risk.

Though often targeted for opaqueness and limited information about their operations and ultimate objective, SWFs as a general precedent tend to gravitate to countries with greater degree of commitment to reform, developed culture of investor protection and corporate governance, and their investment strategy does not significantly differ from equity mutual funds. In its own way, questions on ensuring transparency in SWF's operations have been statutorily addressed through several compliance measures including (a) an audit report to be submitted a month prior to due date specified for submitting return of income (b) requirement of submitting return of income along with audit report (c) requirement of furnishing a quarterly statement within a month from end of the quarter (d) requirement of a segmented account of income and expenditure in respect of eligible investment which qualifies for exemption under section 10(23FE).

Tax exemption has been a significant driver for SWF investments world-wide. Once macroeconomic fall-out from SWF's investments in India is factually determined and a cost- benefit ratio ***pari passu*** with tax foregone is reasonably established, many new and emerging technicalities in direct tax legislation could be comprehensively addressed for a more meaningful and long drawn engagement with SWFs.