

A THEORY OF TAXING SOVEREIGN WEALTH

VICTOR FLEISCHER*

Sovereign wealth funds enjoy an exemption from tax under § 892 of the tax code. This anachronistic provision offers an unconditional tax exemption when a foreign sovereign earns income from noncommercial activities in the United States. The Treasury regulations accompanying § 892 define noncommercial activity broadly, encompassing both traditional portfolio investing and more aggressive, strategic equity investments. The tax exemption, which was first enacted in 1917, reflects an expansive view of the international law doctrine of sovereign immunity that the United States (and other countries) discarded fifty years ago in other contexts. Because § 892 was not written with sovereign wealth funds in mind, the policy rationale for this generous tax treatment has not been closely examined in the academic literature.

This Article provides a framework for analyzing the taxation of sovereign wealth. I start from a baseline norm of “sovereign tax neutrality,” which departs from the current regime under § 892 by treating the investment income of foreign sovereigns no better and no worse than foreign private investors’ income and by favoring no one nation over another. Whether we should depart from this norm depends on several factors, including what external costs and benefits are created by sovereign wealth investment, whether tax or other regulatory instruments are superior methods of attracting investment or addressing harms, and which domestic political institutions are best suited to implement foreign policy. I then consider whether we should impose an excise tax that would discourage sovereign wealth fund investments in U.S. companies. This tax might be designed to complement nontax economic and foreign policy goals by discouraging investments by funds that fail to comply with best practices for transparency and accountability.

The case for repealing the existing tax subsidy is strong. We should tax sovereign wealth funds as if they were private foreign corporations; there is no compelling reason to subsidize sovereign wealth. At the same time, my analysis suggests that policymakers should be cautious about going any further: An excise tax may not be the optimal regulatory instrument for managing the special risks posed by sovereign wealth funds.

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INTRODUCTION

Prologue. Morgan Stanley, the storied New York investment bank, was navigating treacherous waters in late 2007. The white-shoe firm held billions of dollars worth of exposure to subprime mortgages. It had already taken \$5 billion of losses on its income statement, and more losses were expected. Bear Stearns, AIG, and Lehman had not yet collapsed, but Wall Street was already concerned that the credit crunch could induce the death spiral of a major financial institution. Morgan Stanley needed additional equity to shore up its balance sheet.¹

Like many of its investment banking rivals, Morgan Stanley turned to a sovereign wealth fund for assistance. On December 19, 2007, Morgan Stanley announced the sale of a 9.9% equity stake to the China Investment Corporation (CIC), a sovereign wealth fund controlled by the Chinese government.² Just a few years before, this

¹ See Michael J. de la Merced & Keith Bradsher, *Morgan Stanley To Sell Stake to China Amid Loss*, N.Y. TIMES, Dec. 19, 2007, <http://www.nytimes.com/2007/12/19/business/19cnd-morgan.html> (reporting Morgan Stanley had posted its “first quarterly loss ever” due to a \$5.7 billion subprime mortgage write-down).

² *Id.*

kind of financing deal between a New York investment bank and a foreign government was virtually unheard of. An investment bank in dire straits would likely have turned instead to a private investor—perhaps a private equity fund in the United States or a private investor in Europe, Japan, or the Persian Gulf. By 2007, however, sovereign wealth funds had appeared on the scene as ready suppliers of equity capital. These state-controlled investment funds, which had historically invested primarily in Treasury bonds and other government obligations, were eagerly buying up the shares of financial services firms like Morgan Stanley, Citigroup, Blackstone, Carlyle, and Merrill Lynch.

It's easy to understand why Morgan Stanley sold equity to China: It needed the money, and China was an appealing counterparty. China offered the best price, agreed to be locked in to the stock for several years, and was willing to take equity without the control rights or board seats a hedge fund or private equity fund might have demanded. The deal was structured using a tailored financial product that avoids CFIUS review,³ counts as Tier 1 capital for bank regulatory purposes, and receives some equity credit from the rating agencies, but generates a tax deduction for Morgan Stanley when it makes dividend-like quarterly contract payments to China. (Because China's sovereign wealth fund is tax exempt, it pays no tax on the receipt of those payments. As I discuss below, the tax exemption under current law effectively enhances the ability of sovereign wealth funds to purchase U.S. equities.⁴) From Morgan Stanley's point of view, there was little downside.

The challenge is figuring out why China was willing to make the investment on these terms. It's naïve to assume that China bought the stock purely for financial reasons; China did not suddenly become the Warren Buffett of the global capital markets, divining intrinsic value in Morgan Stanley stock that other financial investors failed to unearth. More plausible is the explanation that China bid a higher price for the stock because it had other, nonfinancial motives as well. The problem with sovereign wealth funds is that it's not entirely clear what these motives are. The best we can do is infer China's objectives from the available evidence.

To be sure, the managers of China's state-controlled investment vehicles have a financial motive to achieve good investment returns. But as a sovereign nation, China also has a range of other political and

³ CFIUS stands for Committee on Foreign Investment in the United States, an inter-agency committee chaired by the Secretary of the Treasury that reviews certain cross-border deals for national security considerations.

⁴ See *infra* Part II.A.

strategic interests that shape its investment policy. Through its State Administration of Foreign Exchange (SAFE), for example, China recently bought \$300 million in bonds from Costa Rica as part of a deal in which Costa Rica switched its diplomatic recognition from Taiwan to Beijing.⁵ While CIC is managed separately from SAFE, the structure of CIC ensures that the fund is also sensitive to the political and strategic influence of China's ruling party. CIC reports directly to the State Council (the equivalent of the U.S. President's cabinet), and nearly all of CIC's board of directors hold Party-appointed jobs within China's financial bureaucracy.⁶ Investing in firms like Morgan Stanley, Blackstone, Visa, and Barclays advances China's geopolitical agenda by embedding the Chinese government in Western financial networks. This isn't necessarily bad: China can learn from its relationships with Western financial institutions as it continues to modernize its financial system. More ominously, however, by investing directly in U.S. companies, China expands its influence over American economic and foreign policy.

Our understanding of sovereign wealth funds is limited by the funds' lack of transparency. What we do know for certain, after observing the recent string of investments in U.S. financial institutions by sovereign wealth funds, is that these funds were willing to pay more for the equity of these financial institutions than private investors were willing to pay. Tax may be part of the explanation: Exemption from the U.S. withholding tax on dividends provides sovereign wealth funds with a competitive advantage over private foreign investors. The mixing of political motives with financial motives is likely a factor as well. In corporate finance terms, the funds had a lower "hurdle rate" for these target investments: Their managers count strategic and political gains as well as financial gains in evaluating the success of an investment. The political dynamics of investments by states such as Abu Dhabi, Saudi Arabia, and Singapore differ from China, but all share the potential for mixed-motive investments.

The ambiguity of mixed-motive investment has fueled broad anxiety about sovereign wealth funds. Fifty-five percent of registered voters think investments made by foreign governments in U.S. companies have a negative effect on U.S. national security, while only ten percent see a positive effect.⁷ Voters generally tolerate investment by

⁵ Andrew Batson, *China Used Reserves To Sway Costa Rica*, WALL ST. J., Sept. 13, 2008, at B3.

⁶ For further discussion of CIC's structure, see Appendix, *infra*.

⁷ PUB. STRATEGIES, INC., U.S. NATIONAL OMNIBUS SURVEY CONDUCTED FEBRUARY 12-13, 2008, at 1 (2008), available at http://www.pstrategies.com/pdfs/PR_20080213_PSI_SWF_Poll.pdf (question 5).

Australia, Norway, and Europe, but strongly oppose investment by Kuwait, Russia, China, Saudi Arabia, and Abu Dhabi.⁸ The negative reaction is not restricted to the uninformed or xenophobic. Top leaders in Europe share the American public's skepticism, and a few high-profile American observers, like Senator Evan Bayh and former Treasury Secretary Lawrence Summers, have also expressed concern over sovereign wealth fund investment.⁹

There is a yawning gap between the public's apprehension and the Bush administration's welcome mat. Consider the upbeat comments of Robert Kimmitt, acting as deputy secretary of the Treasury at the time: "[Sovereign wealth funds] may be considered a force for financial stability—supplying liquidity to the markets, raising asset prices, and lowering borrowing yields in the countries in which they invest."¹⁰ Foreign investment in U.S. companies is a key element of our future economic growth, and the Treasury Department has embraced open access to U.S. capital markets by foreign investors as the dominant principle driving public policy in this area. What the Bush administration sought—and what other academics have offered¹¹—is a set of modest regulatory responses that sprinkle holy water on these state-controlled investments, allowing state-owned capital to flow seamlessly across borders without scraping up against geopolitical concerns.

Tax policy offers stronger medicine that Congress and policy-makers in the Obama administration might consider in order to address the risks posed by sovereign wealth. Tax policy also provides a useful framework for examining the institutional context in which sovereign wealth funds operate.¹² Sovereign wealth funds act as both financial institutions and political institutions. The ties between sover-

⁸ *Id.* at 2 (question 11).

⁹ See *infra* note 145 and text accompanying notes 172–74.

¹⁰ Robert M. Kimmitt, *Public Footprints in Private Markets*, FOREIGN AFF., Jan./Feb. 2008, at 119, 122.

¹¹ See *infra* Part II.B.1 (discussing existing proposals for light regulation of sovereign wealth funds).

¹² I have previously studied how tax policy affects the framework of institutional investment, such as how tax policy affects venture capital firms and private equity firms, the companies they own, and the institutional investors they partner with. See, e.g., Victor Fleischer, *The Missing Preferred Return*, 31 J. CORP. L. 77 (2005) (examining how tax policy affects contracting between investors and private equity fund managers); Victor Fleischer, *The Rational Exuberance of Structuring Venture Capital Start-Ups*, 57 TAX L. REV. 137 (2003) (identifying institutional factors to explain why portfolio companies adopt seemingly tax-inefficient structure); Victor Fleischer, *Taxing Blackstone*, 61 TAX L. REV. 89 (2008) (analyzing tax treatment of private equity firms organized as publicly traded partnerships); Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1 (2008) [hereinafter Fleischer, *Two and Twenty*] (proposing tax on carried interest).

eign wealth funds and the political institutions that own and direct their investment policies underscore how they differ both conceptually and in practice from their institutional investor counterparts in the private sector. These institutional differences lead me down two interconnected paths in constructing a theory of taxing sovereign wealth.¹³

First, thinking about sovereign wealth funds as institutional investors exposes a striking tax policy discrepancy. On the one hand, sovereign wealth funds expect to be treated like private financial investors for purposes of corporate law, banking law, and national security law. They promise to invest for purely financial purposes.¹⁴ On the other hand, for tax purposes we unilaterally treat them as sovereigns acting to further political, diplomatic, or humanitarian agendas, and we therefore exempt them from taxation as if it were a matter of international comity. It is hardly obvious that we should allow sovereign wealth funds to enjoy the best of both regulatory worlds. As sovereign wealth funds become powerful players in the capital markets, the more logical presumption is that they should pay

¹³ In addition to tax and public finance scholarship, this Article draws insight from new institutional economics, a methodology that applies transaction cost economics to institutions (as opposed to organizations, firms, or individuals). See generally Ronald H. Coase, *The New Institutional Economics*, 88 AM. ECON. REV. (SPECIAL ISSUE) 72 (1998); Douglass C. North, *Institutions*, 5 J. ECON. PERSP. 97 (1991); Oliver E. Williamson, *The New Institutional Economics: Taking Stock, Looking Ahead*, 38 J. ECON. LITERATURE 595 (2000). Institutions are the set of formal and informal laws, rules, and norms that determine the behavior of individual actors. North, *supra*, at 97.

¹⁴ The International Working Group of Sovereign Wealth Funds, a group coordinated and facilitated by the International Monetary Fund (IMF), recently released its nonbinding guidelines for sovereign wealth fund best practices. While the guidelines stress that investment decisions should aim to maximize financial returns, the guidelines do, in fact, allow for political or strategic investment, so long as the nonfinancial motives are disclosed. The guidelines state:

GAPP 19. Principle

The [sovereign wealth fund's] investment decisions should aim to maximize risk-adjusted financial returns in a manner consistent with its investment policy, and based on economic and financial grounds.

GAPP 19.1. Subprinciple. If investment decisions are subject to *other than* economic and financial considerations, these should be clearly set out in the investment policy and be publicly disclosed.

GAPP 19.2. Subprinciple. The management of [a sovereign wealth fund's] assets should be consistent with what is generally accepted as sound asset management principles.

INT'L WORKING GROUP OF SOVEREIGN WEALTH FUNDS, SOVEREIGN WEALTH FUNDS: GENERALLY ACCEPTED PRINCIPLES AND PRACTICES—"SANTIAGO PRINCIPLES" 8 (2008), available at <http://www.iwg-swf.org/pubs/eng/santiagoprinciples.pdf> [hereinafter SANTIAGO PRINCIPLES].

tax like other financial institutions. There is, after all, no compelling reason to favor state-controlled investment over private capitalism.¹⁵

Second, paying attention to institutional detail illuminates critical differences between sovereign wealth funds and other financial institutions. Many sovereign wealth funds are not mature, experienced financial institutions. They have not yet adopted the norms of professionalization that have led to the flourishing of other potentially politically sensitive institutional investors, like U.S. state pension funds and university endowments.¹⁶ History suggests that we should not encourage investment by financial institutions that have not yet internalized these important norms.¹⁷ Indeed, we may even want to impose an excise tax to actively discourage investments by sovereign wealth funds. That said, institutional analysis also reveals striking differences among funds. China, Singapore, and Abu Dhabi, for example, each have different goals, and each has adopted different governance structures for its various funds in order to achieve those goals. Tax policy may not be the optimal regulatory tool to address the disparate risks created by each fund, particularly as those funds evolve over time.

* * *

Summary of the Argument. This Article provides a framework for analyzing the taxation of sovereign wealth. I start from a baseline norm of “sovereign tax neutrality,” which would treat the investment income of foreign sovereigns no better and no worse than private investors’ income, and would favor no one specific nation over another. Whether we should depart from this norm depends on several factors, including what external costs and benefits are created by sovereign wealth investment, whether tax or other regulatory instruments are superior methods of attracting investment or addressing

¹⁵ See *infra* Part II.A–B.

¹⁶ Broadly speaking, professional norms dictate that pension fund and endowment managers seek to achieve the highest possible risk-adjusted return for their beneficiaries, and that they invest for financial purposes and not political purposes. While public pension funds sometimes bow to political pressure and invest to achieve political ends, such political actions are perceived to be violations of proper investment norms and, perhaps, fiduciary standards. See generally Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 799–820 (1993) (discussing pressures public pension funds face to invest for political or other nonfinancial reasons).

¹⁷ Indeed, lack of political independence in pension fund boards correlates with lower earnings. Cf. *id.* at 820–31 (finding “significant positive relationship between performance and independent . . . composition” of public fund boards). Typically, politically motivated pension funds perform worse, even if they are perceived in local politics as professional. Cf. *infra* note 171 (discussing evidence in support of concerns about sovereign wealth funds with mixed financial and political motives).

harms, and which domestic political institutions are best suited to implement foreign policy. I then consider whether we should impose an excise tax that would discourage sovereign wealth fund investments in U.S. companies. If desired, the tax could be designed to complement nontax economic and foreign policy goals by discouraging investments by funds that fail to comply with best practices for transparency and accountability.

The case for repealing the existing tax subsidy is strong. Absent a compelling reason to subsidize sovereign wealth, we should tax sovereign wealth funds as if they were private foreign corporations. At a minimum, the tax exemption should be offered only if reciprocal treatment is offered for U.S. funds, such as state pension funds and Alaska's Permanent Fund. At the same time, my analysis suggests that policymakers should be cautious about using tax policy to implement foreign policy; an excise tax may not be the optimal regulatory instrument for managing the special risks posed by sovereign wealth funds.

The recent meltdown of the financial services industry does not moot the question of how we should tax sovereign wealth. To be sure, an excise tax on sovereign wealth is politically unpalatable at the moment, given the shakiness of the capital markets. But a framework for understanding the taxation of sovereign wealth is important for several reasons. First, this framework is intended to be useful to policymakers not only in the Obama administration but for many years in the future; understanding the effects of tax policy on sovereign wealth fund investment will be relevant to policymaking in the long term. Second, the bailout and nationalization of banks in the United States and Europe have further blurred the line between sovereign and private investment activity, increasing the need for regulatory clarity. All nations—not just the few discussed above—appear willing to employ sovereign investment as an instrument of economic and foreign policy. Tax is just one regulatory arena affected by the new landscape of financial institutions, but it is a critical one to consider because tax impacts financial returns so directly. Third, even if an excise tax is unwarranted at present, it is still important to consider whether current law is justified.

The recent financial crisis does affect the analysis in one important way. In Part II below, I discuss the various positive and negative externalities associated with sovereign wealth investments. The first-order effects of sovereign investment are mostly positive, tangible, and immediate, while most of the negative externalities are second-order effects, more likely to impact foreign policy in the future. While one should not ignore the thunderclouds on the horizon, the current

financial environment may understandably lead policymakers to exercise regulatory restraint. This reality informs my conclusion that an excise tax might be best kept on the shelf until such a time when the first-order effects become less valuable or the more troubling second-order effects come closer to the fore.

Part I of this Article reviews current law. The tax treatment of sovereign wealth has been ignored by academics in recent years.¹⁸ Under current law, portfolio investments by foreign state-owned entities, including strategic equity investments, are categorically exempt from U.S. tax.¹⁹ By contrast, portfolio investments by private foreign

¹⁸ There is a small literature from the 1970s on § 892. See sources cited *infra* notes 46–51. The articles mainly focus on the distinction between commercial and noncommercial activity. Because sovereign wealth funds had not yet emerged, the articles pay little attention to the portfolio investment activity of sovereigns. Even as sovereign wealth funds drew scrutiny in Congress in 2007 and 2008, their tax treatment was overlooked.

It appears, however, that some policymakers are interested in reconsidering how to tax sovereign wealth. On March 4, 2008, I posted an item on the Conglomerate blog describing an early version of this Article. Posting of Victor Fleischer to The Conglomerate, <http://www.theconglomerate.org/2008/03/taxing-sovereign.html> (Mar. 4, 2008). The item was picked up by financial blogs and the financial press. Christopher S. Rugaber, *Scholar Targets Sovereign Wealth Funds*, S.F. CHRON., Mar. 7, 2008, at C3; John Carney, *Taxing Sovereign Wealth Funds*, DEALBREAKER, Mar. 4, 2008, http://www.dealbreaker.com/2008/03/taxing_sovereign_wealth_fund.php; Nicholas Rummell, *Time To Tax Sovereign Wealth Funds, Says Academic*, FIN. WK., Mar. 5, 2008, <http://www.financialweek.com/apps/pbcs.dll/article?AID=/20080305/REG/363089433/1036> [hereinafter Rummell, *Time To Tax*]; *Should Sovereign Funds Be Taxed?*, N.Y. TIMES DEALBOOK, Mar. 5, 2008, <http://dealbook.blogs.nytimes.com/2008/03/05/blackstone-bill-professors-new-focus-sovereign-funds>; see also Una Galani et al., *U.S. Should Use as Political Lever Its Tax Break on Sovereign Funds*, WALL ST. J., Mar. 14, 2008, <http://online.wsj.com/article/SB120544570178634819.html> (endorsing my suggestion of using tax policy to further nontax objectives).

The tax-writing committees have also shown interest in the topic. On March 13, 2008, Senators Baucus and Grassley, the chair and the ranking member of the Senate Finance Committee, respectively, asked the Joint Committee on Taxation to examine the operation of § 892 in the context of investments by sovereign wealth funds. Press Release, U.S. Senate Comm. on Fin., Baucus, Grassley Seek JCT Analysis of U.S. Taxation of Sovereign Wealth Funds (Mar. 13, 2008), available at <http://finance.senate.gov/press/Gpress/2008/prg031308.pdf>; Nicholas Rummell, *Congress Looks at Tightening Screws on Sovereign Funds*, FIN. WK., Mar. 14, 2008, <http://www.financialweek.com/apps/pbcs.dll/article?AID=/20080314/REG/668397759>. I discuss the Joint Committee's report below. See *infra* notes 129–31 and accompanying text.

Finally, two important academic contributions appeared while this Article was circulating in draft form. See Michael S. Knoll, *Taxation and the Competitiveness of Sovereign Wealth Funds: Do Taxes Encourage Sovereign Wealth Funds To Invest in the United States?* (Univ. of Pa. Law Sch. Inst. for Law & Econ., Research Paper No. 08-28, 2008), available at http://ssrn.com/abstract_id=1291878 (analyzing tax-induced advantages and disadvantages for sovereign wealth funds relative to other classes of investors and in various investment categories); Mihir A. Desai & Dhammika Dharmapala, *Taxing the Bandit Kings*, 118 YALE L.J. POCKET PART 98 (2008), <http://thepocketpart.org/2008/11/17/desaiDharmapala.html> (arguing that tax advantage is illusory).

¹⁹ See generally STAFF OF JOINT COMM. ON TAXATION, 110TH CONG., ECONOMIC AND U.S. INCOME TAX ISSUES RAISED BY SOVEREIGN WEALTH FUND INVESTMENT IN THE

individuals and foreign corporations are taxed at rates as high as 30%, although this rate is often reduced by treaty or, in the case of most capital gains or portfolio interest, the investments are exempt from U.S. tax.²⁰ The tax preference makes the biggest difference with respect to equity investments in dividend-paying stocks. For example, when Morgan Stanley pays a dividend to a private foreign investor, a 30% tax is imposed and withheld at the source, unless a treaty rate applies. By contrast, when Morgan Stanley pays a dividend to the China Investment Corporation, the dividend is not taxed at all, so long as China provides a simple form certifying that it is a foreign sovereign within the meaning of § 892.²¹ The favorable tax treatment of sovereign investments allows sovereign investors to achieve a significantly higher after-tax return on equity investments than private investors.

Part II provides a normative framework for evaluating the taxation of sovereign wealth. It starts from a baseline of sovereign tax neutrality, which would tax sovereign investment vehicles as if they were private foreign corporations. There is a strong case for eliminating the existing tax preference in order to achieve neutrality. But because our tax system already looks favorably on private foreign portfolio investment, the practical impact of treating sovereign wealth funds like private investors would be modest. So, while repealing § 892 is a worthy policy goal that Congress should pursue, Part II.B addresses the more difficult question of whether we ought to go further and impose a higher tax on sovereign wealth than on private investment.

An excise tax on sovereign wealth might be justified in two ways. First, it could help correct for the fact that sovereign wealth funds invest with mixed motives, pursuing both financial and geopolitical gains. Mixed motives lead funds to use a lower hurdle rate when evaluating potential investments, thus raising the possibility of crowding out private investment in target companies with important geopolitical value, including financial institutions. A tax on sovereign wealth fund investment could help level the playing field between private and state-controlled investment.

UNITED STATES 1–2 (Comm. Print 2008) [hereinafter JCT REPORT], available at <http://www.house.gov/jct/x-49-08.pdf>; N.Y. STATE BAR ASS'N TAX SECTION, REPORT ON THE TAX EXEMPTION FOR FOREIGN SOVEREIGNS UNDER SECTION 892 OF THE INTERNAL REVENUE CODE 16–26 (2008) [hereinafter NYSBA REPORT], available at <http://www.nysba.org/ContentFolders20/TaxLawSection/TaxReports/1157rpt.pdf>.

²⁰ See *infra* Part I.C.

²¹ See I.R.S., Dep't of Treasury, Form W-8EXP (2006), Certificate of Foreign Government or Other Foreign Organization for United States Tax Withholding, available at <http://www.irs.gov/pub/irs-pdf/fw8exp.pdf>.

Second, a tax on sovereign wealth could, if imposed at a higher rate than the tax on private investors, affirmatively discourage investment in U.S. equities. If we believe that sovereign wealth funds—or certain types of investments by sovereign wealth funds—cause harm to the general public, a Pigouvian tax is one way to correct for the harm, in much the same way that a carbon tax might be used to control greenhouse gas emissions or a cigarette tax might be used to discourage smoking.

Part II.C of this Article then considers whether tax is the optimal regulatory instrument to address the risks posed by sovereign wealth funds. The academic literature on corrective taxes has largely focused on issues where externalities are relatively uniform regardless of who conducts the activity. Each additional unit of pollution, for example, is harmful to the environment to roughly the same degree, regardless of who emits it. In the sovereign wealth fund context, however, the negative externalities stem from the risk that investments will be made for political purposes that run contrary to the U.S. economic and foreign policy agenda; this political risk varies depending on the country and the institutional characteristics of the vehicle making the investment. Put another way, a sovereign wealth fund is neither a purely rational financial actor, nor, for that matter, a purely irrational or strategic political actor. Rather, a sovereign wealth fund is a financial organization embedded within a sovereign—a complex political institution that changes and develops over time. In the Appendix, I examine two prominent funds to illustrate what I mean by the heterogeneity, or nonuniformity, of this political risk. An excise tax on sovereign wealth would likely discourage investment by professionalized funds with strong separation from politics and strong financial motives—precisely the sort of investment we may want to welcome. Conversely, sovereign wealth funds that lack separation from politicians and bureaucrats pushing a geopolitical agenda might invest anyway.²²

In a world with perfect political institutions, it would be possible to design a tax that was sufficiently fine-tuned to account for the variations among foreign sovereigns who invest here. But it is unlikely that our existing domestic political institutions are well suited for this difficult task. Countries with robust relationships with the United States outside of the tax policy context—such as Saudi Arabia and

²² In more formal economic terms, the supply of financially motivated sovereign wealth is elastic, while the supply of politically motivated sovereign wealth is more inelastic. While the inelasticity of politically motivated sovereign wealth makes a tax promising from a revenue standpoint, the tax may not shape behavior in a manner consistent with long-term U.S. policy goals.

Abu Dhabi—may well be able to influence legislation to achieve favored status over other countries that pose less geopolitical risk, such as Canada. If a treaty mechanism is used, then small, developing countries that pose little geopolitical risk (such as Botswana) may be left out. Neither the tax-writing committees nor the tax treaty process is well positioned to evaluate geopolitical risk, negotiate with foreign sovereigns, or update the law when necessary as foreign financial institutions evolve over time. Thus, I conclude that tax may not be the optimal regulatory instrument to address the risks posed by sovereign wealth funds, although it may be preferable to the status quo.

Part III of this Article concludes, offering a summary of three concrete reform alternatives. The first alternative, which I favor, is to repeal § 892 and replace it with a simple code section that taxes sovereign wealth funds as if they were private foreign corporations. This alternative would dampen any clientele effect that may result from the current tax preference for sovereign wealth fund equity investments.²³ Because the presence of nonfinancial motives may allow sovereign wealth funds to employ a lower hurdle rate in evaluating investments, however, taxing sovereign wealth funds at the same rate as private investors may still leave in place a systematic preference for state-controlled investment. This reform alternative would therefore rely on other regulatory instruments to encourage appropriate behavior by sovereign wealth funds.

A second reform alternative would go further and impose an excise tax intended to discourage investments that are most likely to generate external harms. This reform alternative would make a populist statement in favor of private investment over state-controlled investment. It would twist the arms of autocratic regimes to allow more private foreign direct investment in the United States in place of state-controlled investment. This reform alternative should appeal to policymakers concerned about the creeping influence of sovereign wealth and to those who want to make a strong statement in favor of private capitalism over state capitalism.

Finally, a third alternative would impose an excise tax on investments by sovereign wealth funds but would treat the funds as if they were private corporations on the condition that they comply with specified best practices related to disclosure, investment goals, and accountability. In other words, we would tax sovereign wealth funds as financial investors only if they act like financial investors. This

²³ A clientele effect occurs when two groups of investors face different explicit or implicit tax rates on the same investment, leading the group that receives favorable tax treatment to become the “tax clientele” for the investment. MYRON S. SCHOLES ET AL., *TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH* 142 (4th ed. 2009).

reform alternative should appeal to groups who favor a more technocratic policy response, shifting some of the policymaking power away from CFIUS and the executive branch and into the hands of the tax-writing committees and Treasury Department lawyers who would draft the legislation and implementing regulations. It may also appeal to policymakers who want to do something about sovereign wealth funds, but who worry that relying on international organizations to design and enforce standards may be unrealistic without additional political leverage in the form of a conditional tax increase. I favor this approach only if other regulatory approaches, such as the multilateral coordination led by the International Monetary Fund (IMF), continue to languish.²⁴

* * *

Contributions to the Literature. This Article makes three principal contributions to the academic literature. First, the Article contributes to the tax policy literature by providing a theory of taxing sovereign wealth. While the tax literature on private foreign investment is substantial, this is the first article in thirty years to focus on sovereign investment and the first to focus on sovereign wealth funds.²⁵ Section 892 is outmoded and in need of reform: This Article provides policymakers and academics with a framework for how to think about taxing sovereign wealth.²⁶

Second, the Article advances the broader debate on sovereign wealth funds by integrating tax policy into the discussion. Articles by leading academics provide policy prescriptions without considering either the tax subsidy under current law or the possibility that tax law might be used to discourage investment going forward.²⁷ Tax offers our regulators a powerful nightstick.

Third, this Article illustrates the importance of integrating institutional detail into tax policy analysis. Examining sovereign wealth funds as complex political and economic institutions rather than simply as firms (market actors) or sovereigns (state actors) underscores the fact that the risks associated with sovereign wealth are

²⁴ The IMF has been coordinating the work of the International Working Group on Sovereign Wealth Funds, which has produced a set of principles (the Santiago Principles), also referred to as best practices, designed to guide the behavior of sovereign wealth funds. See SANTIAGO PRINCIPLES, *supra* note 14.

²⁵ The previous articles cited, *supra* note 18, appeared only after this Article was circulated in draft form.

²⁶ While the Joint Committee on Taxation and the New York State Bar Association each have issued helpful reports on § 892, see sources cited *supra* note 19, neither group has addressed whether tax should be used to tackle nontax policy concerns.

²⁷ See *infra* Part II.B.1.

nonuniform. Because harms are nonuniform, taxing all sovereign wealth funds at a uniform rate that is higher or lower than the rate for private investment is a bad policy fit. A more carefully tailored tax would be appropriate. Institutional analysis also suggests that fine-tuning the tax rules to a level of detail that reflects the institutional variations among funds may be asking a lot of our own domestic political institutions. Whether it is worth the effort depends on the alternatives and the strength of the political will to regulate sovereign wealth by other means.

I CURRENT LAW

Before considering the relevant policy questions, a brief review of current law regarding the taxation of sovereign wealth may be helpful. In this Part, I provide historical background, review the taxation of inbound private foreign investment generally, and then compare it with the taxation of sovereign investment under § 892. I make two key points necessary to move the discussion forward: (1) The international law doctrine of sovereign immunity does not limit Congress's ability to impose a tax on sovereign wealth fund investment, and (2) under current law, the active/passive income distinction that pervades international tax treats most sovereign wealth fund investment as passive income, notwithstanding the strategic value of such investment.

A. *What Are Sovereign Wealth Funds?*

Sovereign wealth funds are investment vehicles funded and controlled by foreign governments. The largest funds are owned by Abu Dhabi (part of the United Arab Emirates), Norway, Saudi Arabia, Singapore, Kuwait, and China.²⁸ In total, sovereign wealth funds command about \$3 trillion in capital.²⁹ By contrast, the U.S. private

²⁸ See EDWIN M. TRUMAN, PETERSON INST. FOR INT'L ECON., POLICY BRIEF NO. PB08-3, A BLUEPRINT FOR SOVEREIGN WEALTH FUND BEST PRACTICES 2 tbl.1 (2008), available at <http://www.iese.com/publications/pb/pb08-3.pdf> (listing size of various sovereign wealth funds).

²⁹ Because many funds are not transparent, estimates vary. For a thoughtful, conservative estimate of the size of these funds, see *id.* Truman's estimate rises to \$5.3 trillion if one includes state-directed pension funds. *Id.* I agree with Truman that state-directed pension funds should be treated the same as other state-controlled funds only to the extent that the state, rather than individual participants, makes investment decisions regarding the assets of the fund. See *id.* at 1 n.3 ("[A]s far as 'best practices' are concerned, it is difficult to see why any distinctions should be made among government-owned or government-controlled investment vehicles.").

equity industry has about \$800 billion under management.³⁰ Abu Dhabi's main fund, the Abu Dhabi Investment Authority (ADIA), commands over \$500 billion dollars in capital, or approximately 1% of the total securities holdings worldwide.³¹ Sovereign wealth funds are expected to grow to over \$10 trillion within the next decade.³²

A few sovereign wealth funds, like ADIA, have existed for many years. A number of countries that rely on oil or other natural resources for a large portion of their economic well-being have created state-managed stabilization funds to hedge against future declines in energy prices.³³ In recent years, developing countries have come to view sovereign wealth funds as an alternative method of pursuing economic development. Rather than investing additional dollars domestically in infrastructure or distributing money to citizens, some developing countries have set up sovereign wealth funds to amass resources, achieve higher financial returns, and gain a foothold in global capital markets.³⁴

Sovereign wealth funds invest more aggressively now than in years past. Historically, foreign sovereigns would take excess funds generated from oil or trade surplus and invest in Treasury bonds or other governmental obligations.³⁵ In recent years, however, these sovereigns have diversified their holdings, seeking to increase financial returns and to further strategic political objectives. From the U.S. perspective, the most salient resulting change is the desire of sover-

³⁰ JCT REPORT, *supra* note 19, at 24 fig.12.

³¹ See TRUMAN, *supra* note 28, at 2 tbl.1 (listing total value of holdings of various sovereign wealth funds); *The World's Most Expensive Club*, ECONOMIST, May 26, 2007, at 79 (reporting world's entire supply of global asset shares to be \$55 trillion).

³² See, e.g., MORGAN STANLEY, HOW BIG COULD SOVEREIGN WEALTH FUNDS BE BY 2015?, at 1 (2007), http://www.morganstanley.com/views/perspectives/files/sovereign_2.pdf (estimating that total size of sovereign wealth funds will be \$12 trillion by 2015); see also *Asset-Backed Insecurity*, ECONOMIST, Jan. 19, 2008, at 78, 79 (reporting predictions of \$10 trillion by 2010 and \$12 trillion by 2015).

³³ See TRUMAN, *supra* note 28, at 2 tbl.1 (listing natural resources as source of funds for many countries' sovereign wealth funds); see also *Asset-Backed Insecurity*, *supra* note 32, at 79 (noting that oil-producing states have established funds as precaution against decline of oil prices or oil reserves).

³⁴ For a discussion of sovereign wealth funds' impact on international economic development, arguing that states with unmet development needs should not be allowed to invest in international financial markets until first satisfying development obligations to their own citizens, see Patrick J. Keenan, *Sovereign Wealth Funds and Social Arrears: Should Debts to Citizens Be Treated Differently than Debts to Other Creditors?*, 49 VA. J. INT'L L. 431, 436-37 (2009).

³⁵ *Asset-Backed Insecurity*, *supra* note 32, at 78. For example, prior to its investment in Blackstone, China had mostly invested in U.S. Treasury bonds. *The World's Most Expensive Club*, *supra* note 31, at 79; see also JCT REPORT, *supra* note 19, at 3-20 (discussing trends in foreign borrowing and role of foreign purchasers of Treasury debt in U.S. economy).

eign wealth funds to invest directly in U.S. companies.³⁶ For many years, to the extent that sovereign wealth funds invested in equities at all, they did so indirectly by becoming limited partners in buyout funds operated by U.S.-based private equity firms like Carlyle and TPG.³⁷ Now, direct equity investments have become commonplace.

For tax purposes, sovereign wealth funds are considered part of a “foreign government.”³⁸ The definition of foreign government is very broad, encompassing not only the “integral parts” of a sovereign such as governmental departments or agencies but also separate legal entities controlled by the foreign sovereign, which may or may not have counterparts in the United States.³⁹ Entities that benefit from § 892 include (1) state-owned or state-operated pension funds like Japan’s Government Pension Investment Fund (which has no U.S. federal analogue but is somewhat analogous to California’s CalPERS); (2) sovereign wealth or stabilization funds (somewhat analogous to Alaska’s Permanent Fund); and (3) state-owned enterprises, like Russia’s government-controlled energy giant Gazprom (which has no U.S. analogue).⁴⁰ Central banks are addressed separately in § 895 of the tax code, although the principles discussed in this Article generally apply to central banks.⁴¹

³⁶ See JCT REPORT, *supra* note 19, at 27–29 (discussing recent prominent sovereign wealth fund investments in U.S. companies). For example, Mubadala Development, a sovereign wealth fund owned by the government of Abu Dhabi, purchased a 7.5% stake in the Carlyle Group in September of 2007. Thomas Heath, *Government of Abu Dhabi Buys Stake in Carlyle*, WASH. POST, Sept. 21, 2007, at D1.

³⁷ See KALEB A. SIEH, *THE PRIVATE EQUITY BOOM: IS IT OVER, IS IT SUSTAINABLE, AND WHAT IS ITS LONG TERM ECONOMIC IMPACT?* 14 (2008), <http://www.silicon-flatirons.org/documents/publications/report/SiehPrivateEquity.pdf> (quoting David Bonderman of TPG as arguing that sovereign wealth fund investment in private equity has been “overstated”). Private equity funds facilitate a significant portion of the investment activity that sovereign wealth funds conduct in the United States. Sovereign wealth fund investments are normally structured as passive limited partnership interests, which offer little ability to influence the operations of the fund. More recently, funds have been acquiring direct equity stakes in private equity sponsors or investing directly in portfolio companies rather than investing on a purely passive basis.

³⁸ I.R.C. § 892 (2006).

³⁹ *Id.*; Temp. Treas. Reg. § 1.892-2T(a)(1)–(3) (1988).

⁴⁰ For a listing of various funds, see TRUMAN, *supra* note 28, at 2 tbl.1.

⁴¹ The distinction between central banks and sovereign wealth funds has been blurred by recent deals, including the investment by China’s State Administration of Foreign Exchange (SAFE) in a private equity fund operated by TPG, a U.S. private equity firm. See Jamil Adnerlini et al., *Chinese in \$2.5bn TPG Move*, FIN. TIMES, June 11, 2008, at 17. For present purposes, however, it is helpful to set aside definitional line-drawing questions until later in the discussion. See *infra* notes 97–98 and accompanying text.

B. Historical Background

Current tax law reflects an anachronistic view of the jurisdictional doctrine of sovereign immunity. The tax exemption for sovereign investors dates back to the origins of our income tax. The original provision exempting income of foreign governments was enacted as part of the War Revenue Act of 1917.⁴² While additional subsections have been added, the language of § 892(a)(1) today still closely tracks the original language:

(a) Foreign governments

(1) In general

The income of foreign governments received from—

(A) investments in the United States in—

- (i) stocks, bonds, or other domestic securities owned by such foreign governments, or
- (ii) financial instruments held in the execution of governmental financial or monetary policy, or

(B) interest on deposits in banks in the United States of moneys belonging to such foreign governments,

shall not be included in gross income and shall be exempt from taxation under this subtitle.⁴³

The tax exemption was originally grounded in the international law principle of sovereign immunity.⁴⁴ So long as a foreign sovereign was acquiring property (such as bank deposits or a consulate building) to further governmental purposes and not for commercial purposes,

⁴² War Revenue Act of 1917, Pub. L. No. 50, § 1211, 40 Stat. 300, 336–37 (adding § 30, exempting foreign governments' investment and interest income from tax, to Revenue Act of 1916, Pub. L. No. 271, 39 Stat. 756); BRETT R. DICK, 913-3RD TAX MANAGEMENT PORTFOLIO, U.S. INCOME TAXATION OF FOREIGN GOVERNMENTS, INTERNATIONAL ORGANIZATIONS AND THEIR EMPLOYEES A-1 & n.1 (2005).

⁴³ I.R.C. § 892(a)(1). The original 1917 language of the Act provided:

That nothing in section II of the Act approved October third, nineteen hundred and thirteen, entitled "An Act to reduce tariff duties and to provide revenue for the Government, and for other purposes," or in this title, shall be construed as taxing the income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments, or from interest on deposits in banks in the United States of moneys belonging to foreign governments.

War Revenue Act § 1211, 40 Stat. at 337.

⁴⁴ NYSBA REPORT, *supra* note 19, at 3. Until the mid-twentieth century, U.S. courts tended to adopt an expansive view of sovereign immunity. JCT REPORT, *supra* note 19, at 41–42. Compare, e.g., *The Schooner Exchange v. McFaddon*, 11 U.S. (7 Cranch) 116, 137 (1812) (holding foreign sovereign immunity absolute unless waived), with, e.g., *Republic of Mexico v. Hoffman*, 324 U.S. 30, 35–38 (1945) (declining to recognize sovereign immunity where executive has not done so).

the doctrine of sovereign immunity prohibited taxing the sovereign.⁴⁵ The doctrine was rarely tested in the courts.⁴⁶

In the middle of the twentieth century, the rise of the Soviet empire and its state-owned enterprises caused commercial activities of foreign governments in the United States to increase, forcing the IRS to engage in the difficult exercise of sifting out commercial activities, which were subject to tax, from governmental and other noncommercial activities, which were exempt. The Service had little statutory guidance to work with, and the task was challenging: In dealing with autocratic or communist regimes, it's hard to say where the private sphere ends and the public sphere begins.⁴⁷ At the time, the Service based its rulings on whether the organization conducting the activity resembled a private U.S. business enterprise.⁴⁸ Eventually this test was replaced with a more specific inquiry into the commercial or non-

⁴⁵ See Wm. W. Bishop, Jr., *Immunity from Taxation of Foreign State-Owned Property*, 46 AM. J. INT'L L. 239, 240 (1952) ("An examination of American practice leads to the conclusion that there is a growing tendency to exempt foreign state-owned property from taxation, and that this exemption is coming to be regarded as required by international law."); *id.* at 256–57 ("It is by no means clear, however, that the same result is either probable or desirable when we are dealing with property used for purposes which seem more commercial than governmental.").

⁴⁶ See Jon Taylor, *Tax Treatment of Income of Foreign Governments and International Organizations*, in *ESSAYS IN INTERNATIONAL TAXATION*: 1976, at 151, 157 (Dep't of Treasury ed., 1976) ("The scope of Section 892 remains unresolved, particularly in light of the fact that the phrase 'or any other source' has yet to be satisfactorily defined.").

⁴⁷ See DICK, *supra* note 42, at A-4 ("[I]n certain socialist and OPEC countries, all or most of the country's economic endeavors emanate from the government. When such governments invest their money in the United States perplexing conceptual and practical problems with respect to the § 892 exemption are created. This troublesome situation is further complicated by the fact that in many countries it is difficult to separate investment by the ruling class, as individuals, from investment by a foreign government."); Bernard Fensterwald, Jr., *Sovereign Immunity and Soviet State Trading*, 63 HARV. L. REV. 614, 627–29, 633 (1950) (discussing organization of Soviet foreign trade before and after World War II).

In a 1959 Revenue Ruling, for example, the IRS held that payments from a U.S. distribution company to the Soviet Ministry of Culture for a film were exempt from tax because Sovexport Film, the seller of the film, was deemed to be an integral part of the Soviet government. I.R.S. Priv. Ltr. Rul. (May 21, 1959), [1959] 6 Stand. Fed. Tax Rep. (CCH) ¶ 6532; David R. Tillinghast, *Sovereign Immunity from the Tax Collector: United States Income Taxation of Foreign Governments and International Organizations*, 10 LAW & POL'Y INT'L BUS. 495, 507 (1978). One could just as easily imagine the IRS ruling that the activity was commercial because the films were shown commercially in the United States.

⁴⁸ See Tillinghast, *supra* note 47, at 513–14 ("[A]n organization separate in form and wholly owned by a foreign government, and no part of the net earnings of which inures to the benefit of any private shareholder or individual . . . is exempt under section 892 of the Code, provided it does not constitute a corporation as that term is generally understood in the United States" (quoting Rev. Rul. 66-73, 1966-1 C.B. 174, *revoked*, Rev. Rul. 75-298, 1975-2 C.B. 290)).

commercial nature of the activity conducted by the foreign sovereign rather than the organization conducting the activity.⁴⁹

This gradual narrowing of the § 892 exemption followed a broader legal development in the twentieth century concerning the jurisdictional doctrine of sovereign immunity.⁵⁰ Until the mid-twentieth century, U.S. courts tended to take an expansive view of sovereign immunity. As the business activities of foreign governmental entities increased, however, the United States publicly adopted a more restrictive view of sovereign immunity, as reflected in an oft-cited 1952 letter written by Jack Tate, a legal adviser at the State Department.⁵¹ Under the so-called restrictive view of sovereign immunity, not all actions by a foreign sovereign are immune from jurisdiction in the United States. Rather, only governmental actions, or *acta jure imperii*, are entitled to immunity, while commercial actions, or *acta jure gestionis*, are not immune.⁵² The restrictive view of sovereign immunity was eventually codified in the Foreign Sovereign Immunities Act (FSIA) of 1976.⁵³

The codification of the restrictive view of sovereign immunity in the FSIA dispenses with the notion that all income received by a foreign government should be immune from tax simply because the income may be used to further public goals.⁵⁴ If the nature of the

⁴⁹ See Rev. Rul. 87-6, 1987-1 C.B. 179 (defining commercial activity for purposes of exemption under § 892).

⁵⁰ See Fensterwald, Jr., *supra* note 47, at 618–24 (reviewing and advocating move away from absolute immunity).

⁵¹ Letter from Jack B. Tate, Acting Legal Adviser of the Dep't of State, to Philip B. Perlman, Acting Att'y Gen. (May 19, 1952), in 26 DEP'T ST. BULL. 984 (1952). The "Tate Letter" was viewed by practitioners as a method of minimizing political considerations and State Department involvement when local jurisdictions sought to apply generally applicable laws to foreign governmental entities conducting business activities in the United States. See, e.g., Charles N. Brower, *Litigation of Sovereign Immunity Before a State Administrative Body and the Department of State: The Japanese Uranium Tax Case*, 71 AM. J. INT'L L. 438, 448–49 (1977) (discussing Tate Letter and its invocation in opposition to entry of "political factors" into State Department decisions); *id.* at 459 (urging State Department officials to adhere to Tate Letter's restrictive theory of sovereign immunity).

⁵² Tillinghast, *supra* note 47, at 530.

⁵³ Pub. L. No. 94-583, 90 Stat. 2892 (codified at 28 U.S.C. § 1603(d) (2006)). While the FSIA provides no explicit guidance on tax issues, the statute endorses an approach to distinguishing between commercial and governmental activities that proves useful in the tax context. Specifically, in determining whether an activity is commercial or governmental, the FSIA provides that the "character of an activity shall be determined by reference to the nature of the course of conduct or particular transaction or act, rather than by reference to its purpose." *Id.*; see also Tillinghast, *supra* note 47, at 531 & n.167 ("When Congress enacted the 1976 sovereign immunity legislation, it came down clearly and expressly on the side of making the determination on the basis of the nature of the transaction, rather than its purpose.").

⁵⁴ Conducting an active trade or business in the United States, for example, is an activity that would not be immune, even if the profits were used to support a sovereign

activity is commercial, such as operating a business or investing in securities, there is no argument for an exemption based on the jurisdictional doctrine of sovereign immunity. Rather, the scope of the tax exemption is purely a matter of tax policy and may be tailored as Congress sees fit.⁵⁵

Under current law, then, the international doctrine of sovereign immunity as such imposes no restrictions on our ability to tax sovereign wealth funds.⁵⁶ Section 892, however, creates an analytic distinction between portfolio investment, on the one hand, and direct investment, on the other. Portfolio investment is generally considered to be an investment of less than 10% of the equity of an issuer.⁵⁷ The taxing authorities have long inferred from the language of § 892 that, insofar as investment income was concerned, the exemption applied only to portfolio investments.⁵⁸ In Revenue Ruling 75-298, for example, the Service held that a foreign central bank or any other governmental organization would be exempt from tax so long as it was wholly owned or controlled by a foreign government, its income did not inure to a private person, its investments produced passive income, and it was not engaged in commercial banking.⁵⁹ This ruling clarified that what matters for U.S. tax purposes is the nature of the activity in the United States, not the nature, function, or foreign activities of the foreign governmental organization generally.⁶⁰ The plain

function such as retirement benefits for government workers. As David Tillinghast noted thirty years ago:

Even if one concedes that the OPEC countries, for example, are investing funds in the United States for the public purpose of preserving or enhancing their national patrimonies for the day when their hydrocarbon reserves run out, this should not require a finding of immunity since the reference is to the purpose rather than the nature of the income-producing activity.

Tillinghast, *supra* note 47, at 534–35.

⁵⁵ In a few cases, congressional discretion is constrained by treaties already in force. See JCT REPORT, *supra* note 19, at 61 (discussing treaties with Japan, Canada, France, and Ireland).

⁵⁶ See, e.g., *Qantas Airways Ltd. v. United States*, 62 F.3d 385, 388–90 (Fed. Cir. 1995) (upholding regulatory authority to tax income derived from commercial activity by government-owned entity).

⁵⁷ Michael J. Graetz & Itai Grinberg, *Taxing International Portfolio Income*, 56 TAX L. REV. 537, 539 & n.4 (2003).

⁵⁸ See Tillinghast, *supra* note 47, at 508 (noting unpublished policy of IRS to exempt only portfolio investments).

⁵⁹ Rev. Rul. 75-298, 1975-2 C.B. 290.

⁶⁰ Tillinghast, *supra* note 47, at 519. Thus, even if the foreign governmental organization was engaged in an activity that would ordinarily be private in the United States, such as the provision of health care or insurance, its investment activities would be exempt in the United States so long as it did not conduct any commercial activity here. *Id.* The ruling was somewhat more generous toward state-controlled investment than one might have expected. According to Tillinghast, writing in 1978, the ruling was “motivated, no doubt, by a felt need to be flexible in an effort to attract petro-dollar investment in the

language of § 892, however, presumably would not allow the IRS to tax passive portfolio investment in “stocks, bonds, or other domestic securities” even if such investment were not related to public or humanitarian goals.⁶¹

Congress revamped § 892 as part of the Tax Reform Act of 1986.⁶² According to the legislative history, Congress was concerned, among other things, about the application of the exemption to quasi-commercial entities controlled by foreign governments.⁶³ The Senate Report explained that it was not appropriate to favor nationalized industries over privately owned industries.⁶⁴ Congress was similarly concerned that dividend and interest payments to foreign governments with a controlling interest in U.S. corporations were inappropriately escaping tax.⁶⁵ At the same time, Congress did not see any reason to treat a foreign government “worse than comparable private investors from the government’s country.”⁶⁶ The revisions to § 892 provided that income derived from the direct conduct of commercial activity, whether within or outside the United States, would not be exempt from tax.⁶⁷ Similarly, income received by or from a controlled

United States.” *Id.* at 519–20. Then, as now, the taxing authorities were wary of closing the door to foreign investment driven by trade imbalances, at least absent congressional direction.

⁶¹ I.R.C. § 892(a)(1) (2006).

⁶² Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1987).

⁶³ The Senate Finance Committee Report explains:

The committee’s examination of current law’s tax exemption for investment income of foreign governments has revealed several problems. First, the exemption extends to entities, even business corporations, wholly owned by foreign governments. This treatment tends to favor, for example, nationalized industries over privately owned industries. Under current law, the United States taxes U.S. source investment income received by a privately owned foreign business corporation but not similar income received by a state-owned business corporation. The committee does not believe that this difference in treatment is appropriate.

S. REP. NO. 99-313, at 416 (1986).

⁶⁴ *Id.*

⁶⁵ The Senate Report explains:

[C]urrent law provides an exemption for income (such as interest and dividends) derived by foreign governments or governmental entities from U.S. businesses that they control. For example, a foreign government may buy a controlling interest in a U.S. corporation. Dividend and interest payments from that corporation to the foreign government escape U.S. shareholder level tax. While an exemption for income from passive investments may be appropriate in some cases, payments to a controlling entity, in the committee’s view, . . . are not passive investment income. The committee does not believe that exemption is appropriate in this case.

Id.

⁶⁶ *Id.* at 417.

⁶⁷ I.R.C. § 892(a)(2)(A)(i).

commercial entity would not be exempt from tax.⁶⁸ At the same time, the revisions clarified that a foreign government would be treated as a corporate resident of that country, allowing the government to enjoy any treaty benefits extended to foreign private residents.⁶⁹

The 1986 revisions did not address sovereign wealth funds, which were not yet making significant equity investments in the capital markets. Thus, under current law, so long as a state-owned investment fund limits its investments to noncontrolling stakes and does not conduct commercial activity anywhere in the world, the fund can avoid income tax and withholding taxes on its U.S. investments. Even though the investment activity is commercial in the sense that it is related to commerce (as opposed to diplomatic or humanitarian goals) and is not protected by sovereign immunity, it is not treated as “commercial” for tax purposes. Rather, noncontrolling stakes are treated as portfolio investments, which the 1986 revisions left untouched. Still, the history of revisions to § 892 shows that Congress has been willing to amend the section to make sure that state-sponsored investment is not favored over private investment, and international law leaves ample room for Congress to tax commercial investment (and sovereign activities that resemble commercial investment).

C. Taxing Inbound Foreign Investment

A brief review of how foreign private investors are taxed may be helpful before examining the § 892 exemption more closely. Cross-border investing gives rise to a single stream of income with two potential tax claimants: the source country where the business activity takes place and the residence country of the foreign investor. The chief task of international tax policy is dividing this income into the portion that should be taxed at the source of the business activity and the portion that should be taxed at the residence of the investor. Broadly speaking, the United States, in accordance with international tax norms, taxes foreign investors on active income that arises from a U.S. source or is effectively connected with a U.S. trade or business.⁷⁰

⁶⁸ § 892(a)(2)(A)(ii); *see also* § 892(a)(2)(A)(iii) (providing that income derived from disposition of any interest in controlled commercial entity is not exempt from tax).

⁶⁹ § 892(a)(3).

⁷⁰ *See* Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 *TEX. L. REV.* 1301, 1316–33 (1996) (describing active/passive distinction); Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 26 *BROOK. J. INT'L L.* 1357, 1358 (2001) (describing “1920’s compromise” that “allocate[d] the taxation of business income to country of its source and the taxation of portfolio income to the country of the capital supplier’s residence”); Michael J. Graetz & Michael M. O’Hear, *The “Original Intent” of U.S. International Taxation*, 46 *DUKE L.J.* 1021, 1022–28 (1997) (describing original U.S. tax policy of

A foreign investor with income that is effectively connected with a U.S. trade or business is taxed in the same fashion, and at the same rates, as a U.S. investor. Additionally, if a foreign corporation has a branch that operates an active business in the United States, the U.S. activities are taxed here as if they were being conducted by a U.S. resident.

To encourage foreign portfolio investment in the United States, the tax code gives wide berth to the activity of portfolio investing.⁷¹ When foreign investors invest in U.S. capital markets, they derive income from business activities that take place in the United States. In the case of passive portfolio investments, however, the United States does not attempt to withhold tax, notwithstanding the source of the income in the United States. Rather, most income from passive portfolio investments—such as portfolio interest and capital gains—is not taxed in the United States.⁷² Capital gains received by nonresident individuals and foreign corporations are not normally subject to U.S. withholding so long as the gains are not effectively connected with a U.S. trade or business.⁷³ A foreign investor can therefore make an equity investment in a U.S. business and pay no tax on the appreciation in its stock.

Not all investment income is treated generously, however. Sections 871 and 881 impose a flat 30% tax on certain types of U.S. source income even if they are not effectively connected with a U.S. trade or business.⁷⁴ Forms of what is often called FDAP income—which stands for “fixed or determinable annual or periodical”

source-based taxation). While the question of whether a foreign investor is engaged in a U.S. trade or business requires a facts and circumstances analysis, investing in U.S. securities is not, in and of itself, considered a U.S. trade or business. *See* I.R.C. § 864(b)(2) (2006) (excluding trading in securities through independent agent from definition of “trade or business within the United States”); Joel D. Kuntz & Robert J. Peroni, 2 U.S. INTERNATIONAL TAXATION ¶ C1.04[4][a] (1996) (discussing definition of “trade or business within the United States”).

⁷¹ *See generally* Avi-Yonah, *supra* note 70, at 1320–24 (listing various tax exemptions for portfolio investment).

⁷² *See, e.g.,* Yaron Z. Reich, *Taxing Foreign Investors’ Portfolio Investments in the U.S.: Developments & Discontinuities*, 16 TAX NOTES INT’L 1975, 1975–76 (1998) (“This review demonstrates that the U.S. tax system strongly encourages the investment by foreigners in the U.S. capital markets. Virtually all material categories of portfolio investment income of foreign investors are exempt from U.S. taxation, with the exception of dividend income (and, increasingly, dividend surrogates).”).

⁷³ I.R.C. §§ 881(a), 882(a)(1) (2006).

⁷⁴ *See* I.R.C. §§ 871(a)(1), 881(a) (2006) (imposing tax on certain income “received from sources within the United States” by nonresident aliens and foreign corporations when that income “is not effectively connected with the conduct of a trade or business within the United States”); Kuntz & Peroni, *supra* note 70, ¶ C1.03[1] (explaining § 871(a)(1) and § 881).

income—are subject to withholding on a gross receipts basis at a 30% rate.⁷⁵ These FDAP items (such as interest, dividends, rents, and royalties) are subject to withholding under § 1441 and § 1442.⁷⁶

U.S. tax policy also encourages foreign investment in the debt securities of U.S. companies. As noted above, interest is one of the types of FDAP income that is subject to the 30% tax.⁷⁷ Sections 871(h) and 881(c), however, exempt “portfolio interest” from the FDAP regime.⁷⁸ Thus, a foreign investor holding debt securities that are not effectively connected with a U.S. trade or business typically does not have to recognize interest income or face withholding of any amount paid.⁷⁹

The definition of portfolio interest is broad.⁸⁰ Interest paid by U.S. issuers typically meets the definition so long as the issuer complies with obligations designed to ensure that the bonds are not sold (or resold) to U.S. persons.⁸¹ However, the exemption does not extend to a 10% shareholder or partner in the U.S. issuer.⁸² Thus, a private foreign investor who holds a major stake in a U.S. business will not receive tax-free interest, even if the investment is a noncontrolling stake.⁸³

There are other exceptions to the general approach of lightly taxing foreign capital investment, most notably in the real estate context. In 1980, Congress enacted the Foreign Investment in Real Property Tax Act (FIRPTA) to address the concern that U.S. investors could not compete with their more lightly taxed foreign counter-

⁷⁵ §§ 871(a)(1)(A), 881(a)(1).

⁷⁶ I.R.C. §§ 1441(a)–(b), 1442(a) (2006).

⁷⁷ §§ 871(a)(1)(A), 881(a)(1).

⁷⁸ §§ 871(h), 881(c). Before the portfolio interest exemption was enacted, U.S. corporations accessed the international debt markets through the use of Netherlands Antilles finance subsidiaries, relying on a treaty exemption and IRS rulings then in effect. Reich, *supra* note 72, at 1985. The portfolio interest exemption simplified access to the Eurobond market (in this case, for U.S. corporate issuers raising capital in Europe) by reducing the costs of structuring those deals. *Id.*

⁷⁹ For a critique of international tax policy, including the portfolio interest exemption, see Charles I. Kingson, *The Coherence of International Taxation*, 81 COLUM. L. REV. 1151, 1283–87 (1981).

⁸⁰ See §§ 871(h)(2), 881(c)(2) (each defining portfolio interest as “any interest . . . which would be subject to tax under subsection (a)” of that respective section).

⁸¹ See I.R.C. § 163(f)(1) (2006) (obligations for registered bonds); § 163(f)(2) (obligations for bearer bonds).

⁸² §§ 871(h)(3)(A), 881(c)(3)(B).

⁸³ The portfolio interest exemption is further limited to avoid giving foreign banks a competitive edge over U.S. banks. If a foreign bank, in the “ordinary course of its trade or business” enters into a loan agreement with a U.S. issuer, then interest paid pursuant to that agreement does not qualify as portfolio interest, even if the debt securities would otherwise meet the definition of portfolio interest. § 881(c)(3)(A).

parts.⁸⁴ Before FIRPTA, foreign investors often paid no tax at all on the disposition of U.S. real property, so long as the gains were not effectively connected with a U.S. trade or business. FIRPTA created § 897, which requires a foreign investor to pay U.S. income tax on the net gains derived from the disposition of a U.S. real property interest.⁸⁵ Mechanically, § 897(a) achieves this result by treating a disposition of a U.S. real property interest as if it were effectively connected with a U.S. business, even if it would not normally fit within the usual meaning of the term.⁸⁶ Indirect holdings in real property may be taxed as well, depending on whether the U.S. business is considered a U.S. real property holding corporation.⁸⁷

Dividends are the most significant source of foreign portfolio investors' income that is taxed by the United States. Dividends paid by U.S. corporations are normally sourced in the United States and treated as FDAP income subject to a 30% tax rate.⁸⁸ In many cases, this rate is reduced by treaty, but with few exceptions the rate is not lowered below the 15% rate provided in the Organisation for Economic Co-operation and Development (OECD) model treaty.⁸⁹ Many foreign investors avoid the withholding tax by purchasing a derivative, such as a total return swap, rather than holding shares directly. Avoiding the withholding tax is more difficult, however, for buyers making a strategic investment; the investment bank serving as counterparty on the swap would have difficulty hedging its exposure to the underlying stock.

To recapitulate, foreign investors are generally taxed lightly on their portfolio investments in the United States.⁹⁰ Foreign investors

⁸⁴ See Foreign Investment in Real Property Tax Act of 1980, Pub. L. No. 96-499, §§ 1121-1125, 94 Stat. 2682; S. REP. NO. 96-504, at 6 (1979), *quoted in* Kuntz & Peroni, *supra* note 70, ¶ C1.06[1] ("The committee believes that it is essential to establish equity of tax treatment in U.S. real property between foreign and domestic investors. The committee does not intend by the provisions of this bill to impose a penalty on foreign investors or to discourage foreign investors from investing in the United States. However, the committee believes that the United States should not continue to provide an inducement through the tax laws for foreign investment in U.S. real property . . . [by] effectively exempting [such foreign investors] from U.S. tax on the gain realized on disposition of the property.").

⁸⁵ I.R.C. § 897 (2006).

⁸⁶ See § 897(a)(1).

⁸⁷ See § 897(c)(1)(A)(ii).

⁸⁸ See Reich, *supra* note 72, at 1986 (explaining that dividend income is subject to 30% withholding tax).

⁸⁹ See *id.* at 1986 & n.69 (identifying Mexico, China, and Romania as exceptions to this rule).

⁹⁰ It is worth emphasizing that the generous rules relating to foreign investment only apply if the income is not effectively connected with a U.S. trade or business. If the income is effectively connected, then § 871(b) and § 882 tax such activity at the usual U.S. tax rates

do face significant taxes on some types of income, however, such as dividends from U.S. corporations and certain real estate investments. The withholding tax on dividends affects investment behavior, particularly because borrowing expenses associated with the investment cannot be deducted from the dividend income, which is calculated on a gross, not net, basis.⁹¹

D. Section 892

Section 892 follows the conceptual divide in international tax between commercial activity, which is taxed at the source, and passive portfolio investing, which is generally taxed at the residence. Section 892(a)(1) thus provides that the income of foreign governments received from investments in “stocks, bonds, or other domestic securities owned by such foreign governments,” “financial instruments held in the execution of governmental financial or monetary policy,” and “interest on deposits in banks” is exempt from tax.⁹² Section 892(a)(2) addresses commercial activities conducted by foreign governments, which are taxed in the same manner as commercial activities conducted by foreign nonstate investors. Specifically, § 892(a)(2)(A)(i) provides that § 892(a)(1) shall not apply to any income “derived from the conduct of any commercial activity.”⁹³ To address situations where a holding company or other controlled entity conducts the commercial activity, § 892(a)(2)(A)(ii) provides that any income received directly or indirectly, by or from a “controlled commercial entity,” is not exempt from tax.⁹⁴

The regulations under § 892 provide some clarification of the distinction between commercial and noncommercial activities. They start by broadly defining as commercial activities “all activities” that are conducted “with a view towards the current or future production of income or gain.”⁹⁵ The regulations then specify that investments in stocks, bonds, and other securities are not commercial activities unless

even if the income would otherwise be exempt or taxed at a lower rate. For example, if a foreign individual owns and operates a U.S. corporation and sells her stock in that corporation, generating capital gain, the gain will be taxed in the United States as if the foreign individual were a U.S. citizen.

⁹¹ For an illustration using preferred stock, see Reich, *supra* note 72, at 1989. In order to avoid the withholding tax, foreign investors often seek to invest through equity-like “surrogates,” such as derivatives that offer an equity-like return. *Id.* at 1989–90. For a more detailed discussion of such structures, see Reuven S. Avi-Yonah, *Enforcing Dividend Withholding on Derivatives*, TAX NOTES, NOV. 10, 2008, at 747, 747–48.

⁹² § 892(a)(1)(A).

⁹³ § 892(a)(2)(A)(i).

⁹⁴ § 892(a)(2)(A)(ii). Similarly, income derived from the disposition of any interest in a controlled commercial entity is not exempt under § 892. § 892(a)(2)(A)(iii).

⁹⁵ Temp. Treas. Reg. § 1.892-4T(B) (1988).

one is a “dealer” in securities⁹⁶ or is engaged in an active banking, financing, or similar business.⁹⁷ While there is some question over how to classify mezzanine lending funds, which provide subordinated debt financing, it is generally accepted that private equity funds are not engaged in a “financing” business within the meaning of the current regulations.⁹⁸

Sections 893 and 895 of the code should also be mentioned. Section 893 provides a tax exemption for employees of a foreign sovereign. As with § 892, the tax exemption does not extend to employees of a controlled commercial entity, nor to employees whose services are “primarily in connection with a commercial activity” of a foreign government.⁹⁹

Section 895 provides a tax exemption for foreign central banks of issue investing in obligations of the United States. The section was enacted in 1961 to ensure that central banks that had been organized as separate entities controlled by their sovereign (rather than as integral parts of the sovereign) would be exempt from tax and thus encouraged to hold U.S. Treasury obligations.¹⁰⁰ A 1920 revenue ruling that had given rise to uncertainty was declared obsolete in 1969, and today there is no question that central banks investing in obligations of the United States are entitled to a tax exemption. However, because § 895 only applies to investments in obligations of the United States, such as Treasury bonds, the section offers no guidance as to the treatment of sovereign wealth fund investment in U.S. businesses.¹⁰¹

⁹⁶ The threshold for becoming a “dealer” is high: Trading securities for one’s own account does not make one a dealer. See Treas. Reg. § 1.892-4T(c)(1)(ii) (1988) (citing definition in Treas. Reg. § 1.864-2(c)(2)(iv)(a) (1975)).

⁹⁷ *Id.* Tax practitioners are most concerned with issues that arise when clients engage in commercial activities but also wish to take advantage of § 892. Under the “all or nothing” rule, an entity that engages in commercial activity anywhere in the world may be treated as a controlled commercial entity. While the commercial activities of a corporate subsidiary are not generally attributed to the parent, issues can arise when a sovereign wealth fund invests in a limited partnership, like a hedge fund, which engages in commercial activities. See NYSBA REPORT, *supra* note 19, at 40 (discussing “all or nothing” rule). Securities trading is not generally treated as a U.S. trade or business but may nonetheless be treated as a commercial activity for purposes of § 892, at least the way the regulations are currently drafted. See *id.* (discussing need for regulatory amendment to “state explicitly that trading activities . . . that do not give rise to a U.S. trade or business . . . will not be treated as commercial activities for purposes of section 892”). To avoid treating the U.S. source income of an entire sovereign wealth fund as that of a controlled commercial entity, tax lawyers typically set up blocker entities to isolate limited partnership investments. *Id.* at 34.

⁹⁸ DICK, *supra* note 42, at A-17.

⁹⁹ § 893.

¹⁰⁰ § 895; see also NYSBA REPORT, *supra* note 19, at 10–11 (discussing legislative history of § 895).

¹⁰¹ § 895.

This description of current law raises two conceptual issues that policymakers may wish to address. One problem with the current approach of § 892 is its overly broad conceptualization of passive investment.¹⁰² Even if an investor becomes a company's largest shareholder and wields substantial influence over a target, our tax system will treat the investment as passive so long as the shareholder does not acquire formal control by itself or through a related party. As I discuss below in more detail, this model may be a poor fit for sovereign investors. While sovereign investors may, for political reasons, refrain from acquiring formal control over a target such as a U.S. financial institution, investments in large blocks of equity confer substantial influence that goes beyond what true portfolio investors acquire.

A second, more fundamental problem with the current approach is the assumption that passive portfolio investment by a foreign sovereign should not be taxed. Even assuming, for the sake of argument, that inbound foreign portfolio investment by private investors should not be taxed, the myriad differences between private investors and foreign sovereigns suggest the need for closer analysis. To justify current law, one would have to identify a reason for the preferential treatment of foreign sovereigns with respect to dividends and real estate investments. Of course, to justify a higher tax on foreign sovereigns, distinguishing their treatment from the general approach of lightly taxing inbound foreign investment, one would have to identify specific harms that may accompany inbound investment by foreign sovereigns. I now turn to that task.

II

A THEORY OF TAXING SOVEREIGN WEALTH

The twentieth-century development of the restrictive view of sovereign immunity opens up a new opportunity to consider how we tax investments by entities controlled by sovereigns. These investments are clearly commercial in the sovereign immunity sense: They are made for profit rather than to further diplomatic or humanitarian goals. Freed from the historical baseline of leaving all sovereign actions untaxed, we may stake out a new, normative baseline for

¹⁰² Another problem is an overbroad conceptualization of commercial activity: Because of the way that the mechanics of the section work, a sovereign investment vehicle that is engaged in a commercial activity anywhere in the world may be taxed as a private corporation in the United States, even if there is no commercial activity in the United States. See NYSBA REPORT, *supra* note 19, at 21 (noting that “all or nothing” rule in § 892 “operates to disqualify completely a government-owned entity from *any* benefits under section 892 if it is engaged in *any* level of commercial activity (no matter how trivial) anywhere in the world”).

taxing the investments of foreign governments. This Part begins by making the case for a theory of taxing sovereign wealth based on the principle of sovereign tax neutrality: Absent special circumstances, we should tax sovereign wealth funds and other state-controlled investment vehicles as if they were private foreign corporations.

A. *Sovereign Tax Neutrality*

A useful starting point in tax policy is the concept that equals should be taxed equally.¹⁰³ In the context of cross-border investment, sovereign investors compete with commercial investors: Sovereign tax neutrality is therefore neutral in the sense that it treats sovereign wealth fund investors no better and no worse than the private foreign investors with whom they compete. The main benefits of the approach of sovereign tax neutrality are that it comports with widely shared beliefs of equity and fairness and that it protects against unintended subsidies or penalties in the capital markets that could distort the allocation of economic resources.¹⁰⁴

There are certainly circumstances in which departure from a neutrality norm might be warranted. For example, because politically motivated sovereign wealth funds have a lower hurdle rate for investments, tax neutrality could lead to larger-than-optimal amounts of sovereign wealth fund investment in sectors with strategic value even in the absence of a tax subsidy for sovereign investors.¹⁰⁵ More generally, if the negative externalities from sovereign wealth fund investment outweigh the positive externalities, we may want to impose a

¹⁰³ Taxing equals equally furthers the traditional tax policy goal of horizontal equity. Taxing similar persons at the same rate also furthers efficiency goals by minimizing the distortion that tax can have on the allocation of resources. If two parties face the same tax rate with respect to the expected rate of return from an asset, the party that values the asset higher because it can put the asset to a more productive use will bid a higher price for the asset, thereby placing the asset in the hands of the party that will maximize economic output.

¹⁰⁴ What counts as neutral in this context is a complex question that requires consideration of how both sovereign and private investors are taxed on different types of investments. As Professor Knoll has argued in the context of the Unincorporated Business Income Tax (UBIT), an apparent tax preference can be offset by the presence of a higher hurdle rate for investments. See Michael S. Knoll, *The UBIT: Leveling an Uneven Playing Field or Tilting a Level One?*, 76 *FORDHAM L. REV.* 857, 866–71 (2007) (demonstrating that tax-exempt organizations will not enjoy competitive advantage in bidding against nonexempt organizations for given asset); see also Desai & Dharmapala, *supra* note 18 (arguing that higher hurdle rate of sovereign funds perfectly counterbalances tax preference). For a more complete treatment of the neutrality question in the sovereign wealth fund context, see Knoll, *supra* note 18, which finds that sovereign wealth funds enjoy a limited tax preference over private foreign investors for certain types of investment.

¹⁰⁵ Whether tax neutrality would in fact have this outcome depends on the availability of other regulatory and institutional constraints that may discourage politically motivated investment.

higher tax on sovereign wealth funds. Conversely, of course, if the positive externalities outweigh the negative externalities, we may want to subsidize sovereign wealth funds. Because lawmakers may find the externalities question indeterminate, and because tax policy is not the only regulatory instrument available, I initially focus on setting forth the rationale for a policy of sovereign tax neutrality.

First, sovereign tax neutrality comports with a general view that, all else equal, we should not use tax policy to discriminate against investors based on geographic or ethnic origins or other characteristics unrelated to legitimate tax policy norms like ability to pay.¹⁰⁶ This is no less true in the international context than in the domestic context. The main exception to this rule is the treaty mechanism, which allows the United States to conditionally offer lower tax rates domestically in exchange for lower tax rates for U.S. investors doing business abroad. The treaty mechanism has nothing to do with ability to pay or horizontal equity; rather, it promotes cross-border investment, reciprocity, and avoidance of double taxation. As a general matter, however, none of these treaty-related justifications for departing from the neutrality norm would appear to justify a general subsidy for sovereign wealth.¹⁰⁷

Second, taxing sovereign wealth funds as private corporations is consistent with broader international tax policy norms as reflected in the current practice of other countries.¹⁰⁸ The United States is alone among its OECD peers in granting categorical, unilateral immunity from taxation for sovereign wealth funds.¹⁰⁹ While some OECD

¹⁰⁶ Broadly speaking, international tax policy distinguishes among investors based on whether they are active or passive, treating investors equally within those categories. It does not generally distinguish among foreign investors based on the country of origin.

¹⁰⁷ Writing in 1978, David Tillinghast noted that “[a]s a matter of tax policy alone, however, there is nothing which argues that the government-owned investors are more entitled to exemption from withholding taxes than private investors.” Tillinghast, *supra* note 47, at 538–39.

¹⁰⁸ The great “compromise” of international tax, broadly followed among Organisation for Economic Co-operation and Development (OECD) countries, is to allocate active business income to the source jurisdiction and to allocate passive or portfolio income to the residence of the capital-supplying investor. Avi-Yonah, *supra* note 70, at 1305–06; Graetz & Grinberg, *supra* note 57, at 541. Source countries, however, often tax dividends to portfolio investors despite the “compromise,” sometimes reducing that rate through treaty negotiation just as the United States does. See Graetz & Grinberg, *supra* note 57, at 541 (discussing prevalence of withholding taxes on passive portfolio investments and giving examples of modification through treaties). Taxing dividends paid to foreign sovereigns at the current 30% rate unless reduced by treaty thus fits cleanly into normal international practice.

¹⁰⁹ See Taylor, *supra* note 46, at 154 (“Few foreign governments explicitly exempt other foreign governments from tax on income generated in their country. Countries that do provide such exemptions generally do so on a reciprocal basis only.”).

countries grant an exemption from tax for foreign governments receiving passive income, the exemption tends to be conferred by administrative practice rather than through legislation. Other countries simply treat foreign governments as if they were private entities, and if exemptions are made, they are administered through treaties.¹¹⁰

A Joint Committee Report identified a broad divide between Japan and the Commonwealth countries of Australia, Canada, and the United Kingdom on the one hand, and continental Europe on the other.¹¹¹ Japan and the Commonwealth countries generally grant an exemption for passive income, administered on a case-by-case basis.¹¹² Continental European practice, however, confirms that international law confers no obligation to exempt passive income. In Germany, Norway, Poland, and Switzerland, foreign governments are treated like private foreign entities, enjoying exemption from tax only when a treaty exempting both government and private entities has been negotiated.¹¹³ In Germany, for example, the government recently denied a tax exemption requested by ADIA.¹¹⁴

While the practice of other countries is hardly dispositive, it shows that the United States would not be out of step with international tax norms in following the Continental model of treating sovereign wealth funds as if they were private foreign corporations. Moreover, a default rule treating sovereign wealth funds as private corporations would provide the United States with improved leverage in treaty negotiations, in which the baseline withholding rate of 30% on dividends is typically bargained down to a lower rate.¹¹⁵

¹¹⁰ See JCT REPORT, *supra* note 19, at A-3 to A-4 (discussing practices of various OECD nations).

¹¹¹ *Id.* at A-2.

¹¹² Even compared to the Commonwealth countries, the United States is an outlier in providing an unconditional tax exemption for commercial sovereign wealth funds. In Australia, a sovereign wealth fund seeking an exemption must establish, through a private ruling process, that its portfolio income results from the performance of a governmental function. *Id.* at A-4, A-8. In Canada, the fund must establish that its portfolio income serves a truly governmental function with a public or humanitarian noncommercial purpose. *Id.* at A-4. Chinese state-owned banks, for example, have been denied exempt status. *Id.* The United Kingdom, though, broadly exempts foreign governments from tax on portfolio income by administrative practice, in accordance with their view of customary international law. *See id.* at A-49.

¹¹³ *Id.* at A-3 to A-4.

¹¹⁴ See Steinbrück *verweigert Staatsfonds Steuerbefreiung* [Steinbrück Denies State Fund Tax Exemption], *HANDELSBLATT (F.R.G.)*, May 21, 2008, available at <http://www.handelsblatt.com/politik/deutschland/steinbrueck-verweigert-staatsfonds-steuerbefreiung;1432914>. I am indebted to Professor Heribert Anzinger of Technische Universität Darmstadt for explaining the application of the tax on dividends in Germany.

¹¹⁵ Unilaterally exempting dividends from tax is little more than an anachronism, chiseled into the tax code before sovereign immunity was restricted to exclude commercial activities. This was evident even thirty years ago, as Tillinghast explained:

Third, sovereign tax neutrality is also an appropriate baseline norm because it dampens the potential for a clientele effect, which can occur when particular groups of investors are tax advantaged. Under current law, the subsidy for sovereign wealth fund investment creates the potential for sovereign investment to crowd out private investment. Because dividend yield is tax exempt for sovereign bidders, but not for private bidders, sovereign bidders can bid a higher price for the same asset.¹¹⁶ The tax advantage is more significant for companies that pay a high dividend yield; many of the largest cross-border sovereign wealth fund deals have involved firms paying a high dividend yield.¹¹⁷

Dividends, however, are a different issue [from interest, which the United States might reasonably choose to exempt from tax]. Until such time as the United States becomes a less developed country, it is difficult to hypothesize a case in which dividend income would result from the conduct of inherently governmental operations, unless Congress wished to ratify the view that the investment of public pension funds is a governmental operation.

Tillinghast, *supra* note 47, at 542.

¹¹⁶ Because the capital markets are relatively efficient, a small tax advantage can be sufficient to determine the clientele of a particular class of investments. There is abundant evidence of tax-favored investors crowding out other investors. We already observe a parallel kind of crowding-out effect in the bond market. Large amounts of the bonds of U.S. companies are held by tax-exempt investors, such as pension funds and university endowments, or by foreign investors, who are exempt from tax on portfolio interest. These investors may pay an implicit tax on the investment; an issuer may be able to offer debt at, say, 8% instead of 10% because the interest is exempt from U.S. tax. Because taxable investors would bear both the implicit tax (i.e., receive a lower yield) and explicit tax, the tax-exempt investors tend to crowd out taxable investors. See *SCHOLES ET AL.*, *supra* note 23, at 143–45 (surveying evidence of implicit taxes and clienteles).

¹¹⁷ The table below shows the dividend yield of the U.S. financial services firms that received large investments from sovereign wealth funds:

SEVEN LARGEST SOVEREIGN WEALTH FUND INVESTMENTS IN PUBLIC U.S. TARGETS
(AS OF APRIL 4, 2008)

Target	Buyers	Amount	Dividend Yield
Blackstone	China (CIC)	\$3 billion	6.44%
Citigroup	Abu Dhabi (ADIA)	\$7.5 billion	5.32%
Citigroup	Singapore (GIC)	\$6.88 billion	5.32%
Citigroup	Kuwait	\$3 billion	5.32%
Merrill Lynch	Singapore (Temasek)	\$4.4 billion	3.03%
Merrill Lynch	Kuwait	\$2 billion	3.03%
Morgan Stanley	China (CIC)	\$5 billion	2.27%

See Andrew Ross Sorkin, *The New Global Wealth Machine*, N.Y. TIMES, Apr. 2, 2008, at H4, available at <http://dealbook.blogs.nytimes.com/2008/04/02/follow-the-money/> (listing seven largest U.S.-based deals involving financial services or private equity firm).

The tax treatment of these deals is somewhat complicated. Several deals used financial products designed to take advantage of Revenue Ruling 2003-97, which allows issuers of certain mandatorily convertible securities (specifically, a debt instrument coupled with a forward contract) to enjoy a tax deduction on a portion of the payments to the securities holders.¹¹⁸ The securities holders receive dividend-like “contract payments” which, if held by private investors, would likely be subject to withholding. Because the sovereign recipients are shielded by § 892, however, the payments are free from tax, creating an arbitrage between the issuer (who enjoys a tax deduction) and the recipient (who is tax exempt). Moreover, the sovereign’s tax preference for U.S.-source dividends continues after the securities convert into equity. Thus, it is possible that the ability of foreign sovereigns to receive a tax-exempt yield may increase their bids on the margins.¹¹⁹ Tax is not the only explanation for investment patterns, but the potential for a clientele effect is an important reason to pursue sovereign tax neutrality.¹²⁰

Understanding the effect of the tax exemption on investment behavior is not easy. Professors Mihir Desai and Dhammika

¹¹⁸ See Rev. Rul. 2003-97, 2003-34 I.R.B. 380.

¹¹⁹ The categorical exemption under current law may also enable aggressive tax planning by U.S. private equity funds and hedge funds going public utilizing the Blackstone structure. See Fleischer, *Taxing Blackstone*, *supra* note 12, at 90–92 (“([M]is)treatment of carried interest as capital gains . . . may tempt still more firms to go public as partnerships instead of corporations.”). In the PTP structure, a firm like Blackstone or Och-Ziff must set up a “blocker” corporation to cleanse active income from management fees, deal monitoring fees, and the like. The blocker corporation reduces its corporate tax liability through the use of debt financing from the parent and pays the parent partnership dividends that qualify as “passive income” under the current PTP rules. One apparent downside of this structure is that investors pay current tax on dividends—currently at a rate of 15% for qualifying dividends—while the blocker corporation receives no deduction for dividends paid. (The effective rate may be lower for corporations that can take the dividends-received deduction under I.R.C. § 243 (2006), and may be higher for foreign investors subject to FDAP withholding at 30%.) The character of the cash flow as a dividend payment is maintained as each investor in the PTP receives its distributive share of partnership income. When sovereign wealth funds invest in this structure, however—as in the examples of China’s investment in Blackstone, Dubai’s investment in Och-Ziff, and Abu Dhabi’s investment in Carlyle—they pay no tax on the dividend distributions.

¹²⁰ More likely, the rush into financial services firms is better explained by (1) the network benefits that sovereign wealth funds may acquire by establishing relationships with Western banks, see Katharina Pistor, *Global Network Finance: Organizational Hedging in Times of Uncertainty* (Columbia Law & Econ. Working Paper No. 339, 2008), available at <http://ssrn.com/abstract=1284606> (suggesting that sovereign wealth funds might be “bailing out” Western banks in strategic effort to network with diverse institutions), (2) the unwillingness of private equity investors to be regulated as bank holding companies, see Olivier Sarkozy & Randal Quarles, *Private Equity Can Save the Banks*, WALL ST. J., June 26, 2008, at A15 (discussing “source of strength” doctrine as deterrent to potential new capital), and (3) more broadly, the lower hurdle rate of sovereign investors.

Dharmapala argue that sovereign tax neutrality would actually put sovereigns at a competitive disadvantage. Their conclusion relies on the assumption that because sovereigns are tax exempt on their investment income in many other countries, they therefore employ a higher after-tax hurdle rate than private foreign investors. Thus, if the United States increases the tax rate on equity investments, but all other countries leave such investments untaxed, sovereigns will be the ones crowded out of the U.S. market.¹²¹ Professor Michael Knoll, however, argues that what matters is the difference between the tax rate on U.S. equity investments and the tax rate on a benchmark asset, such as debt instruments of U.S. companies. Because both private and sovereign investors enjoy a zero rate on debt, but private investors face a positive rate on equity, sovereigns may allocate relatively more investment toward the equity sector than private investors, creating a potential clientele effect.¹²²

Whether a clientele effect exists under current law may depend on what investments are the closest substitutes for strategic investments in equity of U.S. companies. If equity investments in other foreign countries where sovereigns are tax exempt (such as the United Kingdom) are the closest substitutes, then a clientele effect is unlikely, as sovereigns presumably employ the higher after-tax hurdle rate that Desai and Dharmapala assume. If, on the other hand, the closest substitutes are investments in which sovereigns have no tax advantage over private investors, such as debt in a U.S. company or equity investments in countries where sovereigns are taxable, like Germany,

¹²¹ See Desai & Dharmapala, *supra* note 18, at 101–02. Desai and Dharmapala’s argument is closely related to Professor Knoll’s research on the Unrelated Business Income Tax (UBIT). Professor Knoll has argued that the tax exemption for nonprofits would not produce a competitive advantage even absent application of UBIT. See Knoll, *supra* note 104, at 868–69. Knoll’s finding depends on an assumption that nonprofits have a higher discount rate because nonprofit investors, unlike for-profit investors, could invest in other assets tax free. See *id.* at 869. Here, unlike in the UBIT context, for-profit foreign portfolio investors and nonprofit foreign portfolio investors can both invest in portfolio debt on a tax-free basis, which suggests that they would use the same hurdle rate in evaluating investments. Thus, Knoll’s findings in the UBIT context do not necessarily extend to the sovereign wealth fund context. Indeed, as discussed below, *infra* note 122, his analysis suggests that the higher tax rate on dividends could indeed create a clientele effect in the sovereign wealth fund context.

¹²² In economic terms, neither foreign private investors nor sovereign investors pay tax on the benchmark asset (debt), but private investors pay some tax on the alternative asset (equity). As Professor Knoll points out, the disparity with regard to portfolio investments may be mitigated by the availability of equity derivatives, such as total return swaps, which may not be subject to withholding. As a result, the tax preference may be limited to strategic equity investments for which derivatives cannot substitute. See Knoll, *supra* note 18, at 24–26. Knoll predicts that “a likely effect of repealing the dividend exclusion in Section 892 is to induce [sovereign wealth funds] to shift from holding shares of [U.S.] companies to holding derivatives on such shares.” *Id.* at 25.

then a clientele effect is likely, as sovereign wealth funds would have cause to allocate more investment to the tax-advantaged investment class. My sense is that most sovereign wealth funds are indeed sensitive to the location of their investments, not just the asset class, and thus investment in the subordinated debt of U.S. companies may be the closest substitute for debt/equity hybrids of U.S. companies in which the funds currently invest. And because neither foreign private nor foreign nonprofit investors are generally taxed on debt instruments, they can be expected to employ the same hurdle rate in evaluating those investments. As a result, the tax exemption for dividends provides sovereign wealth funds with a competitive advantage.¹²³

This competitive advantage is especially significant for strategic investments. For smaller portfolio investments, foreign private investors often avoid the withholding tax by purchasing a derivative, such as a total return swap. Transaction costs make this strategy unworkable for larger strategic positions, however, as the counterparty on the swap would have difficulty hedging the short position on the underlying stock.¹²⁴

In sum, sovereign tax neutrality is a sound baseline norm, but it is not necessarily the only appropriate tax policy. A higher or lower tax rate may be justified in terms of a corrective tax or subsidy, as discussed below.

B. Should We Depart from the Neutrality Norm?

This Section considers whether we should impose an excise tax on sovereign wealth funds. An excise tax would operate as a Pigouvian, or corrective, tax, which is a tax designed to make the person who engages in an activity with negative externalities or public harms internalize the costs associated with that activity.¹²⁵ The goal is not necessarily to raise revenue but rather to influence behavior.¹²⁶ A properly designed carbon tax, for example, might encourage an

¹²³ See *id.* at 25 (“Repealing the exclusion in Section 892 as it applies to dividends will place [sovereign wealth funds] on par with private foreign investors from their country of residence.”).

¹²⁴ To the extent that sovereign wealth funds would avoid a withholding tax by purchasing derivatives, note that many of the negative externalities discussed below would be mitigated. It would be more difficult, for example, for the holder of a total return swap to influence the corporate governance of the underlying firm.

¹²⁵ See Arthur C. Pigou, *THE ECONOMICS OF WELFARE* 192–93 (4th ed. 1932) (discussing corrective taxes on alcoholic drinks, building in crowded areas, petrol, and motor vehicle licenses).

¹²⁶ See, e.g., William J. Baumol, *On Taxation and the Control of Externalities*, 62 *AM. ECON. REV.* 307, 307–09 (1972) (arguing that, in practice, modified Pigouvian approach of setting tax rate on generator of externality in order to reach “tolerable” level is superior to Coasean bargaining).

optimal level of greenhouse gas emissions.¹²⁷ To the extent that investments by sovereign wealth funds create negative externalities in ways that private foreign investment does not, then, we might consider a Pigouvian tax to correct for those public harms. Specifically, I consider the pros and cons of an excise tax on equity investments by sovereign wealth funds, as equity investments raise more troubling concerns than debt investments. If an excise tax on equity investments is not desirable, it seems implausible that we would want to impose an excise tax on debt investments.¹²⁸

Of course, sovereign wealth fund investments may also create public benefits. Generally speaking, cross-border investment encourages economic growth both here and abroad. In a recent report to Congress, the Joint Committee on Taxation argued that taxing sovereign wealth funds might reduce aggregate investment, thereby reducing future growth compared to that achievable in the absence of tax.¹²⁹ “This analysis would argue,” the Committee explained, “that restrictions on investments by [sovereign wealth funds] cannot improve economic well being in the United States.”¹³⁰

Weighing the relative costs and benefits of sovereign wealth fund investment is ultimately a task for Congress and the committee staffs, not academics, lobbyists, or tax lawyers. In recent reports, both the Joint Committee on Taxation and the Tax Section of the New York State Bar Association declined to opine on the nontax policy concerns raised by sovereign wealth fund investment.¹³¹ Still, given the ability

¹²⁷ See Louis Kaplow & Steven Shavell, *On the Superiority of Corrective Taxes to Quantity Regulation*, 4 AM. L. & ECON. REV. 1, 10–14 (2002). But see Jonathan Baert Wiener, *Global Environmental Regulation: Instrument Choice in Legal Context*, 108 YALE L.J. 677, 727–35 (1999) (identifying limited conditions in which Pigouvian taxes are superior to tradable allowances).

¹²⁸ To be sure, there are situations in which the tax code’s preference for issuing debt over equity raises troubling issues about how the tax code may distort financial structures and corporate governance generally. But it is unlikely that taxing debt investments by foreign sovereigns alone (without general repeal of the portfolio interest exemption for private foreign investors) would affect the cost of capital of U.S. companies. Because foreign sovereigns currently enjoy a preference with respect to dividend payments, it is possible that an excise tax could affect the cost of capital for U.S. companies raising equity. It seems more likely, however, that the excise tax would shape the clientele, not the cost, of raising equity; other tax-exempt investors, such as pension funds and endowments, could likely fill the gap now filled by sovereign wealth funds.

¹²⁹ JCT REPORT, *supra* note 19, at 73.

¹³⁰ *Id.*

¹³¹ *Id.* at 2 (“[I]nvestments by [sovereign wealth funds] or foreign governments more generally raise nontax policy concerns, but these fall largely outside the expertise of the Staff of the Joint Committee on Taxation.”); NYSBA REPORT, *supra* note 19, at 2–3 (“This report, however, does *not* make recommendations regarding how the tax laws might be used to address the deeper economic and political issues presented by [sovereign wealth funds] or by other market developments over the last two decades.”).

of tax law to affect investment incentives, a review of the costs and benefits is useful in thinking about the optimal tax policy.

1. *Literature Review: Regulating Sovereign Wealth Funds*

The existing debate generally views equity investments by sovereign wealth funds as a positive development in global finance. Our trade deficit pushes dollars into the hands of foreign governments who manage foreign exchange reserves, and those dollars must be recycled either by purchasing U.S. government obligations or by purchasing the securities or assets of U.S. companies. Most commentators view the proper policy goal as ensuring that the inbound investments in U.S. equities are made in accordance with financial rather than geopolitical motives. A variety of proposals have been advanced to promote that goal.

The leading approach to regulating sovereign wealth is the “best practices” model, which both the Treasury and the IMF have endorsed. The model would have policymakers evaluate funds based on their compliance with certain best practices and would rely on “naming and shaming” techniques to promote compliance. Advocates of the best practices model, while not always dismissive of national security considerations, tend to view the free flow of capital as the paramount consideration. Edwin Truman, an economist at the Peterson Institute and a former Treasury official, has been prominent both in recognizing the potential harms of sovereign wealth funds and in advocating a best practices approach to shaping their behavior.¹³² Truman sorts various elements we might use to group best practices into categories, including structure, governance, transparency and accountability, and investment behavior.¹³³ In making the case for greater transparency and accountability, Truman notes that strategies for managing sovereign wealth assets are often unclear to the managers of those assets, known to the managers but not to the general public, or susceptible to political influence.¹³⁴ Transparency promotes “horizontal accountability” among domestic and international stakeholders as well as “vertical accountability” within the country’s polit-

¹³² TRUMAN, *supra* note 28, at 3, 15 (identifying five major concerns about sovereign wealth funds—government mismanagement, pursuit of political objectives, financial protectionism, market turmoil and uncertainty, and conflicts of interest—and arguing that best practices approach should allay concerns); EDWIN M. TRUMAN, PETERSON INST. FOR INT’L ECON., POLICY BRIEF NO. PB07-6, SOVEREIGN WEALTH FUNDS: THE NEED FOR GREATER TRANSPARENCY AND ACCOUNTABILITY (2007), available at <http://www.iie.com/publications/pb/pb07-6.pdf>.

¹³³ See TRUMAN, *supra* note 28, app. A at 17 (listing and defining factors).

¹³⁴ TRUMAN, *supra* note 132, at 1.

ical process.¹³⁵ Transparency allows the home country's citizens to hold funds accountable while alleviating any suspicion on the part of the host country's citizens.¹³⁶

Professor Paul Rose argues that existing economic and political factors mitigate the risks posed by sovereign wealth funds and that the existing regulatory regime is sufficient to protect our interests.¹³⁷ The greater risk, according to Rose, is not that sovereign wealth funds will make politically motivated investments but rather that politics will infect the regulatory process here, driving investment abroad.¹³⁸ Rose argues that multilateral agreements concerning the regulation of sovereign wealth would provide certainty and stability, protecting sovereign wealth funds from political retribution by target countries.¹³⁹ Given the practical difficulties of reaching a binding multilateral agreement in a short period of time, however, Rose advocates a best practices model that sovereign investors could adopt voluntarily.¹⁴⁰

One problem with the best practices model is the subjectivity involved in measuring compliance.¹⁴¹ One measure of transparency, for example, is whether we know which companies a foreign sovereign has invested in. But many sovereign wealth funds invest through intermediaries, such as private equity funds, which are themselves lightly regulated and not transparent. Would disclosure of an investment in a private equity fund satisfy standards of transparency?¹⁴² A

¹³⁵ *Id.* at 7.

¹³⁶ *See id.* at 8 (arguing that transparency promotes accountability).

¹³⁷ Paul Rose, *Sovereigns as Shareholders*, 87 N.C. L. REV. 83 (2008); *cf.* Richard A. Epstein & Amanda M. Rose, *The Regulation of Sovereign Wealth Funds: The Virtues of Going Slow*, 76 U. CHI. L. REV. (forthcoming 2009) (manuscript at 2, 12, on file with the *New York University Law Review*) (arguing in favor of status quo and against promotion of best practices or other increased regulation).

¹³⁸ Rose, *supra* note 137, at 89.

¹³⁹ *See id.* at 130 (describing ability of multilateral agreements to “provide additional certainty for [sovereign wealth funds’] transactions to the benefit of both the sovereign and the host nation”).

¹⁴⁰ *See id.* at 131–33 (explaining that because of difficulty in setting up multilateral agreement, “[t]he emphasis thus far has been on *voluntary* self-regulation”).

¹⁴¹ *See* TRUMAN, *supra* note 28, at 6 (“Although we have tried to be comprehensive, rigorous, and objective in our evaluation of each fund, some degree of subjectivity necessarily is present.”).

¹⁴² Judging by past experience in the private equity context, institutional investors may fear losing access to high-performing private equity funds if forced to disclose their investments and thus may be reluctant to comply with high standards of transparency. *See generally* Steven E. Hurdle, Jr., *A Blow to Public Investing: Reforming the System of Private Equity Fund Disclosures*, 53 UCLA L. REV. 239 (2005) (discussing how state public disclosure laws can result in exclusion of public institutions from private equity funds). Moreover, institutional investors may lack the ability—let alone the desire—to disclose the identity of portfolio companies in which they have an economic interest, as the information provided to them by general partners of funds in which they invest may be limited, incomplete, or subject to confidentiality requirements.

second problem with the best practices model is that a gap may arise between the stated practices of a fund and its actual practices, and it may be difficult to anticipate such departures from best practices before they occur. It is not difficult to imagine, for example, that managers of China's or Russia's state-owned funds could find themselves subject to unofficial political pressure.¹⁴³ A third problem with the best practices model is the lack of a method for enforcing compliance. While hortatory statements may help establish norms of behavior, many new funds from developing countries may have limited ability to resist the political demands of the sovereigns they serve. On the one hand, naming and shaming campaigns can be surprisingly effective, and such campaigns have been effective with regard to certain IMF and World Bank standards.¹⁴⁴ On the other hand, it is precisely those countries that have shown a pattern of resisting IMF policies that pose the greatest geopolitical risk to the United States.¹⁴⁵

Professors Ron Gilson and Curtis Milhaupt advocate a "minimalist" response that would promote sovereign investment but undercut the ability of sovereign wealth funds to accomplish strategic goals by limiting their influence over target companies.¹⁴⁶ They suggest a targeted response that would defuse the potential conflict between the foreign government (which may have a geopolitical agenda) and ordinary shareholders seeking financial returns without impairing the free flow of capital.¹⁴⁷ Under their approach, the equity shares of a U.S. company acquired by a foreign government-controlled entity would lose the voting rights normally associated with

¹⁴³ See Ronald J. Gilson & Curtis J. Milhaupt, *Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism*, 60 STAN. L. REV. 1345, 1362 (2008) ("Could anyone genuinely believe that the investment managers of China Investment Corporation or Singapore's Temasek would hang up the phone if a senior government (or in China's case, Party) official called to offer advice on the fund's handling of a particular investment to advance the country's, rather than the portfolio company's, interests?").

¹⁴⁴ See TRUMAN, *supra* note 28, at 14 ("As is the case with compliance with existing standards subject to IMF and World Bank surveillance and oversight, the process of naming and shaming, combined with peer pressure from other [sovereign wealth funds] that want to avoid the application of draconian restrictions to their activities, should contribute to a high level of compliance within a short period.").

¹⁴⁵ Cf. Evan Bayh, Editorial, *Time for Sovereign Wealth Rules*, WALL ST. J., Feb. 13, 2008, at A26 ("Incentives for compliance and meaningful consequences for sovereign wealth funds that refuse to comply must be adopted. It would be a mistake to give a multinational organization like the International Monetary Fund responsibility for oversight, because the IMF lacks enforcement power and has proven ineffective.").

¹⁴⁶ Gilson & Milhaupt, *supra* note 143, at 1345–52.

¹⁴⁷ See *id.* at 1352 ("Efforts to diffuse [sic] this tension between the benign and threatening faces of [sovereign wealth fund] equity investments requires [sic] a strategy of regulatory minimalism.").

those shares, regaining those rights only when transferred to nonstate ownership.¹⁴⁸ Sovereign investors with financial motives would still invest despite such restrictions; politically motivated sovereigns seeking strategic benefits, however, “will find [sovereign wealth funds] to be a less attractive vehicle by which to achieve their ends.”¹⁴⁹ Specifically, Gilson and Milhaupt claim that even a sovereign wealth fund’s informal influence depends on its ability to vote its shares.¹⁵⁰

The problem with the minimalist approach is precisely that it assumes that the strategic influence that foreign governments seek derives directly or indirectly from their voting rights in individual companies. But when a sovereign wealth fund is the largest shareholder in a publicly traded firm, it need not vote its shares in order to influence corporate decisions. The implicit threat of selling shares—and the drop in share price that would follow—is enough to command management’s attention. Moreover, as I discuss in more detail below, accumulating substantial equity positions in financial services firms increases the “soft power” of autocratic regimes seeking legitimacy in the capital markets.

Professor Katharina Pistor offers a descriptive model that is helpful in understanding the motivations of both sovereign wealth funds and financial institutions seeking capital. She describes the advantages of these investments in terms of “network finance,” an emerging model of the global financial system.¹⁵¹ As more capital flows from East to West, sovereign wealth funds are emerging as nodes in a horizontal network of global finance, in contrast to the traditional model of finance flowing from West to East (or North to South).¹⁵² Pistor views sovereign wealth funds as a form of “institutional hedging,” employed by developing economies trying to determine the optimal governance structure for their new role as financiers of Western capitalism and by banks in developed countries seeking access to markets in developing countries.¹⁵³ By taking minority stakes in Western financial institutions, sovereign wealth funds

¹⁴⁸ *Id.* at 1362–65.

¹⁴⁹ *Id.* at 1352–53.

¹⁵⁰ *See id.* at 1363–64 (“In important circumstances . . . [e]ven the informal, nonlegal elements [of corporate governance] can operate in the shadow of the formal, legally dictated decision structures. . . . [A sovereign wealth fund’s] informal influence depends, ultimately, on its formal influence—its ability to vote its shares.”).

¹⁵¹ *See Pistor, supra* note 120, at 5–6 (arguing that global network finance has potential to perform critical governance functions).

¹⁵² *See id.* at 7–8 (discussing deals in which capital is “invested from East to West, in contrast to the traditional model of West-East or North-South capital flows”).

¹⁵³ *See id.* at 24–26, 30–34 (defining institutional hedging and discussing its application to Western bank–Eastern sovereign wealth fund alliances).

develop a network relationship where vertical integration is neither politically feasible nor desirable, but where one-off market transactions are inefficient.¹⁵⁴ China gains more from investing in Blackstone equity, in other words, than from making a one-time loan to Blackstone.¹⁵⁵

In sum, the existing literature generally views sovereign wealth fund investment as an inevitable consequence of global financial trends. Academics and policymakers have, for the most part, advocated minimalist responses to the risks posed by sovereign wealth funds.

2. *Positive Externalities*

Many of the benefits from inbound sovereign wealth fund investment inure to the benefit of the target company and its shareholders. When Morgan Stanley sells securities to China for a higher price than private investors offer, that transaction benefits existing Morgan Stanley shareholders, who are less diluted than they otherwise would have been. The benefit to Morgan Stanley shareholders, however, does not necessarily justify a lower tax rate on sovereign wealth investment.

To justify a Pigouvian subsidy, one must believe that investment by sovereign wealth funds generates positive externalities above and beyond the benefits to the parties involved. One must weigh these positive externalities against any negative externalities. I discuss each side of the equation in turn.

Lowering the Cost of Capital. In defending investments by sovereign wealth funds, Wall Street lobbyists have argued that sovereign wealth funds may lower the cost of capital for U.S. companies, which

¹⁵⁴ See *id.* at 10 (discussing implicit and explicit additional commitments beyond deal at hand).

¹⁵⁵ See *id.* at 47–48 (“It is still to [sic] early to identify the purpose of networking in this instance, although some inferences can be drawn from parallels to networking in the 1970s when Western banks expanded into Latin America. One possible explanation is insurance against future losses. . . . A more likely explanation is institutional hedging. The transactions create links among major players from different governance regimes at a time when doubts have emerged about the absolute dominance of the Western regime for global financial markets.”). Pistor’s account of this emerging model provides limited evidence of network benefits. Pistor views the value primarily in terms of institutional hedging—as a method for both Western financial institutions and the autocratic regimes of developing economies to deal with the uncertainties of a financial system in flux. Other advantages that might support Pistor’s account include traditional relational advantages. China’s investment in Blackstone, for example, might offer the opportunity to lend to Blackstone-controlled portfolio companies in the future or to participate directly in equity investments of Blackstone’s targets.

may in turn promote economic growth.¹⁵⁶ Absent tax advantages, however, there is little reason to think that sovereign wealth funds are the marginal investors in the capital markets. Aggregate sovereign wealth fund investment, while growing, remains small in comparison to aggregate investment by other institutional investors, so in the usual case other investors would step in to substitute for sovereign wealth fund investment at the same marginal cost of capital to the issuer.¹⁵⁷ While it seems unlikely that reduced sovereign wealth fund investment would affect the cost of capital in the United States generally, reduced deal activity from sovereign wealth funds could reduce advisory fees from those clients. The fees are substantial, and advisors to sovereign wealth funds have weighed in accordingly.¹⁵⁸

Enhancing Market Stability. The Bush administration has emphasized the role of sovereign wealth funds in stabilizing jittery markets.¹⁵⁹ The argument is that sovereign wealth funds are capital suppliers of last resort—for example, they supplied equity capital to struggling U.S. banks when no one else would. One problem with this argument is that there is little evidence that sovereign wealth funds were, in fact, capital suppliers of last resort. Rather, they simply offered a higher price than other investors. Capital markets are gen-

¹⁵⁶ One financier's initial reaction to the argument set forth in this Article is that "any hint that sovereign funds may have their tax status questioned would be one more reason for them to take their business elsewhere." Landon Thomas Jr., *To Court or Shun the Wealth of Nations*, N.Y. TIMES, Apr. 2, 2008, at SPG1. Professor Steven Davidoff suggested that disclosure backed by CFIUS review, rather than taxation, might serve as a better incentive to encourage compliance with a code of conduct, thereby preserving inbound investment. See Steven M. Davidoff, *Telling Friend from Foe in Foreign Investments*, N.Y. TIMES, Apr. 2, 2008, at SPG11 (referring to academic proposals and concluding that "a firm monitoring and disclosure process" would be preferable).

¹⁵⁷ The Joint Committee explains:

[I]nvestment by [sovereign wealth funds] is small relative to aggregate U.S. investment and even smaller relative to aggregate worldwide investment. If [sovereign wealth funds] are not the marginal investor in the United States, that is if investments made by [sovereign wealth funds] would be readily substituted by other funds at little or no change in the cost of capital, restrictions on the investments of [sovereign wealth funds] would have little or no effect on future economic growth in the United States.

JCT REPORT, *supra* note 19, at 73. The Joint Committee also noted, however, that legislation curtailing sovereign wealth could appear protectionist, in which case private foreign investors might shy away. See *id.* ("However, restrictions on some foreign investors may be interpreted by other potential investors as an indication that the United States is inhospitable to foreign investors. Such a perception could make foreign investment funds more expensive and reduce aggregate investment.").

¹⁵⁸ See, e.g., Stephen Schwarzman, *Reject Sovereign Wealth Funds at Your Peril*, FIN. TIMES, June 20, 2008, at 9 (advocating strongly against political opposition to sovereign wealth funds).

¹⁵⁹ See Kimmitt, *supra* note 10, at 122 (arguing that sovereign wealth funds are force for financial stability).

erally flexible, and when public investors shy away from a sector, institutional investors such as private equity funds, hedge funds, and pension funds are often willing to step in.

To be sure, in 2007 sovereign wealth funds played the role of contrarian investor, buying equity in U.S. financial institutions when others were unwilling.¹⁶⁰ But this is not credible evidence that sovereign wealth funds are uniquely suited to the role of lender of last resort. Private equity firms shied away from investments in banks in part because of regulatory considerations.¹⁶¹ Specifically, if a private equity fund acquires more than 25% of the voting shares of a bank, or owns more than 9.9% of the voting shares of a bank and acquires a board seat, the fund would be treated as a bank holding company for regulatory purposes. Among other things, status as a bank holding company would subject the fund to the “source of strength” doctrine, which could require additional infusions of capital in the future.¹⁶² If policymakers want to expand the pool of available investors and lower the cost of capital for troubled banks, relaxing the restrictions of the bank holding company laws would be more effective than using the tax code to subsidize sovereign wealth funds.¹⁶³ Moreover, it appears that notwithstanding banking laws, private equity remains willing to step in when the price is right.¹⁶⁴

In any event, the value of sovereign wealth funds as capital suppliers of last resort is unproven. In one clear case where an investment bank was in deep trouble, sovereign wealth funds passed. China’s CITIC, a brokerage firm controlled by the Chinese government, had engineered a deal to buy an equity stake in Bear Stearns. As Bear Stearns’ financial position weakened, China sought a bigger investment, but then ultimately walked away from the deal. According to two people with direct knowledge of the deal, political

¹⁶⁰ See *supra* text accompanying notes 1–3.

¹⁶¹ See Sarkozy & Quarles, *supra* note 120, at A15 (“[P]rivate equity represents a large pool of untapped capital for the financial-services industry. Yet an array of regulations and administrative interpretations limits private equity’s ownership and influence in regulated depository institutions.”).

¹⁶² See Eric J. Gouvin, *Of Hungry Wolves and Horizontal Conflicts: Rethinking the Justifications for Bank Holding Company Liability*, 1999 U. ILL. L. REV. 949, 954 (describing obligations imposed on bank holding companies by “source of strength” doctrine).

¹⁶³ See *id.* (suggesting that parent holding companies should be liable in very limited circumstances); Howell E. Jackson, *The Expanding Obligations of Financial Holding Companies*, 107 HARV. L. REV. 507, 564–73 (1994) (positing both “hungry wolf” hypothesis and “regulatory deterioration” hypothesis and finding empirical support for latter, suggesting that enhanced capital requirements are appropriate).

¹⁶⁴ See, e.g., Eric Dash, *Bank Is in Line for a \$5 Billion Infusion*, N.Y. TIMES, Apr. 8, 2008, at C2 (describing TPG’s investment in Washington Mutual).

pressure affected negotiations.¹⁶⁵ All told, there was no evidence that sovereign wealth funds acted to stabilize markets during the financial industry meltdown in 2008.

Finally, while some sovereign wealth funds may act as long-term investors who can help stabilize markets, others may not. Newly formed funds subject to political pressure may be even more fickle than experienced financial investors. Certain funds' lack of transparency may fuel the market's concern that state-controlled investors may not be trustworthy when push comes to shove.

Hostage Argument. Richard Posner has argued that equity investments by sovereign wealth funds enhance national security by effectively taking a "hostage" (in game theory terms).¹⁶⁶ Posner explains: "It does not undermine our national security just because the purchaser is a foreign government, but on the contrary enhances our security because the investment is a hostage. It's as if to guarantee China's good behavior the president of China sent his family to live in the United States."¹⁶⁷

Putting the point more broadly, economic interdependence allows gains from trade and is thought by international relations scholars to decrease the likelihood of armed conflict, at least among liberal states.¹⁶⁸ Giving foreign sovereigns an economic stake in U.S. companies may better align their economic incentives with our own.¹⁶⁹ When Abu Dhabi partners with GE, it may be less willing to act in ways that harm GE, and in many cases (though of course not all), what is good for GE is good for America. The problem is that foreign sovereigns are not committed to acting only according to economic motives. Returning to Judge Posner's hostage analogy, if the hostage

¹⁶⁵ Reporter George Chen quotes two people with knowledge of the deal:

"Chinese regulators will not feel happy if they see [CITIC] buying the stake of Bear Stearns at the original price," one of the people said.

"Beijing is also facing domestic concerns that Chinese firms are probably paying too much for foreign assets," he added, citing recent investments in U.S. companies by China Investment Corp., the country's sovereign wealth fund, as an example.

George Chen, *China Seeks Bigger Share of U.S. Bank*, INT'L HERALD TRIB., Feb. 15, 2008, at 17.

¹⁶⁶ Posting of Richard Posner to The Becker-Posner Blog, <http://www.becker-posner-blog.com/archives/2007/12/sovereignwealth.html> (Dec. 10, 2007, 09:14).

¹⁶⁷ *Id.*

¹⁶⁸ *E.g.*, John R. Oneal & Bruce M. Russett, *The Classical Liberals Were Right: Democracy, Interdependence, and Conflict, 1950–1985*, 41 INT'L STUD. Q. 267, 267 (1997).

¹⁶⁹ *See* Gilson & Milhaupt, *supra* note 143, at 1360 ("Indeed, because equity investments reflect long term values, these investments leave [sovereign wealth funds] hostage to the health of the economies in whose corporations they invest.").

is expendable, the hostage takers have less leverage than they might expect.¹⁷⁰

The critical concern is that one of these strategic investments by a sovereign wealth fund will turn out to be a Trojan horse, allowing a foreign government 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 where the financial interests of the fund and the political interests of the government that controls the fund diverge.¹⁷¹ A country with a ruling monarchy friendly to the United States today may not be so friendly following a revolution.

Monetary Policy. Some argue that allowing sovereign wealth funds to invest in U.S. equities is part of a sensible monetary policy that encourages the free trade of goods and services across borders, which in turn fuels economic growth. The currently weak dollar

¹⁷⁰ Shooting the hostage is a familiar strategy in popular culture. Like Judge Posner's hostage analogy, its relevance to actual international relations is entirely speculative. See Shoot the Hostage: Television Tropes and Idioms, <http://tvtropes.org/pmwiki/pmwiki.php/Main/ShootTheHostage> (last visited Jan. 22, 2009); see also DIE ANOTHER DAY (Eon Productions et al. 2002) (depicting Bond shooting M in simulator program); SPEED (Twentieth Century Fox Film Corp. 1994) (depicting Jack shooting hostage Harry to confuse bad guy); THE USUAL SUSPECTS (PolyGram Filmed Entertainment et al. 1994) (depicting Verbal recounting Keyser Söze's shooting his own family).

¹⁷¹ There is some concrete evidence to back up the concern about mixed financial and political motives. First, the historical track record of government-sponsored funds is poor. See Romano, *supra* note 16, at 852 (examining returns in context of public pension funds). Second, even funds that have performed well display political motives that are inconsistent with purely financial goals. For example, Carlyle's Mideast investment fund avoids investments in Israel out of respect for its Arab partners, no matter how attractive the investment opportunity. See Nathaniel Popper, *As Dubai Heats Up, Is Israel Frozen Out?*, FORWARD (New York), Dec. 7, 2007, at A1. Persian Gulf countries, sensitive to the political fallout following the Dubai Ports controversy, turned to strategic investments in financial services firms, rather than controlling investments in operating firms. These noncontrolling investments, at least when they amount to less than 10% of the equity of the target, were thought to avoid review by CFIUS. The Treasury Department has since clarified that it may review deals below the 10% level. See Regulations Pertaining to Mergers, Acquisitions, and Takeovers by Foreign Persons; Final Rule, 73 Fed. Reg. 70,702, 70,704 (Nov. 21, 2008) (to be codified at 31 C.F.R. pt. 800), available at <http://www.treas.gov/offices/international-affairs/cfius/docs/CFIUS-Final-Regulations-new.pdf> ("However, the regulations do not provide, and never have provided, an exemption based solely on whether an investment is ten percent or less in a U.S. business. If a foreign person holds ten percent or less of the voting interest in a U.S. business but does not hold that interest solely for the purpose of passive investment, then the transaction still may be a covered transaction. For example, a transaction involving a foreign person's acquisition of nine percent of the voting shares of a U.S. business in which the foreign person has negotiated rights to determine, direct, decide, take, reach, or cause decisions regarding important matters affecting that business would be a covered transaction.").

makes investments in U.S. Treasury bonds less appealing to foreign sovereigns than they once were. But it still may not be necessary to subsidize equity investments in order to achieve the monetary policy benefits of having foreign sovereigns recycle dollars into U.S. assets. Foreign sovereigns can achieve higher returns through indirect investments in U.S. assets by investing in financial intermediaries, like hedge funds and private equity funds, which invest in U.S. assets. And foreign sovereigns can invest in the debt of U.S. companies to increase returns above the risk-free Treasury rate.

Summary. In sum, the positive externalities from investment by sovereign wealth funds are significant but not overwhelming, especially if distinguished from a broader overall economic policy of open access to capital markets and monetary policy that allows foreign sovereigns to recycle dollars in one form or another.

3. *Negative Externalities*

A higher tax rate on investments by sovereign wealth funds is justified if sovereign wealth funds cause harm to third parties (such as the American public generally) or if some other factor leads to more investment than is socially optimal.

Threatening American Foreign Policy Interests. Perhaps the most troubling aspect of sovereign wealth fund investment is the potential leverage it gives those sovereigns in foreign policy negotiations. Former Treasury Secretary Lawrence Summers has identified a couple of examples. A sovereign investor, in exchange for supporting U.S. military operations, could press for a tax break for a company in which it has invested.¹⁷² Pressure might also be more subtle: What might it mean for the U.S. government, asks Summers, “when a decision has to be made about whether to bail out a company, much of whose debt is held by an ally’s central bank?”¹⁷³

Summers also suggests the possibility that sovereign investors may want to extract industrial technology.¹⁷⁴ While minority share-

¹⁷² See Lawrence Summers, *Sovereign Funds Shake the Logic of Capitalism*, FIN. TIMES, July 30, 2007, at 11 (“What about the day when a country joins some ‘coalition of the willing’ and asks the U.S. president to support a tax break for a company in which it has invested?”).

¹⁷³ *Id.* The latter concern came to fruition in July 2008, a year after Summers’s column appeared, when the Treasury announced a bailout plan for Fannie Mae and Freddie Mac. China is the largest holder of debt in both companies. The administration’s desire to cultivate good relations with China could have affected its decision to bail out the mortgage companies. More specifically, it may have affected Treasury’s decision to wipe out the common shareholders of these companies but not the subordinated debt holders. I am indebted to Steven Davidoff for making this point.

¹⁷⁴ *Id.* (“They may want to see their national companies compete effectively, or to extract technology or to achieve influence.”).

holders do not enjoy special access to company technology as a matter of state corporate law, management might be willing to grant its largest shareholders a tour of the facilities, access to plans for expansion, or other nonpublic information.

Investment by sovereign wealth funds also increases what international law scholars call the “soft power” of those sovereigns. Soft power is the ability to get what you want through “attraction rather than coercion.”¹⁷⁵ We often think of extending the soft power of the United States through investment abroad: When Americans invest or donate abroad, residents of the target countries are influenced by U.S. norms.¹⁷⁶ But the process can work in reverse as autocratic regimes invest here: Doing business with China arguably legitimizes Chinese investment and may be read as tacit approval of its political system. More precisely, accepting sovereign wealth fund investment establishes a norm that whatever the policies of the foreign sovereign may be, our disagreements do not rise to a level requiring us to reject their money.

To be sure, China, Singapore, the Gulf states, and other countries with prominent sovereign funds, as major trading partners with the United States, already possess some soft power over U.S. foreign policy. After all, it is their trade imbalance with the United States that creates the opportunity to form sovereign wealth funds in the first place. Thus, the incremental gain in soft power through investments in U.S. companies may not be vast.

Lastly, while the influence conferred through investments is substantial, it is unclear whether the foreign policy impact of debt or equity investments is any greater than already exists through foreign holdings of U.S. government obligations. If China were to sell all of its holdings of U.S. Treasury bonds, for example, it could destabilize U.S. financial markets. However, targeted investments in U.S. financial institutions may allow more foreign policy leverage per dollar of

¹⁷⁵ Robert O. Keohane & Joseph S. Nye, Jr., *Power and Interdependence in the Information Age*, FOREIGN AFF., Sept./Oct. 1998, at 81, 86.

¹⁷⁶ See, e.g., Garry W. Jenkins, *Soft Power, Strategic Security, and International Philanthropy*, 85 N.C. L. REV. 773, 795–801 (2007) (discussing international philanthropy as source of soft power); Kal Raustiala, *The Architecture of International Cooperation: Trans-governmental Networks and the Future of International Law*, 43 VA. J. INT'L L. 1, 51–52 (2002) (“In networks, soft power is exercised by traditionally dominant states—no state has more soft power than the U.S.—and the dominant direction of diffusion is clearly from the U.S. (and EU) and toward less advanced economies.”); Peter J. Spiro, Book Review, 97 AM. J. INT'L L. 731, 732 (2003) (reviewing JOSEPH S. NYE JR., *THE PARADOX OF AMERICAN POWER: WHY THE WORLD'S ONLY SUPERPOWER CAN'T GO IT ALONE* (2002)) (“As both means and ends, soft power is about projecting values; only by persuading others to adopt its political, economic, and popular culture, Nye argues, will the United States be able to maintain the hegemony enabled by its unchallenged hard power.”).

investment.¹⁷⁷ Furthermore, investments may co-opt management of the target into supporting the foreign policy goals of the foreign sovereign.

Inefficient Allocation of Resources. Capitalism relies on companies and their shareholders seeking financial returns on their investments.¹⁷⁸ As shareholders learn of good or bad decisions that managers have made, shareholders on the margin buy or sell stock accordingly, pushing the price of the stock up or down. The price signal is thus a valuable mechanism for reducing agency costs. Introducing governments, who may have nonfinancial motives, as shareholders makes noise that interferes with the price signal and the efficiency of the market.

Suppose, for example, that Morgan Stanley is considering expanding its office in either Beijing or Taiwan. China's presence as the company's largest shareholder may influence its managers toward Beijing, even if, in the absence of China's influence, it would have chosen Taiwan. Thus, even when managers do not explicitly seek the approval of their sovereign shareholders, they might shy away from actions that would offend those shareholders. Political influence on such decisions, in the aggregate, may create significant loss of efficiency for the company.

In the absence of transaction costs, the presence of China as a large shareholder might be irrelevant to managers. If managers offend Chinese officials, who in turn pressure CIC to sell the stock, other investors who would see that the managers had made a wise business decision would swiftly rush in to buy the shares. But China's sale of shares could also be interpreted as a signal of bad management. After all, China may be presumed to have better information about Morgan Stanley than do nonshareholders.

In a context where information costs are high, such as in the venture capital–portfolio company context, it is well accepted that existing shareholders exert powerful influence over the ability of companies to secure future equity financing.¹⁷⁹ Because information is asymmetric—the selling company and its existing shareholders have

¹⁷⁷ Because the market for Treasury obligations is so large, it seems unlikely that the sudden sale of, say, \$5 billion of Treasuries would have much of an impact on the market. Suddenly dumping \$5 billion of stock in several financial institutions, on the other hand, could induce a panic that could spread across the markets. In light of the recent bailout of U.S. financial institutions, however, it seems plausible that the U.S. government would step in to recapitalize the banks on short notice if such an event were to occur.

¹⁷⁸ *E.g.*, Summers, *supra* note 172.

¹⁷⁹ *See, e.g.*, Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 *STAN. L. REV.* 1067, 1081 (2003) (“[S]tagged financing coupled with a right of first refusal made potent by high information costs allows the venture cap-

better information about future prospects than potential new shareholders—the refusal of an existing shareholder to participate in a new round of equity financing can be taken as a negative signal by the market. This familiar extension of the “lemons” problem¹⁸⁰ means that potential new shareholders shy away. As a result, the participation of existing, noncontrolling shareholders in future rounds of financing gives them influence separate and apart from any voting rights they may have.¹⁸¹ If, however, transaction costs are assumed to be low, the influence of a minority shareholder might be trivial.

At a higher level of abstraction, the presence of investors with nonfinancial motives can result in the mispricing of securities in another way. The invisible hand of the marketplace relies on the aggregation of preferences of individual actors. Here, rather than individuals or private organizations acting independently, sovereign vehicles aggregate preferences on behalf of their citizens (or perhaps party officials). There is no reason to believe that Chinese party officials are better at identifying good investments—firms that will put capital to its highest and best use—than private investors are. Some

ital fund to behave opportunistically in negotiating the price of a second round of financing.”).

¹⁸⁰ See generally George A. Akerlof, *The Market for “Lemons”: Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970).

¹⁸¹ Similarly, antitrust scholars believe that passive investment in a rival firm can have an anticompetitive effect, at least under certain conditions. See generally David Gilo, *The Anticompetitive Effect of Passive Investment*, 99 MICH. L. REV. 1, 10–11 (2000) (discussing how passive investment facilitates tacit collusion and, even in absence of collusion, tends to reduce output and raise prices); Daniel P. O’Brien & Steven C. Salop, *Competitive Effects of Partial Ownership: Financial Interest and Corporate Control*, 67 ANTITRUST L.J. 559, 571 (2000) (“In simplest terms, when a firm acquires a partial financial interest in a rival, the acquiring firm’s unilateral pricing incentives to compete are reduced at the margin. What about the unilateral competitive incentives of the acquired firm? . . . [I]f the acquiring firm also has control over the rival, then the rival’s incentives to compete are affected.”). Although the competitive effect of passive investment is outside the scope of this Article, the fact that antitrust scholars recognize the possibility that passive shareholders can sometimes influence the behavior of firms puts the formalist approach of Gilson & Milhaupt, *supra* note 143, at 1363–64, in jeopardy.

The MasterCard IPO is illustrative. In the MasterCard IPO, the member banks shed voting control of MasterCard, retaining influence through a passive economic stake in the company and a relationship maintained through a nonprofit foundation, which became a block shareholder in the newly public company. See Victor Fleischer, *The MasterCard IPO: Protecting the Priceless Brand*, 12 HARV. NEGOT. L. REV. 137, 138 (2007) (describing “reverse” dual-class voting and charitable foundation as means for maintaining passive control while reducing antitrust liability). Professor Wright correctly points out that the value of the structure depends on both the reduced regulatory exposure from a “single entity strategy” and on the member banks retaining some control over the future use of the MasterCard brand. Joshua D. Wright, *MasterCard’s Single Entity Strategy*, 12 HARV. NEGOT. L. REV. 225, 233 (2007). In other words, capital markets view the indirect influence of the member banks, even lacking a formal vote, as a powerful factor in the governance of the organization going forward.

sovereign wealth funds might prove to be excellent investors; the wealth funds of Gulf states closely resemble the family offices of wealthy individuals. But not all sovereign wealth funds are so well managed.

There is already substantial evidence that some sovereign wealth funds have a low hurdle rate for certain investments. For example, the CIC has a “fairly clear floor” on its rate-of-return goal of about 5%, which is necessary to service the cost of the bonds issued to CIC by China’s Ministry of Finance.¹⁸² In other words, there is much less pressure on these sovereign wealth funds—relative to private investment vehicles—to make the best possible investment. Even adjusting for risk, this relatively low floor leaves ample room to make inefficient investments, whether for the purpose of achieving political goals or merely because of poor investment decisions.

Finally, it is useful to consider the historical evidence.¹⁸³ Pension funds and endowments have succeeded in the United States and worldwide only as they have become professionalized and institutionalized as financial actors. While empirical data on sovereign wealth funds is scant, there is powerful anecdotal and statistical evidence that pension funds sensitive to political influence underperform peers that are insulated from political influence.¹⁸⁴

Increasing Managerial Slack. Perhaps anticipating political concerns that, as large shareholders, they may wield influence over management, sovereign wealth funds sometimes acquire nonvoting preferred shares in target companies.¹⁸⁵ Fear of political backlash

¹⁸² See *The Implications of Sovereign Wealth Fund Investments for National Security: Hearing Before the U.S.-China Economic and Security Review Commission*, 110th Cong. 66 (2008) [hereinafter *Implications of Sovereign Wealth*], available at http://www.uscc.gov/hearings/2008hearings/transcripts/08_02_07_trans/08_02_07_trans.pdf (statement of Michael F. Martin, Cong. Research Serv.) (“[A]ccording to [CIC Chairman] Lou, the Chinese government only expects the CIC to cover the nominal cost of its debt, or about 5%.”).

¹⁸³ There is little empirical data on the performance of sovereign wealth funds. But the early returns are poor. See Veljko Fotak et al., *The Financial Impact of Sovereign Wealth Fund Investments in Listed Companies* 20 (Sept. 18, 2008) (unpublished manuscript), available at <http://ssrn.com/abstract=1108585> (finding abnormal average returns of negative 14% over 480 trading days following sovereign wealth fund investment).

¹⁸⁴ See Romano, *supra* note 16, at 798, 820–31 (presenting empirical data finding “inverse relation between the return on funds’ investments and the degree of political involvement in their organizational form, and between return on investments and policies favoring social investing”); William H. Simon, *The Prospects of Pension Fund Socialism*, 14 BERKELEY J. EMP. & LAB. L. 251, 251, 254–64 (1993) (analyzing difficulties involved with employing pension fund assets to pursue social goals).

¹⁸⁵ Cf. Rummell, *Time To Tax*, *supra* note 18 (describing fears of corporate takeovers by hostile governments and possibility of “[r]estricting sovereign wealth funds to small, non-voting shares”).

might mean that funds with voting shares hesitate to exercise vigorous oversight of management. Management of a struggling bank that needs equity capital might then prefer the “dumb money” of sovereign wealth funds over the money of a private equity fund or activist hedge fund. As a result, an important element of corporate governance—the accountability associated with profit-minded activist investors—is diminished. The mixed motives of sovereign wealth fund investors thus create a dual threat to corporate governance: Politics can lead funds to act aggressively or to use the target investment as a geopolitical tool, but the lack of a single-minded focus on financial returns can also lead funds to act too passively and ignore their role as a monitor of corporate managerial behavior.

Contagion Effect. The lack of transparency of sovereign wealth funds produces another, more subtle harm. Whereas private investors are generally driven by profit motive, we do not know why sovereign wealth funds invest as they do. This uncertainty can destabilize markets by making it harder to anticipate how investors will respond to economic or political changes and by making it more difficult to assess systemic risk. The lack of transparency can lead to destabilizing rumors.¹⁸⁶ Because the investment strategy of many sovereign wealth funds is unknown, and because the potential for investment for geopolitical or monopolistic gain is a concern, sovereign wealth fund investment can increase market volatility.¹⁸⁷

That sovereign wealth fund investment might increase market volatility may seem counterintuitive, since these funds tout themselves as long-term investors. But they are also a subset of portfolio investors. Foreign portfolio investment, unlike foreign direct investment, reacts quickly to changes, sometimes producing a contagion effect. Portfolio capital “flees when the milk goes sour.”¹⁸⁸ So financial turmoil in the U.S. may be magnified, not dampened, by the presence of portfolio investment in the markets.¹⁸⁹ Sovereign wealth funds may also be subject to political control, which may make them even more likely to overreact to financial turmoil and to rapid changes in the value of their portfolios. The fact that sovereign wealth funds are so

¹⁸⁶ See *Implications of Sovereign Wealth*, *supra* note 182, at 67–68 (discussing volatility of Australian iron ore company Fortescue and Australian mining company Rio Tinto following rumors that companies were targeted by CIC for investment).

¹⁸⁷ See *id.* (discussing sources of market uncertainty and concern arising from sovereign wealth funds).

¹⁸⁸ Graetz & Grinberg, *supra* note 57, at 552.

¹⁸⁹ Many economists advocate constraints on the flow of portfolio capital. See *id.* at 553 & n.82 (referencing proposals by Feldstein, Krugman, and Stiglitz).

trendy now does not bode well for how they might react to bad news in the future.

Encroaching on the Autonomy of American Enterprise. Sovereign wealth fund investment in U.S. equities raises a concern that foreign governments might encroach upon the autonomy of American enterprise. The United States may be unnecessarily acting like a developing nation, giving up autonomy over its affairs in exchange for foreign direct investment.¹⁹⁰ Among tax scholars, the concern about sovereign wealth funds brings to mind similar discussions a generation ago about foreign investment in U.S. real estate, which ultimately led to the enactment of FIRPTA.¹⁹¹

Before FIRPTA, foreign investors could avoid taxation on all gains in U.S. real estate by holding the real estate through corporate intermediaries.¹⁹² When they sold the stock of the corporation that held the real estate, the gains were treated as capital gains and were therefore exempt from tax.¹⁹³ As foreign ownership of U.S. real estate rose during the 1970s, Congress began to investigate the tax loophole. Farmland was a particular concern; the idea of foreign investors crowding out domestic investors did not appeal to politicians in the heartland.¹⁹⁴ Similarly, urban politicians were alarmed by the possibility of “Japan, Inc.” taking over the commercial real estate market.¹⁹⁵ Many tax academics took a dim view of this chapter in American tax lawmaking. Law professor Richard Kaplan called the enactment of FIRPTA symptomatic of a “creeping xenophobia.”¹⁹⁶

¹⁹⁰ See Kingson, *supra* note 79, at 1162 (“The more a country must try to attract direct investment, the more that need conflicts with its independence; and the independence a country wants does not necessarily match the independence it can afford. A country may, therefore, simultaneously seek and selectively limit foreign ownership.”).

¹⁹¹ Foreign Investment in Real Property Tax Act of 1980, Pub. L. No. 96-499, §§ 1121–1125, 94 Stat. 2682 (amending I.R.C. § 861(a)(5) and adding I.R.C. §§ 897, 6039C, 6652(g)).

¹⁹² See S. REP. NO. 96-504, at 6 (1979) (“[A] foreign investor could, . . . under present law, avoid tax on the gain by holding the real estate through a corporation, partnership, or trust and disposing of his interest in that entity rather than having the entity itself sell the real estate.”).

¹⁹³ See *id.* at 5 (noting that foreign investors “generally are not subject to U.S. capital gains tax” and therefore would “not be subject to tax on the gain” in selling stock in real estate holding company).

¹⁹⁴ See Richard L. Kaplan, *Creeping Xenophobia and the Taxation of Foreign-Owned Real Estate*, 71 GEO. L.J. 1091, 1092–95 (1983) (questioning FIRPTA’s administrability and wisdom and criticizing motives of its supporters).

¹⁹⁵ See Steven M. Davidoff, *Telling Friend from Foe in Foreign Investments*, N.Y. TIMES DEALBOOK, Apr. 2, 2008, <http://dealbook.blogs.nytimes.com/2008/04/02/telling-friend-from-foe-in-foreign-investments> (citing “overinflated worry” in 1980s of Japanese takeover).

¹⁹⁶ Kaplan, *supra* note 194.

But one can be concerned about sovereign wealth funds without being xenophobic. Foreign governments pose a higher risk of making decisions based on political interests than foreign individuals. One concern is opportunism, and there is some evidence of opportunistic behavior by sovereign wealth funds: In 2006, Norway's government-owned fund shorted the bonds of Iceland's banks at the tail end of a boom period, a moment when the banks were particularly vulnerable.¹⁹⁷ Sovereigns may be tempted to use intelligence that they can access for regulatory purposes (like information about the health of central banks) to make strategic investments. Perhaps the greater fear is that by becoming the largest shareholders in our public corporations, sovereign wealth funds may influence corporate decisions in a manner inconsistent with current practice. Politically motivated sovereigns have already encouraged companies to allocate resources in an objectionable fashion.¹⁹⁸

Supporting Autocratic Regimes. Sovereign wealth fund investment raises both moral and instrumentalist objections. On the moral level, accepting investments from foreign sovereigns makes U.S. companies complicit in the actions of the foreign sovereign. Setting aside, for the moment, both the efficiency and foreign policy (soft power) implications discussed above, many find it morally objectionable to partner with autocratic regimes, a number of which have poor human rights records. In the era of apartheid, for example, activists pushed for divestment from South Africa not just because divestment would hit South Africa in the pocketbook but because divestment symbolically distanced U.S. companies from offensive policies. Similarly, partnering with China and the Gulf states imposes harm that, while not easily quantifiable, nonetheless counts as a negative externality.

Encouraging direct investment by foreign sovereigns also raises instrumentalist concerns. It may not be in our long-term interest to support the status quo regimes in foreign countries, and interlocking investments make it difficult to pursue a policy of regime change. Furthermore, when the United States encourages investment by foreign sovereigns, it makes it easier for those countries to recycle dollars through sovereign investment rather than distributing trade surplus to their citizens, who could then invest in the capital markets privately. The creation of sovereign wealth funds also is not independent from overall trade policy on inbound and outbound capital movements. Even given China's restrictive policy with respect to foreign direct

¹⁹⁷ *Asset-Backed Insecurity*, *supra* note 32, at 71.

¹⁹⁸ *Cf.* Popper, *supra* note 171 (suggesting that relationship with United Arab Emirates, which boycotts Israel, has caused Carlyle Group to avoid investing in Israel).

investment in China, more foreign direct investment flows into China than out, fueling the already staggering growth of its foreign exchange reserves.¹⁹⁹ While China has begun to allow certain “qualified” Chinese nationals to invest abroad, the outbound investment is limited by quotas.²⁰⁰

Lastly, in many countries the benefits of sovereign wealth funds inure to the benefit of private individuals rather than to the public at large. Particularly in the Gulf countries, it is hard to distinguish between benefits to the sovereign and benefits to the ruling family.²⁰¹ While, in theory, the ruling families safeguard wealth for the citizens they represent and the rising economic tide in the Gulf may eventually improve overall welfare, many observers remain troubled by the shape of progress in the region.²⁰²

Development Agenda. Encouraging investment by sovereign wealth funds may be inconsistent with broader foreign policy goals with respect to development. Sovereign wealth funds concentrate financial resources in the hands of financial managers. In developing countries, these financial managers may be closely tied to political elites.²⁰³

The conflict between our current sovereign wealth fund policy and development policy is clearest in the case of countries, such as Algeria, Libya, and Nigeria, that receive development assistance from other states.²⁰⁴ Development aid flows into the country, intended for domestic infrastructure. Meanwhile, cash from the exploitation of natural resources is diverted away from domestic infrastructure into investments abroad. Our development agenda—whether designed to advance strategic, economic, or humanitarian goals—is frustrated when cash otherwise available to improve the welfare of a recipient country’s citizens is instead hoarded into funds managed by political elites. Welcoming sovereign wealth fund investment with open arms

¹⁹⁹ MICHAEL F. MARTIN, CONG. RESEARCH SERV., CHINA’S SOVEREIGN WEALTH FUND 13 (2008) [hereinafter CRS REPORT].

²⁰⁰ *Id.* at 13–14.

²⁰¹ See Landon Thomas Jr., *Cash-Rich, Publicity-Shy*, N.Y. TIMES, Feb. 28, 2008, at C1 (noting that Abu Dhabi fund ADIA is managed by high-ranking members of royal family).

²⁰² See, e.g., Lucy Williamson, *Migrants’ Woes in Dubai Worker Camps*, BBC NEWS, Feb. 10, 2005, http://news.bbc.co.uk/2/hi/south_asia/4249223.stm (describing plight of migrant workers in Dubai).

²⁰³ See Keenan, *supra* note 34, at 439 (voicing concern that sovereign wealth funds may create “unconditioned wealth” that reinforces “almost complete control” by small number of elites).

²⁰⁴ See *id.* at 435. Countries that simultaneously receive development assistance and maintain sovereign wealth funds include Algeria, Angola, Azerbaijan, Botswana, Chile, China, Iran, Kazakhstan, Libya, Malaysia, Mauritania, Nigeria, Oman, São Tomé & Príncipe, Timor-Leste, Trinidad and Tobago, Venezuela, and Vietnam. *Id.* at 441.

thus may undermine our general foreign policy approach of encouraging developing countries to improve their domestic infrastructure.

4. *Summary*

Neither the brightest promises nor the greatest perils of sovereign wealth funds have yet been realized. While it is impossible to quantify all the positive and negative externalities, policymakers could rationally conclude that the negative externalities outweigh the positive ones, making out a prima facie case for a Pigouvian tax. In my view, because the potential for negative harm is severe, the potential for positive benefit modest, and the capital supplied by sovereign wealth funds so easily replaced by private investors, there is a prima facie case for a Pigouvian tax.

Specifically, a tax on sovereign wealth could help encourage a broader policy of supporting private investment over state-controlled investment, protecting American foreign policy interests, and preventing foreign governments from increasing their power over the United States. Welcoming foreign investment is generally in the country's long-term interest, but there is little reason to encourage the accumulation of wealth by autocratic regimes hoarding the proceeds of international trade from their own citizens.

Setting the right tax rate depends on what policymakers believe the hurdle rate of sovereign wealth fund investors might be. Assuming that the goal is to tax sovereign wealth fund investors more heavily than private investors, this may require a tax rate in excess of 30%, which is the base rate for withholding on dividends paid to private foreign investors. As a placeholder for discussion purposes, let us assume an excise tax rate of 50% on all income received by sovereign investors.

An excise tax of 50% raises some difficult implementation questions, which I discuss in more detail below.²⁰⁵ Before turning to implementation questions, however, it is necessary to consider whether tax is the right regulatory instrument. If sovereign wealth fund investment is something we want to discourage, is taxing it the right policy tool for the task?

C. *What Is the Right Regulatory Instrument?*

There are advantages and disadvantages to the use of tax as a policy lever to address sovereign wealth. Tax might be an effective policy tool to encourage investment within institutional frameworks that are mutually beneficial to both the United States and foreign sov-

²⁰⁵ See *infra* text accompanying notes 215–31.

foreign investors. For example, a Pigouvian tax on investments could help channel investment into debt securities, where the investment by a foreign government is less likely to contravene American industrial and economic policy.²⁰⁶ By channeling investment in this way, tax policy can enhance our ability to achieve both tax-related and broader economic policy objectives. At the same time, tax is likely to be less effective as a policy lever when taxing particular investment activities would test the institutional competence of tax institutions by forcing them to administer foreign policy directly.²⁰⁷

Also, as a practical matter, addressing the existing tax subsidy for sovereign wealth provides a critical opportunity to consider whether tax neutrality is the proper baseline norm. Current law exists as it does largely because of legislative inertia, and if sufficient political will exists to bring the issue of the existing tax subsidy before the tax-writing committee, it would also provide an important opportunity to go one step further and impose an excise tax.

1. *Instrument Choice*

Three ways of limiting activities that create external harms are conduct restrictions (such as command-and-control regulation), liability-based approaches (such as Pigouvian taxes), and property-based approaches (such as cap-and-trade management). One could limit greenhouse gases, for example, by outlawing excessive emissions, taxing emissions, or granting (or auctioning off) carbon allowances and permitting trading of those property rights. A few important threads from the extensive economics literature on instrument choice are relevant here. In addressing greenhouse gas emissions—the context which has received the most academic attention—most economists view Pigouvian taxes as a superior instrument to either command-and-control regulation or cap-and-trade management. Professors Kaplow and Shavell, for example, have argued that even where the state is uncertain about the harm caused by an externality, corrective taxes are considered superior to quantity regulation.²⁰⁸ As one introduces complicating factors of political economy, however, it

²⁰⁶ The benefit of a shift from equity to debt is limited, however. In circumstances where a company is in financial distress, holders of debt securities have considerably more influence than in normal circumstances. Moreover, investors can negotiate for covenants in debt instruments that confer considerable power over the company, even absent the voting rights and residual claim on profits that normally accompany equity investments.

²⁰⁷ Tax is also less likely to be effective as a policy lever in circumstances where raising tax rates would be easily circumvented through wasteful gamesmanship techniques.

²⁰⁸ Compare Martin L. Weitzman, *Prices vs. Quantities*, 41 REV. ECON. STUD. 477, 485 (1974) (finding quantity regulation superior assuming linear cost function), with Kaplow & Shavell, *supra* note 127, at 10–14 (finding corrective taxes superior even when state's infor-

becomes less clear that Pigouvian taxes are superior. For example, if it is exceedingly costly for the state to determine the amount of harm caused by an externality, making a linear tax rate the only feasible schedule, then a corrective tax may be suboptimal.²⁰⁹

The risk posed by sovereign wealth funds does not fit cleanly into the existing literature on instrument choice. In most models, it is assumed that externalities are uniform.²¹⁰ Where the harms are not uniform, however, it may be difficult for policymakers to tailor tax legislation accordingly.²¹¹ If an equity investment by China's CIC poses a threat to American foreign policy but an equity investment by Singapore's Temasek does not, we might want the tax rate to reflect that fact; a uniform tax rate likely would lead to a suboptimal level of investment by Singapore, excess investment by China, or both. Even if harms are not uniform, however, tax may be a useful instrument to the extent the size of the investment (or, more precisely, the return on investment) is a good proxy for harm. In such circumstances, since the penalty increases as the size of the investment increases, tax may be an effective regulatory choice.

In a world with perfect political institutions, where information costs and agency costs are assumed away or at least do not vary across political institutions, a Pigouvian tax with tailored rates could be equivalent to any other method of reducing exposure to the expected harms. In practice, the decision whether to control sovereign wealth fund risk through a corrective tax or some other regulatory instrument depends on institutional comparative advantage.²¹² Discretion should be lodged with the decision makers who have the best information about the risks posed by sovereign wealth funds, who are best positioned to act in a manner consistent with the public interest, and who

mation about control costs is incomplete, because state can impose nonlinear tax rate based on schedule of expected harm, leading to optimal tax rate over time).

²⁰⁹ See Jeff Strnad, *Conceptualizing the "Fat Tax": The Role of Food Taxes in Developed Economies*, 78 S. CAL. L. REV. 1221, 1244 (2005) (suggesting, in context of fat tax, that only feasible tax schedule may be linear, and that such tax schedule might be suboptimal).

²¹⁰ See Louis Kaplow, *Optimal Policy with Heterogeneous Preferences* 2, 19 (Harvard John M. Olin Discussion Paper Series, Discussion Paper No. 617, 2008), available at http://ssrn.com/sol3/abstract_id=1170048 (suggesting that where preference differences are not observable, Pigouvian prescription of complete, uniform internalization of externalities may not be optimal).

²¹¹ For another example of the difficulty of tailoring corrective taxes to nonuniform harms, see David S. Gamage, Note, *Taxing Political Donations: The Case for Corrective Taxes in Campaign Finance*, 113 YALE L.J. 1283, 1290 (2004).

²¹² Cf. David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955, 964, 966 (2004) (suggesting that tax versus regulation decision, like tax expenditure versus direct spending decision, depends in part on institutional competence).

are least subject to agency capture by the regulated industry.²¹³ The choice of instrument may also be affected by realistic consideration of the legislation that would likely be enacted.²¹⁴ How we approach this question of institutional comparative advantage depends in part on the nonuniformity of harms posed by sovereign wealth funds. For readers interested in more detail on the sort of information that regulators will need in order to assess and manage sovereign wealth fund risk, the Appendix to this Article discusses two different funds in some detail: China's CIC and Abu Dhabi's Mubadala Development Corporation. As the nonuniformity of risk is not likely to be a controversial point, I now turn to the question of which domestic political institutions are best suited to managing the myriad risks posed by sovereign wealth funds.

2. *Domestic Political Institutions*

In theory, tax legislation could be fine-tuned enough to account for the diversity among funds. In practice, however, the institutions that make tax law may not be well suited for the task. To be sure, given the flaws of all political institutions, it is not outlandish to believe that our tax institutions may be comparatively better off than nontax institutions, and so I do offer two variations of a Pigouvian tax as reform alternatives below.²¹⁵ On balance, however, there is good reason to think that neither is optimal: Congress would struggle to write a tax law that appropriately distinguished good sovereign wealth funds from bad ones, and the tax lawyers at the Treasury and the IRS would not necessarily relish the task of evaluating and administering foreign policy.

Institutional analysis does not provide a clear answer about whether a corrective tax or some other regulatory instrument is optimal in regulating sovereign wealth, but it does show that implementing an excise tax would not be a simple matter. To begin with the obvious, public choice theory suggests that proposals that are

²¹³ Regarding the capture of tax-writing committees, see, for example, Dhammika Dharmapala, *Comparing Tax Expenditures and Direct Subsidies: The Role of Legislative Committee Structure*, 72 J. PUB. ECON. 421 (1999), Daniel Shaviro, *Beyond Public Choice and Public Interest: A Study of the Legislative Process as Illustrated by Tax Legislation in the 1980s*, 139 U. PA. L. REV. 1 (1990), and Edward A. Zelinsky, *James Madison and Public Choice at Gucci Gulch: A Procedural Defense of Tax Expenditures and Tax Institutions*, 102 YALE L.J. 1165, 1171–84 (1993).

²¹⁴ For example, in the absence of a global policymaker who can impose taxes by unitary fiat, the necessity of attracting support from all countries suggests a preference for employing tradable allowances rather than taxes to control pollution. See Jonathan Baert Wiener, *Global Environmental Regulation: Instrument Choice in Legal Context*, 108 YALE L.J. 677, 780–83 (1999).

²¹⁵ See *infra* Part III.

appealing in terms of the traditional tax policy goals of equity, efficiency, and administrability may not always survive the legislative process.²¹⁶ According to the public choice model, optimal tax policy (in the public interest sense) is likely to be compromised both by the rent seeking of interest groups affected by the legislation and by the rent seeking of legislators who influence the process and can extract political donations from interested parties.²¹⁷ One can easily imagine the effect of interest group lobbying: Nations with better access to policy-makers, like the Gulf states, are more likely to emerge unscathed. By the time legislation emerges, there may be little relationship between the risks posed by a particular country and the tax rate imposed.

Making matters worse, an excise tax on sovereign wealth funds might offer an opportunity for legislators to shake down those who benefit from the status quo, including both foreign sovereigns and the investment bankers, lawyers, and other service providers who execute cross-border transactions.²¹⁸ Like the proposal to raise the tax rate on carried interest,²¹⁹ this issue carries high stakes for a small group of current beneficiaries, legislation is plausible, and the issue has low salience for general voters in comparison to issues like terrorism, climate change, and general economic policy.²²⁰ These factors all create an environment conducive to rent extraction.

²¹⁶ See generally JEFFREY H. BIRNBAUM & ALAN S. MURRAY, *SHOWDOWN AT GUCCI GULCH: LAWMAKERS, LOBBYISTS, AND THE UNLIKELY TRIUMPH OF TAX REFORM* (1987) (recounting tax reform process of 1980s as triumph against antireform special interest lobbies); Stanley S. Surrey, *The Congress and the Tax Lobbyist—How Special Tax Provisions Get Enacted*, 70 HARV. L. REV. 1145 (1957) (describing difficulty of developing and maintaining “proper tax structure”).

²¹⁷ See Richard L. Doernberg & Fred S. McChesney, *On the Accelerating Rate and Decreasing Durability of Tax Reform*, 71 MINN. L. REV. 913, 945 (1987) (“[P]oliticians themselves are principal beneficiaries of the tax process, profiting politically and personally through campaign contributions, speech and appearance fees, and in-kind benefits. Given the benefits to politicians themselves, one should anticipate that they would actively seek contributions rather than wait for lobbyists to come to them.”); Edward J. McCaffery & Linda R. Cohen, *Shakedown at Gucci Gulch: The New Logic of Collective Action*, 84 N.C. L. REV. 1159, 1172–76 (2006) (discussing traditional explanations of rent-seeking behavior of special interest groups and authors’ description of “rent extraction” by legislators in tax law context); Richard L. Doernberg & Fred S. McChesney, *Doing Good or Doing Well?: Congress and the Tax Reform Act of 1986*, 62 N.Y.U. L. REV. 891, 900–08 (1987) (reviewing BIRNBAUM & MURRAY, *supra* note 216) (challenging Birnbaum and Murray’s conclusion that 1986 Act represented triumph of public interest over special interests).

²¹⁸ See McCaffery & Cohen, *supra* note 217, at 1177 (describing lawmaking process as “game [that] looks rather more like an irrational arms race that Congress helps to initiate, or . . . a shakedown scheme or protection racket”).

²¹⁹ See Fleischer, *Two and Twenty*, *supra* note 12 (introducing “Cost-of-Capital Method” to measure and tax carried interest).

²²⁰ See McCaffery & Cohen, *supra* note 217, at 1177–78 (explaining that “shake-down[s]” in lawmaking tend to occur when, among other factors, issue carries high stakes for concentrated groups on both sides and low salience for most voters). The taxation of

On the other hand, refocusing legislation in the tax-writing committees may be more likely to lead to an optimal policy outcome than the status quo. Tax institutions, after all, are not unique in their susceptibility to lobbying and their taste for rent seeking. The CFIUS process already offers ample opportunities for legislators to get involved with reviewing deals. In reviewing a deal, CFIUS reports to

- (i) the majority and minority leaders of the House and Senate,
- (ii) the chair and ranking members of the Senate Banking Committee and the House Financial Services Committee, (iii) any House or Senate committee having oversight over the lead agency in the CFIUS review, (iv) Senators and Members of Congress from the district concerned, and implicitly (v) governors whose states “interact” with the critical infrastructure involved.²²¹

While this structure ensures input from a wide variety of politicians, it also provides numerous opportunities to hold up a deal in exchange for political contributions.

Furthermore, experience shows that the public choice model does not always provide a descriptive account of how tax legislation actually works its way through the political process. Whether out of concern for the public interest or out of self-interested motivation for increased publicity, power, and prestige, politicians sometimes do pass tax legislation that favors the public interest over the interests of powerful lobbying groups.²²² A tax on sovereign wealth has powerful symbolic value to voters and a political salience that could make it attractive on its own merits, potentially insulating it from standard public choice concerns.²²³ Politicians like Senator Bayh and then-Senator Clinton, who have already voiced concerns about sovereign wealth, seem less likely to “sell” their votes to interest groups or waffle on the issue in an attempt to extract political donations. Even assuming self-interested behavior, politicians may be more interested in increasing their prestige by sponsoring legislation that puts them on a global stage than in simply selling their vote to the highest bidder.²²⁴

sovereign wealth is also a potentially two-sided issue, as labor unions such as the SEIU and AFL-CIO are likely to support a tax on sovereign wealth. See Matthew T. Bodie, *Mother Jones Meets Gordon Gekko: The Complicated Relationship Between Labor and Private Equity*, 79 U. COLO. L. REV. 1317, 1340–41 (2008) (describing AFL-CIO’s and SEIU’s support for efforts to raise taxes on private equity carried interest).

²²¹ Rose, *supra* note 137, at 116 (citation omitted).

²²² See Shaviro, *supra* note 213, at 76–111 (discussing various shortcomings of public choice theory in tax legislation context).

²²³ See *id.* at 76–94 (discussing symbolic importance of legislation as significant to voters and salience as important to politicians).

²²⁴ See *id.* at 81–87 (noting that power and prestige or “recognition as a statesman” are important motives for politicians, as “self-interest is agreed to be extremely important to

From the perspective of comparative institutional analysis, institutional competence may pose an even greater concern than rent seeking. The executive branch is likely better suited to the task of managing the geopolitical risk posed by sovereign wealth funds than are the tax-writing committees. Nontax officials in the executive branch specialize in tailoring our foreign policy agenda.²²⁵ They are better positioned to coordinate sovereign wealth fund policy with other aspects of our policies on trade, development, and regime change.²²⁶ Indeed, under current law, the executive branch has the means to discourage unwanted sovereign wealth fund investment; the fact that it has not done so reflects a lack of political will, not an absence of the legal means to do so.

A proposal to tax sovereign wealth could exacerbate a tug of war between the executive branch, which generally enjoys broad authority over national security and economic policy, and Congress, which increasingly weighs in on sovereign wealth fund investment (following notification through the CFIUS process).²²⁷ Because of the tax-writing committees' influence over tax matters, tax policy would tilt power away from the executive branch and back toward the legislature.

Still, while the institutional competence of the executive branch would suggest that it, and not Congress, ought to have primary responsibility for regulating sovereign wealth, placing more power in the hands of the congressional tax-writing committees may at least

politicians, but not primarily the narrow monetary self-interest emphasized by economists").

²²⁵ Cf. Weisbach & Nussim, *supra* note 212 (discussing use of tax mechanisms to implement nontax goals as question of institutional design).

²²⁶ The executive branch is better positioned to manage sovereign wealth fund risk in part because these funds change and develop over time. Sovereign wealth funds are sprouting up rapidly, and existing funds continue to evolve and professionalize. Suppose Congress enacts an excise tax of 50% on sovereign wealth fund investment and carves out exceptions for funds that comply with best practices. Who decides whether a country is in compliance?

Again, in theory, Congress could write legislation that was very specific, setting standards at a level of specificity that might distinguish among funds. But this approach creates several problems. Even assuming that Congress agrees that transparency is a worthy goal, it might be difficult to agree on how to define whether a fund is transparent. Similarly, it is generally agreed that funds should not pursue political goals. Assume for the sake of argument that China's investment in Blackstone was made to achieve network benefits with Western banks. Is that a political goal or a financial goal? The end result would be a complicated set of rules that would be difficult to administer and subject to various forms of regulatory gamesmanship.

²²⁷ See generally David Zaring, National Security and Investment (Aug. 1, 2008) (unpublished manuscript, on file with the *New York University Law Review*) (noting that "real purpose" of CFIUS is less to exercise its own regulatory power than to act "as a congressional notification service").

improve matters over the status quo. In recent years, Congress has found ways to influence the CFIUS process, and it may be more effective to address congressional concerns regarding sovereign wealth funds directly through tax policy rather than awaiting an end run around the ordinary CFIUS process. After all, concerns about sovereign wealth go beyond the national security concerns that CFIUS is designed to address.²²⁸ Furthermore, given that Congress is often more concerned about sovereign wealth funds' risks than the executive branch, redundant programs might be beneficial.²²⁹ Complementing CFIUS with an excise tax—a belt-and-suspenders approach—may be further justified if the risks associated with sovereign wealth investments are of much greater magnitude than the benefits of investment, or if tax administrators bring a different, useful perspective to the analysis.²³⁰ Finally, the tax-writing committees, which answer to heterogeneous interests, might better reflect the political will of the country than either a small group of people within the executive branch or various other congressional committees.²³¹

There are two lessons to extract from this discussion. First, there is much to be said for addressing the risks posed by sovereign wealth funds through regulatory instruments other than tax. Second, if Congress moves forward with a tax on sovereign wealth, it should legislate in broad terms, leaving ample discretion to the Treasury Department, which would implement rules through regulation, and the IRS, which would interpret and enforce those regulations. While vesting foreign policy discretion with tax officials is not ideal, it is probably better for Congress to place such discretion in the executive branch rather than to micromanage the rules itself.

²²⁸ For example, it is hard to imagine CFIUS addressing the potential increase in managerial slack, the nonfinancial harm of partnering with autocratic regimes, or examining how inbound sovereign wealth fund investment fits with our development agenda.

²²⁹ For a discussion of when redundant tax and spending programs may be optimal in the social welfare context, see Nancy Staudt, *Redundant Tax and Spending Programs*, 100 NW. U. L. REV. 1197 (2006). See also David A. Weisbach, *Tax Expenditures, Principal-Agent Problems, and Redundancy*, 84 WASH. U. L. REV. 1823 (2006) (discussing potential benefits of redundancy, including as solution to principal-agent problems, but arguing against redundancy in particular case of low-income-housing tax credit).

²³⁰ Cf. Staudt, *supra* note 229, at 1223–24 (listing “array of legal and policy contexts” in which redundancy is thought to increase reliability); Michael M. Ting, *A Strategic Theory of Bureaucratic Redundancy*, 47 AM. J. POL. SCI. 274, 276 (2003) (finding redundancy helpful where agencies’ policy preferences differ from principal’s preferences); Weisbach, *supra* note 229, at 1840–41 (discussing benefits of bureaucratic diversification).

²³¹ See Zelinsky, *supra* note 213, at 1194–207 (concluding, with empirical support, that tax-writing committees are less susceptible to “clientele groups” and conform more closely to “pluralist norms”); *id.* at 1190 (“[T]ax subsidies ought to be preferred to direct expenditures when there is a need for detached administration and oversight by decisionmakers less susceptible to capture.”).

One potential approach, for example, would be a “most-favored nation” methodology, with executive branch officials making the determination of whether a sovereign wealth fund has sufficiently adopted best practices or other indicia of professional investor norms to make it worthy of a tax preference.²³² This approach would avoid the prickly challenge of demanding an understanding of foreign institutions from tax lawyers. Moreover, this approach would be consistent with the practice followed in several other countries of granting tax preference as a matter of administrative discretion.²³³

Yet another alternative is to set a high baseline tax rate and then reduce that rate through treaty negotiations. But treaty-making carries its own set of problems. Specifically, the United States tends to reach agreements for bilateral tax treaties with other developed countries, where foreign direct investment flows in both directions. Sovereign wealth funds, by contrast, mostly concern the relationship between the United States and developing countries with whom the United States does not have a tax treaty. Additionally, relying on the treaty mechanism could cause long delays.²³⁴ It is not realistic to expect that we could negotiate treaties with the dozens of countries with sovereign wealth funds in an appropriate time frame.

Given the challenges associated with our domestic political institutions, a strong case can be made for situating the taxation of inbound sovereign wealth investment within a framework of cooperative tax norms among OECD countries.²³⁵ If Congress believes, however, that its policy preferences with respect to current law are not

²³² I am indebted to Professors Tom Brennan and Rebecca Kysar for this suggestion. Cf. I.R.C. § 901(j) (2006) (denying foreign tax credit to countries which United States does not recognize, does not conduct diplomatic relations with, or has designated as repeatedly providing support to international terrorism); Rev. Rul. 2005-3, 2005-1 C.B. 334 (denying foreign tax credit for payments to Cuba, Iran, North Korea, Sudan, and Syria).

²³³ See JCT REPORT, *supra* note 19, at 77.

²³⁴ See Tillinghast, *supra* note 47, at 540 (“As a practical matter, of course, relegating the exemption to the treaty-makers ensures long delays and exasperations in making it effective. . . . On the whole, it seems preferable to legislate a properly constructed exemption and utilize the treaty-making process to cure uncertainties . . . or to deal with special cases.”).

²³⁵ In comparison to domestic tax legislation, tax laws that impact cross-border investment tend to comply with broader norms of appropriate tax legislation. As Professor Shaviro has explained, the United States may rationally aspire to a standard of worldwide welfare, rather than national welfare, as an appropriate standard in setting international tax policy. See Daniel Shaviro, *Why Worldwide Welfare as a Normative Standard in U.S. Tax Policy?*, 60 TAX L. REV. 155, 164–66 (2007) (discussing importance of cooperative norms). A normative standard of worldwide welfare may make sense not only altruistically but also as a strategic cooperative move within a framework of a prisoner’s dilemma game. *Id.*

reflected in administrative policy, then complementing CFIUS and other administrative tools with an excise tax may be appropriate.

III

CONCLUSION: REFORM ALTERNATIVES

A review of the current U.S. tax policy with regard to sovereign wealth funds suggests the need for reform. At least three reform alternatives are available. The first alternative would tax sovereign wealth funds as if they were private foreign corporations. The second alternative would impose an excise tax on returns from investments by sovereign wealth funds. The third alternative would offer a continued tax exemption conditioned on compliance with specified best practices. I discuss and evaluate each alternative below.

A. Tax Sovereign Wealth Funds as Private Corporations

The first reform alternative, which I favor, is to replace § 892 with a simple code section that would treat foreign governments as private foreign corporations.²³⁶ This alternative would follow the baseline norm of sovereign tax neutrality, conforming with the current practice of the European Union. Because the impact of this change would be modest, by implication it relies on other regulatory instruments to manage the geopolitical risk of sovereign wealth funds.

The principal advantage of this approach is that it eliminates an unwarranted subsidy for equity investments by sovereign wealth funds. This alternative would dampen any clientele effect that may result from the current tax preference for sovereign wealth fund equity investments. Eliminating the tax subsidy would also raise revenue.²³⁷

Another advantage of this approach is that it ensures that the tax preference for sovereign wealth investment is reciprocal. While the

²³⁶ Congress could simply retain current § 892(a)(3), which states:

For purposes of this title, a foreign government shall be treated as a corporate resident of its country. A foreign government shall be so treated for purposes of any income tax treaty obligation of the United States if such government grants equivalent treatment to the Government of the United States.

²³⁷ I am not aware of any current revenue estimates; in 1976 the Treasury estimated the annual revenue cost of the sovereign tax exemption at \$630 million. *See Taylor, supra* note 46, at 171 (“The estimated revenue cost [under section 892] associated with the \$5 billion in dividend and interest payments made to foreign governments (including foreign central banks of issue) in 1975 was \$630 million.”). The estimate used lower treaty rates where applicable and excluded interest on bank deposits, which are treated as foreign source income. *Id.* at 171 n.4. This calculation does not include an additional \$87 million estimate for the exemption for employees of foreign governments and international organizations. *Id.* at 172.

federal government does not currently invest abroad, the Alaska Permanent Fund and state pension plans may hold securities of foreign companies. Under this approach, exemption from taxes on dividends could be negotiated through the bilateral treaty mechanism rather than unilaterally granted.²³⁸

The principal disadvantage of this approach is that it does not go far enough to address the risks posed by sovereign wealth funds. Because of the potential for nonfinancial motives to lower the hurdle rate for sovereign wealth funds, taxing sovereign wealth funds at the same rate as private investors may still leave in place a systemic preference for state-controlled investment. This alternative would therefore rely on other regulatory instruments, such as CFIUS review, disclosure, or naming and shaming campaigns, to encourage appropriate behavior by sovereign wealth funds.

B. Excise Tax on Sovereign Wealth Funds

A second reform alternative would impose an excise tax on income derived from investments in the United States. By taxing investments at a high rate, it would discourage investments likely to generate negative externalities.

The principal advantage of this approach is largely symbolic: It would make a powerful, populist statement in favor of private investment over state-controlled investment. But an excise tax could also achieve instrumentalist policy goals by protecting the integrity of the price signal in capital markets, improving the efficient allocation of resources, and encouraging foreign governments to promote private rather than sovereign investment. The proposal would not disrupt monetary policy, as foreign governments could still recycle dollars into the U.S. economy through tax-free investments in debt obligations of the U.S. government, private debt obligations, and possibly investments in private equity limited partnerships.²³⁹

The principal disadvantage of this approach is that the “hammer” of Pigouvian taxation would punish good and bad actors alike. As a result, the good actors (financially motivated funds) might shift investments overseas, while the bad actors (politically motivated funds)

²³⁸ Cf. Convention on Double Taxation: Taxes on Income and Capital, U.S.-Can., art. XXI, ¶ 2, Sept. 26, 1980–Mar. 28, 1984, T.I.A.S. No. 11,087.

²³⁹ Although limited partnership interests are equity interests, I would be inclined to carve out a safe harbor for passive limited partnership investments, below a threshold of 10%, in investment funds. Because limited partners in investment funds have limited ability to influence the management of portfolio companies, many of the negative externalities discussed in Part II, *supra*, are less problematic. Because the sovereign partner cannot choose investments, for example, geopolitical concerns are diminished, as are concerns about the allocation of economic resources.

might continue to invest, notwithstanding the lower financial return. The tax still may be better than the status quo, however, as it could both raise revenue and deter “bad” investment on the margins.

C. *Conditional Tax Exemption*

Finally, a third alternative would impose an excise tax on investments by sovereign wealth funds, one that would be waived if the investors met specified goals of transparency, accountability, and low political risk. To address issues of institutional competence, this approach would require tax administrators to coordinate with other executive branch officials to generate a list of “most-favored nations” that would qualify for the tax exemption.²⁴⁰ In other words, we would tax sovereign wealth funds favorably, the same as private financial investors, if they provide evidence that they will act like private financial investors.

The principal advantage of this approach is that it would appeal to groups who favor a more technocratic policy response, shifting some of the policymaking power away from CFIUS and the executive branch and into the hands of the tax-writing committees and Treasury lawyers who would draft the legislation and implementing regulations. It may also appeal to policymakers who want to do something about sovereign wealth funds but who worry that relying on international organizations to design and enforce standards may be unrealistic without offering the additional political leverage of a conditional tax increase.

The principal disadvantage of this approach is the cost associated with determining who is in compliance. Not only must the United States determine appropriate standards, but it would also have to develop mechanisms to investigate whether stated compliance comported with actual compliance, revise withholding rules to collect the tax on dividend payments to foreign sovereigns who are not in compliance, and develop a mechanism to collect capital gains—a practical impossibility, I think, if the sovereign sells to a foreign investor.

D. *Summary*

Each of these proposals offers some advantages and disadvantages over the status quo. Currently, as I have shown, the taxation of sovereign wealth funds ignores the negative externalities they create

²⁴⁰ A conditional exemption was suggested by David Tillinghast. Tillinghast, *supra* note 47, at 540 (“An initial question is whether any exemption should be conditioned on reciprocity, either by making the exemption available only by treaty or by conditioning the operation of the Code provision.”).

and even subsidizes them in spite of the potential foreign policy implications. The current categorical tax exemption for sovereign wealth funds is not a considered policy. It is an anachronism, a relic of an overly broad view of sovereign immunity discarded years ago in other contexts. At a minimum, Congress should enforce a norm of sovereign tax neutrality and treat sovereign funds no better than private foreign investors.

APPENDIX

Just as foreign states are governed by different laws, traditions, norms, and institutions, the sovereign wealth funds they control are managed differently. In this Appendix, I briefly discuss the China Investment Corporation (CIC) and Abu Dhabi's Mubadala Corporation. CIC represents, at present, a clear example of a fund that poses geopolitical risk to the United States and warrants regulatory attention. Mubadala, while more professionalized than CIC, still raises some concerns.

* * *

The China Investment Corporation. China announced plans to form CIC in May 2007, and the fund was formally established in September 2007.²⁴¹ Although there are signs that it is seeking increased legitimacy, CIC, as it is currently structured, poses a greater threat to U.S. interests than most other funds. According to researchers at the Oxford International Review, who conducted a careful review of Chinese-language commentary about CIC, the fund suffers from an “unresolved sense of mission.”²⁴²

CIC floats between the political and financial arms of China's administrative structure. Many commentators believe CIC was formed to “shake up” China's financial bureaucracy,²⁴³ and there is some evidence that CIC is professionally managed. CIC operates independently of the State Administration of Foreign Exchange (SAFE), which is the primary government agency managing China's foreign exchange reserves. Yet CIC was founded by the Ministry of Finance, was funded with foreign exchange reserves from China's central bank, and used approximately one-third of its initial capital infusion to acquire the Central Huijin Investment Company, a government-controlled holding company invested in several Chinese banks.²⁴⁴ CIC has also reportedly invested in two more Chinese banks (the Agricultural Bank of China and the China Development Bank) and the China Railway Group alongside its high-profile U.S. investments in Blackstone and Morgan Stanley.²⁴⁵

²⁴¹ *Implications of Sovereign Wealth*, *supra* note 182, at 1.

²⁴² See Ashby Monk et al., *A Review of Chinese-Language Literature on Sovereign Wealth Funds 4* (Oxford Int'l Review, Working Paper SWF001, 2008) (“Perhaps the most immediately evident theme in Chinese-language discourse on the CIC relates to its unresolved sense of mission and corporate character.”).

²⁴³ *Id.*

²⁴⁴ *Implications of Sovereign Wealth*, *supra* note 182, at 1.

²⁴⁵ *Id.* at 2.

CIC's president, Gao Xiqing, is a Duke Law School graduate with experience on Wall Street, where he worked for the now-defunct Mudge Rose.²⁴⁶ Gao suggested in a recent 60 Minutes interview that CIC would strive for more transparency.²⁴⁷ At the same time, he called the idea of an IMF-issued code of conduct for sovereign wealth funds politically "stupid" and likely to raise problems "emotionally" by effectively singling out China as a potential threat.²⁴⁸ CIC Chairman Lou Jiwei has dismissed calls for transparency, claiming that Western standards of transparency, governance, and accountability would place China at a competitive disadvantage: "I don't want to show other people my cards," Lou stated in a recent speech.²⁴⁹ CIC has made reassuring statements about adopting prudent accounting rules and disclosing completed transactions in compliance with foreign regulations, but it has offered no promise of tracking best practices.²⁵⁰

There are signs that CIC is effectively tethered to China's political administration. CIC reports directly to the State Council, which is analogous to the cabinet in the United States.²⁵¹ By contrast, other government investment organizations report to the Ministry of Finance.²⁵² CIC has also been the object of political jockeying, as the Ministry of Finance has attempted to increase its influence over CIC. The Ministry succeeded in appointing Jin Liquan, a former vice president of the Asia Development Bank with experience dealing with overseas financial markets, to CIC's board of directors.²⁵³

There is only limited separation between CIC's governing board and the Chinese government. CIC's employees are mostly Chinese, notwithstanding the fund's limited experience in global markets.²⁵⁴

²⁴⁶ *Duke Law in China: Gao Xiqing '86*, DUKE L. MAG., Fall 2005, available at <http://www.law.duke.edu/magazine/2005fall/profiles/prcgaoxiqing.html>.

²⁴⁷ See *60 Minutes: China Investment an Open Book?* (CBS television broadcast Apr. 6, 2008), available at <http://www.cbsnews.com/stories/2008/04/04/60minutes/printable3993933.shtml> (quoting Gao as saying that China will become as open as Norway to extent it is "commercially viable").

²⁴⁸ *Id.*

²⁴⁹ Monk, *supra* note 242, at 9.

²⁵⁰ See CRS REPORT, *supra* note 199, at 13 ("However, the degree and pace at which China will make the CIC transparent is uncertain. . . . Lou expanded on his previous statement, 'We will increase transparency without harming the commercial interests of CIC. That is to say, it will be a gradual process. . . . If we are transparent on everything, the wolves will eat us up.'" (alteration in original)).

²⁵¹ *Implications of Sovereign Wealth*, *supra* note 182, at 3 (discussing CIC reporting); Monk, *supra* note 242, at 5 (contrasting CIC reporting with that of other organizations).

²⁵² Monk, *supra* note 242, at 5.

²⁵³ *Id.*

²⁵⁴ See *id.* at 9 (discussing CIC's efforts "to recruit a more internationally-experienced management structure").

While no member of the State Council serves on CIC's board, ten out of eleven CIC board members are in some way linked to the existing financial bureaucracy: Four are employed by the Ministry of Finance, two by the People's Bank of China, another two by China's economic policy think tank, one by the Ministry of Commerce, and one by China's pension fund, with the last board member selected by CIC employees.²⁵⁵ This structure bears the hallmarks of political compromise. As noted by Brad Setser of the Council on Foreign Relations: "The CIC's internal structure almost assures that its investment decisions will be far more politicized than the management of China's formal reserves by the central bank. All parts of China's bureaucracy are represented on its board—a legacy of the bureaucratic battles that accompanied its creation."²⁵⁶

CIC has a complex mandate that includes not just holding a diversified portfolio of investments but also managing China's domestic banks and supporting the expansion of Chinese firms into overseas markets.²⁵⁷ In fact, most of CIC's investments have been made for noncommercial purposes, not the other way around. "For example," explains the Congressional Research Service, "there are indications that the State Council, the [People's Bank of China] and the [National Development and Reform Commission] insisted that the CIC provide help in the restructuring of these two state-owned banks as a condition of the CIC's establishment."²⁵⁸ Similarly, the report continues, CIC's acquisition of Huijin "may have been driven more by political considerations than economic ones."²⁵⁹

There are also signs that CIC views its investment in U.S. banks as a way to enter the network of Western financial institutions.²⁶⁰

²⁵⁵ *Implications of Sovereign Wealth*, *supra* note 182, at 3; *see also* CRS REPORT, *supra* note 199, at 6 (listing CIC board members and their connections to Chinese bureaucracy).

²⁵⁶ BRAD SETSER, COUNCIL ON FOREIGN RELATIONS, WHAT TO DO WITH OVER A HALF A TRILLION A YEAR? UNDERSTANDING THE CHANGES IN THE MANAGEMENT OF CHINA'S FOREIGN ASSETS 12 (2008), *available at* <http://www.cfr.org/content/publications/attachments/Setser%20China%20Paper.pdf>. Setser argues that because the board may be divided, many decisions "likely will need to be made by the top level of China's government, not by the CIC." *Id.* at 13; *see also* Michael H. Cognato, *China Investment Corporation: Threat or Opportunity?*, NBR ANALYSIS, July, 2008, at 15, 15, *available at* <http://www.nbr.org/publications/analysis/pdf/vol19no1.pdf> ("Throughout 2007, debate evidently grew very heated within the State Council over the proper structure and governance of the new fund, with various arms of the Chinese government vying to take on a role in the fund's decisionmaking.").

²⁵⁷ *See Implications of Sovereign Wealth*, *supra* note 182, at 51 (statement of Brad Setser, Council on Foreign Relations) (explaining CIC's mandate).

²⁵⁸ CRS REPORT, *supra* note 199, at 10.

²⁵⁹ *Id.*

²⁶⁰ *See* Monk, *supra* note 242, at 8 ("At least one such analyst, venture capital investor Gao Jianzhi, has interpreted the Blackstone investment as a way to gain access to Western

While integrating China into Western financial capital markets is a positive goal, it also signals a troubling willingness on the part of CIC to make investments based on strategic goals for China rather than seeking the highest available financial return. The goal of domestic financial reform, in other words, is inconsistent with the stated goal of achieving long-term financial returns through diversified holdings.²⁶¹ For example, some Chinese commentators have advocated investing in companies like MasterCard and Wal-Mart to help facilitate the flow of Chinese goods to Western markets; China's recent investment in Visa may bear this out.²⁶² While such investments are not necessarily inconsistent with financial motives, the pattern of investment suggests that CIC is simultaneously pursuing China's geopolitical goals.

In sum, it is hard to dismiss concerns that CIC may invest for political motives.²⁶³ China has stated that it will not acquire strategic stakes in American airlines, telecommunications, energy companies, or infrastructure. But CIC's investments in Blackstone, Morgan Stanley, and Visa show an interest in acquiring strategic positions in American financial infrastructure that would allow China to opportunistically press its advantage and that, tellingly, show little regard for financial returns or diversification from its existing financial assets.²⁶⁴

* * *

Mubadala Development Corporation. Mubadala Development Corporation, a holding company owned by the Emirate of Abu Dhabi, poses a different kind of geopolitical risk to the United States. In contrast to China, Abu Dhabi is adept at managing and massaging the U.S. political process, which raises more subtle concerns that its investments in U.S. markets may increase its soft power and lull the United States into complicity with a regime that may be at odds with broader U.S. foreign policy and development agendas.

financial institutional knowledge, and has suggested that such 'strategic partners' strengthen the CIC's position both domestically and internationally."); Pistor, *supra* note 120, at 15 (noting that CIC's investment in Morgan Stanley reflects strategic plan to expand into Western markets).

²⁶¹ See Monk, *supra* note 242, at 11 (noting potential contradiction in CIC's goals).

²⁶² *Id.* (citing comments of Cao Honghui, economist at Chinese Academy of Social Sciences).

²⁶³ See, e.g., CRS REPORT, *supra* note 199, at 11 (concluding that "China has handled the creation of the CIC in a fairly common Chinese fashion of combining reassuring statements with veiled warnings").

²⁶⁴ See David M. Dickson, *China's Economic 'Bargaining Chip'*, WASH. TIMES, July 27, 2008, Magazine, at 4 ("Given CIC's purchases of Blackstone and Morgan Stanley stock, it's very clear that [CIC] is buying access—lobbying, basically." (alteration in original)).

Mubadala is organized as a “public joint stock” company with the government as the sole shareholder.²⁶⁵ It is managed by a CEO, Kahldoon Khalifa al Mubarak, who holds an economics and finance bachelor’s degree from Tufts University.²⁶⁶ While the Abu Dhabi Investment Authority, the world’s largest sovereign wealth fund, overshadows Mubadala, Mubadala engages primarily in direct investment rather than portfolio investment, offering an instructive example of the risks noted above.

Mubadala primarily seeks strategic equity investments in both domestic and foreign corporations, often buying companies outright or obtaining controlling interests.²⁶⁷ It has made headlines for its purchase of an 8% stake in Advanced Micro Devices (AMD), an Austin-based chip manufacturer;²⁶⁸ has acquired a 7.5% stake in the private equity firm Carlyle Group;²⁶⁹ and has entered into open-ended joint venture partnerships with gaming company MGM Mirage²⁷⁰ and commercial finance conglomerate GE.²⁷¹ Rather than merely seeking the highest financial returns, Mubadala concentrates its activities in sectors that complement Abu Dhabi’s economic advantage in aerospace, aviation, energy, real estate, and health care.²⁷² Mubadala’s press office explains: “As well as ensuring its investments are financially rewarding, Mubadala also evaluates each opportunity based on

²⁶⁵ Mubadala, About Mubadala, <http://www.mubadala.ae/en/category/about-mubadala/> (last visited Jan. 22, 2009).

²⁶⁶ Mubadala, Kahldoon Khalifa al Mubarak, <http://www.mubadala.ae/en/about-mubadala/board-of-directors/kahldoon-khalifa-al-mubarak-2.html> (last visited Jan. 22, 2009).

²⁶⁷ See Mubadala, *supra* note 265 (advertising Mubadala’s “multi-billion dollar portfolio of local, regional, and international investments” and impact in “sectors such as energy, aerospace, real estate, healthcare, technology, infrastructure, and services”); Mubadala, Investments, <http://www.mubadala.ae/en/category/about-mubadala/investments/> (last visited Jan. 22, 2009) (listing Mubadala investments, including many with 100% Mubadala ownership).

²⁶⁸ Laurie J. Flynn, *Abu Dhabi Takes 8% Stake in Advanced Micro*, N.Y. TIMES, Nov. 17, 2007, at C4.

²⁶⁹ See Mubadala, The Carlyle Group, <http://www.mubadala.ae/en/about-mubadala/investments/the-carlyle-group.html> (last visited Jan. 22, 2009) (describing acquisition); Mubadala, *supra* note 267 (including Carlyle Group in list of investments).

²⁷⁰ See Mubadala, *supra* note 267 (including MGM Grand Abu Dhabi in list of investments).

²⁷¹ See *UAE Investment Firm Mubadala, GE Launch \$8 Bln JV*, REUTERS, July 22, 2008, <http://www.reuters.com/article/rbssComputerHardware/idUSDXB00028420080722/> (reporting announcement of joint venture); Mubadala, Coverage, <http://www.mubadala.ae/en/category/media/video-gallery/> (last visited Jan. 22, 2009) (providing video of news reports related to joint venture with GE).

²⁷² See Mubadala, *supra* note 265 (listing sectors in which Mubadala’s impact is evident).

other sustainable benefits it can provide for Abu Dhabi.”²⁷³ Its investment strategy appears to focus on ensuring access to deal flow in sectors in which it already has considerable expertise in evaluating investments. Thus, for example, its investment in AMD is evaluated not just on the basis of the financial returns of AMD stock but also on the financial and strategic value of accessing future deals in the semiconductor and computer technology sector.²⁷⁴

Mubadala is a savvy manager of its corporate image.²⁷⁵ Recognizing the risk that political backlash could pose to its deal flow, Mubadala aggressively manages its image through nonprofit foundations, educational partnerships, and investments in Western entertainment ventures. Mubadala owns 5% of Ferrari and in 2009 will host a Formula 1 Grand Prix for the first time.²⁷⁶ Mubadala hosted Justin Timberlake’s final show of the FutureSex/LoveShow world tour.²⁷⁷ CEO Khaldoon Mubarak is a member of the Board of Trustees of New York University²⁷⁸ and is overseeing the establishment of a satellite NYU campus in Abu Dhabi, to be developed by Mubadala.²⁷⁹ Its charitable activities include a vocational and career guidance program,²⁸⁰ a philanthropic foundation,²⁸¹ and a music and arts foundation.²⁸²

Mubadala’s experience extends into the political arena. It is no accident that Abu Dhabi has been more receptive than other countries to the idea of best practices. While Abu Dhabi may not strictly seek the highest financial returns for its investments, it still seeks to

²⁷³ Mubadala, Acquisitions, <http://www.mubadala.ae/en/category/sectors/acquisitions/> (last visited Jan. 22, 2009).

²⁷⁴ See Associated Press, *Abu Dhabi Buys Stake in Chip Maker AMD*, MSNBC, Nov. 16, 2007, <http://www.msnbc.msn.com/id/21840227/> (expressing concern over Abu Dhabi’s investment in “U.S. businesses that specialize in advanced technologies”).

²⁷⁵ For a discussion of branding effects of deal structures, see generally Victor Fleischer, *Brand New Deal: The Branding Effect of Corporate Deal Structures*, 104 MICH. L. REV. 1581 (2006).

²⁷⁶ See Mubadala, *supra* note 273.

²⁷⁷ Press Release, Mubadala, Justin Timberlake Live in Abu Dhabi (Oct. 18, 2007), available at <http://www.mubadala.ae/en/media/press-releases/justin-timberlake-live-in-abu-dhabi.html>.

²⁷⁸ New York University, Board of Trustees, <http://www.nyu.edu/about/trustees.html> (last visited Feb. 10, 2009).

²⁷⁹ Mubadala, Overview of Mubadala Development Company app. B, <http://web.amd.com/newglobalfoundry/MubadalaFactSheet.pdf> (last visited Feb. 10, 2009).

²⁸⁰ See Mubadala, Tawteen Program, <http://www.mubadala.ae/en/category/corporate-social-responsibility/tawteen-program/> (last visited Jan. 22, 2009).

²⁸¹ See Mubadala, Emirates Foundation, <http://www.mubadala.ae/en/category/corporate-social-responsibility/emirates-foundation/> (last visited Jan. 22, 2009).

²⁸² See Mubadala, Abu Dhabi Music & Arts Foundation, <http://www.mubadala.ae/en/category/corporate-social-responsibility/abu-dhabi-music-and-arts-foundation/> (last visited Jan. 22, 2009).

improve its long-term financial outlook by creating a global network of partners. More to the point, Abu Dhabi recognizes the symbolic value of cooperating with the United States and other OECD countries that are concerned about the practices of sovereign wealth funds. Mubadala has proven itself politically adept in the past, particularly in its completion of potentially sensitive investments in GE, AMD, and Carlyle. As noted by the consulting firm Monitor Group, Mubadala “paid close attention” to the U.S. domestic political process, “sounding out” key senators and congressmen informally and making clear that its investment would allow AMD to open a new chip fabrication facility in upstate New York.²⁸³ Mubadala’s lobbying expenditures, while still quite modest, have increased more than threefold from 2007 to 2008.²⁸⁴

There is much to admire in Mubadala’s professionalism and political savvy, which in many ways outpaces the nascent lobbying efforts of the U.S. private equity and hedge fund industries. The concern is that the more effective Abu Dhabi becomes in managing its image, the more it will be able to mask underlying conflict concerning the United States’ development agenda in the Middle East. As Abu Dhabi successfully greases the wheels for economic investment in U.S. companies, it may reduce the United States’ future ability to oppose Abu Dhabi on matters related to the Israeli-Palestinian conflict, terrorism or military concerns, or other diplomatic efforts.

²⁸³ MONITOR GROUP, ASSESSING THE RISKS: THE BEHAVIORS OF SOVEREIGN WEALTH FUNDS IN THE GLOBAL ECONOMY 44 (2008), available at http://www.monitor.com/Portals/0/MonitorContent/documents/Monitor_SWF_report_final.pdf. The report explains, “The lesson appears clear. If you want to make an acquisition in a strategic company in the United States, check informally first for political concerns. Oh, and increasing the likelihood of building new factories in the United States doesn’t appear to hurt.” *Id.* at 44.

²⁸⁴ OpenSecrets, Lobbying Spending Database, Government of the United Arab Emirates, 2008, <http://www.opensecrets.org/lobby/clientsum.php?lname=Government+of+the+United+Arab+Emirates&year=2008> (last visited Jan. 22, 2009).