



ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT



DISCUSSION DRAFT ON THE APPLICATION OF TAX TREATIES
TO STATE-OWNED ENTITIES, INCLUDING SOVEREIGN WEALTH
FUNDS

25 NOVEMBER 2009 TO 31 JANUARY 2010



CENTRE FOR TAX POLICY AND ADMINISTRATION

25 November 2009

**APPLICATION OF TAX TREATIES TO STATE-OWNED ENTITIES, INCLUDING
SOVEREIGN WEALTH FUNDS**

Public discussion draft

State-owned entities, including sovereign wealth funds, have expanded their cross-border investments in recent years. This has raised a number of questions, including questions related to taxation. The Committee on Fiscal Affairs, through its Working Party 1 on Tax Conventions and Related Questions, has examined questions related to the application of tax treaties to these entities as well as the relationship between tax treaties and national practices related to the application of the doctrine of sovereign immunity to tax matters.

This public discussion draft includes proposals for additions and changes to the Commentary on the OECD Model Tax Convention that result from the work of the Working Party on these issues.

The Committee is considering the inclusion of these additions and changes in the next update to the OECD Model Tax Convention, which is tentatively scheduled for the second part of 2010. It therefore invites interested parties to send their comments on this discussion draft **before 31 January 2010**. These comments will be examined at the February 2010 meeting of the Working Party, when the Working Party intends to complete its work on the next update.

Comments on this discussion draft should be sent electronically (in Word format) to:

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Unless otherwise requested at the time of submission, comments submitted to the OECD in response to this invitation will be posted on the OECD website.

This document is a discussion draft released for the purpose of inviting comments from interested parties. It does not necessarily reflect the final views of the OECD and its member countries.

APPLICATION OF TAX TREATIES TO STATE-OWNED ENTITIES, INCLUDING SOVEREIGN WEALTH FUNDS

Proposed changes to the Commentary of the OECD Model Tax Convention

Add the following heading and new paragraphs 6.8 to 6.12 immediately after paragraph 6.7 of the Commentary on Article 1:

Application of the Convention to States, their subdivisions and their wholly-owned entities

6.8 *Paragraph 1 of Article 4 provides that the Contracting States themselves, their political subdivisions and their local authorities are included in the definition of a “resident of a Contracting State” and are therefore entitled to the benefits of the Convention (paragraph 8.4 of the Commentary on Article 4 explains that the inclusion of these words in 1995 confirmed the prior general understanding of most member States).*

6.9 *Issues may arise, however, in the case of entities set up and wholly-owned by a State or one of its political subdivisions or local authorities. Some of these entities may derive substantial income from other countries and it may therefore be important to determine whether tax treaties apply to them (this would be the case, for instance, of sovereign wealth funds: see paragraph 8.5 of the Commentary on Article 4). In many cases, these entities are totally exempt from tax and the question may arise as to whether they are entitled to the benefits of the tax treaties concluded by the State in which they are set up. In order to clarify the issue, some States modify the definition of “resident of a Contracting State” in paragraph 1 of Article 4 and include in that definition a “statutory body” or an “agency or instrumentality” of a State, a political subdivision or local authority, which would therefore cover wholly-owned entities that are not considered to be a part of the State or its political subdivisions or local authorities.*

6.10 *In addition, many States include specific provisions in their bilateral conventions that grant an exemption to other States, and to some State-owned entities such as central banks, with respect to certain items of income such as interest (see paragraph 7.4 of the Commentary on Article 11 and paragraph 13.2 of the Commentary on Article 10). Treaty provisions that grant a tax exemption with respect to the income of pension funds (see paragraph 69 of the Commentary on Article 18) may similarly apply to pension funds that are wholly-owned by a State, depending on the wording of these provisions and the nature of the fund.*

6.11 *The application of the Convention to each Contracting State, its political subdivisions, and local authorities (and their statutory bodies, agencies or instrumentalities in the case of bilateral treaties that apply to such entities) should not be interpreted, however, as affecting in any way the possible application by each State of the customary international law principle of sovereign immunity. According to this principle, a sovereign State (including its agents, its property and activities) is, as a general rule, immune from the jurisdiction of the courts of*

another sovereign State. There is no international consensus, however, on the precise limits of the sovereign immunity principle. Most States, for example, would not recognise that the principle applies to business activities and many States do not recognise any application of this principle in tax matters. There are therefore considerable differences between States as regards the extent, if any, to which that principle applies to taxation. Even among States that would recognise its possible application in tax matters, some apply it only to the extent that it has been incorporated into domestic law and others apply it as customary international law but subject to important limitations. The Convention does not prejudge the issues of whether and to what extent the principle of sovereign immunity applies with respect to the persons covered under Article 1 and the taxes covered under Article 2 and each Contracting State is therefore free to apply its own interpretation of that principle as long as the resulting taxation, if any, is in conformity with the provisions of its bilateral tax conventions.

6.12 States often take account of various factors when considering whether and to what extent tax exemptions should be granted, through specific treaty or domestic law provisions or through the application of the sovereign immunity doctrine, with respect to the income derived by other States, their political subdivisions, local authorities, or their statutory bodies, agencies or instrumentalities. These factors would include, for example, whether that type of income would be exempt on a reciprocal basis, whether the income is derived from activities of a governmental nature as opposed to activities of a commercial nature, whether the assets and income of the recipient entity are used for public purposes, whether there is any possibility that these could inure to the benefit of a non-governmental person and whether the income is derived from a portfolio or from a direct investment.

Add the following new paragraph 8.5 immediately after paragraph 8.4 of the Commentary on Article 4 (and renumber the existing paragraphs 8.5 to 8.7 accordingly):

8.5 This raises the issue of the application of paragraph 1 to sovereign wealth funds, which are special purpose investment funds or arrangements created by a State or a political subdivision for macroeconomic purposes. These funds hold, manage or administer assets to achieve financial objectives, and employ a set of investment strategies which include investing in foreign financial assets. They are commonly established out of balance of payments surpluses, official foreign currency operations, the proceeds of privatisations, fiscal surpluses or receipts resulting from commodity exports.¹ Whether a sovereign wealth fund qualifies as a “resident of a Contracting State” depends on the facts and circumstances of each case. For example, when a sovereign wealth fund is an integral part of the State, it will likely fall within the scope of the expression “[the] State and any political subdivision or local authority thereof” in Article 4. In other cases, the issue may require clarification in the course of bilateral negotiations, particularly in relation to whether a sovereign wealth fund qualifies as a “person” and is “liable to tax” for purposes of the relevant tax treaty (see also paragraphs 6.8 to 6.12 of the Commentary on Article 1).

1. This definition is drawn from: International Working Group of Sovereign Wealth Funds, *Sovereign Wealth Funds – Generally Accepted Principles and Practices – “Santiago Principles”*, October 2008, Annex 1.

Add the following paragraph 13.2 immediately after paragraph 13.1 of the Commentary on Article 10:

13.2 Similarly, some States refrain from levying tax on dividends paid to other States and some of their wholly-owned entities, at least to the extent that such dividends are derived from activities of a governmental nature. Some States are able to grant such an exemption under

their interpretation of the sovereign immunity principle (see paragraphs 6.10 and 6.12 of the Commentary on Article 1); others may do it pursuant to provisions of their domestic law. States wishing to do so may confirm or clarify, in their bilateral conventions, the scope of these exemptions or grant such an exemption in cases where it would not otherwise be available. This may be done by adding to the Article an additional paragraph drafted along the following lines:

Notwithstanding the provisions of paragraph 2, dividends referred to in paragraph 1 shall be taxable only in the Contracting State of which the recipient is a resident if the beneficial owner of the dividends is that State or a political subdivision or local authority thereof.

Replace paragraph 7.4 of the Commentary on Article 11 by the following (changes to the existing text appear in bold italics for additions and strikethrough for deletions):

7.4 Some States refrain from levying tax on income derived by other States *and some of their wholly-owned entities (e.g., a central bank)*, at least to the extent that such income is derived from activities of a governmental nature. *Some States are able to grant such an exemption under their interpretation of the sovereign immunity principle (see paragraphs 6.10 and 6.12 of the Commentary on Article 1); others may do it pursuant to provisions of their domestic law.* In their bilateral conventions, many States wish to confirm or clarify the scope of these~~at~~ exemptions with respect to interest *or to grant such an exemption in cases where it would not otherwise be available.* States wishing to do so may therefore agree to include the following category of interest in a paragraph providing for exemption of certain interest from taxation in the State of source:

“a) is that State or the central bank, a political subdivision or local authority thereof;”