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## **Immunity or exemption: what are the consequences for sovereign wealth funds with respect to sovereign immunity vis-à-vis tax exemptions?**

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**Abstract:** Sovereign wealth funds are generally afforded tax relief either via immunity or tax exemption. Often considered synonyms, these terms are disparate in a taxation context. While differences in definition are subtle, they are more marked when one considers their basis, legal system, institutional process and how they are derived. Notwithstanding the outcome of granting immunity and total exemption is identical, in that no tax liability arises, their impacts and effects on institutions, processes and policies differ. Assessing the effects of immunity and exemptions against tax principles has mixed results. Neither immunity nor exemption is manifestly superior with respect to efficiency and simplicity whereas an exemption is clearly preferable when equity and certainty are considered. A balanced assessment therefore favours the provision of a tax exemption over the granting of immunity. However, if immunity is to be granted, it is recommended that government interference be minimised and the process is transparent.

**Keywords:** sovereign wealth funds; tax policy; sovereign immunity; immunity; tax exemptions; tax principles; tax relief; investment income.

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### **1 Introduction**

Sovereign wealth funds are used for large-scale offshore investment of government funds. Host countries generally provide tax relief to the investment income of these funds either by granting immunity or through providing an exemption. However, is one better

than the other? This paper seeks to answer this question by comparing immunity and exemptions as they apply to the taxation of sovereign wealth funds.

There is a void in the legal literature of what ‘immunity’ actually means and the term does not appear to have been discussed by the courts in any depth, if at all. Rather, the focus has been on types of immunity. In addition and more specifically, little material is available on the issue of state or sovereign immunity in the context of host state regulations<sup>1</sup>. On the other hand tax exemptions, being a form of tax expenditure, have been dealt with extensively<sup>2</sup>.

The terms ‘immunity’ and ‘exemption’ are often defined as synonyms of each other. This paper seeks to determine if, with respect to the taxation of sovereign wealth funds, this is really the case. This requires two determinations to be made in the first instance. The first, contained in Section 2, is to explore these two terms and identify their differences. As the outcome of granting either immunity or total exemption is identical in that no tax is payable, the second determination is to assess the impacts and effects of these differences. This is dealt with in Section 3. Section 4 then assesses these outcomes according to commonly recognised principles of taxation. From this the consequences for sovereign wealth funds with respect to tax exemptions vis-à-vis sovereign immunity can be ascertained. Section 5 addresses the question this paper poses and makes recommendations.

## **2 Elucidation**

This section commences by exploring the nuances of the terms immunity and exemption, before discussing principles and rules. As immunity is a product of international law and exemptions result from municipal or domestic law, differences arise from these disparate legal systems. Yet, for immunity to be ‘administered’, it needs to be incorporated into a country’s legal system. This may be by way of statute or precedential common law. Thus the institutional process, that is, the role of parliament and the judiciary, is also examined. Finally, because both immunity and an exemption involve receiving a government benefit, differences in how they are derived are explored.

### *2.1 Definitions*

Immunity can be defined as the exemption from performing duties that the law generally requires other citizens to perform, or from a penalty or burden that the law generally places upon other citizens<sup>3</sup>. It makes a law unenforceable. An exemption, on the other hand, is generally described in terms of freedom from a responsibility, duty or liability<sup>4</sup> and is an exception to the ordinary operation of the law. An exemption is also defined, with reference to taxation, as ‘an amount allowed as a deduction from adjusted gross income, used to determine taxable income’<sup>5</sup>.

Immunity, in a legal sense, is most often associated with criminal conduct – as in impunity – and diplomatic immunity – as in inviolability. But it applies equally to royal prerogative, parliamentary privilege, judicial immunity and sovereign immunity to name just a few<sup>6</sup>. Immunity is also a doctrine in torts, providing a complete defence to a tort action. These include inter-spousal or marital immunity, corporate immunity and charitable immunity. These recognise types of immunity rather than its essence or substance.

Another term that is often used interchangeably with 'immunity' is 'privilege'. A privilege may be defined as a 'special legal right, exemption, or immunity granted to a person or class of persons: an exception to a duty'<sup>7</sup>. It is explained as providing the legal freedom to do, or not do, a given act and as immunising conduct that, under ordinary circumstances, would raise liability issues<sup>8</sup>. Privilege, in this context, needs to be differentiated from privilege as an affirmative defence (such as to a defamation claim) or as an evidentiary rule (such as in attorney-client privilege).

Turning now to the more specific term 'sovereign immunity', this is generally defined in terms of being immune from the jurisdiction of municipal courts<sup>9</sup>. The term 'state immunity' or 'crown immunity' is sometimes used in place of 'sovereign immunity' to mean the presumption that a statute does not bind the state unless expressly waived<sup>10</sup>. Sovereign immunity arises from both the equality of states and the independence of states. It is not a concept or idea in and of itself but rather 'the legal principles and rules under which a foreign state may claim exemption from, suspension of, or non-amenability to the jurisdiction of another state'<sup>11</sup>.

## 2.2 *Principle versus rule*

The difference between 'principle' and 'rule' has been widely discussed in legal theory<sup>12</sup>. Rules are more specific than principles, the latter allowing for a broader spectrum of possible behaviour. The distinction is important as they have different legal consequences. A rule has a specific legal consequence, in that it either requires or allows for certain behaviour<sup>13</sup>. Principles, on the other hand, are something which 'officials must take into account, if it is relevant, as a consideration inclining one direction or another'<sup>14</sup>.

In a legal sense, a rule is typically associated with regulations rather than legislation. However, both constitute the law. And, while the process is different, both regulations and legislation have to pass through some form of due process in order to take effect. Regulations are commonly referred to as 'secondary legislation'. In some cases the distinction between a rule and legislation is not made<sup>15</sup>. Indeed, the legislation may be referred to as 'the rule'<sup>16</sup>.

The majority of states, with only a few exceptions, accept sovereign immunity as something that is legally binding under international law<sup>17</sup>. However, consensus is only at a high level of abstraction. That is, countries agree that sovereign immunity exists. How sovereign immunity is dealt with differs substantially from state to state. For example, some countries legislate sovereign immunity while for others it is embodied in common law or administrative practice. As Finke states: "it is the very nature of a principle that it can be specified in different ways"<sup>18</sup>. It is therefore submitted that sovereign immunity is a principle. This assertion is further endorsed by the fact that legislation is not a prerequisite to the granting of immunity<sup>19</sup>. A tax exemption, on the other hand, requires legislation to give it effect. It is specific in its application with respect to type of activity and/or taxpayer and is therefore more accurately classified as a 'rule' rather than as a 'principle'.

## 2.3 *Legal systems – international and municipal*

Sovereign immunity is a principle of international law. So too is jurisdiction of states. Both are based on the independence of sovereignty which itself is a fundamental principle. Neither sovereign immunity nor jurisdiction takes priority over the other, their

limits being governed by international law<sup>20</sup>. Nevertheless, while limited and protected by international law, sovereign immunity is essentially a political necessity.

There is no presumption or obligation on states to provide for sovereign immunity in municipal law. That is, codification is not necessary to give effect to the sovereign immunity principle. Converting international law into municipal law is generally explained in terms of the doctrines of transformation and incorporation. The doctrine of transformation requires a statute or Act of Parliament. An example of where transformation applies is with respect to treaties. Under the doctrine of incorporation, however, international law is generally regarded as automatically incorporated into municipal law<sup>21</sup>. Such law is commonly referred to as 'customary law'. Sovereign immunity is an example.

While many states have codified the principle of sovereign immunity, this is not universal. Countries with no municipal legislation with respect to sovereign immunities include Malaysia, Germany and Brazil. Further, where legislation has been enacted, the codification has not been uniform. For example Singapore's *State Immunity Act* does not apply to an entity (referred to as a 'separate entity') that is distinct from the executive branch of the government and 'capable of suing or being sued'<sup>22</sup>. Therefore entities such as statutory bodies, public agencies and government corporations are excluded. Australia, on the other hand, extends immunity to these 'separate entities' under its *Foreign State Immunities Act*<sup>23</sup>.

On the other hand, municipal (or domestic) law does require a statute or act of parliament for legitimacy. Tax exemptions are legislated for in specific tax legislation, depending on the type of tax<sup>24</sup>. They cannot be derived from customary law or from common law. Being contained in municipal law the exemptions will inevitably differ between states.

#### 2.4 Institutional process

The separation of powers is a model commonly used for the governance of a state. In this model the political authority, or government, is divided into three branches, each having discrete responsibilities. As such, no branch can exercise the core functions of another branch<sup>25</sup>. The legislative branch, or legislature, is responsible for enacting the laws of the state and appropriating the money necessary to operate the government. The executive branch is responsible for implementing and administering the public policy enacted and funded by the legislative branch. The third branch is the judiciary. It is responsible for interpreting the laws and applying these interpretations to controversies brought before it.

In some jurisdictions these three branches are quite distinct. In the USA for example, Congress is the legislature, the President is the executive and the Supreme Court represents the judiciary. In France, the president, prime minister and cabinet form the executive. They are answerable to the National Assembly (or lower house) which, together with the Senate (or upper house), forms the legislature. The judiciary is made up of courts and tribunals. Yet in other jurisdictions the distinction between the executive and legislature may not be as explicit. For example, Australia does not maintain a strict separation as government ministers (the executive) are required to be members of parliament (the legislature). India is another example in that the prime minister is elected by parliament itself. Nevertheless, even where there is a blurring between the executive and legislative branches of government, the judicial branch is considered to be independent.

In the first instance it is the executive and/or legislature that determine firstly, who is immune and secondly, to whom, or for what, an exemption applies. But thereafter the process is generally different. With respect to a tax exemption, once legislated no further recourse is made to the legislature (and/or executive) unless an amendment is deemed necessary. Any further developments to the exemption, whether expanding or narrowing it, are made by the judiciary through the process of interpretation<sup>26</sup>.

With respect to immunities on the other hand, the judiciary invariably defer to any determination made by the executive and/or legislature. In the USA, the Supreme Court referred to this as ‘the command of congress’<sup>27</sup>. In both *Ex parte Republic of Peru*<sup>28</sup> and *Republic of Mexico v Hoffman*<sup>29</sup>, Chief Justice Stone stated that, when the executive branch (in this case the department of state) determined that a claim of sovereign immunity should be allowed in the interests of foreign relations, courts must ‘accept and follow the executive determination’<sup>30</sup>.

More recently, the Chinese Government intervened in the Hong Kong case of *Democratic Republic of the Congo & Others v FG Hemisphere Associates LLC*, at first instance and at each appeal<sup>31</sup>. The intervention included letters from the Ministry of Foreign Affairs and the requirement that Hong Kong defer to China on matters of foreign affairs, of which sovereign immunity is such an ‘affair’<sup>32</sup>. The Hong Kong Court of Final Appeal was obliged to abandon its common law restrictive sovereign immunity approach and adopt China’s traditional stance on absolute sovereign immunity<sup>33</sup>.

On the institutional process, and whether it involves a principle or a rule, Finke has cautioned:<sup>34</sup>

But if international law does not oblige states to behave in a specific way because they have not agreed on precise rules, but only on an abstract principle, and if states are thus free to determine the rules within the limits set by international law, then it is not for the courts to second-guess the balancing process in detail. Otherwise it would be the courts and not the states that actually make these rules.

This is not to say that the judiciary has no role to play with respect to immunities. On the contrary, courts have a responsibility to rule on questions of law. The point here is whether or not the circumstances regarding the granting of immunity are such as to make it a political question rather than a question of law<sup>35</sup>.

## 2.5 Derivation

Both immunity and an exemption involve receiving a government benefit. But their conditions for receipt and how they are received differs. These are now discussed in turn.

Immunities were originally derived from royal grants and later by the king in parliament<sup>36</sup>. More recently, as noted above, they are granted by parliament itself. Immunity is automatic in that the entity receiving it is not required to take any action<sup>37</sup>. It is also necessary to note that immunity is usually not granted *per se* but depends on the activity in question that is being pursued by the state. Notwithstanding sovereign immunity’s long tradition, it has been commented that the ‘legal literature is still void of a theoretical analysis in what circumstances immunity should be granted and, more importantly, why’<sup>38</sup>. Any decision can therefore be ad hoc and discretionary<sup>39</sup>.

A tax exemption, on the other hand, is provided for in tax legislation and only those taxpayers who meet the qualifying criteria are entitled to take advantage of such exemptions. But it is not automatic; it requires a conscious decision and specific action

on the part of the taxpayer, such as the making of an election. Thus, exemptions must be requested or applied for by the party seeking to obtain the benefit.

It can therefore be asserted that immunity is bestowed as a privilege, a favour or as a right. An exemption only becomes a right because it is granted.

## 2.6 *In summary*

Immunities permit their recipient special treatment in that they are excused from a law imposed on others. Granted by ministerial discretion, it is not dependent on fixed or predetermined facts or circumstances but is a privilege bestowed in an ad hoc manner. It is a principle, malleable to achieve a certain outcome irrespective of the particular regime or relevant legal system. The methodology is irresolute but the result is assured. If granted this is automatic, requiring no action on the part of the recipient. If granted it is also assured in that the legal process will submit to the political decision. Whether customary or statutory, sovereign immunity is entrenched in international law.

As an exception to the law, an exemption provides a specific legal consequence. Rather than being ad hoc, certain conditions have to be met in order to qualify for receipt of the benefit. Legislation not only gives it authenticity but also efficacy. As such, exemptions are ‘there for the taking’, requiring qualifying persons to take action in order to secure the benefit. Contrived by the executive and/or legislature branch of government, it is left to the judiciary to interpret the exemption within the applicable law. Always statutory, exemptions are grounded in municipal law.

## 3 **Impacts and effects**

The outcome of granting immunity and (total) exemption are identical in that there is no liability for tax. Just as ‘immunity’ and ‘exemption’ have different meanings in the context of taxing sovereign wealth funds, so too do they have different consequences, impacts and effects on institutions, processes and policies. This is discussed under the sub-headings of regulatory regimes and the rule of law, due process and market behaviour.

### 3.1 *Regulatory regime and the rule of law*

With a regulatory regime, issues can arise with state oversight, whether they are called ‘ministerial discretion’ or ‘political interference’. The effects can be illustrated by looking at Australia’s foreign direct investment (FDI) regime as a case in point. On a share of global FDI flows relative to its share of global GDP, Australia has slipped from around 15th place globally to 131st place in the two decades to 2008. This slippage is due to the regulatory regime. The regulatory regime for FDI is the fifth most restrictive, after China, India, Russia and Iceland. These are also countries where the rule of law is weak. This fall in global rankings is directly attributable to the fact that the legislative framework for the regulation of FDI is built around ministerial discretion rather than the rule of law<sup>40</sup>.

Numerous empirical studies support the contention that government-owned banks underperform private-owned banks<sup>41</sup>. Studies by Shen et al. found that political interference undermines the performance of government banks<sup>42</sup>. They suggest that “[t]o

improve the performance of government banks, the government should not provide excessive guidance<sup>43</sup>. This is supported by a study which concluded that the performance of government-owned banks deteriorated more than private-owned banks during the Asian economic crisis in 1997 and 1998<sup>44</sup>. Further, the differences were most acute in countries whose governments intervened frequently in the banking system.

An example of a regulatory regime that works well is that pertaining to diplomatic immunities. This is largely because such immunities are derivative in nature – they are granted to persons because they are representatives of a state. Thus every state, regardless of size, influence or circumstances is accorded the same juridical respect. The rules are well established and universally accepted; there is no place here for ministerial discretion.

Where interventions are discretionary rather than rule-based or institutionalised, there is greater propensity to corruption and rent seeking<sup>45</sup>. Political interference, especially if accompanied by a lack of transparency, may be considered a form of corruption. Corruption does not have to mean fraudulent or moral depravity; it can mean that the outcome is tainted and the institution involved tarnished. It is nevertheless important to remember that ministers, as the executive branch of government, are responsible for executing policy. This necessarily implies the vesting of ministerial discretion. However, such discretion should be exercised in accordance with the rule of law, giving due consideration to procedural and substantive fairness<sup>46</sup>.

The hallmark of the rule of law is that authority is distributed in a way that ensures no single branch of government has the practical ability to exercise unchecked power. It may take the form of defining government powers in the law or effectively limiting government powers by the legislature and/or the judiciary. Thus the rule of law is effectively a constraint on government powers where government officials and agents are subject to, and held accountable under, the law.

Exemptions are based on the rule of law. Not only are they granted under legislation, but they are under the direct supervision of the judiciary in that the judiciary has interpretation oversight and direction of them. There is no ministerial discretion.

### 3.2 *Due process*

Due process relates to appropriate legal procedures and safeguards. Associated with the Magna Carta, the strict adherence to regular procedure was seen as ‘the most important safeguard against tyranny’<sup>47</sup>. The core meaning of ‘law of the land’, the term used in the Magna Carta, is to ensure that the substance of executive or judicial action is grounded in legal authority. A guarantee of due process ensures that, whenever a sovereign wealth fund interacts with a private entity, the law binds the sovereign or government from both a substantive and procedural perspective.

A lack of transparency and lack of accountability undermine due process. The term ‘transparency’ is concerned with openness of decisions and actions. It relates to the ‘right to know’ and public access to information<sup>48</sup>. Accountability requires the analysis of the potential effects of decisions on affected parties and explanation of the rationale for why the decision was reached<sup>49</sup>. It is a term that holds ‘strong promises of fair and equitable governance’<sup>50</sup>. Accountability is a means of controlling the exercise of power by holding the agent to account<sup>51</sup>. It also serves to enhance the integrity of government as it deters misuse or abuse of power and other forms of inappropriate behaviour<sup>52</sup>. Transparency and accountability assure the public confidence thereby providing legitimacy of

government<sup>53</sup>. Without these political biases may go undetected and good governance undermined.

Yet it must be acknowledged that, when dealing with other sovereign governments a certain degree of confidentiality, even secrecy, may be required. Whether this is necessary for a decision on whether a particular sovereign wealth fund is granted immunity with respect to taxation on its investment income is a moot point. While the issue of sovereign immunity often comes within the prerogative of the foreign affairs portfolio or ministry, the taxation of sovereign wealth funds can hardly be considered a foreign affair matter.

Tax exemptions are policy-based and, being part of a statute, undergo a rigorous process before passing into law. Once enacted, they can only be amended by further legislation which too undergoes the same rigorous process. Tax exemptions may well provide certain taxpayers with advantages not afforded to taxpayers generally. This may be based on the activity of the taxpayer (such as primary producers, mining or the film industry) or on the status of the taxpayer (such as charities or government agencies). While there may be a perceived bias in favour of those taxpayers eligible for the exemption, there is a valid policy reason to support it. It is economic or social bias rather than political bias.

### *3.3 Market behaviour*

Immunities provide an opportunity to ‘opt out’ of a deal by removing the incentive or extrinsic motivation to do the right thing and/or to behave as promised. van Aaken warns that the ‘credibility of the commitment of the state is considerably weakened due to the moral hazard danger inherent in immunity’<sup>54</sup>. Where governments are involved, performance, or a lack of performance, is often viewed as political acts (unwillingness to behave as promised) rather than commercial acts (inability to behave as promised)<sup>55</sup>.

From an economic and efficiency perspective, contracts and transactions must be enforceable. It is only then that they can be expected to be carried through against the threat of sanctions. A legal adage, as stated by Sir Blackstone in the 18th century is that “the sentence of a court would be contemptible, unless that court had power to command the execution of it”<sup>56</sup>. This applies equally to contracts and commercial transactions.

Institutional investors are the most influential stock market participants given the size and volumes of trades they conduct. This can have a significant impact on share prices. Asset managers also influence stock market prices when they carry out their investment decisions. The most influential participants in forex markets are governments and their central banks. They need to maintain foreign reserve volumes in order to meet certain economic objectives. Sovereign wealth funds can be all of these: institutional investors, asset managers and governments.

Invariably investment disputes arise. When involving a sovereign wealth fund the situation can be precarious and delicate for host governments. Not only are there political considerations such as foreign policy goal but there is also the potential to politicise investment disputes where power politics dictates the outcome<sup>57</sup>. Immunity can exacerbate this when viewed as a privilege. In the market or commercial context, a tax exemption is nothing more than a legitimate deduction in determining taxable income.



## **4 Principles of taxation**

As noted in the introduction, the objective of this paper is to determine the differences between granting immunity or an exemption when it comes to the taxation of sovereign wealth funds. The taxation aspect is explored by considering how the application of immunity and of exemptions relates to the commonly recognised tax principles of efficiency, equity, simplicity and certainty. After defining each term for the purposes of this paper, these principles will be discussed by reference to their impacts and effects.

### *4.1 Efficiency*

Efficiency is essentially an economic term. The state of being efficient is to be able to accomplish something with the least amount of waste, be that time, effort or resources. In other words, the tax system should not impede the productive capacity of the economy. The neutrality sub-element of efficiency means that the effect of a tax should not affect a taxpayer's decision<sup>58</sup>. That is, the tax law should not determine if or how an activity or transaction is entered into. This results in less distortion in decision making. As investment vehicles this is a fundamental objective as well as concern for sovereign wealth funds.

Economic theory dictates that any human action (such as a transaction) entails a cost: human action means choice and therefore foregone opportunities<sup>59</sup>. There is both a measurable objective cost (the accountancy cost) and a subjective choice cost (the economic cost). Efficiency requires low transaction costs<sup>60</sup>. The character of institutions is a very important determinant of these transaction costs<sup>61</sup>. When left to the market, the owners of resources have total freedom to employ the resources where they make the most valuable contribution, hence minimising transaction costs. In the case of investments, the type of resource used is capital. However, state intervention tends to increase transaction costs; the more interventionist, the greater the costs. Thus Marinescu deduces that 'a business environment characterised by a higher degree of economic freedom is one where the imposed transaction costs are lower, and vice versa'<sup>62</sup>.

It is important to remember that a tax system can be a tool for executing government policy. It is not uncommon for taxes to be intentionally designed to encourage or discourage certain activities in line with desired policy. Examples are establishing multiple tax rates, the provision of tax holidays and extending tax credits. Tax exemptions always have a 'behaviour influencing' objective as their provision ensures a reduction in tax revenue. This can therefore compromise the efficiency of the tax system.

Enforceability is also important as it is 'crucial to ensure efficiency of the tax system' as it 'influences the collectability and the administerability of taxes'<sup>63</sup>. This is also related to equity as it is inherently unfair when a class of taxpayers that are technically subject to a particular tax never pay it due to the inability to enforce it.

Immunity and exemptions can both affect efficiency depending on the facts and circumstances. A tax exemption will only be efficient if it does not impact on transaction costs. In other words, where the tax exemption does not influence the decisions on where resources are deployed. However, the intention of the policy with respect to the exemption may be to invoke such a deviant response. Similarly, with immunity state intervention will not necessarily increase transaction costs if resource use is not adversely affected. Further, provided enforceability does not become an issue, immunity may not create inefficiencies.

## 4.2 *Equity*

A tax system that applies to all target taxpayers in the same way is more likely to be equitable, where one entity has a tax advantage not available to another, distortions in decision making invariably result<sup>64</sup>. The ability to influence a favourable outcome is also considered to be fundamentally unfair<sup>65</sup>. Further, being seen to be fair can be as important as actually being fair<sup>66</sup>.

Ministerial discretion provides a government with flexibility in its decision making. Further, when dealing with matters involving a foreign government, as in decisions regarding sovereign wealth funds, it is not encumbering on the government to disclose reasons for its decisions. Sovereign confidentiality tends to override transparency and accountability, and may negate the need to give due consideration to procedural and substantive fairness. This secrecy means that it cannot be definitively established if the granting of immunity is equitable. What is clear is that immunity, because it is granted by ministerial discretion, is not seen to be fair which gives the impression that it may not be equitable.

Exemptions are legislated to apply to certain taxpayers and/or for certain activities. With respect to all taxpayers, restricting access to a tax benefit is not equitable. However, the exemption is provided pursuant to a certain policy. As such it is considered equitable for those who are the intended beneficiary of that policy.

## 4.3 *Simplicity*

Simplicity essentially means minimising complexity. There is also a positive correlation between simplicity of tax legislation and a reduction in compliance and administrative costs<sup>67</sup>. Not only does complexity make legislation difficult to understand and administer, it contributes to problems of interpretation and disputes.

Simplicity is also related to efficiency. A simple tax system makes it easier for taxpayers to understand their obligations and entitlements and, as a result, “businesses are more likely to make optimal decisions and respond to intended policy choices”<sup>68</sup>.

In taxation law, ‘exemption’ is a more developed notion than ‘immunity’, which may translate to the former being a simpler, or more pointedly, less complex, concept. But this does not necessarily imply that the application of an exemption is simpler than immunity. Indeed, where immunity is granted no further action is required. An exemption, however, requires the taxpayer to assess qualifying conditions and take any necessary action to secure the tax benefit.

## 4.4 *Certainty*

Certainty, or knowing the state of play, is an essential requirement when making investment decisions as it enables informed decisions to be made. It is particularly important for sovereign wealth funds given the long-term nature of their investments. Certainty is not only about how much tax to pay but also when and how it is to be paid. But there is another aspect to the principle of ‘certainty’: it helps to improve compliance and increases respect for the system<sup>69</sup>. This is significant as uncertainty and lack of credibility are important constraints on investment<sup>70</sup>, as is ensuring that taxpayers cannot avoid their legal liabilities<sup>71</sup>.

Legislation provides certainty, as does the rule of law. While tax legislation can be amended or abrogated, this would only affect future transactions as governments rarely legislate with retrospective effect, especially in the areas of penal and tax laws<sup>72</sup>. Whilst in some countries non-retroactivity is observed as a legally binding principle, most countries uphold it as a principle of tax policy<sup>73</sup>. Thus a taxpayer can take advantage on a legislated exemption with the full knowledge and confidence that it will be honoured.

Immunity can be rescinded as it is not based on the rule of law but on the discretion of the government of the day. Thus the foreign sovereign who has been granted immunity may have this revoked on a change of government in the issuing state or in retaliation for some political wrong, perceived or otherwise, as a form of sanction.

An investment transaction always has at least two parties: the investor (being the sovereign wealth fund) and the investee, which may be a company (for dividends) or other entity (for interest). Certainty is also important for the investee, given the long-term nature of the investments and hence of the relationship. As noted above there is a 'moral hazard danger' in being able to opt out of a transaction simply by claiming immunity. Thus, even if the non-sovereign party has fulfilled their contractual obligations, they may have no recourse to ensure the sovereign party completes. This risk may be sufficient to prevent non-sovereign parties from entering into contracts and/or transactions with sovereign entities.

The certainty principle is more likely to be met by an exemption rather than immunity. While immunity could be as certain as an exemption, not being grounded in the rule of law and due process nevertheless creates the perception of potential uncertainty.

## **5 Conclusions and recommendations**

The decision of whether to grant immunity or provide exemptions is an important one for governments. Where the government has a sovereign wealth fund, the government has a role as an investor. A primary goal of an investor is to get the best possible return on an investment. However, governments also have responsibility in attracting foreign investment in and to their state. Sovereign wealth funds are a significant source of long-term investment.

From a host country or taxing country perspective, efficiency and simplicity are of greater importance as these minimise tax costs. The brief assessment given here does not definitively resolve the question of whether immunity or exemption is preferable when it comes to providing tax benefits. That granting immunity may be considered a political act does not preclude its possible preference. Indeed, making tax exemption policy could also be perceived as a political act. Nevertheless, transparency and minimal government interference is recommended.

Sovereign wealth funds have different requirements. They seek equity in that they have access to benefits provided to other similar investors, and they seek certainty. With legislated tax exemptions, equity is assured. The granting of immunity is not necessarily a transparent process being of ministerial discretion and therefore its equitability may be unknown or perceived to be lacking. Certainty is also assured for tax exemptions. This is predominantly because legislation is the product of due process and the rule of law, with oversight provided by the judiciary.

Immunity or exemption: what are the consequences for sovereign wealth funds? A balanced assessment from a taxation perspective must favour exemption. Where the granting of immunity is deemed necessary it is recommended that this be as transparent as possible, keeping intervention to a minimum. Perception is as important as fact.

## Notes

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- 4 Garner, above no. 3, ‘exemption’.
- 5 Ibid, ‘exemption’.
- 6 Law and Martin, above no. 3, ‘immunity’.
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- 8 Ibid, pp.1390–1391.
- 9 Nygh, P.E. and Butt, P. (Eds.) (1997) *Butterworths Australian Legal Dictionary*, Butterworths, Sydney, ‘sovereign immunity’; Law and Martin, above no. 3, ‘sovereign immunity’.
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- 14 Dworkin, above no. 12, p.25.
- 15 See for example income tax (exemption of income of SICOM) rules, *Income Tax Act Chapter 134* (Singapore).
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- 17 Finke, above no. 13, p.874.
- 18 Ibid, p.880.
- 19 This point is discussed in the next section.
- 20 *Encyclopedia of Public International Law* (2000) Vol. 4, p.619, Elsevier, Amsterdam.
- 21 It should be noted that international treaties require legislation to be effective and are therefore a product of the doctrine of transformation.
- 22 Singapore *State Immunity Act* (chapter 313) subsection 16(1). A separate entity will only be immune from the jurisdiction of the courts in Singapore if, and only if, it was exercising a sovereign authority and the circumstances are such that a State would have been immune in those same circumstances: subsection 16(2).

- 23 Australia *Foreign States Immunity Act* 1985 subsection 3(1) definition of 'separate entity'.
- 24 For example exemptions from income tax are found in income tax legislation; exemptions from taxes on goods or services are found in goods and services tax (GST) or value-added tax (VAT) legislation.
- 25 This section is summarised from National Conference of State Legislatures, *Separation of Powers – An Overview* [online] <http://www.ncsl.org/research/about-state-legislatures/separation-of-powers-an-overview.aspx> (accessed 14 March 2016).
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- 31 (2011) 14 HKCFAR 95, p.395.
- 32 *Basic Law of Hong Kong* Articles 13 and 19. See also Ding, Y. (2012) 'Absolute, restrictive, or something more: did Beijing choose the right type of sovereign immunity for Hong Kong?', *Emory International Law Review*, Vol. 26, No. 2, pp.997–1038.
- 33 This means that no exceptions to immunity apply and any waiver must be explicit. The restrictive approach allows for exceptions, most notably for commercial activities where the other party is a non-government entity.
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- 35 *Encyclopedia of Public International Law* (2000) Vol. 4, p. 619, Elsevier, Amsterdam.
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