

Financial Services Tax News

Special Edition: September 2009

PwC Japan Tax Newsletter

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Taxation of Sovereign Wealth Funds in Japan

Rising oil and commodities prices, together with the export boom in Asia underpinning Asian central bank's excess foreign exchange reserves, fuelled the rapid growth of Sovereign Wealth Funds (SWFs) in recent years. Whilst SWFs have been in existence for over 50 years, their assets under management (AuM) and number formed over the last five years accelerated dramatically, raising their profile as key players in the global investment market.

Although there is evidence the current economic downturn is leading SWFs to become more circumspect with their investments in the western market and thus more inclined to invest in their home markets in support of local distressed enterprises, this trend may be temporary. As the world economy is recovering from the current recession, the investments of SWFs' are likely to become more diversified, not only in the types of investments they own, but also in the regions where these investments are located. One of the drivers behind the emergence of SWFs as an investing class was that, unlike general government reserves, they are less controlled by government policy and politics, and more focused on investment returns.

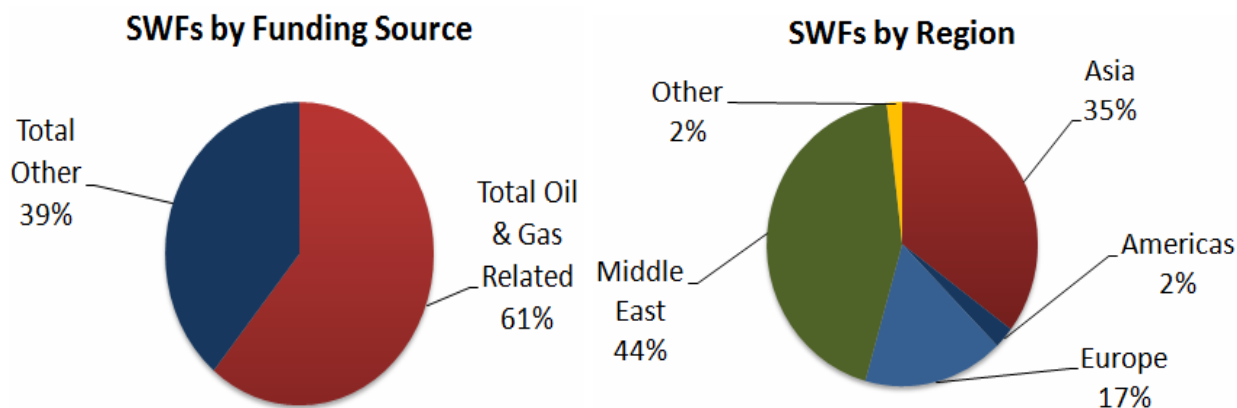
In order to encourage more foreign funds, including SWFs, to invest in Japan, the Japanese government relaxed the incidence of taxation of capital gains and permanent establishment rules for certain non-resident investors over the last two fiscal year reforms. This Special Edition will focus on the taxation in relation to SWFs making investments generally, including the Japanese taxation of foreign governments and SWFs investing in Japan.

Background

What are Sovereign Wealth Funds?

Whilst there is no generally agreed definition, SWFs may be considered special purpose investment funds or arrangements owned by the general government¹. Created for macroeconomic purposes, SWFs hold, manage and administer assets to achieve financial objectives, and employ a set of investment objectives which include investing in foreign financial assets. SWFs are commonly established out of balance of payments surpluses, official foreign currency operations, privatization proceeds, fiscal surpluses, and/or receipts from commodity exports.

The charts below represent worldwide SWFs by source of funding and region:



The table below lists SWFs around the world, ranked by the volume of AuM in US dollars:

Country	Fund Name	Assets \$Billion	Inception	Origin
UAE - Abu Dhabi	Abu Dhabi Investment Authority	\$627	1976	Oil
Saudi Arabia	SAMA Foreign Holdings	\$431	n/a	Oil
China	SAFE Investment Company	\$347.1		Non-Commodity
Norway	Government Pension Fund - Global	\$326	1990	Oil
Singapore	Government of Singapore Investment Corporation	\$247.5	1981	Non-Commodity
Russia	National Welfare Fund	\$219.9	2008	Oil
Kuwait	Kuwait Investment Authority	\$202.8	1953	Oil
China - Hong Kong	Hong Kong Monetary Authority Investment Portfolio	\$193.4	1998	Non-Commodity
China	China Investment Corporation	\$190	2007	Non-Commodity
Singapore	Temasek Holdings	\$85	1974	Non-Commodity
China	National Social Security Fund	\$82.4	2000	Non-Commodity
UAE - Dubai	Investment Corporation of Dubai	\$82	2006	Oil
Libya	Libyan Investment Authority	\$65	2006	Oil
Qatar	Qatar Investment Authority	\$62	2003	Oil
Algeria	Revenue Regulation Fund	\$47	2000	Oil
Australia	Australian Future Fund	\$42.2	2004	Non-Commodity
Kazakhstan	Kazakhstan National Fund	\$38	2000	Oil
Brunei	Brunei Investment Agency	\$30	1983	Oil
France	Strategic Investment Fund	\$28	2008	Non-Commodity
South Korea	Korea Investment Corporation	\$27	2005	Non-Commodity
US - Alaska	Alaska Permanent Fund	\$26.7	1976	Oil
Malaysia	Khazanah Nasional	\$23.1	1993	Non-Commodity
Ireland	National Pensions Reserve Fund	\$22.8	2001	Non-Commodity
Chile	Social and Economic Stabilization Fund	\$21.8	1985	Copper

¹ See International Monetary Fund, Monetary and Capital Markets Policy Development and Review Departments, "Sovereign Wealth Funds - A Work Agenda", February 29, 2008, www.imf.org/external/np/pp/eng/2008/022908.pdf.

Country	Fund Name	Assets \$Billion	Inception	Origin
UAE - Abu Dhabi	Mubadala Development Company	\$14.7	2002	Oil
Bahrain	Mumtalakat Holding Company	\$14	2006	Oil
UAE - Abu Dhabi	International Petroleum Investment Company	\$14	1984	Oil
Iran	Oil Stabilisation Fund	\$13	1999	Oil
Canada	Alberta's Heritage Fund	\$11.9	1976	Oil
US - New Mexico	New Mexico State Investment Office Trust	\$11.7	1958	Non-Commodity
Azerbaijan	State Oil Fund	\$10.8	1999	Oil
Nigeria	Excess Crude Account	\$9.4	2004	Oil
New Zealand	New Zealand Superannuation Fund	\$8.6	2003	Non-Commodity
Oman	State General Reserve Fund	\$8.2	1980	Oil & Gas
Botswana	Pula Fund	\$6.9	1966	Diamonds & Minerals
Brazil	Sovereign Fund of Brazil	\$5.9	2009	Non-Commodity
Saudi Arabia	Public Investment Fund	\$5.3	2008	Oil
China	China-Africa Development Fund	\$5	2007	Non-Commodity
East Timor	Timor-Leste Petroleum Fund	\$4.2	2005	Oil & Gas
US - Wyoming	Permanent Wyoming Mineral Trust Fund	\$3.6	1974	Minerals
US - Alabama	Alabama Trust Fund	\$3.1	1986	Gas
Trinidad & Tobago	Heritage and Stabilization Fund	\$2.9	2000	Oil
Malaysia	Terengganu Investment Authority	\$2.8	2008	Oil
UAE - Ras Al Khaimah	RAK Investment Authority	\$1.2	2005	Oil
Venezuela	FIEM	\$0.8	1998	Oil
Vietnam	State Capital Investment Corporation	\$0.5	2006	Non-Commodity
Kiribati	Revenue Equalization Reserve Fund	\$0.4	1956	Phosphates
Indonesia	Government Investment Unit	\$0.3	2006	Non-Commodity
Mauritania	National Fund for Hydrocarbon Reserves	\$0.3	2006	Oil & Gas
UAE - Federal	Emirates Investment Authority	x	2007	Oil
Oman	Oman Investment Fund	x	2006	Oil
UAE - Dubai	Dubai World	x	2006	Oil
	Total Oil & Gas Related	\$2,203.1		
	Total Other	\$1,424.6		
	TOTAL	\$3,627.7		

As the above charts and table illustrate², most countries with SWFs tend to be either oil exporters or Asian countries, which have had rapid accumulation of foreign assets due to high oil prices or sustained large global surpluses in trade. Most current estimates place SWFs' AuM as between \$2 trillion and, likely nearer to, \$3 trillion.

Growing Profile

Owing to some high profile investments, SWFs have recently become increasingly recognized as major investors in international financial markets. Public interest from the media, politicians, and multinational financial institutions surged when several Asian and Middle Eastern SWFs made significant investments in newly issued stock in some of the largest American and European banks at the height of the subprime mortgage crisis.

Regulatory Framework

In response to the public reactions to SWFs and their investment activities, international bodies such as the International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD) have worked together, developing best practices that will provide guidance to SWFs on how to

2 Charts and table compiled by the Sovereign Wealth Fund Institute, www.swfinstitute.org/funds.php. All figures from official sources as of April, 2009, or, where the institutions concerned do not issue statistics of their assets, from other publicly available sources. Some figures are best estimates, as market values change day to day and many SWFs do not formally report their AuM. Other sources includes: Sovereign Wealth Funds, Joint Economic Committee, US Congress, Research Report #110.21, February 2008; Weathering the Storm, Sovereign Wealth Funds in the Global Economic Crisis of 2008, April 2009, Monitor Group and Fondazione Eni Enrico Mattei.

improve institutional arrangements, organizational structures and risk management and information dissemination practices.

A group of 23 countries (together with three observer countries, the OECD and the World Bank) with SWFs convened on May 1, 2008 and established the International Working Group of Sovereign Wealth Funds (IWG), which devised and released on October 11, 2008 a set of voluntary "Generally Accepted Principles and Practice" for SWFs, known as the Santiago Principles³, aiming to provide a framework that reflects appropriate governance and accountability arrangement as well as the conduct of investment practices by SWFs on a prudent and sound basis.

Overview of the Global Taxation of Sovereignty and SWFs

Sovereign Immunity

In general, there tends to be no explicit provision in respect of sovereign immunity for commercial activities in host investment states; however, foreign governments may be exempt from tax on passive income, including interest on deposits and dividends, sometimes through administrative practice or regulation. However, it is often uncertain whether such immunity may be extended to non-passive income (including portfolio income beyond interest and dividends) received by foreign governments or central banks, and if so, how it may be sought in practice.

SWFs

There is typically a specific exemption from taxation in the home state of a SWF. However, there is no consistent global approach, suggested in practice or by the OECD, for the taxation of SWFs investing outside their home state⁴.

Some jurisdictions - a minority - have regimes which may allow foreign SWFs to obtain an exemption from taxation; although this is generally restricted to passive type income derived in that country. Where applicable, such exemption provisions may be enacted in the domestic law, operated by administrative practice or through reciprocal double tax treaty provisions.

Taxation Status of Foreign Governments and SWFs in Japan

Under the Japanese tax laws, foreign corporations are subject to Japanese corporation tax and withholding income tax on certain Japan sourced income.

Under diplomatic practice and conventions, certain income derived by foreign governments in Japan is not subject to taxation. However, the taxation of foreign governments and foreign public corporations is not clearly stipulated under the Japanese tax laws and regulations; in particular, foreign governments and foreign public corporations are not included in the definition of "public corporations" and "public interest corporations" of which certain income are specifically exempt from taxation under the Japanese tax laws.

Unlike foreign governments in certain circumstances, SWFs could be subject to Japanese corporation tax and withholding income tax.

In practice, then, SWFs investing in Japan – whether directly or indirectly - have to date generally conducted their taxation affairs like any investment fund, paying taxation and considering their investment profile in the same manner as private equity, real estate and other global or regional funds formed outside of Japan making Japanese investments.

Double Taxation Treaties

To the extent that SWFs investing in Japan are subject to Japanese tax, SWFs may consider whether there is a tax treaty in place between Japan and the country of its residence, and, if so, the eligibility of the legal entity making the investment for or on behalf of the particular SWF, which may either reduce the rate of tax payable,

³ Details on the Santiago Principles available at the IWG website, <http://www.iwg-swf.org/pubs/gaplist.htm>.

⁴ For an outline of the taxation of SWFs in the US and other selected countries, see reports issued by the Joint Committee on Taxation in June 2008 and the Directorate of Legal Research for International, Comparative, and Foreign Law at the Library of Congress in May 2008, available at www.house.gov/ict/x-49-08.pdf

or eliminate the tax altogether.

One example is from the Japan-Singapore Tax Treaty⁵, which has an explicit provision exempting a particular SWF (the Government of Singapore Investment Corporation) from taxation on interest income earned in Japan. Of current interest are Japan's recent treaty negotiations with some of the Middle Eastern countries, in particular Saudi Arabia, UAE and Kuwait, and whether these treaties will contain any exemption for certain Japanese taxes for any specific SWFs formed in those states.

5 Agreement between the Government of Japan and the Government of the Republic of Singapore for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, signed April 9, 1994; refer Article 11.

For more detailed information, please do not hesitate to contact your financial tax services representative or any of the following members:

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