Australian Government

Greater certainty for sovereign investments – the framework rules

Consultation Paper
June 2010

ISBN

CONSULTATION PROCESS

Request for feedback and comments

The Government is seeking your feedback and comments on the legislative design of its announcement to introduce amendments to the income tax law to formalise the existing tax practice of exempting certain income earned by foreign governments and their sovereign funds.

While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please email responses in a Word or RTF format. An additional PDF version may also be submitted.

All information (including name and address details) contained in submissions will be made available to the public on the Treasury website, unless you indicate that you would like all or part of your submission to remain in-confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as such in a separate attachment. A request made under the Freedom of Information Act 1982 (Commonwealth) for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

Closing date for submissions: 21 July 2010

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BACKGROUND

Certain income derived by foreign governments has traditionally been exempt from Australian taxation under the international law doctrine of sovereign immunity.

The doctrine of sovereign immunity is a principle of customary international law according to which one country is immune from suit in another country. The scope of this doctrine has evolved from an absolute, wide-ranging immunity to a more restrictive one.

This evolution is primarily due to the fact that governments have increasingly engaged in commercial activities, activities for which it would be inappropriate to extend sovereign immunity. Gradually, therefore, the doctrine has been narrowed so that a country only enjoys immunity with respect to its non-commercial activities.

Sovereign Wealth Funds (SWFs) have been included in the doctrine of sovereign immunity in recent years where they have been considered to be a part of the government itself. The term SWF is a relatively expansive concept that covers a range of different entities. The OECD defines SWFs as 'special purpose investment funds or arrangements created by a State or a political subdivision for macroeconomic purposes'.

SWFs have grown rapidly over recent years in both size and number. There are currently more than 50 SWFs in operation around the world, with total assets under management estimated to exceed US$3.85 trillion.

It is anticipated that the SWF market will continue to grow, with some sources estimating that assets under management will reach US$10 trillion by 2015. Australia's Future Fund currently ranks 14th globally in terms of the value of its assets.

While early SWFs tended to invest mainly in international bond markets, in more recent times the search for higher returns has seen SWFs expand into equity markets and in some cases direct investment, including real property.

Foreign government and SWF investments have the potential to provide Australia with a significant additional source of capital, but in order for Australia to compete and improve its attractiveness as a destination for these funds it is important that Australia's taxation laws set out clear and certain outcomes for potential investors.

The Government announced on 20 August 2009 that it would codify the current administrative practice that exempts from Australian taxation certain income arising from investments made by foreign governments. The current administrative practice is set out in ATO ID 2002/45. (Appendix A refers).

Against this backdrop, the Government invites your comments on the rules set out below.

POLICY OBJECTIVES

The policy objective behind the proposed law is to enhance Australia's attractiveness as a destination for foreign government investment by providing greater certainty as to the Australian tax consequences for investment by foreign governments and the withholding obligations for Australian residents.

The policy also aims to reduce compliance costs (by allowing foreign governments and certain entities to self-assess their tax position) and assist in promoting Australia as a regional financial services hub.

These policy objectives will be achieved through the codification of existing administrative practice.

It is important the concessional tax treatment afforded under sovereign immunity does not shelter the commercial operations of foreign governments. Such an outcome would provide an unfair competitive advantage over businesses operating domestically.

PROPOSED DESIGN

The legislative design proposal set out below has been assembled against the following core concepts:

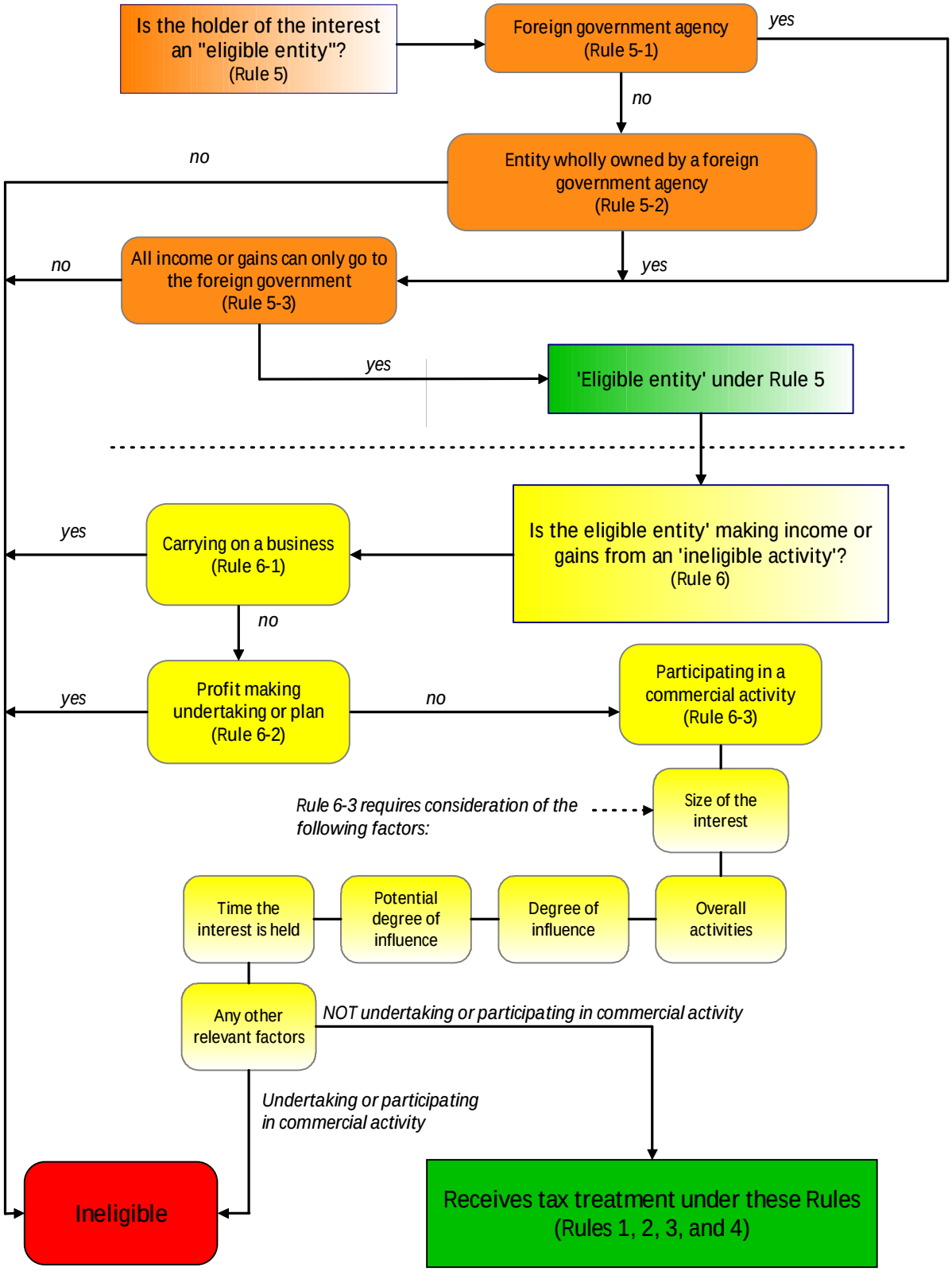
- tax treatment
- eligible entities
- commercial activity

This paper provides a brief description of what the core concept is intended to achieve followed by a statement of the rule itself.

While the Government is particularly interested in your view in respect of any of the design elements, it would also like to hear from you about any other matters that will assist in the final design of the law. In particular, you may have comments about the general structure of the rules, the nature of any additional or ancillary rules that might be required, and the appropriateness of a rule after having 'road-tested' it against your particular circumstances.

The diagram below sets out the legislative scheme.

LEGISLATIVE SCHEME



1. WHAT THESE RULES ARE ABOUT

Summary of the rules

Ordinary income, statutory income and capital gains made in respect of a CGT asset will be non-assessable non-exempt income to the extent the income or gains do not relate to carrying on a business, a profit making undertaking or plan, or a commercial activity.

This principle establishes the basic framework for the legislative scheme by providing the conditions under which sovereign immunity from Australian taxation will be granted to a foreign government, namely through the satisfaction of Rules 5 and 6. In general terms, Rule 5 prescribes the types of entities that may be eligible for relief from Australian taxation while Rule 6 limits this eligibility on the basis of the character of the relevant entity's holding.

Rules 1 to 4 explain the applicable tax treatment where Rules 5 and 6 are satisfied.

2. RULE 1: NON-ASSESSABLE, NON-EXEMPT AND NOT SUBJECT TO WITHHOLDING

Rule 1 applies to ordinary or statutory income made in respect of an interest held in an Australian entity or asset (a CGT asset). The Rule provides that relief from Australian tax will be granted through non-assessable, non-exempt income status and the removal of any obligations to withhold. In relation to withholding obligations, there will be no liability to withholding tax on interest income, dividend income or distributions from managed investment trusts (including capital distributions). Similarly, where a foreign government agency or 'sovereign fund' satisfies these rules the trustee will not be taxed on the present entitlement of the foreign entity.

Rule 1: Non-assessable, non-exempt and not subject to withholding

Ordinary or statutory income made in respect of a CGT asset is non-assessable, non-exempt income and is not subject to any Australian withholding tax if Rules 5 and 6 are satisfied.

2.1 SUB-RULE 1-1: CGT ASSET

The tax treatment available under these rules is intended to apply to income or gains made from any type of property or legal and equitable interests that are held by a foreign government where Rules 5 and 6 are satisfied. The definition of CGT asset contained in section 108-5 of the *Income Tax Assessment Act 1997* (ITAA 1997) is an appropriate existing legal term that covers such holdings.

Sub-rule 1-1: CGT asset

CGT asset has the meaning given to that term in section 108-5 of the ITAA 1997.

3. Rule 2: Capital gains

As individual capital gains are not of themselves statutory income (which captures net capital gains and losses) it is necessary to make specific provision that they be disregarded to the extent that they satisfy Rules 5 and 6.

Rule 2: Capital gains

Capital gains made in respect of a CGT asset are disregarded if Rules 5 and 6 are satisfied.

4. Rule 3: Treatment of losses

Rule 3 states that any losses incurred in respect of a CGT asset are disregarded where Rules 5 and 6 are satisfied. This provision operates so that losses cannot be applied to another form of assessable income that is not covered by these rules (such as income from a commercial activity) that is made by an eligible entity where those losses are incurred through activities which comply with the requirements of these rules.

Rule 3: Treatment of losses

Losses incurred in respect of a CGT asset are disregarded if Rules 5 and 6 are satisfied.

5. Rule 4: Treatment of deductions

Rule 4 states that any deductions that might otherwise be claimed in respect of a CGT asset are disregarded where Rules 5 and 6 are satisfied. As under Rule 3, this provision operates so that deductions in relation to income made from a CGT asset covered by these rules cannot be applied to other forms of assessable income that are not covered.

Rule 4: Treatment of deductions

Deductions incurred in respect of a CGT asset are disregarded if Rules 5 and 6 are satisfied.

6. RULE 5: ENTITIES TO WHICH THESE RULES APPLY

Rule 5 prescribes the type of entities that will be eligible for relief from Australian taxation under these rules. An important requirement of this Rule is that such treatment is restricted to foreign government agencies and the wholly-owned entities through which they invest in Australia.

The term 'foreign government agency' is currently defined in the law. The class of eligible entities is extended to include wholly-owned entities of foreign government agencies such as wholly-owned companies or investment vehicles. For the purposes of these rules, such entities are referred to as a 'sovereign fund'.

Rule 5: Entities to which these rules apply

The entity that makes the ordinary income, statutory income, capital gains, or incurs the losses or deductions, must be a foreign government agency or a sovereign fund.

6.1 SUB-RULE 5-1: FOREIGN GOVERNMENT AGENCY

Sub-rule 5-1 is specifically intended to encompass all levels of government of a foreign country or parts of that country, including but not limited to its regional, local, provincial and other political subdivisions. The definition of foreign government agency under section 995-1 of the ITAA 1997 clearly articulates all of those concepts.

Sub-rule 5-1 includes governments that take the form of kingdoms or monarchies provided all other requirements under these rules are satisfied and such governments are acting in their official public capacity. Consideration of what constitutes a 'foreign country' should involve a broad interpretation of that term and be made in accordance with the definition articulated by paragraph 22(1)(f) of the *Acts Interpretation Act 1901*.

Sub-rule 5-1: Foreign government agency

Foreign government agency has the meaning given to that term in section 995-1 of the ITAA 1997.

6.2 SUB-RULE 5-2: SOVEREIGN FUNDS

Sub-rule 5-2 is designed to exclude any non-government or private entities by strictly limiting eligibility to entities that are wholly-owned by a foreign government agency. Under these rules, such

entities are referred to as 'sovereign funds' (SF). Although indirect ownership is permitted, any entity in which the ultimate membership interests are not wholly beneficially owned by a foreign government agency will not be considered a SF.

Control or influence over the entity in question is not a directly relevant consideration in determining whether a foreign government agency beneficially owns the membership interests in an entity. Rather, and in accordance with section 960-135 of the ITAA 1997, the test to be considered is whether the foreign government agency ultimately has exclusive possession of all interests or rights in relation to an entity.

The term 'SF' is intended to cover instances where a SF is jointly-owned by any number of other wholly-owned entities of a foreign government agency, joint-ownership between the foreign government agency itself as well as any number of its other wholly-owned entities and circumstances where an entity is wholly-owned by any number of foreign government agencies. An entity will not be a SF however where it is jointly owned by a foreign government agency and an entity that is not wholly-owned by a foreign government agency.

Sub-rule 5-2: Sovereign funds

An entity will be a sovereign fund if it is wholly-owned (whether directly or indirectly) by a foreign government agency.

An entity will be treated as being wholly-owned by a foreign government agency if all the membership interests in the entity are beneficially owned by:

(i) a foreign government agency;

(ii) one or more wholly-owned entities of the foreign government agency;

(iii) the foreign government agency and one or more wholly-owned entities of the foreign government agency; or

(iv) one or more foreign government agencies.

'Membership interest' has the meaning given to that term in section 960-135 of the ITAA 1997.

6.3 SUB-RULE 5-3: SOVEREIGN FUND MUST BE ESTABLISHED WITH 'PUBLIC MONEY' OR 'PUBLIC PROPERTY'

Sub-rule 5-3 provides that a SF seeking the tax treatment under Rules 1 to 4 must be established solely with 'public money' or 'public property'.

The term 'public money' or 'public property' relates to the money or property that a government has at its disposal to fulfil its general functions. For the purposes of this sub-rule, money or property will be 'public money or public property' where it is in the custody or under the control of a foreign government agency, or money or property in the custody or under the control of any person acting for or on behalf of the foreign government agency.

Where an entity is acquired by a foreign government agency, such an entity will, for the purposes of sub-rule 5-3, be considered to be 'established' by a foreign government agency provided that the foreign government agency acquires the entity in its entirety (that is, does not acquire a mere share or part of an entity).

Example 1

A foreign country nominates an accumulation style superannuation fund for government employees. Government employees contribute a nominated percentage of their income into the fund and a fund manager invests it on behalf of the government employee members. The fund manager makes passive investments in Australia.

Assuming Rule 6 is satisfied, the following question: 'is the income from the passive investments in Australia non-assessable and non-exempt on the basis that the superannuation fund is a sovereign fund?'

Answer: No. The foreign superannuation fund does not satisfy sub-rule 5-3 as it is not established using the public money or public property of the foreign government. The fund is established through capital accumulated from member contributions.

Sub-rule 5-3: SF must be established with 'public money' or 'public property'

If the recipient of the income is a sovereign fund, the sovereign fund must have been established solely with 'public money' or 'public property' provided (directly or indirectly) by a foreign government agency, otherwise the treatment in Rules 1 to 4 will not apply.

6.4 SUB-RULE 5-4: ASSETS, INCOME OR GAINS MUST BE MADE SOLELY BY FOREIGN GOVERNMENT AGENCY OR SOVEREIGN FUND

A fundamental concept of these rules is that only foreign government agencies or SFs should receive the tax treatment available under Rules 1 to 4. Sub-rule 5-4 gives effect to this condition by providing that any assets, income or gains made by a foreign government agency or SF is incapable of passing to any other entity or organisation other than the foreign government agency or SF.

This requirement is intended to act as an integrity measure designed to preclude individuals (including foreign sovereigns, officials or administrators) or another ineligible entity under these rules from receiving a private benefit from the tax treatment available under Rules 1 to 4.

This sub-rule is not, however, intended to capture instances where a foreign government agency or SF enters into an arms-length arrangement with an investment manager involving incentive based compensation (provided such arrangements directly relate to remuneration for an investment manager's role as a service provider).

Example 2

A foreign country nominates a defined benefit style superannuation fund for government employees. Government employees do not contribute any of their income into the fund. A fund manager invests funds provided by the government for the purpose of meeting their pension obligations in relation to government employee members. The benefits to members are defined with reference to a formula that does not relate to the earnings of the fund. The fund manager makes passive investments in Australia.

Assuming Rule 6 is satisfied, the following question arises: 'is the income from passive investments in Australia non-assessable and non-exempt on the basis that the superannuation fund is a sovereign fund?'

Answer: No. While the foreign superannuation fund may satisfy sub-rule 5-3 (as it is established using the public money or public property of the foreign government), the foreign superannuation fund has obligations to pay identifiable amounts to specific individuals. Sub-rule 5-4 is therefore not satisfied as all the capital and earnings of the fund do not pass solely to the foreign government. Rather, private benefits arise in relation to the member superannuants.

Example 3

The defined benefit superannuation fund in Example 2 is completely unfunded and the foreign government in question is amassing pension liabilities that will become a drain on revenue in future years. The foreign government decides that it will allocate a portion of its current budget surplus and establish an investment trust. The trust deed does not require the funds to go to the members of the superannuation fund previously discussed nor does it require that the capital and earnings of the investment trust be used to fund that liability. That is, while the foreign government had an intended use for the accumulated capital and earnings of the investment trust in mind on establishment, they are not obliged to use the funds for that purpose. Rather, they can apply the funds to any macroeconomic purpose they see fit. All capital and earnings of the investment fund can only be paid or become payable to the foreign government.

Assuming Rule 6 is satisfied, the following question arises: 'is the income from passive investments in Australia non-assessable and non-exempt on the basis that the investment trust is a sovereign fund?'

Answer: Yes. The investment trust is wholly-owned by a foreign government agency satisfying sub-rule 5-2 and solely established using the public money of the foreign country (an allocation from a budget surplus) satisfying sub-rule 5-3. Finally, sub-rule 5-4 is satisfied as the accumulating capital and earnings of the investment trust can only be paid or become payable to the foreign government and cannot be directly applied to confer a private benefit.

Sub-rule 5-4: Assets, income or gains must be made solely by a foreign government agency or SF

Assets, ordinary income, statutory income or capital gains of the sovereign fund cannot be transferred, paid or become payable to any entity or person, other than a foreign government agency or sovereign fund.

7. RULE 6: GAINS MUST NOT BE FROM AN INELIGIBLE ACTIVITY

Rule 6 is designed to limit eligibility for the tax treatment in Rules 1 to 4 to forms of income, gains, losses or deductions that do not form part of carrying on a business, a profit making undertaking or plan, or amount to undertaking or participating in a commercial activity by a foreign government agency or SF.

For the purposes of these rules, where a foreign government agency or SF engages in a variety of activities, some of which might be considered ineligible, only the income related to the relevant ineligible activities should be denied the tax treatment provided under Rules 1 to 4.

Rule 6: Gains must not be from an ineligible activity

The ordinary income, statutory income, capital gains, losses and deductions must NOT be made from 'carrying on a business', a 'profit making undertaking or plan', or undertaking or participating in a 'commercial activity'.

7.1 SUB-RULE 6-1: CARRYING ON A BUSINESS

A foreign government agency or SF which carries on a business will be denied the tax treatment available under Rules 1 to 4 to the extent that any income, gains, losses or deductions relate to that business.

Whether or not a foreign government agency's or SF's activities amount to carrying on a business is a question of fact and degree.

The nature of the activity, the foreign government agency's or SF's intention and the method of operation assist in determining whether a business is being carried on.

The term 'business' is currently defined in the law and includes any profession, trade, vocation or calling, but does not include occupation as an employee. Consistent with established standards, assessing whether a foreign government agency or SF is 'carrying on a business' requires consideration of a number of indicators. The nature of the activities is important, particularly where they have the purpose of profit-making. Repetition and regularity of the activities is also important. The organisation of activities in a businesslike manner, the keeping of books, records and the use of

systems may all serve to indicate that a business is carried on. The volume of operations and the amount of capital employed may be significant.[1]

Similarly, the question of where business is carried on is one of fact and requires consideration of where the activities of the company are carried on and will be dependent on the facts and circumstances of the case. The Commissioner's approach to this factual determination is to draw a distinction between a company with operational activities and a company which is more passive in its dealings.[2]

Sub-rule 6-1: Carrying on a business

Business has the meaning given to that term in section 995-1 of the ITAA 1997.

7.2 SUB-RULE 6-2: PROFIT MAKING UNDERTAKING OR PLAN

A foreign government agency or SF that makes income, profits or gains from a profit making undertaking or plan will be denied the tax treatment available under Rules 1 to 4 to the extent that the income, gains or losses relate to that profit making undertaking or plan.

The concept of 'profit making undertaking or plan' has been subject to a body of judicial consideration, most notably in *FC of T v Myer Emporium* (1987) 163 CLR 199 and *FC of T v Whitfords Beach* (1982) 150 CLR 355. A profit making undertaking or plan relates to isolated transactions or ventures entered into with a view to making a profit. Importantly the concept of 'profit making undertaking or plan' will only be relevant for the purposes of section 15-15 of the ITAA 1997 where it relates to the disposal of property acquired prior to 20 September 1985.

The unanimous judgement of the High Court in *Myer Emporium* encapsulated the concept of a profit making undertaking or plan as follows:

> *a receipt may constitute income, if it arises from an isolated business operation or commercial transaction entered into otherwise than in the ordinary course of the carrying on of the taxpayer's business, so long as the taxpayer entered into the transaction with the intention or purpose of making a relevant profit or gain from the transaction.*

Whitfords Beach explores the difference between the mere realisation of an asset and an isolated transaction that could satisfy the concept of profit making undertaking or plan with reference to the judgement of Gibbs J in *London Australia Investment Co. Ltd. v. Federal Commissioner of Taxation* (1977) 138 CLR 106:

> *It is one thing if the decision to sell an asset is taken after its acquisition, there having been no intention or purpose at the time of acquisition of acquiring for the purpose of profit-making by sale. Then, if the asset be not a revenue asset on other grounds, the profit made is capital because it proceeds from a mere realization. But it is quite another thing if the decision to sell is taken by way of implementation of an intention or purpose, existing at the time of acquisition,*

[1] ATO Tax Ruling 97/11
[2] ATO Tax Ruling 2004/15

of profit-making by sale, at least in the context of carrying on a business or carrying out a business operation or commercial transaction.

A core feature of the concept of profit making undertaking or plan is that of the overall character of a business dealing. To be a profit making undertaking or plan, for example in instances where a capital asset is ventured in an undertaking or scheme, a transaction must involve more than the mere realisation of the capital asset. It is not necessary, however, that every step is foreseen or predetermined prior to the commencement of the undertaking or plan.

Rule 6-2: Profit making undertaking or plan

Profit making undertaking or plan has the meaning given to that term for the purposes of section 15-15 of the ITAA 1997.

7.3 SUB-RULE 6-3: COMMERCIAL ACTIVITY

A key aspect of these rules is that there will be no entitlement to the tax treatment under Rules 1 to 4 where a foreign government agency or SF undertakes or participates in a commercial activity with respect to an interest it has in a CGT asset.

In cases where a foreign government agency or SF directly pursues its commercial activities through an interest in a CGT asset, it will be clear that the treatment under Rules 1 to 4 will not apply to the income arising from the interest in that CGT asset. In this context sub-rules 6-3 (ii) & (v) are particularly relevant.

In other cases a foreign government agency or SF may also be ineligible for the tax treatment under Rules 1 to 4 if its level of participation in the CGT asset in which it holds an interest is such that it can be considered to be conducting or influencing the commercial activities undertaken through the CGT asset. Commercial activities of this nature will also be considered inappropriate and in this context sub-rules 6-3 (i)(iii) & (iv) are particularly relevant.

Sub-rule 6-3 is applied on an interest-by-interest basis as opposed to requiring an overall assessment of the interests or nature of a foreign government agency or SF. This means that each interest in a CGT asset must be considered separately and if one interest is found to amount to a commercial undertaking or participation, other interests held by the foreign government agency are not tainted by that characterisation. Any consideration of the overall activities of the foreign government agency or SF will only be relevant in so far as it provides context to a particular interest. Example 8 below illustrates this concept further.

A range of factors have been set out in sub-rule 6-3 to test whether the nature of the interest held by the foreign government agency or SF can be assessed to be a 'commercial activity':

7.3.1 The size of the interest in the right to vote on financial, operating and policy decisions made in respect of the CGT asset

The size of the interest that a foreign government agency or SF holds in relation to rights to vote on the financial, operating and policy decisions of a CGT asset is relevant in determining whether the

interest in the CGT asset forms part of a commercial activity undertaken or participated in by the foreign government. A foreign government agency or SF will be considered to be engaged in a commercial activity under these rules where they have an active role in the determination of such issues.

In most cases there will be a direct correlation between the size of such interests and the level of commerciality, with small interests generally considered to be non-commercial in nature (such as portfolio interests that involve less than 10 per cent of the equity in the CGT asset).

In arriving at any determination regarding commerciality the size of the interests held must always be considered against other relevant factors. For example, where such an interest is relatively small but clearly forms part of the commercial activity of a foreign government agency or SF, the simple fact of the size of the interest will not be sufficient to establish an absence of commerciality. Conversely, 'larger' interests might be considered to be non-commercial in nature in appropriate circumstances.

7.3.2 The degree of influence over the CGT asset

Another relevant consideration relates to a foreign government agency's or SF's ability to exert influence over the financial, operating and policy decisions of the CGT asset in which it holds an interest. In this context, the ability to exert influence will be indicative of engaging in a commercial activity and is intended to articulate a lower standard than ownership or control.

Relevant factors in considering 'influence' are the foreign government agency's or SF's capacity to influence:

(i) representation on the board of directors or equivalent governing body of the CGT asset;

(ii) participation in the policy-making processes, including participation in the decisions about dividends or other distributions;

(iii) material transactions of the CGT asset;

(iv) interchange of managerial personnel; or

(v) the provision of essential technical information.

Example 3

A SF holds a 9 per cent interest in an Australian company. As a result of the widely-held nature of the Australian company the SF is the majority shareholder and has a representative on the board of directors of the Australian company.

While the ability to influence the financial, operating and policy decisions of the Australian company will not, of itself, be determinative it will weigh in favour of participating in a commercial activity.

7.3.3 The potential degree of influence over the CGT asset

In some circumstances it may also be necessary to look at the foreign government agency's or SF's potential ability to exert influence as a result of the interest held in a CGT asset.

This consideration looks beyond the explicit rights conveyed by an interest. Although a foreign government agency or SF might generally hold interests such as ordinary share or debt interests, the notion of 'potentiality' is intended to be sufficiently broad so as to take into account circumstances in which a foreign government agency or SF has the capacity to engage in commercial activity through another arrangement without holding an obviously active or direct interest in the CGT asset.

Example 4

A SF holds a 5 per cent equity interest in an Australian company. The SF also holds convertible notes issued by the Australian company. The convertible notes are exercisable at any time by the SF. If the SF chose to exercise its convertible notes its equity interest in the Australian company would increase to 25 per cent. The SF would then be entitled to representation on the Australian company's board of directors and would, in fact, be the majority shareholder. While of itself the potential to influence the Australian company will not be determinative as to whether the SF is participating in a commercial activity, it will weigh in favour of participating in a commercial activity.

7.3.4 The overall activities of the foreign government agency or SF

The nature of the overall activities of the foreign government agency or SF in addition to the activity involved in making the particular investment in question are relevant in determining the nature of an individual holding. Although in this instance factors beyond the specific holding in question are necessarily examined, this consideration remains consistent with the holding-by-holding approach in that it is illustrative of the context in which a given holding exists.

Example 5

The overall activities of a SF are akin to that of a share trader. The SF also makes a small loan to an Australian company from which it derives interest. In considering whether the SF is participating in a commercial activity in relation to the loan the overall activities of the SF will be considered. While the share trading activities of the SF may be commercial the loan to the Australian company would not appear to form part of those activities.

In this case the overall activities of the SF would not weigh in favour of the loan arrangement constituting participation in a commercial activity.

7.3.5 How long the interest has, or will be, held

The length of time an interest has been, or will be, held may be relevant when considering whether a foreign government agency or SF is undertaking or participating in a commercial activity.

In general terms, interests held for only brief periods might be indicative of some form of commercial trading. In contrast, a longer term arrangement paying interest-like dividends may be more representational of a non-commercial, or passive form of investment.

It is logical that this consideration should operate in conjunction with the above 'overall activities' consideration, in that foreign government agencies or SF will deal with their interests in differing ways depending on their overall character.

Example 6

A SF acquires a 1 per cent direct interest in a large metropolitan office block in Sydney. The SF holds the interest for 18 years before disposing of it. During the period the SF did not enter into any other arrangement in respect of the office block nor did the interest convey any right to influence the operational or financial decision making in respect to the office block.

The time period will not of itself be determinative but the long term nature of the investment would NOT weigh in favour of the SF participating in a commercial activity.

7.3.6 Any other factors

Any other factors that are relevant in the circumstances should be considered where they are indicative of whether a foreign government agency or SF undertakes or participates in a commercial activity with respect to a holding they have in a CGT asset.

Some examples of the way these rules interact are:

Example 7

A foreign government agency with a 15 per cent equity interest in an Australian entity (a large interest relative to a portfolio holding) may still be considered to possess a non-commercial interest. Having regard to all relevant circumstances, an interest that gave rise to an interests in profits only, that conveys no substantive voting rights, forms no part of the foreign government agency's broader commercial activities and provides no capacity to influence the operational or managerial activities of the entity might be considered an interest which derives income through a non-commercial activity of the foreign government agency.

Example 8

A foreign government agency might acquire a 1 per cent equity interest in an Australian entity conveying no substantive voting rights or influence and might therefore generally be considered to constitute a non-commercial interest. If consideration of the foreign government agency's overall activity were to reveal that it were actively engaged in the business of share-trading and it was reasonable to suggest that the 1 per cent investment was conducted as part of the foreign government agency's broader commercial activity, it would be inappropriate for income derived in such instances to be considered non-commercial.

Alternatively, if upon consideration of the overall nature of the foreign government agency and its overall activities it was evident that it actively engaged in the practice of commercial lending, the 1 per cent equity interest might not be considered to form part of the commercial activity of the foreign government agency.

Rule 6-3: Commercial activity

To determine whether a foreign government agency or a sovereign fund is undertaking or participating in a 'commercial activity', it is necessary to take into account the following factors:

(i) size of the foreign government agency's or sovereign fund's interest, whether directly or indirectly, in the right to vote on financial, operating and policy decisions made in respect of the CGT asset (measured as a total of all rights to vote on financial, operating and policy decisions made in respect of the CGT asset);

(ii) the overall activities of the foreign government agency or sovereign fund;

(iii) the degree of influence that the foreign government agency or sovereign fund is able to exercise in respect of the financial, operating and policy decisions made in respect of the CGT asset;

(iv) the degree of influence that the foreign government agency or sovereign fund could potentially exercise in respect of the CGT asset, after taking into account the existence of options, convertible notes and other instruments or agreements which allow the foreign government agency or sovereign fund to increase its interest in profits or gains from the CGT asset, or its interest whether directly or indirectly in the right to vote on financial, operating and policy decisions made in respect of the CGT asset;

(v) the period of time that the foreign government agency or sovereign fund has owned an interest in the CGT asset and intends to continue to own its interest in the CGT asset; and

(vi) any other relevant factors.

8. RULE 7: PRIVATE RULINGS AND ADVANCE OPINIONS

A current private ruling or advance opinion in relation to an existing investment will continue to apply to that investment regardless of the application of Rules 1 to 6. Rule 7 applies to ongoing investments only and does not extend to new investments of the same or similar character as other investments to which a private ruling or advance opinion might apply.

Rule 7: Private rulings and advance opinions

A foreign government agency or sovereign fund with a current private ruling ('PR') or advance opinion ('AO') in respect of a specific investment which is inconsistent with Rules 1 to 6 is able to continue relying upon the PR or AO.

APPENDIX A: ATO ID 2002/45

ATO ID 2002/45: Withholding Tax/Sovereign Immunity

Issue: Is a foreign Government Agency eligible for 'exemption' from Australian withholding tax on dividends received?

Decision: Yes

Facts: A foreign Government Agency Fund holds investments in Australian securities and receives dividends from those shareholdings. Exemption was sought from Australian dividend withholding tax.

Reasons for Decision: Certain income derived from within Australia by foreign governments is exempt from Australian tax under the international law doctrine of sovereign immunity. In accordance with that doctrine, Australia accepts that any income derived by a foreign government from the performance of governmental functions within Australia is exempt from Australian tax. An activity undertaken by a foreign Government Agency will generally be accepted as the performance of governmental functions provided that it is functions of government, provided that the agency is owned and controlled by the government and does not engage in commercial activities.

When determining whether sovereign immunity applies to a particular operation or activity, it is necessary to establish whether the operation or activity is commercial in nature. Whether an operation or activity is commercial in nature will depend on the facts of each particular case. However, as a guide, a commercial activity is generally an activity concerned with the trading of goods and services, such as buying, selling, bartering and transportation, and includes the carrying on of a business.

Income derived by a foreign government or by any other body exercising governmental functions from interest bearing investments or investments in equities is generally not considered to be income derived from a commercial operation or activity. Accordingly, provided the funds used to make such investments are and remain government moneys, the income is accepted as being exempt from tax under the common law doctrine of sovereign immunity.

In relation to a holding of shares in a company, there would be instances where the extent of the holding gives rise to questions as to whether it constitutes a passive investment or the carrying on of a business, but this would depend on the particular circumstances. A portfolio holding in a company (i.e., a holding of 10 per cent or less of the equity in a company) will generally be accepted as a non-commercial activity and any dividends received from such a holding would be exempt from tax.

To establish that sovereign immunity applies to exempt dividend and interest income from withholding tax, it is necessary to establish the following:

- that the person making the investment (and therefore deriving the income) is a foreign government or an agency of a foreign government;
- that the moneys being invested are and will remain government moneys; and
- that the income is being derived from a non-commercial activity.

If these three conditions are satisfied, then the dividend and interest income will not be subject to Australian income or withholding taxes.

The doctrine of sovereign immunity only applies to foreign governments and their instrumentalities that engage in governmental functions. In determining whether a particular activity constitutes the performance of governmental functions we need to examine the nature of the activity conducted by the foreign government or its instrumentality. This approach is consistent with the decision of the British House of Lords in the case *I Congreso del Partido* [1981] 2 All ER 1064 which held that activities of a trading, commercial or other private law character were not governmental functions.

The foreign government agency is engaged in exercising governmental functions and therefore is eligible for exemption from Australian withholding taxes in relation to dividends received.