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# Canadian Income Taxation of Sovereign Wealth Funds

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UNIVERSITY OF CALGARY

Canadian Income Taxation of Sovereign Wealth Funds

by

Andrea Michelle Ryer

A THESIS

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## **Abstract**

This thesis is a comparative analysis of the Canadian income taxation of sovereign wealth funds (SWFs). Because SWFs are owned and controlled by foreign governments, they are subject to different rules than private foreign investors, notably tax rules. The taxation of SWFs in Canada is determined by the interaction of domestic tax rules, bilateral tax treaties, and the law of state immunity. In certain cases, SWFs may be immune from taxation. The thesis examines the Canadian tax law and policy applicable to SWFs and compares Canadian practice to that of three other jurisdictions (Australia, Germany and the United States). In particular, it argues that the existing rules lack certainty and transparency and recommends legislative change to address these shortcomings.

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# **Chapter 1: Introduction**

## **1.1 Introduction**

As state-owned entities, sovereign wealth funds (SWFs) that operate in Canada are subject to different rules than private foreign investors, notably tax rules. The tax treatment of SWFs is determined by the intersection of domestic tax law, as provided under the *Income Tax Act* (the Act)<sup>1</sup> and Canada's network of tax treaties, and, on the other hand, the customary international law doctrine of sovereign immunity, as codified in the *State Immunity Act* (SIA).<sup>2</sup> The taxation of SWFs in Canada has yet to receive detailed attention in the scholarly literature. As SWFs continue to grow in size and prominence, this is a topic that will become increasingly relevant.

## **1.2 The Rise of Sovereign Wealth Funds**

SWFs have attracted significant attention over the last ten years as a result of their growth in both size and number and because of the important role they played in the aftermath of the global financial collapse of 2008, when they provided key liquidity and support to international markets.<sup>3</sup> In the wake of the credit crisis, SWFs made headlines by infusing major financial institutions, such as Merrill Lynch, Citigroup, and Morgan Stanley, with much needed capital.<sup>4</sup>

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<sup>1</sup> *Income Tax Act*, RSC 1985, c 1 (5<sup>th</sup> Supp) (hereinafter "the Act"). Unless otherwise specified, all statutory references contained in this thesis are to the corresponding provisions of the Act.

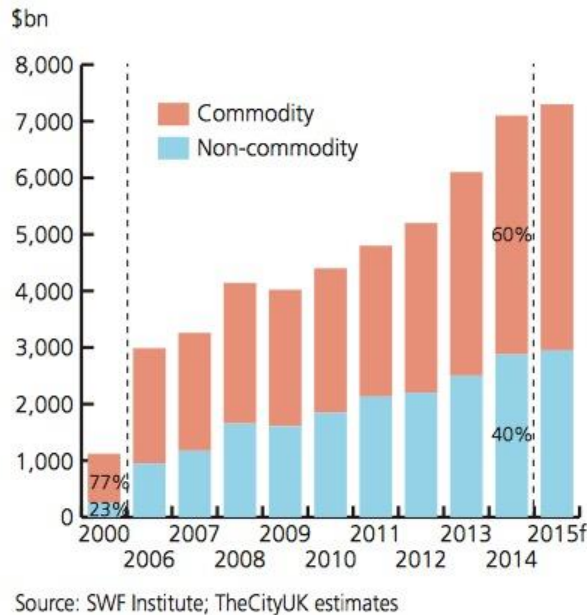
<sup>2</sup> *State Immunity Act*, RSC 1985, c S-18 (hereinafter "SIA").

<sup>3</sup> Mark Gordon & Sabastian V Niles, "Sovereign Wealth Funds: An Overview," in Karl P Sauvart, Lisa E Sachs & Wouter PF Schmitt Jongbloed, eds, *Sovereign Investment: Concerns and Policy Reactions* (Oxford: Oxford University Press, 2012) 24 at 24.

<sup>4</sup> Ben Wright, "Why Sovereign Wealth Funds Are a Bank's Best Friend" *Wall Street Journal* (19 May 2014); "The Invasion of the Sovereign Wealth Funds" *The Economist* (17

Notwithstanding this recent spate of attention, SWFs are not a new phenomenon. The first SWFs were established more than 70 years ago. These funds are essentially large pools of capital owned by local governments and used to invest abroad, very similar to public pension funds. Nevertheless, SWF investment is not a particularly well-understood phenomenon, and SWF investors are frequent targets of economic protectionism.<sup>5</sup> Because they are owned by governments, SWFs perhaps inevitably face scepticism that their investment decisions are politically motivated, rather than purely profit seeking.

Figure 1: Sovereign Wealth Fund Assets Under Management (\$billion USD)<sup>6</sup>



January 2008); Richard Wray, “Revealed: How Sovereign Wealth Funds Were Left Nursing Multibillion Losses” *The Guardian* (22 March 2008).

<sup>5</sup> See e.g., Victor Fleischer, “A Theory of Taxing Sovereign Wealth” (2009) 84 NYUL Rev 440, for an argument considering excise taxes to deter sovereign wealth funds from investing.

<sup>6</sup> TheCityUK, “UK, The Leading Western Centre for Sovereign Wealth Funds” (June 2015) at page 7 online:< <https://www.thecityuk.com/assets/2015/Reports-PDF/Sovereign-Wealth-Funds-2015.pdf>>.

SWF growth since the turn of the century has been immense (see Figure 1). They are some of the largest institutional investors in the world today and are expected to grow in both absolute and relative terms.<sup>7</sup> The Norwegian SWF, Government Pension Fund Global, owns more than one percent of all the world's equity, an immense amount for a country with a population of just over 5 million people. Meanwhile, the Abu Dhabi Investment Authority invests broadly across 22 asset class, and the China Investment Corporation staffs offices around the world.<sup>8</sup> Of the over 40 SWFs in existence, more than two thirds were established after the year 2000 (Figure 2).<sup>9</sup> During the same time period, the dollar value of SWF assets has skyrocketed. With over \$7.1 trillion USD in assets, the wealth of SWFs is now larger than that of the hedge fund and private equity industries combined.<sup>10</sup> Astonishingly, given their strong presence in oil and gas economies, SWF assets have continued to grow in the face of the oil price collapse in 2015.<sup>11</sup>

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<sup>7</sup> Robert M Kimmitt, "Public Footprints in Private Markets: Sovereign Wealth Funds and the World Economy," (2008) 87:1 *Foreign Affairs* 119 at 122.

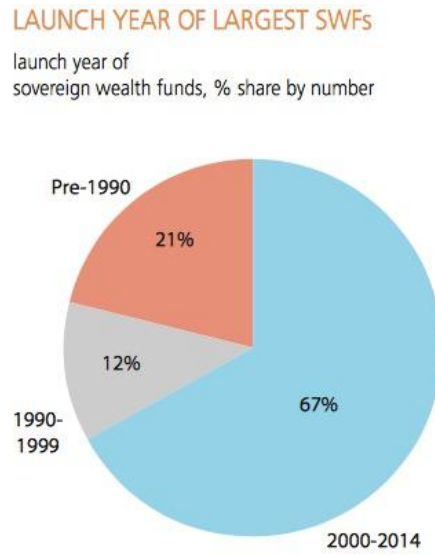
<sup>8</sup> Christopher Balding, *Sovereign Wealth Funds: The New Intersection of Money & Power* (Oxford: Oxford University Press, 2012) at 22.

<sup>9</sup> *Supra* note 6 at page 2.

<sup>10</sup> *Ibid* at page 5.

<sup>11</sup> Bernardo Bortolotti, "The Sky Did Not Fall: Sovereign Wealth Fund Annual Report 2015" (Sovereign Investment Lab, 2016) online: <<http://www.ifswf.org/sites/default/files/Bocconi%20SIL%202016%20Report.pdf>>.

Figure 2: Launch Year of the 20 Largest Sovereign Wealth Funds<sup>12</sup>



Source: TheCityUK calculations

SWFs are increasingly important players in global equity markets and private markets in Canada. Alberta, of course, is home to its own SWF, the Alberta Heritage Savings Trust Fund, which invests in a globally diversified portfolio of assets.<sup>13</sup> They are attractive investors because of their wealth, liquidity, and long-term investment horizons.<sup>14</sup> SWFs have traditionally been portfolio investors holding liquid financial assets in mature market economies, but in recent years they have been more willing to take on direct stakes and make riskier bargains.<sup>15</sup>

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<sup>12</sup> *Supra* note 6 at page 10.

<sup>13</sup> See Alberta Treasury Board and Finance, “Alberta Heritage and Savings Trust Fund: Annual Report, 2013-2014,” online: <<http://www.finance.alberta.ca/business/ahstf/annual-reports/2014/Heritage-Fund-2013-14-Annual-Report.pdf>> for a summary of the Heritage Fund’s global asset mix.

<sup>14</sup> See Balding, *supra* note 8 at page 9; Paul Rose, “Sovereign Investing and Corporate Governance: Evidence and Policy” (2013) 18:4 *Fordham J Corp & Fin L* 913 at 914.

<sup>15</sup> *Supra* note 6 at page 2.

Although SWFs have certain common features, in many respects they differ from one another. This diversity reflects the range of countries (and subnational entities) that employ SWFs as investment vehicles. The largest funds belong to Norway, China, the United Arab Emirates, Saudi Arabia, Kuwait, Singapore, and Qatar (see Figure 3). Each of these funds controls hundreds of billions (USD) in assets. The largest – Norway’s Government Pension Fund Global – is worth nearly 1 trillion dollars (USD) as of October 2017.<sup>16</sup> Meanwhile, some of the smaller funds belong to Ghana, Indonesia, Australia, West Virginia, Mexico, Turkmenistan, and Papua New Guinea. Each of these funds controls less than half a billion dollars (USD).<sup>17</sup> For its part, Alberta Heritage Fund is a mid-size fund with \$17.5B in assets under management.<sup>18</sup>

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<sup>16</sup> *Ibid* at page 4.

<sup>17</sup> Sovereign Wealth Institute. “Sovereign Wealth Fund Rankings” (October 2017), online: < <https://www.swfinstitute.org/sovereign-wealth-fund-rankings/> >

<sup>18</sup> *Supra* note 13.

Figure 3: Largest Sovereign Wealth Funds by Assets Under Management at the End of 2014<sup>19</sup>

	Assets Under Management (\$billion USD)	Country	Year Established	Source of Funds
Government Pension Fund – Global	893	Norway	1990	Commodity
Abu Dhabi Investment Authority	773	UAE-Abu Dhabi	1976	Commodity
SAMA Foreign Holdings	675	Saudi Arabia	1952	Commodity
China Investment Corporation	653	China	2007	Non-commodity
SAFE Investment Company	568	China	1997	Non-commodity
Kuwait Investment Authority	548	Kuwait	1953	Commodity
Hong Kong Monetary Authority Investment Portfolio	400	China-Hong Kong	1993	Non-commodity
Government of Singapore Investment Corporation	320	Singapore	1981	Non-commodity
Qatar Investment Authority	256	Qatar	2005	Commodity
National Social Security Fund	240	China	2000	Non-commodity
Temasek Holdings	177	Singapore	1974	Non-commodity

<sup>19</sup> See Figure 7 in *supra* note 6 at page 10. As not all SWFs publicly disclose their assets, the data in this chart contains estimates.

Australian Future Fund	95	Australia	2006	Non-commodity
Abu Dhabi Investment Council	90	UAE-Abu Dhabi	2007	Commodity
Reserve Fund	89	Russia	2008	Commodity
Korea Investment Corporation	85	South Korea	2005	Non-Commodity
National Welfare Fund	80	Russia	2008	Commodity
Samruk-Kazyna JSC	78	Kazakhstan	2008	Non-commodity
Revenue Regulation Fund	77	Algeria	2000	Commodity
Kazakhstan National Fund	77	Kazakhstan	2000	Commodity
Investment Corporation of Dubai	70	UAE – Dubai	2006	Commodity

### 1.3 The First Wave of Public Policy Concern

Although they are deep-pocketed investors with low leverage and long-term investment horizons, SWF investment has nevertheless been received with considerable uncertainty. The funds have been the object of significant public scrutiny and debate in the last decade. Some commentators express concern that SWFs may be Trojan horses with covert political or strategic motives lurking below the surface.<sup>20</sup> Investment decisions made by SWFs have assumed political significance because many funds belong to authoritarian

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<sup>20</sup> See e.g., Fleischer *supra* note 5 at 443 noting that “the structure of CIC [China Investment Corporation] ensures that the fund is sensitive to the political and strategic influence of China’s ruling party. CIC reports directly to the State Council (the equivalent of the US President’s cabinet) and nearly all of the CIC’s board of directors hold Party-appointed jobs within China’s financial bureaucracy.”

governments, while the recipients of their investment are typically developed, democratic countries.<sup>21</sup> Nine of the ten largest SWFs are from emerging markets, and Asian and Middle Eastern countries account for almost three quarters of SWF assets, with China's combined three funds holding the largest share.<sup>22</sup> According to Henry Kissinger in 2008, for example, the growth of SWFs, alongside the rapid rise in oil prices, represented a vast wealth transfer to weak and/or authoritarian regimes who would inevitably exert influence over Western economies – and their governments.<sup>23</sup> Also, former US Treasury Secretary Lawrence Summers (who oversaw the bailout of American banks and automotive firms in 2008) cautioned against SWFs on the basis of free market principles, arguing “the logic of the capitalist system depends on shareholders causing companies to act to maximize the value of their shares. It is far from obvious that this will over time be the only motivation of governments as shareholders.”<sup>24</sup>

The overall consensus, however, on sovereign investment has been much more sanguine.<sup>25</sup> The editors of a comprehensive study of SWFs concluded that concerns about political influence and market destabilization from SWF investment are unfounded:

It is not immediately clear to what extent these various concerns are systematically valid across the wide range of foreign direct investment projects undertaken by state-controlled entities. In addition, it is not clear how the possibility of a negative impact from opacity and potential government control of state-controlled entities differs systematically and substantially from similar concerns regarding private enterprises, notably privately held multinational

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<sup>21</sup> *Ibid.*

<sup>22</sup> *Supra* note 6 at page 10.

<sup>23</sup> Henry A Kissinger & Martin Feldstein, “The Rising Danger of High Oil Prices,” *New York Times* (15 September 2008).

<sup>24</sup> Lawrence Summers, “Funds That Shake Capitalist Logic,” *Financial Times* (29 July 2007).

<sup>25</sup> See Alhashel Bader, “Sovereign Wealth Funds: A literature review,” (2015) 78 J of Econ & Bus 1 (“the literature exhibits strong support for the idea that the motives of SWFs are economic, rather than political”).



enterprises and hedge/mutual funds. Regardless of the evidence (or lack thereof), it is public perception that drives policy reactions.<sup>26</sup>

The same conclusion was reached in the Canadian context by the Bank of Canada, which concluded that SWFs play an overall positive role in financial markets:

SWFs are long-term investors that can play a stabilizing role in financial markets by supplying liquidity and reducing market volatility. SWFs use low amounts of leverage and adopt investment strategies that minimize their impact on markets. SWFs also contribute to the gradual unwinding of global imbalances as they diversify their portfolios gradually into other asset classes and currencies. The recent injection of capital into a number of distressed banks and financial institutions highlights the constructive role that SWFs can play as stabilizing, long-term investors. While the potential for one or more SWFs to disrupt markets does exist if other investors mimic the same investment strategies, there is little evidence that this has occurred during the recent period. Similarly, the rise of financial protectionism, as host countries adopt rules to protect sensitive industries, might unduly restrict global capital flows, but it is not likely to destabilize the international financial system.<sup>27</sup>

The first wave of inquiry into SWFs following their rise in the lead up to the 2008 global financial crisis addressed the question of whether SWF investment is good for domestic and global markets. The chief concerns of academics and policy makers at that time were SWFs' impact on financial stability, national security, and economic efficiency.<sup>28</sup> In Canada, the issues received significant political and media attention at the time of the takeovers of Progress Energy Resources, a natural gas company, by Petronas, an oil and gas

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<sup>26</sup> Wouter PF Schmit Jongbloed, Lisa E Sachs & Karl P Sauvart, "Sovereign investment: An Introduction" in in Karl P Sauvart, Lisa E Sachs & Wouter PF Schmitt Jongbloed, eds, *Sovereign Investment: Concerns and Policy Reactions* (Oxford: Oxford University Press, 2012) at page 16. See also Steffen Kern, "Commodity and Non-Commodity Sovereign Wealth Funds" (July 18, 2008) OECD Working Paper Series online: <<https://www.oecd.org/dev/pgd/41212577.pdf>>.

<sup>27</sup> Tamara Gomes, "The Impact of Sovereign Wealth Funds on International Financial Stability," (2008) Bank of Canada Discussion Paper No. 2008-14, at page 1, online: <<http://www.bankofcanada.ca/wp-content/uploads/2010/01/dp08-14.pdf>>.

<sup>28</sup> See e.g. Matt Krzepkowski & Jack Mintz, "Canada's Foreign Direct Investment Challenge: Reducing Barriers and Ensuring a Level Playing Field in the Face of Sovereign Wealth Funds and Other State-Owned Enterprises," (Oct, 2010) 3:4 University of Calgary School of Public Policy Research Paper 4 online: <<https://www.policyschool.ca/wp-content/uploads/2016/03/mattkrzepkowski-online2.pdf>>; see also Gomes, *ibid*.

company owned by the Malaysian government, and of Nexen, a Canadian oil and gas company, by CNOOC, an oil and gas producer owned by the Chinese government.<sup>29</sup>

Concern over foreign state investors lead to the adoption of new legislative frameworks for dealing with foreign direct investment by state-controlled entities and investment vehicles (including SWFs) in Canada, Australia, and the United States.<sup>30</sup> France, Germany, Israel, Japan, Republic of Korea, and Mexico also have extensive policy mechanisms in place that can restrict foreign investment (including or especially investment by foreign states) on the grounds of national interest.<sup>31</sup> These legal frameworks were aimed at achieving a balance between openness to investment and the government's concern that "[t]he larger purpose of state-owned enterprises may go well beyond the commercial objectives of privately owned companies."<sup>32</sup> Under the 2013 *Investment Canada Act*,<sup>33</sup> prospective sovereign buyers will have to demonstrate that their ownership of Canadian companies is in Canada's best interests. For example, Industry Canada may scrutinize whether the acquisition of a Canadian business by a foreign government investor would preclude the business from continuing to operate in a commercial manner – for instance,

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<sup>29</sup> Claudia Cattaneo, "Two years in, Nexen deal still a tough swallow for state-owned CNOOC," *Financial Post* (13 December 2014).

<sup>30</sup> Amendments were made in 2013 to the *Investment Canada Act*, RSC 1985, c 28. See Bill C-60, *Economic Action Plan 2013 Act, No. 1*, 1<sup>st</sup> Sess, 41<sup>st</sup> Parl, 2013 (SC 2013, c 33). These amendments included an expanded definition of "state-owned enterprise" (SOE) and special rules addressing control of a Canadian companies by SOEs. The United States enacted reforms in 2007 to the Committee on Foreign Investment in the United States (CFIUS). See *Foreign Investment and National Security Act of 2007*, Pub L No 110-49, 121 Stat 246. In 2015, Australia enacted the *Foreign Acquisitions and Takeovers Legislation Amendment Act 2015* (Cth).

<sup>31</sup> Kathryn Gordon & David Gaukrodger, "Foreign Government-Controlled Investors and Host Country Investment Policies: OECD Perspectives," in Karl P Sauvart, Lisa E Sachs & Wouter PF Schmitt Jongbloed, eds, *Sovereign Investment: Concerns and Policy Reactions* (Oxford: Oxford University Press, 2012) 496 at 503.

<sup>32</sup> Stephen Harper, "Statement by the Prime Minister of Canada on Foreign Investment" (7 December 2012) online:<<https://www.canada.ca/en/news/archive/2012/12/statement-prime-minister-canada-foreign-investment.html>>.

<sup>33</sup> *Supra* note 30.

whether a foreign government might influence the choice of where to export products or where to locate operations.

Meanwhile, policy makers at the international level addressed concerns regarding the openness, transparency, and commercial motivation of state-owned enterprises and other government investment vehicles.<sup>34</sup> These efforts culminated in 2008 with the International Monetary Fund's (IMF) efforts to pre-empt national attempts at regulation by uniting the largest SWFs behind a set of principles and best practices, commonly known as the Santiago Principles.<sup>35</sup> Concomitantly, a consortium of SWFs established the International Forum of Sovereign Wealth Funds, which describes itself as “a voluntary organization of global sovereign wealth funds committed to working together and strengthening the community through dialogue, research, and self-assessment.”<sup>36</sup>

The Santiago Principles consist of a set of 24 principles and practices voluntarily accepted and endorsed by the signatories, a group of 30 SWFs representing approximately 70 percent of the assets under SWF management.<sup>37</sup> These principles are “designed to

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<sup>34</sup> The Organization for Economic Cooperation and Development (OECD) first published guidelines for state-owned enterprises in 2005: OECD, *OECD Guidelines on Corporate Governance of State-Owned Enterprises* (Paris: OECD, 2005). These guidelines were revised in 2015: OECD, *OECD Guidelines on Corporate Governance of State-Owned Enterprises, 2015 Edition* (Paris: OECD, 19 November 2015) online: <<http://www.oecd-ilibrary.org/docserver/download/2615061e.pdf?expires=1511308903&id=id&accname=guest&checksum=F0896B45C0C4418BE01F9531EA1EAF2E>>.

<sup>35</sup> International Working Group on Sovereign Wealth Funds, “Sovereign Wealth Funds Generally Accepted Principles and Practices – Santiago Principles” (IWG-SWF, 2008), online: <[http://www.ifswf.org/sites/default/files/santiagoprinciples\\_0\\_0.pdf](http://www.ifswf.org/sites/default/files/santiagoprinciples_0_0.pdf)> [Santiago Principles].

<sup>36</sup> International Forum of Sovereign Wealth Funds (IFSWF), “About Us,” online: <<http://www.ifswf.org/about-us>>.

<sup>37</sup> International Forum of Sovereign Wealth Funds (IFSWF), “Our Members” online: <<http://www.ifswf.org>>.

promote good governance, accountability, transparency, and prudent investment practices whilst encouraging a more open dialogue and deeper understanding of SWF activities.”<sup>38</sup>

#### 1.4 Sovereign Wealth Funds and Unanswered Tax Policy Questions

Many observers stress that the Santiago Principles are only the beginning of efforts to formalize and clarify the role of SWF investors in international markets. While the rise of SWFs is not a cause for alarm, sovereign investment raises a variety of concerns – ranging from national security and market stability to regulatory enforcement and, the topic of this thesis, taxation. The Santiago Principles state that SWF activities must be in compliance with all applicable regulatory and disclosure requirements of the host countries in which they operate – “including applicable tax rules.”<sup>39</sup>

What are the “applicable tax rules”? Canada has yet to elucidate whether and how its domestic tax laws apply to state investors like SWFs, leading to considerable uncertainty.<sup>40</sup> SWFs may enjoy preferential tax treatment in Canada and elsewhere under the doctrine of state immunity – a rule of international law that vastly predates the rise of SWFs – but the extent of this preferential treatment is uncertain. It remains Canada’s prerogative to determine the nature and scope of tax privileges enjoyed by SWFs. To date, the issue has not

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<sup>38</sup> *Ibid.*

<sup>39</sup> Santiago Principles, *supra* note 35, GAPP 15. This principle states: “SWF operations and activities in host countries should be conducted in compliance with all applicable regulatory and disclosure requirements of the countries in which they operate. [...] The SWF should (i) abide by any national securities laws, including disclosure requirements and market integrity rules addressing insider trading and market manipulation; (ii) provide disclosure to local regulators, upon request and in confidence, of financial and non-financial information as required by applicable laws and regulation; (iii) where required by applicable law or regulation, be subject to local regulators, and cooperate with investigations and comply with regulatory actions initiated by local regulators or other relevant authorities; (iv) abide by any anti-monopoly rules; and (v) comply with all applicable tax rules.”

<sup>40</sup> See e.g., Michael N Kandev, “Sovereign Wealth Funds: Are They Welcome in Canada?” (2010) 64:12 Bulletin for International Taxation 649.

been dealt with in any detail, leading to a vacuum in Canadian tax law that creates undue confusion.

Naturally, SWFs wish to preserve their special status as taxpayers; the Santiago Principles pointedly suggest “recipient countries may grant to SWFs certain privileges based on their governmental status, such as sovereign immunity and sovereign tax treatment.”<sup>41</sup> Evidence suggests that SWF investment is more sensitive to source-country level taxation than other international investment.<sup>42</sup> Whereas a private investor is typically able to offset underlying foreign tax on their income with a foreign tax credit or other mechanism, SWFs are typically tax exempt in their home jurisdictions. As such, SWF investment decisions tend to be highly responsive to the tax burden in the host country.

### **1.5 Methodology and Evaluative Criteria**

All of the foregoing suggest that the time is ripe for a detailed examination of the tax law and policy considerations stemming from foreign SWF investment in Canada. This thesis attempts to address the deficit in the literature by analyzing the existing Canadian law with regard to the taxation of SWFs. My methodology is doctrinal: I identify the laws applicable to the taxation of SWFs in Canada – in statutes, case law, treaty, and customary international law – and attempt to organize and analyze the relevant legal rules, principles, and doctrines. The analysis is supported with research in scholarly journals, commentaries, textbooks, and conference papers. The issues are further contextualized by reference to news articles. In addition, I submitted an access to information request soliciting information

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<sup>41</sup> Santiago Principles, *supra* note 35.

<sup>42</sup> Craig Maurice, “Private Equity Investments in the Oil & Gas Sector” (2013) 26:3 Canadian Petroleum Tax Journal at 4.

about the Canada Revenue Agency's (CRA) administrative practice with respect to the taxation of foreign governments.<sup>43</sup>

The topic of this thesis is primarily *how* SWFs are taxed under Canadian law, and I appraise the existing law in light of core legal evaluative criteria – namely, certainty, transparency, and ease of compliance.<sup>44</sup> Given that my evaluation identifies shortcomings in the law in light of these criteria, I briefly compare the Canadian approach to that of three other jurisdictions: the United States, Australia, and Germany. Like Canada, these three jurisdictions represent developed economies that are likely net importers of SWF capital. The countries were selected because their legal regimes cover the broad range of approaches available in devising a system for taxing foreign states. These approaches are evaluated chiefly in terms of their ability to provide a certain and transparent system for the taxation of SWFs. Of course, should Parliament wish to tackle the question, they will want to consider other factors, such as economic efficiency and competitiveness. However, those issues are beyond the scope of this thesis.

The following chapters provide an overview of SWFs, a discussion of the law of state immunity as it applies in Canada, an analysis of the existing tax rules as they relate to SWF investment, and a comparison of Canada's silence on the tax treatment of SWFs relative to other jurisdictions. Based on my analysis of the Canadian legal regime in comparison with recent efforts at codification of tax rules for SWFs in other jurisdictions, I

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<sup>43</sup> See Access to Information file number A-073859 (CRA), available by request from the Government of Canada, online: <<http://open.canada.ca/en/content/about-access-information-requests>>

<sup>44</sup> Certainty, transparency, and ease of compliance are well-accepted desiderata of a law. These qualities are included among Lon L Fuller's eight minimal conditions for a legal rule, alongside generality, consistency, non-retroactivity, constancy, and fairness in administration. See Lon L Fuller, *The Morality of Law* (New Haven: Yale University Press, 1969).

conclude with the recommendation that specific legislation be adopted in Canada to clarify our tax treatment of SWF investors and provide greater certainty to both taxpayers and the revenue authorities.

## **Chapter 2: Sovereign Wealth Funds: An Overview**

### **2.1 Introduction**

What are SWFs? In brief, they are large pools of capital owned by local governments and invested in private markets outside their homelands. SWFs typically invest a portion of foreign exchange reserves outside their home country in search of higher returns than those sought on official currency reserves. This brief definition, however, fails to capture the complexity and diversity of SWFs, which are far from homogeneous. As Andrew Rozanov, who coined the term “sovereign wealth fund,” observed: “There is no such thing as a ‘typical’ sovereign wealth fund, as they differ in structure, governance, policy objectives, risk-return profiles, investment horizons, eligible asset classes, and instruments, not to mention levels of transparency and accessibility.”<sup>45</sup>

This chapter, therefore, provides context to the thesis by means of an overview of SWFs. It begins with a history of the world’s first SWF, the Kuwait Investment Authority (KIA). In many ways a paradigmatic SWF, the history of the KIA highlights some of the political, economic, and historical factors that have shaped SWFs from their early days as stabilization funds located in Gulf countries to the diverse array of sophisticated investors commanding a vast array of global assets that exists today. Next, the chapter examines the macroeconomic role of SWFs and distinguishes them from other types of sovereign investment or financial activity. The objectives, sources of funding, and activities of SWFs are discussed. Finally, the chapter presents competing definitions of SWFs.

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<sup>45</sup> Andrew Rozanov, “Definitional Challenges of Dealing with Sovereign Wealth Funds” (2011) 1:2 Asian Journal of International Law 249 at 251.



## 2.2 The First Modern Sovereign Wealth Fund: The Kuwait Investment

### Authority

The modern SWF has its roots in the problems facing countries whose economies depend heavily on commodity exports, which are known for their boom and bust cycles. The Kuwait Investment Authority (KIA) is the world's first SWF, created in 1953, eight years before Kuwait gained its independence from Britain.<sup>46</sup> Today it is one of the largest SWFs in the world, with an estimated \$300B to \$592B USD in assets under management – although the actual size of the fund is not publicly disclosed.<sup>47</sup>

As is typical of most SWFs, the KIA began as a commodity-based stabilization fund. Kuwait, awash with oil, created the fund to manage its excess money by allocating a share of oil revenues to the fund each year.<sup>48</sup> As one of the original SWFs, the KIA's mandate was simple: it would help the government cope with volatile oil and gas prices by holding on to extra money. In the beginning, the KIA was essentially a rainy-day fund known at the time as the Kuwait Investment Board.<sup>49</sup> The fund accumulated money “to be used by the people of Kuwait,” without any broader mandate.<sup>50</sup> Management of the current account surplus was initially outsourced to the Bank of England, while Kuwait slowly began to undertake its own investment activities via a number of government-linked entities.

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<sup>46</sup> Balding, *supra* note 8 at page 4. For an overview and analysis of the development of the Kuwait Investment Authority, see Balding at pages 141 to 149.

<sup>47</sup> TheCityUK, *supra* note 6 at page 8.

<sup>48</sup> Elizabeth Pfeuti, “Where in the World is the Kuwait Investment Authority?” (June 27, 2014) Chief Investment Officer online: <<https://www.ai-cio.com/news/where-in-the-world-is-the-kuwait-investment-authority/>>.

<sup>49</sup> Khalid A Alsweilem, *et al*, “A Comparative Study of Sovereign Investor Models: Sovereign Fund Profiles” (Cambridge, Mass: Harvard Kennedy School, 2015) online: <[https://projects.iq.harvard.edu/files/sovereignwealth/files/fund\\_profiles\\_final.pdf](https://projects.iq.harvard.edu/files/sovereignwealth/files/fund_profiles_final.pdf)> at page 65.

<sup>50</sup> Balding *supra* note 8 at page 9.

By 1965, following Kuwait's independence, the fund was sizable enough that the decision was made to establish an office, the Kuwait Investment Office, in the United Kingdom, and to hire professional investment advisors. The fund did not become a separate entity, however, until the passage of Law No. 47 in 1982, which created the KIA as an autonomous governmental body.<sup>51</sup> The KIA's articles establish the fund as an independent public authority with juridical status whose purpose is to manage the country's financial assets.<sup>52</sup> Its board of directors consists of the ministers of finance and oil, the governor of the Central Bank of Kuwait, plus five Kuwaiti nationals drawn from the private sector.<sup>53</sup> Its objects are:

To achieve a long term investment return on the financial reserves entrusted by the State of Kuwait to the Kuwait Investment Authority, providing an alternative to oil reserves which would enable Kuwait's future generations to face the uncertainties ahead with greater confidence.<sup>54</sup>

In addition, the fund has three primary institutional objectives: (1) to achieve a rate of return that exceeds its composite benchmarks, on a three-year rolling average, through a suitable asset allocation overseen by professional investment managers with specialization in each asset class and by making tactical changes to investments and allocation in response to a changing economic climate; (2) to be a world-class investment management organization among large investment bodies, endowments, and pension funds worldwide; and (3) to foster the excellence of the private sector in Kuwait by forming its human capital, doing

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<sup>51</sup> Kuwait Investment Authority, "Overview" online: <<http://www.kia.gov.kw/en/ABOUTKIA/Pages/Overview.aspx>> (under About KIA).

<sup>52</sup> Kuwait Investment Authority, "KIA law 47/1982" online: <http://www.kia.gov.kw/en/Pages/KIALaw.aspx> (under Governance Structure).

<sup>53</sup> Alsweilem, *supra* note 49 at page 65.

<sup>54</sup> Kuwait Investment Authority, "KIA's Implementation of the Santiago Principles (Generally Accepted Principles and Practices) IFSWF Case Study" (nd), online: <<http://www.kia.gov.kw/en/Documents/IFSWF/Wspp.pdf>>.

business with the best performing companies, and reinforcing sound corporate governance, transparency, and fair business dealings in Kuwait.<sup>55</sup>

In 1976, the KIA divided its assets into two funds. The first, the General Reserve Fund (GRF), is the government treasury, and it receives all revenues, including oil revenues, and pays the government's budgetary expenditures. The other, the Future Generation Fund (FGF), was created from one half of the GRF at the time of formation. Law No. 106 of 1976 stipulates that 10 percent of all state revenues (including oil revenues) shall be transferred to the FGF each year and that all the fund's investment income is to be reinvested; in 2012, the percentage was increased to 25.<sup>56</sup>

The managers of the GRF invest domestically to promote economic and financial development in Kuwait. In contrast, the FGF is an international investor whose money is invested "outside of Kuwait based on an approved Strategic Asset Allocation in various asset classes."<sup>57</sup> Withdrawals from the FGF are prohibited unless specifically sanctioned by law. As part of its efforts toward greater transparency, the KIA joined the International Forum of Sovereign Wealth Funds (IFSFW) in 2008 and began to publish information about its structure, objectives, and investment frameworks each year.<sup>58</sup>

As the KIA matured, it began to attract international attention, for example, following its acquisition of nearly 15 percent of Daimler-Benz in 1974.<sup>59</sup> As it grew in size

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<sup>55</sup> Alsweilem *supra* note 49 at page 65.

<sup>56</sup> *Ibid* at page 66.

<sup>57</sup> *Supra* note 52 The Strategic Asset Allocation includes investments in real estate, private and public equity, fixed income, and alternative investments, including hedge funds, funds of funds, and other investments, which are benchmarked against a variety of indexes in order to assess overall performance. See Bloomberg, "Capital Markets: Company Overview of Kuwait Investment Authority," (Bloomberg, October 2017), online: <https://www.bloomberg.com/research/stocks/private/snapshot.asp?privcapId=21922514>.

<sup>58</sup> *Supra* note 542.

<sup>59</sup> Mercedes-Benz Classic Archives, "Kuwait buys shares in Daimler-Benz," 28 November 1974 online: Mercedes-Benz Illustrated Chronicle <<https://mercedes-benz->

and profile throughout the 1970s, it became an object of concern and suspicion. By the mid-Seventies, rising oil prices and a series of increasingly high-profile investments by the KIA “put its intentions and its wealth in a political framework.”<sup>60</sup> Target countries worried about sudden outflows of capital as a consequence of the size and liquidity of the KIA’s assets. As the price of Gulf oil more than quadrupled throughout the 1970s, concern about rising Arab wealth and foreign investment mounted.<sup>61</sup> Thus, protectionism gained ground in America and Europe and along with it, the fear that that “petrodollars” could be laundered into American and European assets, leading some to advocate for the nationalization of large companies as a preventative measure.<sup>62</sup>

However, protectionism was not the only concern, as larger geopolitical conflicts were sometimes reflected in the KIA’s activities and policies. For example, news of the Arab League’s blacklist of Jewish investment firms created political turmoil and market upheaval in the United States.<sup>63</sup> This culminated with the passage of the Ribicoff Amendment to the Tax Reform Act of 1976, which imposes sanctions on US taxpayers who participate in unauthorized boycotts.<sup>64</sup> Apart from geopolitical aims, the KIA’s investment mandate is sometimes guided by religious scruples, which preclude the fund from investing in sectors where gaming or alcohol-related activities constitute the main source of business.<sup>65</sup>

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publicarchive.com/marsClassic/en/instance/ko/Kuwait-buys-shares-in-Daimler-Benz.xhtml?oid=4910689>.

<sup>60</sup> Balding, *supra* note 8 at page 142.

<sup>61</sup> *Ibid* at page 144.

<sup>62</sup> *Ibid* at page 143.

<sup>63</sup> *Ibid* 143.

<sup>64</sup> US taxpayers who participate in unauthorized boycotts may be denied the foreign tax credit and other benefits provided under US domestic tax law. See Melissa Redmiles, “International Boycott Reports, 2003 and 2004,” Internal Revenue Service page 168 available online: <<http://www.irs.gov/pub/irs-soi/03-04boycott.pdf>>.

<sup>65</sup> *Supra* note 49; In one instance, the KIA was forced to sell its investment in the scotch producer Arthur Bell and to divest itself from its partnership with the Irish brewer

By the late Seventies, Kuwait grew more comfortable with the publicity surrounding the KIA's investments. Still, the fund preferred to make investments that fell below the 5% threshold for public disclosure in most foreign jurisdictions.<sup>66</sup> By 1985, the KIA was large enough to entice a prominent Citibank executive to manage the fund by presenting him the opportunity to work for an institution "even bigger" than the banking and financial services giant.<sup>67</sup> Indeed, with assets near \$100B USD, the fund had by then grown to the largest in the world.

As its assets grew, the KIA began to take on riskier, higher profile investments. It was one of the first major foreign investors in China and, at one point, owned a majority stake in Union Explosivos Rio Tinto, a military hardware firm.<sup>68</sup> Once again, the KIA began to be viewed with suspicion regarding its size and its motives. In 1989, the Kuwait Investment Office, the UK division of the KIA, purchased a sizable stake in the newly privatized British Petroleum, at one time holding 22 percent of outstanding shares. Although the transactions were open market purchases, political backlash led the British Monopolies and Mergers Commission to investigate whether the Kuwaiti stake was in the public interest. Ultimately, the fund was ordered to divest itself to less than 10 percent holdings out of concern that as a sovereign state, Kuwait could be expected to exercise its influence in its own national interest.<sup>69</sup>

To date, only one withdrawal has been made from the FGF throughout its long history of growth and accumulation. This was done to finance the rebuilding of Kuwait

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Guinness when its domestic government decided the investments were incompatible with moral values, irrespective of financial gain, see Balding, *supra* note 8 at page 79.

<sup>66</sup> Balding, *supra* note 8 at page 145.

<sup>67</sup> *Ibid* at page 56.

<sup>68</sup> *Ibid* at page 145-146.

<sup>69</sup> *Ibid* at pages 83-84.

following the Iraqi invasion – and destruction of Kuwait’s oil fields – in 1990.<sup>70</sup> Following the Persian Gulf War, the KIA was in a position to fund the rebuilding of Kuwait with an \$85 billion (USD) loan made to the Kuwaiti government. (The loan was subsequently repaid, as the Kuwaitis are quick to point out.) Coming to the aid of the country was part of the fund’s larger purpose. As one financier put it, “it’s our rainy-day fund. We have needed it in the past, and it is likely we will need it again.”<sup>71</sup>

The KIA continues to make headlines for its large-scale deals, globally and in Canada. For example, in 2013, it partnered with Borealis Infrastructure, a division of Ontario’s OMERS pension fund, in an attempted takeover of the British utilities company, Severn Trent.<sup>72</sup> Likewise, KIA partnered with Quebec’s public pension plan, Caisse de depot et placement de Quebec, to buy up troubled energy infrastructure in India.<sup>73</sup>

From this overview of the KIA, I would like to highlight several important points. The first is the development of SWFs in the context of oil and gas economies, predominately in the Middle East. This is typical of the earliest SWFs, and many of the largest SWFs today are based in oil and gas exporting countries.<sup>74</sup> SWFs typically, although not exclusively, begin as stabilization funds intended to smooth out the boom-and-bust cycles of commodity markets. Over time, however, the funds have evolved into modern SWFs. Their mandates no longer focus on revenue stabilization; instead, they seek growth in annual, risk-adjusted returns that outperform various indexes across a variety of asset classes.

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<sup>70</sup> Pfeuti, *supra* note 48.

<sup>71</sup> *Ibid.*

<sup>72</sup> “Severn Trent shares surge after takeover approach” (14 May 2013) online: BBC Business <<http://www.bbc.com/news/business-22521235>>.

<sup>73</sup> Sarah Ahmed, “KIA to invest in distressed Indian power assets” Kuwait Times (14 February 2016) online: <<http://news.kuwaittimes.net/website/17235-2/>>.

<sup>74</sup> Five of the ten largest SWFs (measured in terms of assets under management) are owned by oil-rich countries: Norway, Kuwait, Saudi Arabia, Qatar, and the UAE (Dubai and Abu Dhabi). See Sovereign Wealth Fund Institute, “Sovereign Wealth Fund Rankings,” online: <<http://www.swfinstitute.org/sovereign-wealth-fund-rankings/>>.

The second is that, at some point in a fund's evolution, its institutional structure, mandate, and governance are usually formalized. In the case of the KIA, the fund's foremost purpose is to profit by investing internationally. However, it continues to exist to cushion the country from the ill effects of economic dependence on oil and gas and to raise up the country as a whole by developing its human capital and encouraging economic growth.

Finally, even where SWFs are welcome to invest, it is still common for foreign states to refuse to allow SWF investment in strategic sectors. Such limitations are in effect in many jurisdictions – notably, Canada,<sup>75</sup> the United States,<sup>76</sup> and Germany<sup>77</sup> – to prevent foreign government takeovers (including SWF takeovers) of firms in key industries like natural resources or national defence. As such, SWFs are limited in terms of the equity investments they are able to make.

Although there are legitimate policy concerns at play, the oscillation between suspicion and inattention that the KIA's investments have been subject to globally is typical for SWF investors. SWFs have historically behaved as private investors do; nevertheless, they are always and irreducibly agents of government. As a consequence, SWFs true motives are often a concern for the countries in which they invest, who worry about the potential for non-commercially motivated investment. Despite the long histories of many SWFs, they are often greeted with mistrust and, occasionally, outright hostility.<sup>78</sup> This reflects the complex geopolitical reality that SWFs inevitably occupy as state-controlled investors. The reputation of SWFs, therefore, follows a pattern of advance and retreat, as public perception cycles

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<sup>75</sup> Major amendments were made to the *Investment Canada Act*, *supra* note 30. These amendments enable the government to bar “significant” foreign government investment in Canada where such investment is considered not to be in the public interest.

<sup>76</sup> United States, *Foreign Investment and National Security Act of 2007*, *supra* note 30.

<sup>77</sup> Germany, Foreign Trade and Payments Act of June 6 2013 (*Außenwirtschaftsgesetz*) (German Federal Law Gazette [BCBI] Part 1, p 1482).

<sup>78</sup> Kern *supra* note 26.

from inattention and neglect, to fascination and fear, and legitimate concerns mix together with irrational fears and prejudice.

### **2.3 Situating Sovereign Wealth Funds Within Public Finance**

SWFs are but one manifestation of government involvement in international finance. Despite the trend toward market liberalization and privatization in the three decades since the dissolution of the Soviet Union, the role of the state in international markets has arguably become more important.<sup>79</sup> Rather than simply holding foreign currency reserves, states now actively seek to diversify their assets internationally across different asset classes and sectors – and SWFs are but one means for doing so.

Thus, SWFs are only one facet of the larger trend toward government participation in financial markets. Governments own and control a variety of funds, such as central bank reserves and pension funds, which are not considered SWFs. Furthermore, governments can invest abroad using a variety of sovereign investment vehicles, such as state-owned enterprises, which are likewise not considered SWFs. It is therefore helpful to begin by distinguishing SWFs from other types of government funds and/or investment vehicles.

In a widely cited article, Robert M Kimmitt helpfully provides a taxonomy of sovereign investment involving four categories: international reserves, public pension funds, state-owned enterprises, and SWFs. First, international reserves are “external assets that are controlled by and readily available to finance ministries and central banks.”<sup>80</sup> They are used to cushion export shortfalls and to support currency; such reserves always consist in currencies, treasury bills, and other highly liquid securities. Central banks hold these assets to

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<sup>79</sup> Jongbloed, *supra* note 26 at page 3.

<sup>80</sup> Kimmitt, *supra* note 7 at page 120.



support the domestic currency and are generally not seeking to maximize their return on investment.

Next, public pension funds (such as the Canada Pension Plan Investment Board) are “investment vehicles funded with assets set aside to meet the government’s future entitlement obligations to its citizens.”<sup>81</sup> The investment strategies of pension funds often closely resemble those of SWFs.<sup>82</sup> They often invest abroad, and in some cases they even use national SWFs to manage their assets.<sup>83</sup> Indeed, certain SWFs – such as, for example, the Norwegian Pension Plan Global – refer to themselves as both a pension fund and as a SWF. However, pension plans differ from SWFs in both the source of their funds, which typically include employer and employee plan contributions, and, importantly, in terms of their fixed obligation to provide entitlements to pensioners at a future date.

Still, the distinction between SWFs and public pension funds is frequently lost.<sup>84</sup> Many sources treat the two as if they were identical, often including public pension plans on the lists of SWFs.<sup>85</sup> Nevertheless, SWFs and pension funds are different in important ways. Rozanov describes the distinction between SWFs and public pension funds as follows:

If the main source of the fund is individual and employer contributions on behalf of current and future retirees, and if the underlying beneficiaries are effectively the legal owners of the fund, then the entity cannot be considered an SWF. The fact that a sovereign institution happens to be the agent entrusted with managing the fund does not make it meaningfully different from similar

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<sup>81</sup> *Ibid.*

<sup>82</sup> Paul Rose, *supra* note 14 at page 916.

<sup>83</sup> Kimmitt, *supra* note 7 at page 120.

<sup>84</sup> See e.g., Ashby HB Monk, “Is CalPERS a Sovereign Wealth Fund?” Center for Retirement Research at Boston College Issue in Brief (December 2008) No 8-21 online: <[http://crr.bc.edu/wp-content/uploads/2008/12/IB\\_8-21-508.pdf](http://crr.bc.edu/wp-content/uploads/2008/12/IB_8-21-508.pdf)>.

<sup>85</sup> This includes many official and reputable sources. See, e.g., UN Conf on Trade and Dev, “World Investment Report 2011: Non-Equity Modes of International Production and Development” 14-15, UN Doc UNCTAD/WIR/2011 (2011) online: <[http://unctad.org/en/PublicationsLibrary/wir2011\\_en.pdf](http://unctad.org/en/PublicationsLibrary/wir2011_en.pdf)>, which considers both the Canada Pension Plan Investment Board and the Ontario Teachers’ Pension Plan to be SWFs.

sub-sovereign public or private pension plans. If, on the other hand, the source of the money is not pension contributions, but taxes, privatization proceeds, and other payments out of the general budget, and if the fund is effectively owned not by the underlying beneficiaries, but by the taxpayers, then it can legitimately be considered a SWF – which just happens to be managed to meet a particular future pension liability on behalf of the sovereign state.<sup>86</sup>

The third category, state-owned enterprises (SOEs), are companies controlled by the state through full ownership, such as the China National Offshore Oil Corporation (CNOOC), or through majority or significant minority ownership, as with Norway's Statoil. In principle, if not always in practice, SOEs are self-funding, using the revenues from their own activities. SOEs are common in utilities and infrastructure industries, such as energy, transport, and telecommunication.<sup>87</sup> They typically engage in business directly, rather than merely as financiers, and often have business-related goals beyond simply earning a return on investment.

## **2.4 Varieties of Sovereign Wealth Fund**

As the fourth category of sovereign investment, SWFs, is the topic of this thesis, it is worth examining in somewhat greater detail. Kimmitt defines SWFs as “government investment vehicles funded by foreign exchange assets and managed separately from official reserves.”<sup>88</sup> However, as there is no one-size-fits-all definition for SWFs, it is helpful to understand them by reference to three questions: (1) what are the fund's objectives?; (2) where does the fund get its money?; and (3) what does it do?

### 2.4.1 Objectives

SWFs are established for a variety of reasons, such as the desire to “enhance the diversification of national wealth, stabilize revenues, carry wealth over to future generations,

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<sup>86</sup> Rozanov *supra* note 45 at page 253.

<sup>87</sup> Gordon & Gaukrodger, *supra* note 31 at 497.

<sup>88</sup> Kimmitt, *supra* note 7 at page 120.

further socio-economic objectives, and achieve higher rates of return than are realized on foreign exchange.”<sup>89</sup>

According to one scholar, SWFs cannot be properly understood without reference to the economics of commodities, which exhibit extreme levels of volatility (see Figure 4).<sup>90</sup> Most SWFs began as stabilization funds, technically known as “anticyclical fiscal expenditure” programs.<sup>91</sup> For economies dependent on commodity production, a stabilization fund can help to cope with the mismatch of vastly unpredictable commodity revenues, on the one hand, and mostly stable government expenditures on the other. For many SWFs, such as the Russian Reserve Fund, stabilization continues to be the predominant function; these funds typically have less risk tolerance than others and have strict fiscal rules stipulating contributions to and withdrawals from the fund.<sup>92</sup>

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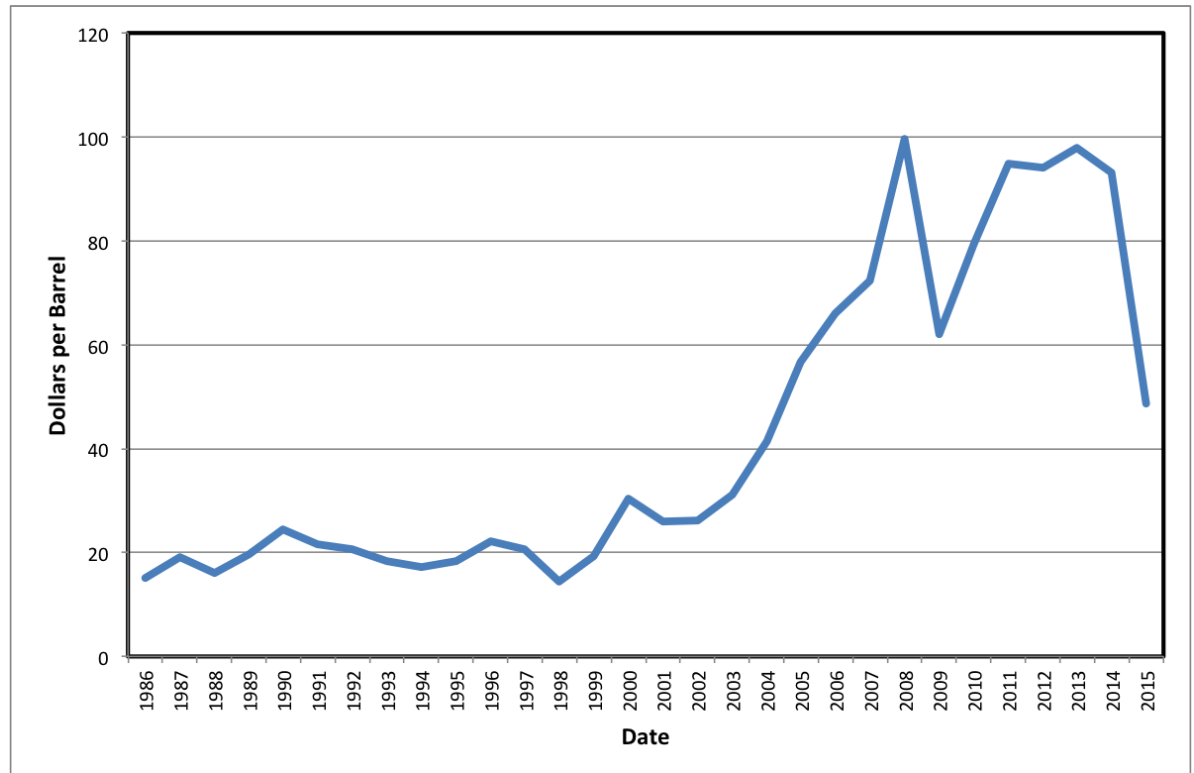
<sup>89</sup> Jongbloed *supra* note 26 at 5.

<sup>90</sup> Balding, *supra* note 8 at 10.

<sup>91</sup> *Ibid.*

<sup>92</sup> *Ibid* at 16.

Figure 4: Price Volatility (Dollars per Barrel) of West Texas International Crude



Source: Data from the US Energy Information Administration, online:  
<http://www.eia.gov>

For other funds, the diversification of wealth is of paramount importance. The Norwegian SWF, Norwegian Pension Fund Global – the world’s largest SWF and the only major SWF controlled by a liberal democracy – was established for this purpose. As Norway has drawn down its oil and gas reserves, the fund has grown such that its annual revenue now exceeds oil and gas revenue.<sup>93</sup> In this way, Norway hopes to transfer its natural resource wealth into diversified financial assets.

Another motivation – which is intimately related to the predominance of SWFs in resource-rich countries – is to transfer wealth to future generations. An influential school of

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<sup>93</sup> “Norway’s Global Fund: How Not to Spend It” *The Economist* (24 September 2016).

thought follows Hartwick's rule for intergenerational equity.<sup>94</sup> Hartwick formulated the rule and its rationale as follows:

Invest all profits or rents from exhaustible resources in reproducible capital such as machines. This injunction seems to solve the ethical problem of the current generation short changing future generations by "overconsuming" the current product, partly ascribable to current use of exhaustible resources.<sup>95</sup>

By following the Hartwick rule, countries can offset wealth depletion from the extraction of non-renewable resources by reinvesting the proceeds of resource development in other forms of capital. Establishing a SWF can be one mechanism by which to accomplish this.

For mature SWFs, however, the key objective is often simply to earn a high rate of return on investment. This is perhaps an inevitable consequence of the mammoth growth of the largest SWFs, whose size now dwarfs their original stabilization mandate. As funds grow, their risk tolerance increases and, typically, direct government oversight decreases as management of the fund shifts to professional investment managers. As Balding observes:

Early in their existence, the predecessors of the SWFs managed hundreds of millions, or billions, of dollars. With more than twenty years of capital accumulation and compounded interest, SWFs now manage hundreds of billions of dollars with sophisticated operations to oversee the global risk managed by these increasingly independent firms. Intended to smooth government spending and public consumption, stabilization funds accumulated increasingly large amounts of capital and complex operations. As the assets under management grew, the sovereign funds gained a constituency and pushed for increased independence to manage their personnel, operations, and finances. [...] SWFs, due simply to their size, moved beyond the need to manage their finances for the purpose of stabilizing government finances and now existed for their own purpose of maximizing returns.<sup>96</sup>

#### 2.4.2 Source of Funds

There are, broadly speaking, two types of SWF depending on the source of the fund's assets: commodity funds and non-commodity funds. Commodity-based SWFs are

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<sup>94</sup> John M Hartwick, "Intergenerational Equity and the Investment of Rents from Exhaustible Resources" (1977) 67:5 American Economic Review 972.

<sup>95</sup> *Ibid* at 972.

<sup>96</sup> Balding, *supra* note 8 at 17.

funded from excess commodity export revenue (usually from oil and gas exports). These funds are established for counter-cyclic, macroeconomic purposes. They help to stabilize public finance revenues within commodity-based economies, which are typically volatile. When royalty or taxation revenues diminish, the funds can be drawn upon to finance public spending; meanwhile, they work to curb inflation when the balance of payments deteriorates. Finally, they are a mechanism to transfer the wealth of non-renewable resources to future generations.

Commodity-based funds, in contrast with other types of funds, typically represent net savings on the part of their respective governments. On the other hand, non-commodity based funds are usually funded by issuing local currency-denominated debt. This is typical of SWFs created from excess foreign exchange reserves held in central banks.<sup>97</sup> China's State Foreign Exchange Investment Corporation is an example of this latter type of fund. In some cases, a non-commodity fund may be established out of another type of asset such as the proceeds from the privatization of a public utility. For example, the Saudi Arabian wealth fund, known as SAMA Foreign Holdings, invests the proceeds from the privatization of Saudi Arabia's airports.<sup>98</sup>

#### 2.4.3 What they do

Given their differing objectives and sources of funding, it is unsurprising that SWFs have different investment strategies. Many SWFs have high foreign currency exposure and

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<sup>97</sup> Rozanov *supra* note 45 at 253.

<sup>98</sup> Mahmoud Kassem, "Saudi Arabia to transfer ownership of airports to sovereign wealth fund ahead of privatization", *The National* (August 22, 2017) online: <<https://www.thenational.ae/business/saudi-arabia-to-transfer-ownership-of-airports-to-sovereign-wealth-fund-ahead-of-privatization-1.621942>>.

risk tolerance, while others are invested primarily domestically and managed conservatively. Rozanov identifies four types of SWFs based on their aims and investment strategies.<sup>99</sup>

The first are contingent liability funds (also known as stabilization funds). Contingent liability funds are used to “smooth budget revenues and expenditures, help sterilize excess liquidity, and protect the economy from overheating, ‘Dutch disease’, and boom-bust cycles.”<sup>100</sup> Given these goals, such funds have lower risk tolerance and are typically managed similarly to central bank reserves. Their focus is on nominal returns on foreign currency investments in order to stabilize the economy and minimize fluctuations in the exchange rate. Examples of this type of fund are Chile’s Economic and Social Stabilization Fund, the Russia Reserve Fund, and the Mexico Oil Income Stabilization Fund.<sup>101</sup>

Fixed future liability funds are SWFs established to meet a fixed future liability; in nearly all cases, the liability is a shortfall in the public pension system. These funds are similar to pension plans in terms of their investment strategies, but they are funded differently and do not support any beneficiaries in the near to medium term, although their capital will eventually be transferred to a pension plan to support beneficiaries. They have a long but definite investment horizon. As such, these funds typically seek to maximize returns in their early years and to look for safer investments as the end of their investment horizon nears. This category of SWF includes France’s Fonds de Réserve pour les Retraites (FRR), Ireland’s National Pension Reserve Fund (NPRF), Australia’s Future Fund, the National Fund of Kazakhstan, and New Zealand’s Superannuation Fund.<sup>102</sup>

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<sup>99</sup> Rozanov, *supra* note 45 at 254.

<sup>100</sup> *Ibid.*

<sup>101</sup> PWC, “Sovereign Investors 2020: A Growing Force,” (June 2016) at page 6 online: <<https://www.pwc.com/ee/et/publications/pub/sovereign-investors-2020.pdf>>.

<sup>102</sup> Rozanov, *supra* note 45 at 254.

The third type of fund is a mixed liability fund. The KIA is an example of such a fund, as is Norway's Pension Fund Global. These funds are managed like a large endowment. They are considered "mixed" liability funds because they have a structural obligation to make payments into the general budget of their home country, but this obligation is not a fixed one.<sup>103</sup> As these funds have grown in the past 15 years, they have effectively transitioned into Rozanov's fourth category of SWF, open-ended liability funds. While many may continue to have so-called "fiscal rules" which mandate contribution to and spending from the fund, the growing size of the funds has dwarfed their original obligations. As such, they enjoy a high degree of freedom in their investment decisions and are more willing to take on risk.<sup>104</sup> Their investment horizons are effectively limitless.

There is a yet another important category of SWF, which Rozanov overlooked in his original classification. These are economic development funds. As SWFs, these funds invest outside their home countries, but they are typically heavily invested domestically as well. When investing abroad, their chief objective is return on investment, while at home they invest to develop domestic infrastructure and to achieve national industrial policy goals. These funds are typically smaller, and maintain a larger proportion of domestic investments than other types of SWFs. Funds of this type include the Nigeria Infrastructure Fund, Singapore's Temasek Holdings, and France's Baque publique d'investissement (BPI).<sup>105</sup>

## 2.5 Defining Sovereign Wealth Funds

Thus far, this chapter has discussed the origins and development of a paradigmatic SWF, the KIA; contextualized SWFs within the larger sovereign investment landscape; and

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<sup>103</sup> *Ibid.*

<sup>104</sup> *Ibid.*

<sup>105</sup> PWC, *supra* note 101.



described SWFs in terms of their objectives, sources of funds, and investment activities. This final section analyzes different definitions of SWFs.

The existence of SWFs significantly precedes the origin of the term, which was first used to describe this type of investor by Andrew Rozanov in 2005.<sup>106</sup> There is no legal definition, and usage of the term “sovereign wealth fund” varies widely between sources. As Rozanov observes, “the required clarity and commonality of definitions and terms have been elusive. There does not seem to be universal agreement about the precise meanings of even the most fundamental terms in the SWF debate.”<sup>107</sup>

Historically, SWFs were defined in the negative. Rozanov first formulated a definition of SWFs as sovereign-owned and managed asset pools that were neither traditional currency reserves nor public pension funds.<sup>108</sup> In a widely cited article, Robert M Kimmitt defined “sovereign wealth fund” as “a government investment vehicle funded by foreign exchange assets and managed separately from official reserves.”<sup>109</sup> Kimmitt’s definition resembles another early definition, this one from Clay Lowery, then Acting Secretary for International Affairs at the US Treasury. Lowery defined a SWF as “a government investment vehicle which is funded by foreign exchange assets, and which manages those assets separately from official reserves.”<sup>110</sup> Another early definition, from the IMF, described SWFs as “special purpose investment funds created or owned by

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<sup>106</sup> See Andrew Rozanov, “Who Owns the Wealth of Nations?” (2005) 15 Central Banking Journal 4.

<sup>107</sup> Rozanov, *supra* note 45 at 250.

<sup>108</sup> See Rozanov, *supra* note 106.

<sup>109</sup> Kimmitt, *supra* note 7 at 120.

<sup>110</sup> Clay Lowery, “Remarks by Acting Secretary for International Affairs, Clay Lowery on Sovereign Wealth Funds and the International Financial System” presented to the Conference on the Asian Financial Crisis, delivered at the Federal Reserve Bank of San Francisco, 21 June 2007, online: <<https://www.treasury.gov/press-center/press-releases/Pages/hp471.aspx>>.

governments to hold foreign assets for long-term purposes.”<sup>111</sup> These definitions emphasize that SWFs are government owned and invest in foreign assets, but otherwise lack precision.

In 2008, at the encouragement of the IMF, a group of SWFs made an effort at self-definition by positing the following description as part of the Santiago Principles:

SWFs are defined as special purpose investment funds or arrangements, owned by the general government. Created by the general government for macroeconomic purposes, SWFs hold, manage, or administer assets to achieve financial objectives, and employ a set of investment strategies, which include investing in foreign financial assets. The SWFs are commonly established out of balance of payments surpluses, official foreign currency operations, the proceeds of privatizations, fiscal surpluses, and/or receipts resulting from commodity exports.<sup>112</sup>

As well, the Santiago Principles specify three additional features that an SWF must possess.

These three elements are:

Ownership: SWFs are owned by the general government, which includes both central government and sub-national governments.

Investments: The investment strategies include investment in foreign financial assets, so it excludes funds that solely invest in domestic assets.

Purposes and Objectives: Established by the general government for macroeconomic purposes, SWFs are created to invest government funds to achieve financial objectives, and (may) have liabilities that are only broadly defined, thus allowing SWFs to employ a wide range of investment strategies with a medium- to long-term timescale. SWFs are created to serve a different objective than, for example, reserve portfolios held only for traditional balance of payments purposes. While SWFs may include reserve assets, the intention is not to regard all reserve assets at SWFs.<sup>113</sup>

In addition, the Santiago Principles specify that the definition excludes “foreign currency reserve assets held by monetary authorities for the traditional balance of payments

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<sup>111</sup> International Monetary Fund, “Global Financial Stability Report: Financial Market Turbulence: Causes, Consequences and Policies” (Washington DC: International Monetary Fund, 2007) at 45 online: <<http://www.imf.org/external/pubs/ft/gfsr/2007/02/pdf/text.pdf>>.

<sup>112</sup> Santiago Principles *supra* note 35.

<sup>113</sup> *Ibid.*

or monetary policy purposes, operations of state-owned enterprises in the traditional sense, government-employee pension funds, or assets managed for the benefit of individuals.”<sup>114</sup>

There are several significant aspects of the Santiago Principles’ definition. First, under this definition, there is always an international aspect to SWF investment. A special purpose fund owned by government and created to achieve macroeconomic goals that does *not* invest internationally is not considered a SWF.<sup>115</sup> Secondly, SWFs are distinct from other types of government vehicles or entities that hold financial assets, such as reserves or pension funds. Thirdly, national and subnational government entities, such as Alberta’s Heritage Fund, the Permanent Wyoming Mineral Trust Fund, and the Alaska Permanent Fund, are considered SWFs for the purposes of this definition. Considering that many subnational governments, such as Alberta, enjoy full sovereignty over their natural resources, it is sensible that the funds established out of those resources as part of government policy would not be distinguished from other similar funds owned by central governments.

One weakness of the definition is its silence on the question of what SWFs are for, beyond vague reference to “macroeconomic purposes” and “financial objectives.” These terms subtly suggest that SWFs’ purposes and objectives are rooted in management of the domestic economy, rather than directed at foreign influence.

Nevertheless, the Santiago Principles definition is the “consensus definition” that is most widely used. It is the one recognized by SWFs themselves, and it is acknowledged by some commentators as striking a good, if imperfect, balance between precision and

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<sup>114</sup> *Ibid.*

<sup>115</sup> Many domestically-oriented investment funds have been set up in developing countries, such as State Capital Investment Corporation in Vietnam. See State Capital Investment Corporation, “Corporate Profile” online:<<http://www.scic.vn/english/>>. See also Rozanov *supra* note 45 at 257.

inclusivity.<sup>116</sup> The exclusion of funds that do not invest abroad is consistent with the policy concerns of the IMF Working Group on SWFs, which was created to address concerns of market investors and national regulators with respect to the transparency and governance of SWFs investing abroad.

The OECD, in the Draft Commentary to the Model Tax Convention, appears to accept an abbreviated version of Santiago definition:

[S]overeign wealth funds [...] 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 privatizations, fiscal surpluses or receipts resulting from commodity exports.<sup>117</sup>

Given the adoption of the Santiago Principles definition by the IMF and the OECD, it is likely that it will prevail as the generally accepted definition for most policy-making purposes. In any case, there is no pressing need for a fixed definition of SWFs. For present purposes, an understanding of SWFs' origins, activities, and purposes is sufficient to elucidate the phenomenon.

## 2.6 Conclusions

SWF are not a new phenomenon, although policymakers have only recently turned their minds to the question of their regulation. These funds have their roots in the early stabilization funds formed in the Middle East in response to the extreme volatility of oil and gas prices. Since those early days, SWFs have evolved into sophisticated international investors commanding large pools of capital in search of high returns.

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<sup>116</sup> Rozanov, *supra* note 45 at 264.

<sup>117</sup> See paragraph 8.5 of the Commentary to Article 4 of the OECD, *Commentaries on the Articles of the Model Tax Convention*, online: <http://www.oecd.org/berlin/publikationen/43324465.pdf>.

## **Chapter 3: State Immunity in Canada**

### **3.1 Introduction**

The principle *par in parem non habet imperium* (equals have no sovereignty over each other) is the ancient foundation of sovereign immunity (also known as state immunity) in customary international law.<sup>118</sup> State immunity is the concept that, all states being equal members of the international community, no one state can force another to submit to the jurisdiction of its courts. It bars a national court from adjudicating and enforcing certain claims against a foreign state. The precise limits of a foreign state's immunity are unclear, as the law in Canada and internationally has come through a century of rapid change and remains unsettled. The questions surrounding sovereign immunity's limits concern the types of state-linked entities that may benefit from immunity; the types of state activities that attract immunity; and finally, the type of laws and legal proceedings from which a foreign state may be immune.

Given this uncertainty, there are many questions about the application of state immunity to SWFs that invest in Canada. Are SWFs a type of foreign government-controlled entity that enjoys immunity? Which, if any, or all, of their investment activities attract immunity? Finally, does the doctrine of sovereign immunity restrict Canada's ability to tax SWFs, or does the doctrine only apply with respect to judicial process? This chapter addresses these questions by first reviewing the origins and history of state immunity law. The next two parts of this chapter discuss the modern period in sovereign immunity – namely, the codification of the restrictive theory of immunity and the distinction between

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<sup>118</sup> European Convention on State Immunity - Explanatory Report [1972] COETSER 2 (16 May 1972) at paragraph 1 online: <<http://www.worldlii.org/int/other/COETSER/1972/2.html>>. See also *Schreiber v Canada (Attorney General)*, 2002 SCC 62, [2002] SCR 269, at para 13.

commercial and governmental activities. Next, consideration is given to state agencies and the circumstances in which they can benefit from immunity. Finally, the chapter discusses the application of sovereign immunity in the field of income taxation.

### 3.2 History of Sovereign Immunity

The history of sovereign immunity, in the words of one scholar, is “this history of the triumph of the doctrine of restrictive immunity over that of absolute immunity.”<sup>119</sup> Under the doctrine of absolute immunity, foreign states were totally immune from any and all legal processes of a national courts and from the compulsory force of municipal law. The principle applied equally to actions *in personam* and *in rem*. The doctrine was expressed succinctly by Lord Atkin in *The Christina*, who spoke of two “propositions of international law” that have been engrafted into English common law:

The first [proposition] is that the courts of a country will not implead a foreign sovereign, that is, they will not by their process make him against his will a party to legal proceedings whether the proceedings involve his person or seek to recover from him specific property or damages.

The second is that they will not by their process, whether the sovereign is a party to the proceedings or not, seize or detain property which is his or of which he is in possession or control.<sup>120</sup>

The roots of state immunity can be traced to the Peace of Westphalia in 1648, which brought an end to the Thirty Years’ War and, with it, over three decades of unprecedented European conflict.<sup>121</sup> The goal of the Peace was to settle religious conflict in the dwindling Holy Roman Empire on a permanent basis. The eventual terms of the accord enshrined prescriptive rights throughout the region and ensured peace through the mutual restraint of

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<sup>119</sup> Xiaodong Yang, *State Immunity in International Law* (Cambridge: Cambridge University Press, 2012) at page 6.

<sup>120</sup> *Compania Naviera Vascongado v Steamship Christina and Others*, [1938] AC 485 at 490, 1 All ER 719 (HL).

<sup>121</sup> Nathaniel Koppel, “Nails in the Coffin of the Vampire: Personal Sovereign Immunity and Its Timely But Incomplete Death” (2014) 2014:4 U Ill L Rev 1293 at 1307.

sovereign powers. The hallmark of the Peace was the inviolability of national borders. With this newfound respect for borders came a concomitant agreement among the German princes not to exercise power in one another's territories or over one another.<sup>122</sup>

The political roots of the doctrine were reflected in early theories for the absolute immunity doctrine, which stressed the independence of states and the comity of nations. These principles – independence and equality – were believed to be essential to peaceable relations and cooperation between sovereign powers. The immunity of states facilitated the tenuous balance between, on the one hand, the absolute sovereignty of states and, on the other hand, the equality between these absolute powers. The earliest expression of these principles was in Chief Justice Marshall's decision in the *Schooner Exchange v M'Faddon*:

This perfect equality and absolute independence of sovereigns, and this common interest compelling them to mutual intercourse, and an exchange of good offices with each other, have given rise to a class of cases in which every sovereign is understood to waive the exercise of a part of that complete exclusive territorial jurisdiction, which has been stated to be the attribute of every nation.<sup>123</sup>

Likewise, the authoritative expression of the absolute principle in English law was given by Lord Justice Brett of the English Court of Appeal in the celebrated case of *The Parlement Belge*:

The principle to be deduced from all these cases is that, as a consequence of the absolute independence of every sovereign authority, and of the international comity which induces every sovereign state to respect the independence and dignity of every other state, each and every one declines to exercise by means of its courts any of its territorial jurisdiction over the person of any sovereign or ambassador of any other state, or over the public property of any state which is destined to public use, or over the property of any ambassador, though such sovereign ambassador or property be within its territory and therefore, but for the common agreement subject to jurisdiction.<sup>124</sup>

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<sup>122</sup> Mark Greengrass, *Christendom Destroyed, Europe 1517 -- 1648* (London: Penguin Books, 2014) at 641-643.

<sup>123</sup> *The Schooner Exchange v M'Faddon*, 11 US (7 Cranch) 116 (1812).

<sup>124</sup> *The Parlement Belge*, (1880) 5 PD 197 (Court of Appeal, England) at 212-214.

The rationale of the equality and independence of states is still operative in modern times. The Canadian Supreme Court has described state immunity as one of the “organizing principles between independent states. It ensures that individual nations and the international order remain faithful to the principles of sovereignty and equality.”<sup>125</sup> Elsewhere, the Court has described sovereign immunity as an “ancient principle ... established as a fundamental principle of public international law in recognition of the autonomy and equality of states.”<sup>126</sup>

### 3.3 The Adoption of Restrictive Immunity in Canada

As can be gleaned from Brett LJ’s reference to the immunity of public property “destined for public use,” even in the age of absolute immunity there was some sense of a limit to state immunity, even if glimpsed only dimly. That limit is the public, or governmental, quality of the activity. Over time, the scope of immunity would wane in recognition of the fact that not all sovereign activities have a truly public character. The recognition of the boundaries of immunity is known as the restrictive theory of state immunity. The distinction between the public acts of state (*acta jure imperii*) and private acts (*acta jure gestionis*) characterizes the restrictive theory, which affords immunity from the state’s territorial jurisdiction to only those activities on the part of a foreign state that are the manifestation of sovereign power.

The rationale for restrictive immunity was clearly expressed by a Belgian court as early as 1879 in a case arising out of a contract for sale of guano, wherein the court observed that there can be no question of immunity where a foreign state “takes actions and enters

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<sup>125</sup> *Kazemi Estate v Republic of Iran*, 2014 SCC 62 at paras 35-37, [2014] SCR 176.

<sup>126</sup> *Kuwait Airways Corporation v Iraqi*, 2010 SCC 40 at para 13, [2010] 2 SCR 571.



into contracts which, always and everywhere, have been considered to be commercial contracts, subject to the jurisdiction of commercial courts.”<sup>127</sup>

Nevertheless, the principle of absolute immunity still predominated in Canadian common law a hundred years later. Only after the passage of the SIA<sup>128</sup> in 1982 did the restrictive theory of immunity definitively become the law of Canada. The adoption of the SIA “cleared up the doubt that had been lingering in the case law over the continued application of the old common law rule of absolute immunity.”<sup>129</sup>

The old rule was proving unworkable, impractical, and even unfair to the business community and to individual rights in Canada.<sup>130</sup> Consider the case of *Congo v Venne*.<sup>131</sup> The facts giving rise to the case were a dispute between a Montreal architect and the Democratic Republic of Congo. The architect said he was hired by the Republic of Congo to prepare preliminary studies and sketches for a national pavilion that Congo wished to build for Expo '67 and that he was not paid for his work. In response, the Republic of Congo filed a declinatory exception claiming that, as a sovereign state, it was immune to suit in Canada. In deciding in favour of the Republic of Congo, the Supreme Court of Canada was able to sidestep the question of the continuing application of the doctrine of absolute immunity by holding that, even under the restrictive theory, the construction of a national pavilion was a sovereign act of state. This seemed a perhaps strained interpretation of the facts.<sup>132</sup>

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<sup>127</sup> *Rau, Vanden Abeele et Cie v Duruty* (Brussels 1879) cited in Nout van Woudenberg, *State Immunity and Cultural Objects on Loan* (Leiden: Martinus Nijhoff, 2012) at 51.

<sup>128</sup> *State Immunity Act* (SIA), *supra* note 2.

<sup>129</sup> Ross Hornby, “State Immunity - Re Canada Labour Code: A Common Sense Solution to the Commercial Activity Exception” (1992) 30 Can YB Int'l L 301 at 301.

<sup>130</sup> Henry L Molot, “Suability, Taxability, and Sovereign Immunity in Canada: A Brief Glance” (1974) 22:9 Chitty's Law Journal 314 at 314.

<sup>131</sup> *Gouvernement de la République Démocratique du Congo v Venne*, [1971] S.C.R. 997.

<sup>132</sup> Molot, *supra* note 130 at 316.

As states began to participate in a broader range of activities, the rationale for absolute immunity began to wane. The rise of planned economies and state capitalism in the 20<sup>th</sup> century sounded the death knell for the doctrine. Henry L Molot & ML Jewett describe political and philosophical changes leading to the endorsement of restrictive immunity as follows:

The principal reason for the support given to the restrictive immunity doctrine lies in the changing role of the modern twentieth-century state. While it may be true that there never was a time when the governments of western democratic states confined themselves to strictly non-commercial, non-trading, or so-called purely governmental activities, during a significant period *laissez-faire* principles did dominate the economic scene and perceptions of it. Not only could it be said with some justification that the states then tended to confine themselves to very traditional governmental tasks, but *laissez-faire* being more than mere economics became a *Weltanschauung* for a majority of those holding political and judicial office. Nevertheless, the social, political, and economic view of how the world operated had to shift in order to meet the development of the mixed enterprise state. It was not only that states engaged in quasi-commercial undertakings such as railways and utilities where a natural monopoly and hence the relative absence of market forces were present; state-run enterprises also expanded into economic sectors where they were likely to compete with domestic and international private traders. Internationally, the preservation and encouragement of a market economy remained more than just a cliché. Private entrepreneurs, increasingly forced to compete with publicly financed and domestically protected state enterprises, were being subjected to unequal and hence unfair competition. This situation was compounded by an absolute immunity doctrine that could be seen as encouraging foreign government traders to take a rather light-hearted approach to the enforcement of their legal obligations. Moreover, being relieved of all the financial consequences of litigation was a negative cost to such traders that their private counterparts did not enjoy. One obvious way of correcting the balance was by more nearly equalizing the jurisdictional positions of foreign governments and the private sector where their activities overlapped and competed with one another. That area of overlap, generally speaking, relates to the commercial sphere of economic activity, and so was born the notion of carving out of a foreign state's jurisdictional immunity an exception relating to its commercial activities.<sup>133</sup>

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<sup>133</sup> HL Molot & ML Jewett, "The State Immunity Act of Canada" (1982) 20 Can YB Int'l L 79 at 85-86.

Besides the changes in the political and philosophical conception of the modern state, limits had already been placed on the immunity of the federal Crown in Canada.<sup>134</sup> Federal legislation providing a legal remedy against the Crown had been adopted in Canada as early as 1885 in the *Supreme and Exchequer Courts Act, and the Petition of Right Act*.<sup>135</sup> Crown liability in Canada was then pruned back dramatically with the passage of the *Crown Liability Act* in 1953.<sup>136</sup> This legislation was subsequently repealed and replaced with the *Crown Liability and Proceedings Act*.<sup>137</sup> As such, the Canadian government was generally suable in its own courts, while foreign states were not similarly amenable. Compounding the issue was the fact that restrictive immunity had been widely adopted abroad before it became the law of Canada, and thus many foreign states, which would have been liable to suit in the courts of their home jurisdiction, were able to plead immunity in Canada. This led to a situation in which “fundamental principles of international law, such as reciprocity and comity, [were] obviously being ignored or honoured in the breach.”<sup>138</sup>

### 3.4 The Distinction Between Commercial and Governmental Activity

Thus, the stage was set for a change of law in Canada. This change was accomplished with the passage of the SIA, which definitively enshrined restrictive state immunity as the law of Canada.<sup>139</sup> The central feature of the modern, restrictive approach to state immunity is the distinction between *acta jure imperii* and *acta jure gestionis* – that is, between commercial and governmental acts. This distinction is embedded in the United States’ *Foreign Sovereign*

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<sup>134</sup> See generally, Jacques Rosseau, *The Crown Liability Act: Has It Kept Up With the Times?* (Ottawa: Library of Parliament, Research Branch, 1986).

<sup>135</sup> *Supreme and Exchequer Courts Act*, SC 1885, c 11, *Petition of Right Act*, SC 1885, c 12.

<sup>136</sup> *Crown Liability Act*, SC 1952-53, c 30.

<sup>137</sup> *Crown Liability and Proceedings Act*, RSC 1985, c C-50.

<sup>138</sup> Molot, *supra* note 130 at 315.

<sup>139</sup> Hornby *supra* note 129 at 301.

*Immunities Act* of 1976,<sup>140</sup> the Council of Europe's *Convention on State Immunity*,<sup>141</sup> the United Kingdom's *State Immunity Act 1978*,<sup>142</sup> the Australian *Foreign State Immunities Act, 1985*,<sup>143</sup> and, of course, Canada's *State Immunity Act*.<sup>144</sup>

Under section 3 of the SIA, the general rule is that foreign states are immune from the jurisdiction of Canadian courts. However, the remainder of that part of the Act, in sections 4 through 8, carves out exceptions to this general immunity. The most important of these is the exemption from immunity in respect of commercial activities. The SIA defines commercial activity in section 2 as “any particular transaction, act or conduct or any regular course of conduct that by reason of its nature is of a commercial character,” and provides in section 5 that “a foreign state is not immune from the jurisdiction of a court in any proceedings that relate to any commercial activity of a foreign state.”

The Canadian definition is clearly circular: a commercial activity is any activity of a commercial character. In contrast, the United Kingdom's *State Immunity Act 1978* attempts a more fulsome definition by providing a list of certain types of activity that are considered commercial, including a “contract for the supply of goods,” a “loan or other transaction for the provision of finance,” and any other activity, whether of a commercial, financial or professional character, that a state engages in “otherwise than in the exercise of sovereign authority.”<sup>145</sup> The Canadian legislation's silence is deliberate, as the selection of an open-ended definition was thought to more readily permit Canadian courts to make use of the comparatively voluminous case law decided in the United States. Parliament evidently hoped

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<sup>140</sup> Pub L No 94-583, 90 Stat 2891.

<sup>141</sup> Council of Europe, European Treaty Series No 74 online: <<https://rm.coe.int/16800730b1>>.

<sup>142</sup> (UK), 1978, c 33.

<sup>143</sup> No 196, 1985 (Cth).

<sup>144</sup> *Supra* note 2.

<sup>145</sup> *Supra* note 142, s 3(3).

that Canadian judges would find the American jurisprudence useful, and, in any case, were cognizant of the fact that reliance on the same precedents tends to promote more uniform jurisprudence.<sup>146</sup>

#### 3.4.1 Nature vs Purpose

Another feature of the Canadian definition is the reference to an act or conduct that is commercial “by reason of its nature.” American and European jurisprudence had developed two approaches to determining commercial activity: the nature test and the purpose test. The former looks to the activity itself to see if it has the usual hallmarks of commercial activity, while the latter permits examination of the state’s intentions in engaging in the activity. One of the purported advantages of a nature test is that it tends to depoliticize the dispute by allowing the court to sidestep an examination of the motives and intentions behind a foreign government’s actions and to avoid classifying acts according to “politically contested categories of social and economic policy.”<sup>147</sup> In contrast, the purpose test looks directly at the state’s aims and intentions in undertaking the activity in question.

The application of the nature test tends to narrow the scope of immunity in comparison to the purpose test, as any activity undertaken by a government almost by definition has a governmental purpose. The United States Court of Appeals for the Second Circuit noted this difficulty in *De Sanchez v Banco Central de Nicaragua*, where they observed:

[Whenever] a government enters the marketplace to buy or sell goods, its purpose ultimately is not to earn profits; in some sense, its motivation is the public good. Consequently, if the purpose of an activity defined in full whether the activity was sovereign or commercial, all governmental activities would be sovereign.<sup>148</sup>

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<sup>146</sup> *Supra* note 133 at 98.

<sup>147</sup> *Ibid* at 100.

<sup>148</sup> *De Sanchez v Banco Central de Nicaragua*, 770 F 2d 1385 at 1393 (5th Circuit, 1985).

If the purpose test tends to regard all state activities as sovereign, however, the nature test can lead to the opposite extreme. The nature test has come in for criticism for producing overly literal, sometimes absurd outcomes. Courts have sometimes been uncomfortable with the results of a strict nature test, which tends to treat governments as if they were private contractors. The United States Court of Appeals for the Second Circuit, for example, decried “the holdings of some European courts that purchases of bullets or shoes for the army, the erection of fortifications for defense, or the rental of a house for an embassy are private acts.”<sup>149</sup> Other critics have noted that the “nature” test would not protect a developing state that “sought to boost its economy (a sovereign act) through normal commercial contracts with foreign investors.”<sup>150</sup> The test has proven so difficult to apply in certain cases that, despite the fact that the US *Foreign Sovereign Immunities Act* explicitly rules out considerations of purpose,<sup>151</sup> several American courts have discarded the statutory test as unworkable, leading the US Supreme Court to remind them that “[h]owever difficult it may be in some cases to separate ‘purpose’ ... from ‘nature’ ..., the statute unmistakably commands that to be done.”<sup>152</sup>

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<sup>149</sup> *Victory Transport Incorporated v Comisaria General de Abastecimientos y Transportes*, 336 F.2d 354 (2nd Circuit, 1964) at 359.

<sup>150</sup> Martin Dixon, *Textbook on International Law*, 7<sup>th</sup> ed (Oxford: Oxford University Press, 2013) at page 190. However, contrast this with the result in *AIG Capital Partners v Republic of Kazakhstan*, [2005] EWHC 2239 (Comm), [2006] 1 All E.R. 284, discussed *infra* note 162.

<sup>151</sup> The definition of “commercial activity” in §1603 of the US *Foreign Sovereign Immunities Act*, *supra* note 140, states “a ‘commercial activity’ means either a regular course of commercial conduct or a particular commercial transaction or act. The commercial 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” (emphasis added).

<sup>152</sup> *Republic of Argentina v Weltover Inc*, 504 US 607 (1992) at 612, cited in Howard J Lager, “Avoiding the ‘Nature-Purpose’ Distinction: Redefining an International Commercial Act of State,” (1997) 18:3 U Pa J Int’l Econ L 1085 at 1102.

### 3.4.2. The Canadian Approach

The Canadian approach, perhaps wisely, has therefore been to steer a middle course between nature and purpose. Beginning with *Congo v Venne*,<sup>153</sup> the Supreme Court offered some limited comment on the distinction between a state's public acts and its private ones, stressing that the perspective of the foreign state is germane to the issue. As discussed, the facts of the case concerned an architect who was not paid for drawings he prepared for a national pavilion that Congo wished to build at Expo '67. In holding that the Congo was performing a public act of state by constructing a national pavilion at the Expo, Justice Ritchie (for the majority) stated that:

Considered from the point of view of the architect, it may well be that the contract was a purely commercial one, but, even if the theory of restrictive immunity were applicable, the question to be determined would not be whether the contractor was engaged in a private act of commerce, but whether or not the Government of the Congo, acting as a visiting sovereign state through its duly accredited diplomatic representatives, was engaged in the performance of a public sovereign act of state.<sup>154</sup>

*Congo v Venne* was decided before the adoption of the SIA in 1982. It was not until 1992 that the Supreme Court of Canada was given its first, and most lengthy, opportunity to consider the meaning of the SIA's commercial activity exception. In *Re Canada Labour Code*,<sup>155</sup> the Court considered the jurisdiction of the Canada Labour Relations Board to consider an application for certification of the Public Service Alliance of Canada as the bargaining agent for civilian trades people working at the United States naval base in Argentia, Newfoundland. The employees in question were Canadians working in a non-military capacity who had only restricted access to secure facilities on the military base.

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<sup>153</sup> *Supra* note 131.

<sup>154</sup> *Ibid* at 1002.

<sup>155</sup> *United States of America v Public Service Alliance of Canada*, (*sub nom* *Re Canada Labour Code*) [1992] 2 SCR 50.

In holding the United States immune from the jurisdiction of the Labour Relations Board, the majority was clearly concerned about the intrusiveness of the labour relations regime under the *Canada Labour Code*<sup>156</sup> and its potential to interfere with the sovereign sphere of military operations on the base. The Court stated that the employment contracts had a multifaceted nature,<sup>157</sup> and they found that certification of the union would afford the Labour Relations Board jurisdiction over both the sovereign and the commercial aspects of the base. The Court noted that labour relations tribunals necessarily impinge upon powers that have traditionally been considered management prerogatives, such as, in the instant case, the right to dismiss an employee without notice for security reasons.<sup>158</sup> Given this, they felt that the certification process would encroach upon the exercise of sovereign authority.

In contrast, the minority reached the opposite conclusion, noting that the employees were support workers with only limited access to the secure portions of the naval base. They emphasized that the US Military had been willing to engage in collective bargaining under American law, and so it could not be said that the imposition of a labour relations regime was, *per se*, an unworkable infringement on their power to manage the base.

The lower courts, using the nature test, had found that the contracts of employment at the naval base were commercial and that, therefore, state immunity did not apply. In contrast, both the majority and the minority of the Supreme Court endorsed a contextual test that includes both nature and purpose. La Forest J (for the majority) opined that, although the SIA directs courts to consider the nature of the activity, nothing in the Act “precludes consideration of its purpose. ... If consideration of the purpose is helpful in

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<sup>156</sup> *Canada Labour Code*, RSC 1985, c L-2.

<sup>157</sup> *Ibid* at 76 para g.

<sup>158</sup> *Supra* note 155 at pages 77 – 78, *per* La Forest J.



determining the nature of the activity, then such considerations should be an area allowed under the Act.”<sup>159</sup>

In endorsing a contextual approach, La Forest J noted that rigid dichotomies of nature and purpose are unhelpful. However, while purpose may be considered as a relevant factor, it should not be allowed to predominate:

It seems to me that a contextual approach is the only reasonable basis of applying the doctrine of restrictive immunity. The alternative is to attempt the impossible -- an antiseptic distillation of a “once-and-for-all” characterization of the activity in question, entirely divorced from its purpose. It is true that purpose should not predominate, as this approach would convert virtually every act by commercial agents of the state into an act *jure imperii*. However, the converse is also true. Rigid adherence to the “nature” of an act to the exclusion of purpose would render innumerable government activities *jure gestionis*. Neither of these extremes offers an appropriate resolution of the problem.<sup>160</sup>

Cory J (for the minority) concurred on the interrelation of nature and purpose and likewise endorsed a contextual approach, stating:

[T]o identify this “nature” or quality of any activity, a Court should have regard to the context in which the activity took place. In order to do that, it will often be necessary to consider the immediate purpose of the actions taken by the foreign state. This approach fosters the goal of reasonably restricting state immunity. It does so by looking beyond the ultimate purpose of the foreign state’s action, which will almost always be public, while continuing to protect by immunity the truly sovereign acts of states from domestic court proceedings. It does not unduly restrict the courts in classifying an activity according to its nature by unnecessarily narrowing the scope of inquiry. This contextual approach complies with the definition of “commercial activity” contained in the Canadian statute by retaining the nature of the activity as the focus of the decision. On the other hand, it avoids the problems caused by attempting to treat the nature and purpose of an activity as completely separate and discrete inquiries.<sup>161</sup>

Following the contextual approach, courts should undertake a two-step analysis to the question of commercial activity. This involves separating the activity in question into its

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<sup>159</sup> *Ibid* at 70.

<sup>160</sup> *Ibid* at 73.

<sup>161</sup> *Ibid* at 106-7.

various components and identifying which of those components are at issue in the proceedings at hand:

[Section 5], in combination with the definition of “commercial activity” in s. 2, raises two basic questions. First, what is the “nature” of the activity in question – i.e., does employment at the base constitute commercial activity? Second, are the proceedings in this case – a union certification application – “related” to that activity? The two questions are, of course, interrelated, and neither can be answered in absolute terms. Certain aspects of employment at the base are commercial, but in other respects the employment relationship is infused with sovereign attributes. Accordingly, the certification proceeding affects both the commercial and sovereign aspects of employment at the base. The issue then becomes whether the effect on the commercial realm is sufficiently strong as to form a “nexus” so that it can truly be said that the proceedings “relate” to commercial activity.<sup>162</sup>

Thus, contracts of employment at the military base involve entering the labour market and hiring workers – commercial activity. However, the imposition of the labour relations regime impinges upon the management and direction of the operations on the base – sovereign activities. Under the two-step analysis, the majority of the Court found that the bare contracts of employment were commercial and that locally engaged staff would, therefore, be able to enforce their contracts in Canadian courts. The Canadian labour relations regime, however, would strike at the heart of the US military’s ability to manage and control the operations of the base – that is, on the immune aspects of the activities.<sup>163</sup>

#### 3.4.3 Continuing Uncertainty About the Meaning of “Commercial Activity”

The contextual approach endorsed by in *Re Canada Labour Code* was intended to avoid the difficulties of either the nature test or the purpose test. However, while the majority’s conclusion is pragmatic and sensible, it remains the case that the distinction between commercial and governmental activity is hard to articulate. Quite apart from the

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<sup>162</sup> *Ibid* at page 69, *per* La Forest J.

<sup>163</sup> Hornby *supra* note 129 at 308.

long-standing difficulties separating nature and purpose, the two-step contextual test adds issues surrounding the “nexus” or relationship between the proceedings and the commercial or sovereign realm. The contextual test does very little to promote certainty, as is evidenced by the fact that both the majority and the minority, applying the same test to the same facts, reached opposite conclusions.

Furthermore, the development of the case law on this subject has been far less rapid than Parliament and commentators seem to have expected when the SIA was adopted in 1982, and it is difficult to glean principles from the cases than have since been decided.<sup>164</sup> As recently as 2007, the courts noted that “there is not an abundance of Canadian case law that has considered the definition of ‘commercial activity’ within the context of the *State Immunity Act*.”<sup>165</sup>

#### 3.4.4 Are Sovereign Wealth Fund Activities Commercial or Governmental?

There remains considerable uncertainty about the precise contours of the distinction between commercial and governmental activities as a general matter, never mind as applied

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<sup>164</sup> See, e.g., *Kuwait Airways Corporation v Iraq*, *supra* note 126 (the conduct of litigation relating to the recovery of aircraft seized and appropriated by Iraq during the first Gulf War was commercial activity, even though the seizure and appropriation of the aircraft itself was a sovereign act); *Homburg v. Stichting Autoriteit Financiële Markten*, 2017 NSCA 62 (the imposition of fines for breach of domestic securities law by the Dutch regulators of the Netherlands domestic financial market had a virtually exclusively sovereign aspect); *The Ship 'Atra' v Lorac Transport*, [1987] 1 FCR 108 (FCA), (the purchase of utility poles by Iran for use by a state-owned electrical utility was primarily commercial); *Smith v Chin*, 2006 CanLII 34347 (ON SC) (proceedings for breach of contract under a St Kitts’ program to develop the local economy related to commercial activity); *Butcher v Saint Lucia*, [1998] OJ No 2026, 79 A.C.W.S. (3d) 815 (a contract of employment where a person is hired by a foreign state to carry out consular activities has a sovereign aspect); *Ferguson v Artic Transportation Ltd*, [1995] 3 FCR 656, 1995 CanLII 3529 (FC) (the operation, management, and maintenance of the Panama Canal by the Panama Canal Commission is primarily commercial in nature); and *Bentley v Consulate General of Barbados/Invest Barbados*, 2010 HRTO 2258 (the operation and management of a consulate, including dismissal of an employee, is quintessentially sovereign activity).

<sup>165</sup> *Collavino Incorporated v Yemen (Tihama Development Authority)*, 2007 ABQB 212 at para 130.

to SWFs, which are far from homogenous as a group. As discussed in Chapter 2, SWFs are large, institutional investors seeking to maximize their return on investment – activities generally understood to be commercial in nature. On the other hand, SWFs are established for macroeconomic purposes, such as the stabilization of government revenues, economic development, and intergenerational wealth transfer – sovereign activities. Thus, it is safe to say that SWF activities have a hybrid character. Following the approach in *Re Canada Labour Code*, we would first have to consider whether any hypothetical proceedings “relate” to the commercial or to the sovereign side of SWF activities before we could determine if a SWF enjoys immunity in any particular case. Sovereign immunity will depend, therefore, not just on the nature and purpose of the activity in question, but also on the relationship between that activity and the hypothetical legal proceedings.

The few authorities located are divided on the question of whether or not SWF activities are commercial. In the most substantial analysis of the question, the Court considered their activities to be squarely governmental. In *AIG Capital Partners v Republic of Kazakhstan*,<sup>166</sup> the claimants wanted to enforce an arbitration award against the assets of the National Fund of Kazakhstan, a “national resources fund” established by Kazakhstan. The National Fund is a natural resource stabilization fund, and it appears very similar to a number of SWFs, such as the KIA. Aikens J, of the English High Court of Justice, described the Fund as follows:

Kazakhstan has large oil resources. In common with other states which are rich in natural resources like oil and gas (such as Norway, Venezuela, and Canada), Kazakhstan has set up a “national resources fund.” The object of such funds is to “help stabilize fiscal policy and save a portion of oil and gas revenues.” As described by Miss Tsalik in *Caspian Oil Windfalls*, natural resources funds are established to deal with the principal challenge that faces a country whose state revenues are mainly dependent on the export of natural resources such as oil

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<sup>166</sup> *AIG Capital Partners v Republic of Kazakhstan*, [2005] EWHC 2239 (Comm), [2006] 1 All E.R. 284.

and gas. This challenge arises from the volatility of commodity prices. When prices are high, there is a temptation to spend all the revenues obtained from the production and export of the commodities, without retaining some for times when prices, and so state revenues, are low. Natural resources funds can be used as “stabilization funds” or “savings funds” or a combination of both. Stabilization funds smooth out government spending by transferring funds for government spending when prices are low. Savings funds “act as a kind of ‘rainy day’ fund, storing up wealth for future generations.”<sup>167</sup>

Under subsection 13(4) of the UK *State Immunity Act 1978*,<sup>168</sup> the London-based assets of the National Fund would not have been available for enforcement unless the assets were “in use or intended for use for commercial purposes.” In holding that they were not, the judge found that the Fund was “created to assist in the management of the economy and government revenues of the Republic of Kazakhstan, both in the short and long term. Management of a State’s economy and revenue must constitute a sovereign activity.”<sup>169</sup> This was true even though the assets consisted of an actively managed securities trading account, and subsection 3(3) of the UK Act provided that “any loan or other transaction for the provision of finance” constitutes a commercial transaction. Nevertheless, the Court found that the Fund’s trading activities must be set against the background of the purpose of the Fund, which was sovereign. This approach, if followed, would afford very broad immunity to the trading activities of SWFs.

In contrast, the US Second Circuit, in a matter of a first impression, considered whether the SK Fund (also a Kazakhstani SWF) was immunized against claims that it violated American securities laws by making representations outside the United States that overestimated the value of securities.<sup>170</sup> In that case, the Court appears to have assumed, without argument, that the SWF’s activities were commercial. Instead, argument centered on

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<sup>167</sup> *Ibid* at paragraph 11.

<sup>168</sup> *Supra* note 142.

<sup>169</sup> *Ibid*.

<sup>170</sup> *Atlantica Holdings, Inc et al v Sovereign Wealth Fund Samruk-Kazyna JSC*, United States Court of Appeal for the Second Circuit, 14-917-cv.

whether the representations made outside the US had a strong enough connection with the country to bring them within the court's jurisdiction.

### 3.5 Immunity of State Agencies

Perhaps equally fraught as the question surrounding the meaning of “commercial activity” is that of the status of quasi-independent state entities. There is a broad spectrum of government-linked entities, ranging from state-owned businesses and utilities to departments of foreign affairs and national defence. As has been alluded to, it is precisely the range of such entities and their increasing participation in commerce that prompted governments across the world to turn toward the restrictive theory of immunity.

Like a corporation, a state is incapable of acting on its own. It can only function through its various agents or instrumentalities, which compose the machinery of government. These include representatives, subordinate organs, corporations, and government departments. Whether or not these entities attract immunity depends on the extent to which they are an integral part of the state.<sup>171</sup> To the extent that an entity is an integral part of the state, it may be said that its acts are those of the state. Therefore, the entity should enjoy the same privileges and immunities, and attract the same duties and liabilities, as the state.

The definitions of “foreign state” and “agency of a foreign state” in the section 2 of the SIA state:

*foreign state* includes

- (a) any sovereign or other head of the foreign state or of any political subdivision of the foreign state while acting as such in a public capacity,
- (b) any government of the foreign state or of any political subdivision of the foreign state, including any of its departments, and any agency of the foreign state, and

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<sup>171</sup> Yang, *supra* note 119 at page 230.

(c) any political subdivision of the foreign state; (*État étranger*)<sup>172</sup>

*agency of a foreign state* means any legal entity that is an organ of the foreign state but that is separate from the foreign state; (*organisme d'un État étranger*)<sup>173</sup>

Thus, a foreign state, for purposes of the SIA, includes state entities that are integral to the foreign state, but enjoy separate legal personality.<sup>174</sup> One approach to determining whether an entity is an agent or organ of a foreign state is the alter ego test. This test looks to whether the entity performs functions of governmental authority and whether the entity is effectively controlled by the state. It is derived from Lord Denning's opinion in *Trendtex Trading Corp v Central Bank of Nigeria*, where he wrote:

I can think of no satisfactory test except that of looking to the functions and control of the organization. I do not think that it should depend on the foreign law alone. I would look to all the evidence to see whether the organization was under government control and exercised governmental functions.<sup>175</sup>

Lord Denning's test was subsequently adopted into Canadian case law,<sup>176</sup> but its continued utility has been lessened by the passage of the SIA. This is because, under the alter ego test, the form the entity takes is of little relevance in comparison to the control exercised over the entity by government and the type of functions it performs. However, the SIA insists that legal form matters, as an agency of a foreign state must have separate legal personality. Still, the criteria used in the alter ego test, such as those concerning control,

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<sup>172</sup> *State Immunity Act*, supra note 2, s 2.

<sup>173</sup> *Ibid.*

<sup>174</sup> The distinction between the foreign state itself and agencies of the foreign state plays a critical role in the provisions of the SIA dealing with legal process, such as service, and with enforcement powers. These provisions have little, if any role, to play as regards the taxation of SWFs, and so are beyond the scope of this thesis.

<sup>175</sup> *Trendtex Trading Corp v Central Bank of Nigeria*, [1977] 1 QB 529 at 559, [1977] 1 All ER 881 (Court of Appeal, Civil division).

<sup>176</sup> See *Ferranti-Packard Ltd v Cushman Rentals Ltd*, 31 OR (2d) 799, 115 DLR (3d) 691, [1981] OJ No 2883 (Ont CA).

ownership of assets, and conduct of legal proceedings, remain relevant in determining whether an entity is an “organ” or a foreign state.<sup>177</sup>

In the end, the question may ultimately circle back to the distinction between commercial and governmental activity. For instance, in *Walker v Bank of New York Inc.*,<sup>178</sup> the Court held that Bank of New York employees who assisted US law enforcement officials in a sting operation were “organs” of a foreign state on the basis that their actions, if they had been performed by the state directly, would have been sovereign activities:

Applying the definition [of “foreign state” in section 2 of the SIA] to the Bank and its employees, it is clear that each is a “legal entity” and each is “separate from the foreign state.” The only question remaining is whether each is an “organ of the foreign state.” The word “organ” is a very broad one. The Oxford English Dictionary defines it as “a means of action or operation, an instrument, a ‘tool’; a person, body of persons, or thing by which some purpose is carried out or some function performed.” In this case the bank employees involved did not act on their own initiative. They acted at the request of the US government law enforcement officers for the purpose of assisting them in their investigation of possible criminal activities. ... [W]e are of the view that the use of the broad word “organ” in the Act, which was promulgated to codify the application of the doctrine in Canada, indicates the intention of parliament to protect individuals and institutions who act at the request of a foreign state in situations where that state would enjoy sovereign immunity.

### 3.5.1 Sovereign Wealth Funds As Separate Entities

The question of SWFSs as separate entities was considered in *Kuwait v X*,<sup>179</sup> where the Swiss Federal Tribunal rejected Kuwait’s claim that the assets of the KIA were immune from execution because the KIA formed part of the State of Kuwait. The Court found that KIA was an independent entity, noting that it was created as an autonomous entity by law.

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<sup>177</sup> *Collavino Incorporated supra* note 165 at paragraph 107.

<sup>178</sup> *Walker v Bank of New York Inc.*, CanLII 8712, 16 OR (3d) 504, [1994] OJ No 126, leave to appeal to the Supreme Court denied, File No 24057, SCC Bulletin 1994.

<sup>179</sup> *Kuwait v X*, Swiss Federal Tribunal (24 January 1994) (unreported), cited in David Gaukrodger, “Foreign State Immunity and Foreign Government Controlled Investors” (201) OECD Working Papers on International Investment, 2010/02, OECD Publishing online: <http://dx.doi.org/10.1787/5km91p0ksqs7-en>.



In comparison to Canadian law, however, the property of independent state entities is generally not immune from attachment and execution in any circumstance. As a result, the Swiss approach places greater significance on the legal structure of the foreign entity. In contrast, the Canadian approach considers both legal form and the type of functions the entity performs.

### 3.6 Sovereign Immunity from Taxation?

#### 3.6.1 Federal Jurisdiction to Tax in Canada

In Canadian law, the federal government's legislative power to tax knows no geographic limits.<sup>180</sup> As a matter of law, this theoretically limitless power is restrained by the refusal of other states to give effect to one another's tax laws, meaning that there is no effective way for Canada to assert its notionally limitless taxation power.<sup>181</sup> This is known as the revenue exclusion in private international law. The Canadian position is represented by *United States of America v Harden*.<sup>182</sup> There, the Court refused to enforce a US judgement for unpaid taxes on the basis that to do so would violate Canadian sovereignty:

Enforcement of a claim for taxes is but an extension of the sovereign power which imposed the taxes...an assertion of sovereign authority by one State within another ... is contrary to all concepts of independent sovereignties.<sup>183</sup>

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<sup>180</sup> See *BC Electric Railway Co v R*, [1946] AC 527, [1946] 4 DLR 81 [BC Electric Railway Co]. Viscount Simon held that s. 91(3) of the *Constitution Act* (then then *British North America Act*) should be read as granting the Dominion Parliament the jurisdiction for "the raising of money by any mode or system of taxation, even though such laws have an extra-territorial operation." He reasoned that Parliament's taxation power was subject only to its own constitutional limitations and was "not restricted by any consideration not applicable to the legislation of a fully sovereign state."

<sup>181</sup> See generally FA Mann, "The International Enforcement of Public Rights" (1987) 19 NYU J Int'l L & Pol 603; Nicholas Rafferty ed, *Private International Law in Common Law Canada: Cases, Texts and Materials*, 3d ed (Toronto: Edmond Montgomery Publications, 2010) at 109-22.

<sup>182</sup> *United States of America v Harden*, [1963] SCR 366.

<sup>183</sup> *Ibid*, per Cartwright J at 634.

Subsequently, British Columbia tried to enforce a Canadian judgement for taxes in the United States. Citing *Harden*, the US federal court dismissed the action on the basis of negative reciprocity in *Her Majesty the Queen v Gilbertson*.<sup>184</sup>

Consistent with international practice, Canada does not attempt to realize the global scope of its self-defined taxation power and only brings into the embrace of its jurisdiction income and taxpayers with some nexus within Canadian territory – either because of the residence of the taxpayer or by virtue of the income having its source within Canada.<sup>185</sup>

Does sovereign immunity constitute a limit, either under international or domestic law, to Canada's notionally limitless jurisdiction to tax?<sup>186</sup> Certain authorities make reference to the maxim, allegedly embedded in international law and rooted in the doctrine of sovereign immunity, that "one government does not tax another."<sup>187</sup> This principle, however, has never had universal acceptance in principle or in practice, as governments have historically taxed one another and continue to do so, albeit in limited circumstances. Internationally, there is no consensus on the substantive limits of state immunity from taxation. The topic of taxation was excluded from the only two multilateral instruments on

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<sup>184</sup> *Her Majesty the Queen v Gilbertson*, 597 F2d 1161 (9th Cir 1979).

<sup>185</sup> Canada's assertion of boundless taxation power, as in *BC Electric Railway Co*, *supra* note 180, may or may not be at odds with the international law. See Martin Norr, "Jurisdiction to Tax and International Income" (1961) 17 Tax L R 431 at 431, stating "no rules of international law exist to limit the the extent of any country's tax jurisdiction." In contrast, see Rutsel Silvestre J Martha, "Extraterritorial Taxation in International Law," in Karl M Meessen, ed, *Extraterritorial Jurisdiction in Theory and Practice* (Martinus Nijhoff Publishers, 1996) arguing that public international law limits the assertion of fiscal jurisdiction to full taxation of residents and nationals, source-based taxation of non-residents, and *in rem* taxation of property located within the state's sovereign territory.

<sup>186</sup> See Edward M Morgan, *International Law and the Canadian Courts: Sovereign Immunity, Criminal Jurisdiction, Aliens' Rights and Taxation Powers* (Toronto, Carswell, 1990).

<sup>187</sup> Jon Taylor, "Tax Treatment of Income of Foreign Governments and International Organizations" in *Essays in International Taxation* (Washington: United States Department of the Treasury, 1976), cited in David R Tillinghast, "Sovereign Immunity from the Tax Collector: United States Income Taxation of Foreign Governments and International Organizations," (1978) 10 Law & Pol'y Int'l Bus 495 at 495.

state immunity – the *European Convention on State Immunity* and the *United Nations Convention on the Jurisdictional Immunities of States and Their Property*.<sup>188</sup> Therefore, the scope of sovereign immunity is a matter of forum law; that is, it falls to Canadian domestic lawmakers, whether courts or the legislature, to determine whether sovereign immunity affords foreign governments an exemption from Canadian taxation.

### 3.6.2 Does Sovereign Immunity Apply in the Canadian Tax Context?

International law recognizes different types of jurisdiction: prescriptive, adjudicative, and enforcement.<sup>189</sup> Narrowly understood, the doctrine of sovereign immunity is primarily concerned with immunity from the jurisdiction of the courts, i.e., from judicial process. Historically, Canadian law afforded immunity to a broader range of activities, including immunity from penal or confiscatory law, such as taxation. This was given expression in by the Supreme Court in *St John v Fraser-Brace Overseas Corp.*<sup>190</sup> The background to the case was an agreement between the Government of Canada and the United States to construct a radar defence system. To this end, the United States hired construction companies to build the buildings, and those companies leased property in New Brunswick. The municipality of Saint-John levied taxes on the leasehold and personal property interests, which the companies paid under express protest. The companies subsequently sought to recover the taxes paid on the principle of international law that a foreign sovereign is immune from taxation by local authorities. The Supreme Court agreed, stating:

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<sup>188</sup> Article 29 of the *European Convention on State Immunity*, *supra* note 118, expressly provides that the convention does not apply to proceedings concerning taxation, while the *United Nations Convention on Jurisdictional Immunities of States and Their Property* is silent on taxation. Neither of these instruments has the force of law in Canada.

<sup>189</sup> Vaughan Lowe, “Jurisdiction,” in Michael Evans, ed, *International Law* (Oxford: Oxford University Press, 2003), cited in Kandevis, *supra* note 40 at note 29.

<sup>190</sup> *The Municipality of the City and County of Saint-John et al v Fraser-Brace Overseas Corporation et al*, [1958] SCR 263, 1958 CanLII 40 (SCC).

In general, the immunity of a sovereign, his ambassadors, ministers, and their staffs, together with his and their property, extends to all processes of Courts, all invasions or of interferences with their persons or property, and all applications of coercive public law brought to bear affirmatively, including taxation.<sup>191</sup>

Similarly, the Supreme Court in the *Foreign Legations Reference*,<sup>192</sup> which dealt with the power of the municipal authority to levy taxes on the premises of foreign diplomats, held that the equality of states precluded the levying of property taxes on a foreign state. The Court distinguished between rates (akin to user fees) and general taxes, stating:

The taxes in question may be broadly divided into two classes: those which constitute payment for services rendered for the beneficial enjoyment of the particular property in respect of which they are assessed, and those which are levied for general purposes. As regards the first class, water rates may perhaps be taken as typical. There is, of course, no obligation upon a state which receives an envoy from a foreign state to provide him gratuitously with water, or electricity, and it would be generally agreed that where a tax is in the nature of the price of that commodity, the person enjoying the benefit of that commodity ought to pay the price. As regards taxes (strictly so-called), they are imposed by the authority of the state, whether immediately, or mediately, through a municipality, or other agency. The imposition of a tax presupposed a person from whom, or a thing from which, it is exacted, or collected. It is so exacted, or collected, in virtue of a superior political authority. It does not require much argument to establish that, consistently with the general principles enunciated in the authorities already quoted, such an exaction cannot be demanded by one equal sovereignty from another, or from its diplomatic agent; and there is a general acceptance of the view that such tribute is not exigible, consistently with the principles of the law of nations.<sup>193</sup>

The decisions in *Fraser-Brace* and the *Foreign Legations Reference* deal with, respectively, military matters and diplomatic premises – two spheres of activity that are generally understood as purely governmental. As such, it is not clear whether they stand for the premise that foreign governments are entitled to a general immunity from taxation under Canadian law, especially in light of the subsequent adoption of the SIA.

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<sup>191</sup> *Ibid* at page 268.

<sup>192</sup> *Reference re Powers to Levy Rates on Foreign Legations*, [1943] SCR 208 (“*Foreign Legations Reference*”).

<sup>193</sup> *Ibid* at page 222.

In any case, the SIA deals primarily with the jurisdiction of courts – that is, with the adjudicative and enforcement jurisdiction of Canada. The question remains, therefore, whether following the codification of Canadian common law in the SIA, there continues to exist residual state immunity from the prescriptive jurisdiction of Canada? Cory J, dissenting in *Re Canada Labour Code*, was of the opinion that there is not:

[S]tate immunity only exists with respect to court proceedings. There is no principle of state immunity which exempts a foreign government from the application of Canadian laws when the questioned actions are commercial in nature, as defined in the *State Immunity Act*.<sup>194</sup>

In contrast, the majority of the Supreme Court in *Kazemi Estate v Iran* were of the opinion of the “the SIA is the complete codification of Canadian law *as it relates to state immunity from civil proceedings*” (emphasis added),<sup>195</sup> leaving open the possibility that there remain other immunities outside the scope of the SIA. Of course, neither of those precedents are concerned with tax matters.

The question of sovereign immunity’s continuing application to tax matters was at issue in *R v Inland Revenue Commissioners, ex parte Camacq Corporation and another*,<sup>196</sup> an application for judicial review of the UK revenue authority’s refusal to authorize the gross payment of a dividend by a British company to the US Treasury. The refusal occurred against the backdrop of an attempted takeover of the UK company by an American corporation. If the takeover did not proceed before an imminent deadline, the parent company of the American corporation would be exposed to a significant tax liability. Thus, the application for judicial review was heard on an *ex parte* basis.

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<sup>194</sup> *Re Canada Labour Code*, *supra* note 155 at page 110.

<sup>195</sup> *Kazemi Estate v Iran*, *supra* note 125 at paragraph 54.

<sup>196</sup> *R v Inland Revenue Commissioner, ex parte Camacq Corporation and another*, [1989] STC 785.

Counsel for the Revenue argued that sovereign immunity relates to process only, not to taxation, while counsel for the company argued that the US Treasury continued to enjoy immunity from taxation. Kennedy J declined to decide the question in the context of an *ex parte* application, and held that for present purposes it was sufficient to show that “in the field of taxation at least arguably sovereign immunity is not a principle of universal application.”<sup>197</sup> Dillon J, concurring, opined that “it is very desirable that [the question] should be clarified by legislation.”<sup>198</sup>

As will be seen in the following chapter, the Canadian practice is to afford sovereign immunity to foreign state in limited circumstances. That policy is informed by the principle of restrictive immunity, which suggests that the Canadian approach has been to retain immunity from the prescriptive taxation powers of Canada, but only in line with the immunities provided under the SIA. However, it is interesting to note that the immunity of a foreign government investor arises primarily (although not exclusively)<sup>199</sup> in the context of Canada’s withholding tax regime, and thus it is possible for Canada to collect all its taxes without court process.<sup>200</sup>

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<sup>197</sup> *Ibid*, *per* Kennedy J.

<sup>198</sup> *Ibid*, *per* Dillon J.

<sup>199</sup> For example, a SWF might be liable for tax under Part I if it were carrying on business in Canada.

<sup>200</sup> Documents produced as part of an Access to Information request, *supra* note 43, indicate that it is the view of some Canada Revenue Agency officials that the SIA has no application to the collection of taxes, which can be accomplished via the withholding tax regime.

## **Chapter 4: Taxation of Sovereign Wealth Funds in Canada**

### **4.1 Introduction**

There is currently a dearth of jurisprudence, Canadian or otherwise, with respect to the taxation of SWFs. In Canada, there is a patchwork of rules found in domestic law, tax treaties, and the administrative policies of the CRA, all of which can be difficult to navigate. There is no consistent or clearly articulated approach to the taxation of state entities. Thus, the tax burden on foreign investment may vary between private investors and SWFs – and between SWFs themselves – depending on a variety of factors, such as their country of origin, their form of organization, their willingness to deal with the revenue authorities, and the type of income they receive. As such, practitioners have indicated their reluctance to rely on the sovereign immunity exemption purportedly available under Canadian law.<sup>201</sup>

This chapter begins with an overview of the taxation of non-resident investors under the Act. The focus of this chapter is limited to the taxation of non-resident investors on certain gains under Part I of the Act and on passive income under Part XIII of the Act, i.e., taxes on passive payments. This is the “baseline case.” If the doctrine of sovereign immunity were to apply to exempt SWFs from Canadian income taxation, then it is liability for this baseline tax burden that SWFs would avoid.

Other types of income tax that could theoretically apply to SWFs in Canada are beyond the scope of this thesis. For example, a SWF could be subject to tax under Part I of the Act if it were carrying on business in Canada. However, this is unlikely as SWFs are typically passive investors who lack sufficient presence in Canada to be considered carrying

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<sup>201</sup> Chris Roberge, Claude Magnan & Tan Ong, “Structuring Foreign Private Equity and Sovereign Fund Investments from Selected Asian Countries Into Canada” in *Report of Proceedings of the 62<sup>nd</sup> Annual Tax Conference* (Toronto: Canadian Tax Foundation, 2010).

on business. In any case, if a SWF were carrying on business in Canada, it is unlikely that any special exemptions (e.g., on the basis of state immunity) would apply to it. For the same reason the thesis does not consider the tax on management fees or administrative charges.<sup>202</sup> Such fees and charges almost necessarily would arise in the context of carrying on business and, therefore, likely would constitute commercial activity for the purposes of the *State Immunity Act*.<sup>203</sup> Also beyond the scope of this thesis are provisions that would apply to related parties, such as the thin capitalization rules, which may have an indirect effect on a non-resident investor, such as a SWF.

#### **4.2 Tax Without Immunity: the Baseline Case**

The Act contains many rules governing the taxation of non-residents earning income in Canada. These rules address four types of income that a non-resident might earn: employment income, business income, capital gains, and passive investment income (e.g., interest, dividends, rents and royalties). As SWFs are generally portfolio investors, only the latter two are likely to be earned by a SWF in Canada. As such, this section only considers the tax liability of non-residents on capital gains and passive income.

A foreign SWF that invests in Canada may be liable to (1) Part XIII withholding tax on certain types of passive income paid or credited to it and to (2) tax under Part I on gains realized from the disposition of certain types of Canadian property. As will be discussed below, a tax treaty between Canada and another country may apply to reduce or even eliminate Canadian tax on such passive income or gains.<sup>204</sup>

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<sup>202</sup> See paragraph 212(1)(d), *supra* note 1.

<sup>203</sup> *State Immunity Act*, *supra* note 2.

<sup>204</sup> Canada Revenue Agency, Information Circular 76-12R6, “Applicable Rate of Part XIII Tax on Amounts Paid or Credited to Persons in Countries with which Canada has a Tax Convention” (2 November 2007) online: <<https://www.canada.ca/content/dam/cra-arc/migration/cra-arc/E/pub/tp/ic76-12r6/ic76-12r6-e.pdf>>.



This section is divided into two parts. This first examines the charging provisions that impose liability for Part XIII tax and the administrative provisions for the collection of that tax. The next looks at the charging provisions for capital gains arising from the disposition of taxable Canadian property and concomitant withholding obligations therefrom.

#### 4.2.1 Non-Resident Tax Liability under Part XIII of the Act

Part XIII of the Act imposes a 25 percent tax on a non-resident who receives certain amounts, and it places an obligation to withhold, report, and remit the non-resident's tax on the Canadian-resident payor of such amounts. As non-resident taxpayers, SWFs could be subject to the statutory 25 percent withholding tax imposed on many different types of Canadian-source payments, the most commercially significant of which are interest,<sup>205</sup> rents, royalties,<sup>206</sup> and dividends,<sup>207</sup> unless an income tax treaty applies to reduce or eliminate the tax (see Figure 5). Tax under Part XIII of the Act is imposed on a gross basis – that is, no deductions for expenses (e.g., borrowing costs) are permitted in calculating the non-resident's Canadian-source income.<sup>208</sup>

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<sup>205</sup> *Income Tax Act*, *supra* note 1, para 212(1)(b).

<sup>206</sup> *Ibid* para 212(1)(d).

<sup>207</sup> *Ibid* para 212(2).

<sup>208</sup> *Ibid* subsection 214(1) stipulates that the tax charged under section 212 is payable on the amounts paid or credited to the non-resident “without any deduction from those amounts whatever.” See also, *Barki v MNR*, [1975] CTC 2300 TRB.

Figure 5: Passive Payments to SWFs Potentially Subject to Canadian Income Tax

Type of Payment	Legislative Provision
Interest	s. 212(1)(b)
<ul style="list-style-type: none"> <li>• Non-arm's length interest other than "fully exempt interest"</li> </ul>	s. 212(3)
<ul style="list-style-type: none"> <li>• "participating debt interest"</li> </ul>	s. 212(3)
<ul style="list-style-type: none"> <li>• deemed interest</li> </ul>	s. 214(6)
<ul style="list-style-type: none"> <li>• accrued interest</li> </ul>	s. 214(7)
<ul style="list-style-type: none"> <li>• guarantee fees deemed to be interest</li> </ul>	s. 214(15)
Rents & Royalties	s. 212(1)(d)
Dividends	s. 212(2)
<ul style="list-style-type: none"> <li>• taxable dividends</li> </ul>	s. 212(2)
<ul style="list-style-type: none"> <li>• capital dividends</li> </ul>	s. 212(2)
<ul style="list-style-type: none"> <li>• deemed dividends in respect of shareholder benefits and indirect payments</li> </ul>	s. 214(3)(a)
<ul style="list-style-type: none"> <li>• deemed dividends in respect of certain non-resident transfers of shares in a Canadian corporation</li> </ul>	s. 212.1(1.1)

The charging provisions for the 25 percent tax on passive receipts are subsections 212(1) and 212(2) of Part XIII of the Act. The preamble to subsection 212(1) states that:

Every non-resident person shall pay an income tax of 25 percent on every amount that a person resident in Canada pays or credits, or is deemed by Part I to pay or credit, to the non-resident person as, on account or in lieu of payment of, or in satisfaction of [...]

Subsection 212(1) then lists various types of income to which the tax applies in paragraphs (a) through (x), including interest in paragraph (b) and rents and royalties in paragraph (d). In the case of dividends, the charging provision is subsection 212(2). Its preamble is identical, except that it refers to amounts received from a corporation resident in Canada. Tax under subsection 212(2) is imposed on certain taxable dividends and on capital dividends.

An amount is considered paid or credited under Part XIII of the Act if it is legally set aside for use by the non-resident, regardless of whether it is ultimately reinvested, rather than distributed to the non-resident. The word “credit” implies that the Canadian resident has “set aside and made unconditionally available to the non-resident an amount due to the non-resident.”<sup>209</sup> Although subsection 212(1) refers to amounts that a person resident in Canada pays or credits to a non-resident, various other provisions of the Act extend the scope of the provision to transfers between non-residents in cases where the income is derived from or related to Canadian real property or natural resources.<sup>210</sup>

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<sup>209</sup> Jinyan Li, Arthur Cockfield, & J Scott Wilkie, *International Taxation in Canada* (Toronto: LexisNexis Canada, 2006) at page 115. This also is the view of the Canada Revenue Agency (CRA). See Canada Revenue Agency. *Information Circular 77-16R4*, “Non-Resident Income Tax” (11 May 1992) at paragraph 5 and, for example, Canada Revenue Agency, Technical Interpretation 2015-0618191E5 (“group term life insurance policy”).

<sup>210</sup> See subsections 212(13), (13.1), and (13.2) of the Act *supra* note 1, which deem non-residents who pay or credit amounts derived from rent of Canadian property, timber royalties, and other types of payments, to be Canadian residents. For further discussion, see *Information Circular 77-16R4*, “Non-Resident Income Tax,” *supra* note 201 at paragraphs 9 to 13.

#### 4.2.1.1 Interest

The term “interest” is not defined in the Act. According to case law, interest is compensation for the use another person’s money. It is considered to have three necessary features: (1) it is compensation for the use of money; (2) the amount must be referable to a principal sum; and (3) it accrues daily.<sup>211</sup>

The charging provision for non-resident withholding tax on interest is paragraph 212(1)(b) of the Act. This provision is subject to a number of exceptions that exclude certain types of interest from Part XIII tax; at the same time, other provisions deem certain payments to be interest and, therefore, make them subject to tax under paragraph 212(1)(b). Following the 2007 Budget, withholding tax on arm’s length interest was eliminated. In addition, tax on interest on non-arm’s length cross-border debt between Canada and the United States was eliminated.<sup>212</sup> As such, withholding tax on interest is only payable in limited circumstances, each of which is discussed below.

First, withholding tax is payable on interest paid or credited to a non-resident person where (1) the interest is not “fully exempt interest” and (2) the Canadian resident who pays the interest does not deal at arm’s length with the non-resident. The “arm’s length” concept runs throughout the Act. Although the term is not defined, certain relationships are deemed to be non-arm’s length by subsection 251(1) of the Act, e.g., where one corporation enjoys *de*

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<sup>211</sup> Tim Edgar, “The Concept of Interest Under the Income Tax Act,” (1996) 44:2 CTJ 277 at 284.

<sup>212</sup> *Budget Implementation Act 2007*, SC 2007, c 29. The 5<sup>th</sup> Protocol to the Canada-US Tax Treaty contains an exception to this exemption from Canadian withholding tax on interest arising in Canada that is determined with reference to receipts, sales, income, profits, or other cash flow of the debtor or related person; *The Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital*, signed at Washington, DC, on September 26, 1980, as amended by the protocols signed on June 14, 1980, May 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007 online: <https://www.fin.gc.ca/treaties-conventions/unitedstates-etatunis-eng.asp> [Canada-US Tax Treaty] See Article XI (Interest).

*jure* control over another.<sup>213</sup> In addition, parties are dealing with each other at arm's length where a common mind bargains for both sides of a transaction, where parties act in concert or without separate interests, or where one person exercises *de facto* control over the other.<sup>214</sup>

“Fully exempt interest” is defined in subsection 212(3) of the Act. Paragraph 212(3)(a) exempts from tax interest on certain types of Canadian government debt, including bonds and other debt obligations of Canadian federal, provincial, and municipal governments. Paragraph 212(3)(b) exempts interest paid on mortgages secured against real property located outside Canada. Paragraph 212(3)(c) exempts interest paid to prescribed international organizations; section 806 of the *Income Tax Regulations* lists those exempt payees, including the International Monetary Fund (IMF) and the two arms of the World Bank, the International Bank for Reconstruction and Development and the International Development Association. Finally, paragraph 212(3)(d) exempts certain amounts that are deemed interest by subparagraph 260(8)(c)(i) of the Act in respect of qualified securities where those securities are loaned under a securities lending arrangement entered into by a borrower who is carrying on business outside Canada.

Secondly, Part XIII withholding tax is payable in respect of “participating debt interest.” The term is defined in subsection 212(3) to mean interest that is:

- paid or payable on an obligation, all or any portion of which interest is contingent or dependent on the use of or production from property in Canada;
- computed by reference to revenue, profit, cash flow, commodity price, or any other similar criterion; or

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<sup>213</sup> A discussion of the meaning of “arm's length” is beyond the scope of this thesis. For more information, see Canada Revenue Agency, Income Tax Folio S1-F5-C1, *Related Persons and Dealing at Arm's Length*, online: <<http://www.cra-arc.gc.ca/tx/tchncl/ncmtx/fls/s1/f5/s1-f5-c1-eng.html>>.

<sup>214</sup> See e.g., *William J. McNichol et al v The Queen*, 97 DTC 111, at pages 117 and 118, [1997] 2 C.T.C. 2088.

- computed by reference to dividends paid or payable to shareholders of any class of shares of the capital stock of a corporation.

The “participating debt interest” definition is in essence an anti-avoidance provision that applies where the debt obligation is essentially a substitute for direct ownership of securities, the dividends or gains on which would normally be subject to tax in Canada.<sup>215</sup>

In addition, certain provisions deal with deemed interest and accrued interest. If a non-resident sells or transfers certain debt obligations for an amount that is greater than the issue price, subsection 214(7) generally deems the excess portion to be a payment of interest made by a Canadian resident payor to a non-resident payee.<sup>216</sup> Similarly, subsection 214(6) deals with accrued interest on certain obligations issued by a Canadian resident that are assigned or transferred to a non-resident. Subsections 214(6) and 214(7) normally apply where a non-resident transfers an obligation to a person resident in Canada; subsection 214(9) extends the scope of those provisions by deeming certain non-resident transferees to be resident in Canada for the purposes of Part XIII of the Act. As a result, a transfer between two non-residents may be caught by the Act.<sup>217</sup>

Finally, subsection 214(15) of the Act deems certain guarantee fees to be interest – and therefore subject to withholding tax unless the interest is otherwise exempt – where a non-resident guarantees the repayment of a debt on behalf of a Canadian resident.

#### *4.2.1.2 Rents and Royalties*

Pursuant to paragraph 212(1)(d) of the Act, rents, royalties, and other similar payments are subject to Part XIII withholding tax. The charging provision is broadly worded

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<sup>215</sup> See Canada Revenue Agency, Technical Interpretation 2014-0547431I7 (21 January 2015) and Canada Revenue Agency, Technical Interpretation 2000-0046375 (22 November 2000).

<sup>216</sup> See *Information Circular* 77-16R4, “Non-Resident Income Tax” *supra* note 201 paragraph 24.

<sup>217</sup> *Ibid* at paragraph 26.

to include payments for the use in Canada of various forms of intellectual property, trade secrets, and so on – as well as specific payments listed in the provision. However, the paragraph does not apply to copyright royalties, including software royalties.<sup>218</sup> The terms “rent” and “royalty” are not defined in the Act and therefore have their ordinary commercial meaning.<sup>219</sup> Both refer to payments for the use of property. A rent is generally a fixed amount, whereas a royalty is typically an amount that is calculated based on the use of, or production from, property.<sup>220</sup> The Act provides a non-exhaustive list of “similar payments” in paragraph 212(1)(d) that includes, *inter alia*, payments for trade names, trademarks, patents, industrial, commercial, or scientific knowledge.

A tax treaty may apply to reduce the rate of withholding tax on certain royalties, but the reduction of withholding tax rates on rentals of real property situated in Canada is almost never permitted by treaty. However, section 216 of the Act does permit a non-resident to elect to be taxed under Part I on rent from real property in Canada. This may allow the non-resident to make certain deductions from rental income, rather than pay tax on the gross rental amount under Part XIII.

#### 4.2.1.3 Dividends

Subsection 212(2) imposes a 25 percent withholding tax on taxable dividends (other than certain capital gains dividends) and on capital dividends paid or credited to a non-resident person. The terms “dividend,” “taxable dividend,” and “capital dividend” are

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<sup>218</sup> See *Angoss International Ltd v The Queen*, [1999] 2 CTC 2259, 99 D.T.C. 567 (TCC).

<sup>219</sup> In contrast, the term “royalty” is usually defined in tax treaties. The OECD Model Tax Treaty *supra* note 117, upon which Canada’s tax treaties are based, defines royalties in Article 12 as “payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.”

<sup>220</sup> See *Vauban Productions v Canada*, [1975] CTC 511, 75 DTC 5371.

defined in subsection 248(1) of the Act. The term “dividend” has its ordinary commercial meaning and includes stock dividends. The courts have held that a dividend is a *pro rata* distribution from a corporation to its shareholders other than a distribution made upon winding down or an authorized reduction of capital.<sup>221</sup> A taxable dividend is one received from a corporation resident in Canada that must be included in income.<sup>222</sup> A capital dividend is essentially a dividend paid out of the tax-free portion of capital gains or other tax-exempt income.<sup>223</sup>

In addition, certain payments are deemed to be dividends received from a corporation resident in Canada and therefore subject to the charging provision in subsection 212(2) of the Act.<sup>224</sup> Paragraph 214(3)(a) of the Act applies to the payment of an amount where that amount would, if the non-resident were resident in Canada, have been included in income as a shareholder benefit under section 15 of the Act or as an indirect payment under subsection 56(2). Paragraph 214(3)(a) ensures that non-resident shareholders, who are not subject to Part I tax, do not escape Part XIII tax on certain corporate distributions. Meanwhile, section 212.1 of the Act deems a dividend to have been paid to and received by a non-resident person in circumstances where that non-resident has disposed of shares of one Canadian corporation to another Canadian corporation with which the non-resident does not deal at arm’s length. This is essentially an anti-capital gains stripping provision analogous to section 84.1 of the Act.

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<sup>221</sup> See *Hill v Permanent Trustee Co of New South Wales Ltd*, [1930] All ER Rep 87, [1930] AC 720 (PC).

<sup>222</sup> See subsections 248(1) and 89(1) of the Act *supra* note 1, *sub verbo* “taxable dividend.” For further discussion, see Canada Revenue Agency, IT-67R3, “Taxable dividends from corporations resident in Canada” (15 May 1992).

<sup>223</sup> See subsection 83(2) of the Act *supra* note 1. For further discussion, see Canada Revenue Agency, Income Tax Folio S3-F2-C1, *Capital Dividends*.

<sup>224</sup> See *Placements Servo Ltée v MNR*, [1987] FCJ No 920, [1988] 1 CTC 213.



#### *4.2.1.4 Payor's Obligation to Withhold and Remit Part XIII Tax*

Although the 25 percent tax is imposed on the non-resident under section 212 of the Act, subsection 215(1) requires the Canadian payor of taxable amounts to withhold, remit, and report the tax to the CRA. Subsection 215(1) reads as follows:

When a person pays, credits or provides, or is deemed to have paid, credited or provided, an amount on which an income tax is payable under this Part, or would be so payable if this Act were read without reference to subparagraph 94(3)(a)(viii) and to subsection 216.1(1), the person shall, notwithstanding any agreement or law to the contrary, deduct or withhold from it the amount of the tax and forthwith remit that amount to the Receiver General on behalf of the non-resident person on account of the tax and shall submit with the remittance a statement in prescribed form.<sup>225</sup>

In addition, the Canadian payor is made liable for the withholding tax that ought to have been paid to the Receiver General pursuant to subsection 215(6) of the Act, which provides that a payor who fails to deduct or withhold Part XIII tax is obliged to pay on behalf of the non-resident person the whole amount of tax that should have been deducted or withheld. Where possible, a payor who has neglected to withhold tax as required may be able to deduct from subsequent payments to be made to the non-resident, or otherwise recover from the non-resident, any tax that the payor has paid on their behalf. In the case of periodic payments, recovery may be a simple matter; in other cases, it may be very difficult.

#### *4.2.1.5 Penalties, Interest, and Refunds*

Besides liability for Part XIII tax, the Canadian payor may be subject to a penalty equal to 10 percent of the amount that should have been withheld under subsection 227(8) of the Act. The penalty is increased to 20 percent if the failure to withhold was made knowingly. Subsection 227(8.1) makes the Canadian payor jointly and severally liable with

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<sup>225</sup> The tax is due by the 15<sup>th</sup> day of the month following the payment to the non-resident. The prescribed form is PD7AR-NR, "Remittance Form." See paragraph 54 of IC 77-16R4, *supra* note 209.

the non-resident payee for interest on the unpaid tax, calculated at the prescribed rate and compounded daily.

Canadian persons who have paid or credited interest, dividends, rents, or royalties (as well as other amounts) to non-residents are required to complete an information return.<sup>226</sup> This information return must also be sent to each non-resident on whose behalf the tax has been withheld and remitted. If the non-resident believes that the tax has been withheld in excess or in error, it may request a refund from the CRA.<sup>227</sup>

#### 4.2.2 Non-Resident Tax Liability for Gains on the Disposition of Taxable Canadian Property

A non-resident SWF that invests in Canada may be liable to tax on the gain arising from the disposition of certain Canadian property. In particular, the non-resident SWF may be subject to tax on the “taxable capital gain”<sup>228</sup> arising from the disposition of “taxable Canadian property” (TCP). As will be discussed in further detail, TCP is Canadian real property or resource property (or an interest therein) as well as certain other types of property. As under Part XIII of the Act, the non-resident’s tax liability is enforced through withholding obligations – this time imposed on the purchaser of property.

##### *4.2.2.1 Gains on the Disposition of Taxable Canadian Property*

The charging provision for non-resident capital gains tax is paragraph 2(3)(a) of the Act, which provides that an income tax shall be paid “as required by this Act” where a non-resident disposes of TCP. The calculation of the tax is determined according to section 115

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<sup>226</sup> The prescribed form is NR4, Statement of Amounts Paid or Credited to Non-Residents of Canada.

<sup>227</sup> The prescribed form is NR7-R, “Application for a Refund on Non-Resident Part XIII Tax Withheld.”

<sup>228</sup> Per section 38 of the Act *supra* note 1, a taxpayer’s taxable capital gain from the disposition of a property is one half of the taxpayer’s capital gain from the disposition of that property.

of the Act. Unlike Part XIII tax on passive income, income from the disposition of such property is taxable under Part I, Division D, of the Act on a net basis – that is, certain deductions for expenses and carryovers of certain losses are permitted in calculating the non-resident’s income. Where capital cost allowance has been claimed in respect of the property, there may be recapture. Generally, the gain from the disposition of TCP is the amount by which the non-resident investor’s proceeds of disposition (less reasonable expenses related to the disposition) exceed the adjusted cost base of the property.<sup>229</sup> The taxable portion of gain is one half. The tax rate varies progressively for individuals and certain trusts; in the case of a corporation, the applicable rate is the flat corporate tax rate.<sup>230</sup>

The definition of “taxable Canadian property” in subsection 248(1) of the Act includes, among other things:

- real or immovable property situated in Canada;
- property used in a business carried on in Canada;
- shares of unlisted Canadian corporations (under certain circumstances);
- shares of listed Canadian corporations (under certain circumstances);
- a Canadian resource property;<sup>231</sup>
- a timber resource property;<sup>232</sup>
- an income interest in a Canadian-resident trust; and
- an option or interest in, or a right to, one of the types of property listed above.

Shares of unlisted Canadian corporations are TCP if they at any time in the 60-month period before the shares are sold by the non-resident investor, more than half of the fair market value of the shares was derived from (1) real property situated in Canada, (2)

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<sup>229</sup> See subsection 40(1) and section 54 of the Act, *supra* note 1.

<sup>230</sup> For 2016 and 2017, the general corporate rate is 28 percent federally.

<sup>231</sup> Canadian resource property is defined under subsection 66(15) of the Act and includes nearly all forms of oil and gas-related properties, including wells, royalties, exploration and drilling rights.

<sup>232</sup> Timber resource property is defined under subsection 13(21) of the Act and includes rights or licences to harvest timber in Canada.

Canadian resource properties, (3) timber resource properties, and (4) options, interests, or rights in any of the foregoing. This is sometimes known as the “value test.” Likewise, shares of listed Canadian corporations are TCP if they meet the value test and, additionally, if, at any time in the 60-month period before the shares are sold by the non-resident investor, more than one-quarter of the issued shares of the listed corporation were owned by the non-resident either alone or in combination with others with whom it did not deal at arm’s length (the “votes” test).

Finally, subsection 115(1)(b) excludes from Part I tax the gain arising from the disposition of “treaty-protected property.” “Treaty protected property” is defined in subsection 248(1) of the Act as property any income or gains from a disposition of which would, because of a tax treaty with another country, be exempt from tax under Part I. For example, many treaties prevent the source country from taxing gains from the disposition of unlisted company shares, unless the company derives its value principally from real property situated in Canada.<sup>233</sup>

#### *4.2.2.2 Withholding Obligations and Filing Requirements*

The non-resident’s tax liability is enforced through obligations to report and withhold imposed on the purchaser of the property under section 116 of the Act. Subsection 116(3) requires a non-resident who disposes of TCP (other than “excluded property”) to send to the Minister of National Revenue, within 10 days of the disposition, certain information related to the disposition, including a description of the property, the proceeds of disposition, and the non-resident’s adjusted cost base.<sup>234</sup> The non-resident is required to

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<sup>233</sup> See, e.g., Article XIII(3) of the Canada-US Tax Treaty *supra* note 212.

<sup>234</sup> The relevant form is T2062, *Request by a Non-Resident of Canada for a Certificate of Compliance Related to the Disposition of Taxable Canadian Property*.

do this, regardless of whether or not the gains are exempt from tax, unless the non-resident has obtained a clearance certificate under subsection 116(1) of the Act.<sup>235</sup>

A clearance certificate may be obtained in advance of the disposition of TCP pursuant to subsection 116(1) of the Act. In order to do so, the non-resident must send notice to the Minister setting out information with regard to the proposed disposition, including the name of the prospective purchaser, the expected proceeds, the adjusted cost base of the property, and so forth. The non-resident must pay to the Minister one-quarter of the anticipated gain on the disposition of the property or furnish acceptable security for the anticipated tax liability.

If the non-resident vendor does not obtain a clearance certificate, the purchaser may be liable for one-quarter of the purchase price of the property and is authorized by subsection 116(5) to withhold one-quarter of the purchase price from the sale on behalf of the Minister. If this amount exceeds the amount that the non-resident vendor would be required to pay to obtain a clearance certificate, it will usually be advantageous for the vendor to obtain clearance in advance of a proposed disposition. Where there is no clearance certificate and the purchaser fails to withhold and remit the requisite amount to the Minister, subsection 116(5) imposes liability on the purchaser for the amount that ought to have been withheld.

The foregoing withholding and filing obligations do not apply if the property is “excluded property,” as defined in subsection 116(6) of the Act. Excluded property includes shares of a company listed on a designated stock exchanges. This is to ensure feasibility of administration and compliance, given that it is not possible for a purchaser to know the identity of the vendor of shares purchased on a stock exchange. In addition, withholding and

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<sup>235</sup> For more information, see CRA, IC72-17R6, *Procedures concerning the disposition of taxable Canadian property by non-residents of Canada – Section 116*.

filing obligations for gains on listed company shares might impair the efficient functioning of stock exchanges. In any case, listed company shares are generally not TCP, so the exclusion is of limited effect. Evidently, where listed shares do qualify as TCP – that is, where a non-resident vendor owns more than 25 percent of the issued stock of a Canadian company whose value is chiefly derived from Canadian resource, timber or real property – the non-resident vendor may have a tax liability under paragraph 2(3)(a) in concert with paragraph 115(1)(b) of the Act. However, there is no filing requirement under subsection 116(3) of the Act and no corresponding withholding obligation. In practice, this suggests that a non-resident investor's tax liability for gains arising from listed TCP shares may be unenforceable.

### **4.3 Impact of Part I and Part XIII on Non-Resident SWFs**

The previous section outlined the two main types of tax that may apply to a foreign SWF that invests in Canada. First, a foreign SWF may be subject to a withholding tax of 25 percent on passive income received from Canada, such as certain types of interest and dividends. Secondly, a foreign SWF that disposes of TCP may be liable to tax on any gain arising from the disposition of TCP, which includes shares in Canadian companies whose value is derived primarily from Canadian resources, timber, or real property.

#### **4.3.1 Tax Saliency and Lack of Foreign Tax Credit**

For most non-resident private investors, in contrast with state investors, relief from Canadian tax may be available in their home country by means of a foreign tax credit: the underlying Canadian tax may be credited against tax owing in the non-resident investor's country of residence. However, since SWFs are generally not subject to tax in their home countries,<sup>236</sup> as a practical matter a foreign tax credit will not compensate a SWF for any

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<sup>236</sup> A notable exception is China, see Chris Roberge et al, *supra* note 201.

Canadian tax borne by it. Thus, due to their tax-exempt status in their home jurisdictions, SWFs display a “relatively strong desire to mitigate tax at the investment level [and] ... a lower tolerance for investment level tax leakage.”<sup>237</sup>

All things being equal, the lack of a foreign tax credit can be expected to increase the salience of the Canadian tax. Tax salience refers to how the presentation or visibility of a tax affects taxpayer behaviour.<sup>238</sup> The literature on tax salience is essentially empirical, measuring how the presentation, visibility, timing, and relation to benefits of various taxes impacts taxpayer behaviour. Where a foreign tax credit is available in respect of a cross-border transaction, one would expect the behavioural effect of any source country taxation to be blunted by foreign tax credit. However, where there is no foreign tax credit to offset source country taxes, those taxes are more visible and, therefore, more likely to impact the decision of a SWF to invest in the source country.

#### **4.4 Availability of Treaty Relief**

Although SWFs generally do not benefit from foreign tax credits, they may be able to benefit from the provisions of an applicable tax treaty. Canada has entered into more than 90 bilateral income tax treaties intended to avoid double taxation and, increasingly, to prevent fiscal evasion. This network of bilateral tax treaties overlays the domestic tax system and creates the framework for the division of the tax base between countries with competing claims to tax the same income. For example, if residents of country A invest in a corporation incorporated in country B that carries on business in country C, all three countries may have a claim to tax the resulting income. Tax treaties provide a negotiated framework within which the tax claims of each contracting state are stipulated. Thus, tax

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<sup>237</sup> Maurice, *supra* note 42.

<sup>238</sup> See David Gamage & Darien Shanske, “Three Essays on Tax Salience: Market Salience and Political Salience” (2011) 65:1 Tax L Rev 19.

treaties help each country to protect its tax base, promote cooperation between taxing authorities, and remove barriers to cross-border investment and business transactions.

#### 4.4.1 Features of Canadian Tax Treaties

Nearly all of Canada's recent tax treaties are based on the OECD Model Tax Convention on Income and on Capital (OECD Model).<sup>239</sup> The distribution of competence to tax in the OECD Model reflects two competing norms: the residence principle and the source principle. The residence principle holds that income is taxable where a taxpayer resides. The source principle holds that income is taxable in the jurisdiction where the income originates. Virtually all countries levying an income tax do so, at a minimum, on the basis of source.<sup>240</sup> However, many countries, including Canada, define their tax jurisdiction according to residence as well.

Residence taxation has worldwide reach, while source taxation is limited to income arising within the territory only. Because of the difference in scope between residence and source jurisdiction, the international portion of the Canadian tax system has two major components: outbound taxation of Canadian residents on their foreign source income and inbound taxation of non-residents on their Canadian-source income. Each set of rules distinguishes between active and passive income. Active income is produced by exertion on the part of the taxpayer, e.g., through employment or carrying on a business. Passive income

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<sup>239</sup> Canada's tax treaties also draw on the UN Model Treaty, which was developed in response to the criticism that the OECD Model is unfavourable to developing countries. In practice, it appears that the Department of Finance has two unpublished model treaties – "one for use in negotiations with developed countries, and one for less developed countries that adopts some of the departures from the OECD model found in the UN model." See David A Ward, "Canada's Tax Treaties," (1995) 43:5 CTJ 1719 at 1726-1727.

<sup>240</sup> Nancy H Kaufman, "Fairness and the Taxation of International Income," (1998) 29 Law & Pol'y Int'l Bus 23 at page 46. In addition to residence and source, countries may also assert tax jurisdiction over all their citizens, regardless of where they live. The United States is the only developed country that taxes citizenship.



is earned by making capital available to another person and receiving a return on investment in exchange. Whether for reasons of efficiency or of entitlement, Canadian tax rules and most bilateral tax treaties assume that active income should be taxed at the source country rate, while passive income should be taxed at the residence country rate.<sup>241</sup>

Finally, Canadian tax treaties are relieving in nature: they do not impose any additional tax, but merely offer relief from double taxation that might arise where source and residence countries share overlapping jurisdiction to tax. As such, Canada's tax treaties do not alter the domestic tax scheme (which was discussed at the beginning of this chapter), apart from offering reduction in the extent of tax that Canada may impose.

In the case of passive payments, such as dividends or interest, Canadian tax treaties reduce the tax rate from the statutory 25 percent to a lower rate, ranging from nil to 15 percent depending on the treaty and the type of income. Where a treaty reduction is available, subsection 10(6) of the *Income Tax Application Rules*<sup>242</sup> overrides the 25 percent rate for both the non-resident's tax liability and the payer's withholding obligations. In the case of capital gains, the OECD Model and the Act both permit taxation of capital gains in the residence country only, except where the gain arises from the disposition of real or resource property situated in the source country. Under the Act, this is reflected in the definition of TCP in subsection 248(1) (as discussed earlier in this chapter). Under the OECD Model, this is reflected in Article 13, which provides that gains from the alienation of property are taxable only in the jurisdiction where the vendor is resident, except where the property is immovable property located in the source country or where the property derives its value

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<sup>241</sup> Li, *supra* note 209 at pages 14 – 16.

<sup>242</sup> RSC 1985, c 2 (5<sup>th</sup> Supp).

from such immovable property (e.g., shares whose value is mostly attributable to immovable property located in the source country).<sup>243</sup>

#### 4.4.2 Treaty Residence of SWFs

The benefits afforded under treaties based on the OECD Model are available only to “residents” of the contracting states.<sup>244</sup> However, the OECD Model was not originally drafted with the “state-as-taxpayer” in mind. As described in Article 4 of the OECD Model, a resident of a contracting state was understood as a person liable to tax in that state. A “person” was defined in Article 3 as an individual, a company, or a body of other persons.

The Model Convention was amended in 1995 to make explicit that the government of each Contracting State, as well as any political subdivision or local authority thereof, is a resident of that State for the purposes of the treaty. Article 4 reads as follows:

For the purposes of this Convention, the term “resident of a Contracting State” means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein. [Emphasis added.]

Certain of Canada’s tax treaties still contain the original wording without reference to “the State.” The commentary to the OECD Model states that “it has been the general

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<sup>243</sup> The OECD’s proposed *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* online: <http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-BEPS.pdf> [the Multilateral Convention]. It expands the source country’s right to tax capital gains on real property. At present, the source country generally has the right to tax capital gains where the value of the property – at the time it was disposed of – is mainly derived from real property located in the source country (see the discussion of TCP earlier in this chapter). The Multilateral Convention, if implemented, would expand this right where the value threshold was met at any time in the 365 days preceding the disposition. See Article 9 of the Multilateral Convention.

<sup>244</sup> As with other investors, sovereign wealth funds are capable of structuring their investments in order to access preferential treaty benefits under other jurisdictions’ tax treaties (i.e., treaty shopping).

understanding of most member countries that the government of each State, as well as any political subdivision or local authority thereof, is a resident of that State for the purposes of the Convention.”<sup>245</sup> The Supreme Court of Canada has recognized the “high persuasive value” of OECD Model and the Commentary thereto as extrinsic interpretive aids to Canada’s tax treaties.<sup>246</sup> However, caution must be exercised where the wording of the treaty under interpretation differs from the OECD Model.<sup>247</sup>

Although based on the OECD Model, each Canadian tax treaty is separately negotiated between Canada and the foreign country, and, as such, each treaty has its own distinct wording. Negotiating tax treaties allows Canada to agree to mutually beneficial tax treatment for its investors and to carve out special rules as a result of agreement and compromise with other states. In two cases, individual SWFs have been expressly afforded treaty benefits under Canadian tax treaties. Those are the Abu Dhabi Investment Authority and the KIA (see Figure 6), who likely bargained for the inclusion of their national SWFs. As well, the Canada-Norway Tax Treaty exempts dividends paid to one of the Contracting States from source-country taxation from time to time as agreed by the competent authorities.

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<sup>245</sup> See paragraph 8.4 of the commentary on Article 4 in OECD, *Commentaries* supra note 117.

<sup>246</sup> *Crown Forest Industries Limited v Canada*, [1995] 2 S.C.R. 802, 95 DTC 5389 at paragraph 55.

<sup>247</sup> See Stephen R Richardson & James W Welkoff, “The Interpretation of Tax Conventions in Canada” (1995) 43:5 CTJ 1759 at 1784.

Figure 6: The Definition of “Resident” in Article 4 of Certain Canadian Tax Treaties

Treaty Partner	The definition of resident includes:
Australia	<ul style="list-style-type: none"> <li>• the State</li> <li>• a political subdivision of the State</li> <li>• an agency or instrumentality of the State</li> </ul>
China	<ul style="list-style-type: none"> <li>• any person who is liable to tax therein by reason of his domicile, residence, place of head office, place of management or any other criterion of a similar nature</li> </ul>
Germany	<ul style="list-style-type: none"> <li>• the State</li> <li>• a “Land” or political subdivision or local authority of the State</li> <li>• an agency or instrumentality of the State</li> </ul>
Kuwait	<ul style="list-style-type: none"> <li>• the Government of the State</li> <li>• a political subdivision or local authority of the State</li> <li>• any corporation, Central Bank, fund, authority, foundation, commission, agency or other entity that is wholly-owned and controlled by the Government</li> <li>• any entity all the capital of which has been provided by the Government</li> </ul>
Norway	<ul style="list-style-type: none"> <li>• the State</li> <li>• a political subdivision or local authority of the State</li> <li>• an agency or instrumentality of the State</li> </ul>
Russia	<ul style="list-style-type: none"> <li>• The definition does not include any reference to the State.</li> </ul>
Singapore	<ul style="list-style-type: none"> <li>• The definition does not include any reference to the State.</li> </ul>
United Arab Emirates	<ul style="list-style-type: none"> <li>• the State</li> <li>• a political subdivision or local authority of the State</li> <li>• an agency or instrumentality of the State</li> <li>• the Government of the State</li> <li>• any corporation, Central Bank, Abu Dhabi Investment Authority, fund, authority, foundation, commission, agency or other entity established under the law of the State that is wholly-owned and controlled by the Government</li> <li>• any entity all the capital of which has been provided by the Government</li> </ul>
United States	<ul style="list-style-type: none"> <li>• the State</li> <li>• a political subdivision or local authority of the State</li> <li>• an agency or instrumentality of the State</li> </ul>

The question of whether a SWF can claim treaty benefits remains a live one in the majority of cases. Paragraph 6.36 of the commentary to Article 1 of the OECD Model discusses entities that are wholly owned by a State. With respect to these, some states modify the definition of “resident” in Article 4 to include a “statutory body,” an “agency or instrumentality of the State,” or a “legal person of public law.” According to the commentary, these phrases extend the scope of the Convention to wholly owned entities. As indicated in Figure 6, several Canadian tax treaties do refer to an agency or instrumentality of the state, but it is not clear that all wholly owned entities of a state are *de facto* agents or instruments of that state.<sup>248</sup>

Finally, paragraph 8.5 of the commentary to Article 4 of the OECD Model has the following to say about SWFs:

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, paragraphs 8.6 and 8.7 below will be relevant.<sup>249</sup> States may want to address the issue 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.

In summary, a SWF might be entitled to claim treaty benefits via four possible avenues, subject of course to the wording of the particular treaty in question. The first, and most direct, is to expressly include the SWF in Article 4, as has been done for the Abu Dhabi Investment Authority and for the KIA. This has the benefit of certainty, but it does require negotiation between the state parties, which is costly and time consuming. Secondly,

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<sup>248</sup> It is certainly not the case that every Crown Corporation is an agent of the Crown. The Supreme Court of Canada stated in *Nova Scotia Power Inc v Canada*, [2004] 3 SCR 53, that an entity is an agent of the Crown where the Crown closely controls it or where the legislature has explicitly created it as an agent (at paragraphs 12 and 13).

<sup>249</sup> Paragraphs 8.5 and 8.6 of the commentary to Article 4 of the OECD Model *supra* note 117 discuss the meaning of “liable to tax,” particularly as regards pensions, charities, and other tax-exempt entities.

a SWF may be considered a person liable to tax under the laws of one of the contracting states. However, this requires that the SWF be constituted as a company, e.g., a corporation, and, furthermore, most SWFs are immune, rather than merely exempt, from taxation in their home countries. Thirdly, a SWF may be considered such an integral part of the state that it qualifies as the state itself for the purposes of the tax treaty. Finally, a SWF may be considered an agent or instrument of the state and, therefore, it would be entitled to benefits under treaties whose definition of “resident” includes an agency or instrumentality of the state. This requires an analysis of the SWF’s relationship to the state and whether its actions could be regarded as those of the state itself.

#### **4.5 Sovereign Immunity from Canadian Taxation**

##### The Canada Revenue Agency’s Administrative Policy

The CRA recognizes that the doctrine of sovereign immunity applies to exempt certain foreign government investments from Canadian taxation. In this regard, the CRA’s administrative policy is to issue letters of exemption or written authorization confirming that an exemption from Part XIII withholding tax can be applied in respect of certain amounts paid to the government of another country. The administrative policy is described in a single paragraph in IT-77R4 that is now more than 25 years old. It reads:

Under the Doctrine of Sovereign Immunity, the Government of Canada may grant exemption from tax on certain Canadian-source investment income paid or credited to the government or central bank of a foreign country. Written authorization not to withhold tax is given to the Canadian resident payer upon request after substantiation that such investment income (other than that already exempt under the Act and Regulations) is the property of the government or central bank of a foreign country. The written authorization will have an expiry date at which time the Canadian payer would be required to re-apply for further authorization not to withhold. A request for authorization not to withhold should be forwarded to: Revenue Canada, Taxation 875 Heron Road Ottawa, Ontario K1A 0L8 Attention: Provincial and International Relations Division. Investment income of a foreign government or its agency is exempt only if (a)

the other country would provide a reciprocal exemption to the Canadian Government or its agencies; (b) the income is derived by the foreign government or agency in the course of exercising a function of a governmental nature and is not income arising in the course of an industrial or commercial activity carried on by the foreign authority; and (c) it is interest on an arm's length debt or portfolio dividends on listed company shares. Income such as rentals, royalties or direct dividends from a company in which the foreign government has a substantial or controlling equity interest does not qualify for exemption.<sup>250</sup>

Reference to the doctrine of sovereign immunity is also made in IC72-17R6, which states that:

Under the Doctrine of Sovereign Immunity, the Government of Canada may grant exemption from tax on certain Canadian-source investment income paid or credited to the government of a foreign country. Capital gains on the disposition of taxable Canadian property may be eligible for this exemption, subject to the conditions described in the current version of IC77-16, *Non-Resident Income Tax*. When the vendor of taxable Canadian property is a foreign government, the CRA will issue a certificate of compliance once it is substantiated that the property is, in fact, wholly-owned by that government.<sup>251</sup>

Finally, IC76-12R6 states that:

Interest and dividends paid to the government of another country might not be subject to the non-resident withholding tax either due to a standard provision in the tax conventions or according to the Doctrine of Sovereign Immunity. The current version of Information Circular 77-16 discusses how to obtain a written authorization from the CRA for the Doctrine of Sovereign Immunity exemption to apply.<sup>252</sup>

The CRA's interpretation of the scope of sovereign immunity within Canadian tax law limits the exemption from tax to certain Canadian-source investment income paid or credited to the government or central bank of a foreign country. Specifically, the exemption

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<sup>250</sup> Canada Revenue Agency, Information Circular IC 77-16R4, *supra* note 209 at paragraph 50.

<sup>251</sup> Canada Revenue Agency, Information Circular IC72-17R6, "Procedures Concerning the Disposition of Taxable Canadian Property by Non-residents of Canada," (September 29, 2011) at paragraph 71.

<sup>252</sup> Canada Revenue Agency, Information Circular IC 76-12R6, *supra* note 204 at paragraph 11.

applies to certain capital gains, interest on arm's length debt, and portfolio dividends of listed company shares, provided that the income is derived from activities of a governmental (rather than commercial) nature and that the other country would provide a reciprocal exemption to the Canadian government or its agencies. The exemption explicitly does not apply to rents, royalties, or direct dividends from a company in which the foreign government has a substantial or controlling equity interest.<sup>253</sup>

A representative seeking an exemption may request a letter of authorization in writing from the CRA and must include supporting documentation that establishes that the investment income is the property of the government or central bank of a foreign country. The letter will authorize the Canadian resident payer not to withhold tax for a defined period of time. The CRA does not consider a declaration of exemption from a foreign government or agency to be sufficient<sup>254</sup>; therefore, a Canadian resident payor should not rely on such a declaration at the risk of penalties.<sup>255</sup>

The policy closely resembles those set out in paragraph 6.39 of the OECD commentaries to Article 1 of the Model Tax Convention, which reads:

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

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<sup>253</sup> Canada Revenue Agency, IC 77-16R4, *supra* note 209, at paragraph 50.

<sup>254</sup> Canada Revenue Agency, Pending updates to IC76-12, Applicable rate of part XIII tax on amounts paid or credited to persons in countries with which Canada has a tax convention related to form NR301, NR302, and NR303, August 6, 2013, online: <<http://www.cra-arc.gc.ca/formspubs/frms/ic76-12r6-eng.html>>.

<sup>255</sup> Pursuant to section 227 of the *Income Tax Act*, where a Canadian payer fails to withhold an amount required under Part XIII of the *Income Tax Act*, the CRA may assess the Canadian payer for the amount of tax it ought to have deducted, as well as interest and a penalty of 10% of the tax. The penalty can rise to 20% for subsequent or repeat failures to withhold. See also Canada Revenue Agency, NR4 – Non-Resident Withholding, Remitting, and Reporting (2016) online: <<https://www.canada.ca/content/dam/cra-arc/migration/cra-arc/E/pub/tg/t4061/t4061-16e.pdf>>.



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 direct investment. [Emphasis added.]

The CRA adopted its administrative policy many years ago, at a time when SWF investment activity was considerably lower than today. As mentioned, the policy is brief, and it does not contemplate all possible scenarios. It is, therefore, not surprising that there are several shortcomings to the policy. The most serious is that the policy does not track directly to the requirements for sovereign immunity as provided in the SIA<sup>256</sup> and, as such, it lacks a clear basis in law. In addition, the policy is out of date and unclear.

As discussed in Chapter 3, the legislative basis for exemption from taxation is the non-commerciality of the income-producing activity; the administrative policy is, evidently, the CRA's interpretation of that requirement. Recall that the SIA provides immunity to foreign states, including foreign heads of state, governments, political subdivisions, and government agencies, except with respect to their commercial activities. The CRA's administrative position does not track exactly with the requirements of the SIA, which offers a broader scope of immunity. First, it imposes a requirement of reciprocity that is not contained in the SIA. Section 15 of that Act allows the Governor in Council, upon the recommendation of the Minister of Foreign Affairs (now Global Affairs), to make an order restricting the immunity afforded under the Act where the immunity Canada grants exceeds that accorded by another state. For example, the Minister has made an order, in respect of the United States, limiting the immunity of government agencies to only those government-

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<sup>256</sup> *Supra* note 2.

linked entities in which the US has a majority ownership.<sup>257</sup> Apart from this mechanism, there is no other avenue to restrict the immunity conferred by the SIA. To date, no orders have been made under that Act in respect of tax matters.

The CRA's exemption applies only to foreign governments or central banks and is limited to certain types of passive income, namely to certain capital gains, so-called "portfolio" dividends from listed shares, and to interest on arm's length debt. The exemption does not apply to other types of passive income (rents, royalties, and so-called "direct" dividends). Presumably, the Agency has determined that portfolio dividends and interest on arm's length debt are not *prima facie* commercial sources of income – although there is the additional caveat that such income must be derived from activities of a governmental nature. In contrast, the CRA has ruled out certain sources of income outright, even if derived from governmental activities. It may often be the case that direct dividends, rents, and royalties arise out of, in essence, an indirect share of a business; nevertheless, the test for exemption is the nature of the activity, not the type of property.

Finally, the administrative policy is also excessively narrow as regards the type of entities that may qualify. To qualify for the CRA's exemption, an applicant must establish that the income is the property of a foreign government or central bank, whereas under the SIA, agencies of a foreign state also qualify for immunity.<sup>258</sup> Despite this, however, practitioners report that the exemption has been granted to at least a few SWFs.<sup>259</sup>

Apart from the uncertainty of its legislative support, the policy is, by now, out of date. Following Budget 2007, interest on arm's length debt was eliminated from being

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<sup>257</sup> *Order Restricting Certain Immunity in Relation to the United States*, SOR/97-121.

<sup>258</sup> Documents produced as part of an Access to Information request, *supra* note 198, suggest that this requirement is not administered in practice.

<sup>259</sup> Henry Chong, "Canada-US Tax on Foreign SWFs," (2011) 19 *Canadian Tax Highlights* 5 at page 6.

subject to Canadian non-resident withholding tax, rendering that part of the policy moot.<sup>260</sup>

Perhaps more significantly, Budget 2007 also repealed subsection 212(14), which formerly allowed the Minister of National Revenue to issue a certificate of exemption from withholding obligations.<sup>261</sup> The former subsection read:

(14) Certificate of exemption --

The Minister may, on application, issue a certificate of exemption to any non-resident person who establishes to the satisfaction of the Minister that

(a) an income tax is imposed under the laws of the country of which the non-resident person is a resident;

(b) the non-resident person is exempt under the laws referred to in paragraph (a) from the payment of income tax to the government of the country of which the non-resident person is a resident; and

(c) the non-resident person is

(i) a person who is or would be, if the non-resident person were resident in Canada, exempt from tax under section 149,

(ii) a trust or corporation that is operated exclusively to administer or provide superannuation, pension, retirement or employee benefits, or

(iii) a trust, corporation or other organization constituted and operated exclusively for charitable purposes, no part of the income of which is payable to, or is otherwise available for, the personal benefit of any proprietor, member, shareholder, trustee or settlor thereof.

Subsection 212(14) allowed the Minister to grant certificates of exemption to foreign charities, pension funds, and other tax-exempt entities. It provided at least some legislative basis for the CRA to issue the certificates of exemption describes in the administrative policy. In its absence, it is unclear what authorizes the CRA's administrative policy, although arguably the Act is being interpreted so as to save the immunities provided to foreign states under the SIA.

Another concern is the ambiguity of the CRA's policy, particularly as regards the meaning of "portfolio" dividend, in contrast with "direct" dividends. Obviously, a portfolio investment is one that falls short of a substantial or controlling interest, but what is the

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<sup>260</sup> See text at note 212.

<sup>261</sup> *Budget and Economic Statement Implementation Act 2007*, SC 2007, c 35 s 59(4), applicable after 2007.

threshold?<sup>262</sup> Once again, there is no judicial or administrative guidance. The term “portfolio investment” is used in section 94.1 of the Act, an anti-avoidance provision that applies in certain circumstances where a taxpayer has an interest in a non-resident entity whose value is derived primarily from portfolio investments in listed assets. The term was recently considered in *Gerbro Holdings Company v Canada*,<sup>263</sup> wherein the Associate Chief Justice of the Tax Court offered the following analysis:

The common thread between the various definitions [of “portfolio investment”] is that they consider portfolio investments to be investments over which the investor does not exercise significant control, but merely wishes to passively benefit from an appreciation in value.

I therefore find that the ordinary commercial meaning of portfolio investment in the international investment context is an investment in which the investor (non-resident entity) is not able to exercise significant control or influence over the property invested in.

Since the OIFP [offshore investment fund property] Rules do not specify thresholds for determining whether or not a non-resident entity is taking a controlling interest, this determination will have to be made on the facts. Taken as a whole, the definitions suggest thresholds ranging from 10% to 25% ownership. However, one should be cognizant of the fact that a small group of well-organized investors could have a controlling interest while having less than 10% ownership, especially in the case of sizeable investments.

A helpful indicator of a controlling interest is that the investments are usually long-term investments acquired at a premium to gain access to some level of control. This suggests that portfolio investments are passive investments that do not entail active management of, or control over, the operations of the underlying investment in any manner whatsoever. Investments that are bought and sold within a short time are more compatible with portfolio investment classification.

[...]

According to the definition I have accepted, the same investment could be classified differently with respect to different persons. For example, a minority shareholder with a small block of shares may be deriving value from a portfolio

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<sup>262</sup> Documents produced as part of an Access to Information request, *supra* note 198, indicate that the CRA uses a 25% threshold for portfolio investments.

<sup>263</sup> *Gerbro Holdings Company v Canada*, 2016 TCC 173.

investment, whereas another shareholder, who has a controlling interest, will not be.

The decision in *Gerbro* highlights several considerations. First, a portfolio investment is one over which the investor does not exercise significant control. Secondly, the ownership threshold is likely a maximum of 10 to 25 percent, but this will depend on the facts of each case.<sup>264</sup> Thirdly, short-term investments are more likely to be considered portfolio investments. Finally, a determination of whether an investment is a portfolio one involves looking at the relationship between the investor and the property, so the same property may be considered a portfolio investment for one investor and not for another.

Apart from that, the only other guidance provided about the extent of sovereign immunity's application in Canadian tax law is *Cloutier v The Queen*,<sup>265</sup> an informal procedure decision of the Tax Court of Canada. As an informal procedure decision, *Cloutier* has no precedential value.<sup>266</sup> In any case, the decision does not provide substantive guidance as to the distinction between functions of a governmental nature in contrast with a trade or business carried on by a government.

In *Cloutier*, the appellant was an American citizen and a resident of Canada. She worked as a public school teacher in the United States. She reported her teacher's salary on her Canadian income tax return and sought to deduct the corresponding amount on the basis that her income was exempt from Canadian taxation.<sup>267</sup> Article XIX of the *Canada-US*

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<sup>264</sup> Section 122.1 of the Act, *supra* note 1, contains a definition of "non-portfolio property" for the purposes of the SIFT that makes use of a 10 percent equity threshold.

<sup>265</sup> *Cloutier v The Queen*, 2003 TCC 58, 2003 DTC 317 ("*Cloutier*").

<sup>266</sup> Pursuant to section 18.28 of the *Tax Court of Canada Act*, RSC 1985, c T-2, a judgement rendered under the informal procedure "shall not be treated as a precedent for any other case."

<sup>267</sup> Subparagraph 110(1)(f)(i) of the *Income Tax Act*, *supra* note 1 permits the deduction from taxable income of amounts exempt from income tax under a Canadian tax treaty.

*Tax Treaty*<sup>268</sup> exempts remuneration paid by one Contracting State for services of a governmental nature from taxation in the other Contracting State. The provision reads:

Government Service

Remuneration, other than a pension, paid by a Contracting State or a political subdivision or local authority thereof to a citizen of that State in respect of services rendered in the discharge of functions of a governmental nature shall be taxable only in that State. However, the provisions of Article XIV (Independent Personal Services), XV (Dependent Personal Services) or XVI (Artistes and Athletes), as the case may be, shall apply, and the preceding sentence shall not apply, to remuneration paid in respect of services rendered in connection with a trade or business carried on by a Contracting State or a political subdivision or local authority thereof.<sup>269</sup>

The Court was therefore asked to consider the meaning of the phrase “functions of a governmental nature” as it appears in Article XIX. In the taxpayer’s view, the provision contemplates only two types of activities performed by government employees: activities of a “governmental nature” and activities “rendered in connection with a trade or business” of the government. The Minister of National Revenue argued that the fact that one works for the government is not, on its own, sufficient basis to conclude the services performed are of a governmental nature; instead, the provision applies only the narrow circumstance where a government sends its employee to a host country to perform activities of a governmental nature, for example, where an employee of the United States military is sent to perform services of a governmental nature in Canada on behalf of the United States.

The Court concluded that public school teachers are not performing functions of a governmental nature for the purposes of Article XIX of the *Canada-Us Income Tax Convention*. In reaching this conclusion, the Court relied on various extrinsic sources that, although non-binding, provide context for the treaty. In that regard, the Technical Explanation to Article XIX in the OECD Model Convention stated that functions of a governmental nature

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<sup>268</sup> *Supra* note 212.

<sup>269</sup> *Ibid.*

“would not include functions that commonly are found in the private sector (e.g., education, health care, utilities). Rather is it limited to functions that generally are carried on solely by the government (e.g., military, diplomatic service, tax administrators) and activities that directly support the carrying out of those functions.”

#### **4.6 Conclusion**

A non-resident investor in Canada, other than one directly or indirectly carrying on business, is liable to tax on certain passive payments, the most significant of which are interest, dividends, rents and royalties, and capital gains. As with other foreign investors, a SWF may or may not be able to benefit from the terms of a tax treaty, either as a “resident” entitled to treaty benefits or by structuring their investment using an intermediary holding entity so as to benefit from a third country’s tax treaty.

As investment capital is mobile, all non-resident investment decisions are responsive to the Canadian tax burden, but SWF investment is particularly sensitive in this regard because a SWF will generally not benefit from a foreign tax credit, which would otherwise blunt the effect of underlying Canadian taxes. However, SWFs may be entitled to certain exemptions from tax on the basis of sovereign immunity. Although there is no express provision on tax matters under the SIA and no provision addressing sovereign immunity in the Act, the CRA does have an administrative policy to grant rather narrow exemptions from withholding for income and gains realized from non-commercial transactions (i.e., certain capital gains from the disposition of TCP, portfolio dividends on listed company shares, and interest on arm’s length debt).

There is considerable uncertainty as to how the CRA’s administrative policy would apply to foreign SWFs investing in Canada. What would count as reciprocity? Which SWF transactions would the CRA consider governmental, and which commercial? Furthermore, it

is not clear what law authorizes the CRA's administrative practice now that subsection 212(14) has been repealed. If the SIA is the legislative basis for the CRA's policy, it is unclear how the SIA supports certain aspects of that policy, such as the requirement of reciprocity or the perhaps excessively narrow range of investments to which immunity may apply. Given this, it would be preferable for exemptions from tax on the basis of sovereign immunity to be resolved in substantive legislation so as to resolve these uncertainties.



## **Chapter 5: International Approaches to the Taxation of SWFs**

### **5.1 Introduction**

At present, no country has a legislative or administrative tax regime specific to SWFs. As such, the taxation of SWFs will be determined under the rules applicable to foreign state investors generally. In particular, the tax treatment of SWFs depends on the taxing state's interpretation of the doctrine of sovereign immunity. As recognized in the commentaries to the OECD Model Tax Convention, the principle of sovereign immunity does not have uniform application, and with respect to tax matters, there is a particularly marked lack of consensus among countries as to its applicability:

Most States, for example, would not recognise that the principle [of sovereign immunity] 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.<sup>270</sup>

Virtually all states, and certainly all states with developed economies, do not exempt business income from tax on the basis of sovereign immunity.<sup>271</sup> As such, the doctrine mostly applies with respect to passive income and capital gains.<sup>272</sup> Within this comparatively narrow scope, there are broadly three approaches to the taxation of SWFs. The first is to provide a legislative exemption; the second is an administrative exemption; and the third is

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<sup>270</sup> See paragraph 6.38 of the commentary to Article 1, *Commentaries*, *supra* note 114.

<sup>271</sup> United States, Joint Committee on Taxation, "Economic and U.S. Income Tax Issues Raised by Sovereign Wealth Fund Investment in the United States," JCX-49-08 (June 17, 2008) at page 46 ("Joint Committee Report"), online: <https://www.loc.gov/law/help/reports/pdf/2008-00763.pdf>

<sup>272</sup> See also John McLaren, "The Taxation of Foreign Investment in Australia by Sovereign Wealth Funds: Why Has Australia Not Passed Laws Enshrining the Doctrine of Sovereign Immunity?" (2015) 17 J Austl Tax'n 53 at 55ff.

no exemption at all. Within these three categories, there are of course further variations and distinctions in terms of national approach. The diversity of approaches affords Canada the opportunity to benefit from other countries' experience with respect to sovereign immunity in the field of taxation.

The approaches of three countries are reviewed in this chapter: Australia, Germany and the United States. These three have been selected because, like Canada, they are all developed economies and each is likely to be a net importer of SWF capital. Germany does not have a SWF, and the Australian and American funds, like Alberta's Heritage Fund, are relatively small in comparison to the major funds. Furthermore, these three countries have adopted very different *modus operandi*, which allows for comparison across a broad range of approaches.

## **5.2 The United States' Approach: Legislative Exemption**

The United States levies a gross withholding tax of 30 percent on passive income received by non-residents; as in Canada, the withholding rate may be reduced, e.g., as provided under a tax treaty. As well, the US provides a unilateral exemption from income tax for certain income received by foreign governments in section 892 of the *Internal Revenue Code*.<sup>273</sup> This provision dates back to 1917, when it first appeared as part of the *War Revenue Act of 1917*, and it has been amended many times in the intervening years.<sup>274</sup> The current exemption is more generous than the CRA's administrative exemption, applying to US-source dividends and interest received from non-controlled entities and to gains from the sale of such entities, as well as to gains from the sale of shares in a United States Real

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<sup>273</sup> United States, *Internal Revenue Code*, USC 26, section 892.

<sup>274</sup> United States, *War Revenue Act of 1917*, Pub L No 65-50, section 1211, 40 Stat 300, 337.

Property Holding Company (USRPHC).<sup>275</sup> The first paragraph of section 892 reads as follows:

(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.

The US exemption is also available to a much wider group of government-linked entities than the Canadian exemption. It applies to “foreign governments” and their “integral parts,” as well as controlled entities. Temporary treasury regulations promulgated in 1988 define “integral part” broadly, including any person, body of persons, organization, agency, bureau, or fund that constitutes a “governing authority” of a foreign government. However, an integral part does not include an individual acting in a private capacity; moreover, no portion of the earnings of the governing authority may inure to the benefit of a private person.<sup>276</sup> A “controlled entity” is a separate entity from the foreign government that (1) is created under the laws of the foreign state; (2) is wholly-owned and controlled by the foreign government; (3) is managed by people who are appointed or employed by the foreign government; and (4) has its assets vest in the foreign government upon dissolution.<sup>277</sup>

According to a report of the United States’ Joint Committee on Taxation, “absent unusual

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<sup>275</sup> Michael J Miller, “Proposed Regulations Would Improve Access to US Sovereign Exemption, but Significant Problems Remain,” (2012) 60:2 Can Tax J 495 at 496.

<sup>276</sup> United States, Temporary Treasury Regulation, section 1.892-2T(b).

<sup>277</sup> *Ibid.*

circumstances, SWFs will generally constitute either an integral part or a controlled entity of a foreign sovereign for purposes of section 892.”<sup>278</sup>

The commercial exception to the rule is contained in the second paragraph of section 892, which provides that the exemption does not apply to any income derived from the conduct of commercial activity (whether within or outside the United States) or received by or from a “controlled commercial entity.” A “controlled commercial entity” is an entity controlled by the foreign government, i.e., one in which the government holds or owns more than 50% of the votes or value of the entity or otherwise has effective control, which is engaged in commercial activity of any kind, anywhere in the world.<sup>279</sup> Temporary regulations define “commercial activity” as all activity that is ordinarily conducted with a view to earning income,<sup>280</sup> but those regulations specifically exclude five types of activity as categorically non-commercial:

1. investments in stocks, bonds, and other securities; loans; investments in financial instruments held in the execution of governmental financial or monetary policy; the holding of net leases on real property or land that is not producing income; the holding of bank deposits in banks; and trading on a foreign government’s own account;
2. certain amateur athletic and cultural events;
3. activities that are not customarily attributed to or carried on by private enterprise for profit;
4. governmental functions; and
5. the mere purchasing of goods for the use of a foreign government.<sup>281</sup>

In addition, specific rules may attribute commercial activity of one entity to a related entity for purposes of section 892<sup>282</sup> and detailed rules are provided for partnerships.<sup>283</sup>

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<sup>278</sup> Joint Committee Report, *supra* note 268 at page 46.

<sup>279</sup> United States, *Internal Revenue Code*, USC 26, Section 892(a)(2).

<sup>280</sup> United States, Temporary Treasury Regulation, section 1.892-4T(b).

<sup>281</sup> United States, Temporary Treasury Regulation, section 1.892-4T(c).

<sup>282</sup> United States, Temporary Treasury Regulation, section 1.892-5T(d).

<sup>283</sup> United States, Treasury Regulation, sections 702-703, sections 1.702-1(a)(8)(ii).

The prohibition on commercial activity, for the purposes of section 892, is quite onerous, as even minor commercial activity will cause a controlled entity of a foreign government to become a controlled commercial entity, and hence all its income will be “tainted” for the purposes of the exemption. This was referred to as the “all or nothing” rule, and its drastic consequences led to the adoption of proposed regulations in 2011 that provide a *de minimus* exemption for commercial activity.<sup>284</sup> Under the proposed regulations, so-called “inadvertent commercial activity” will not cause a controlled entity to become a controlled commercial entity if the failure to avoid conducting commercial activity was “reasonable,” the fault was promptly cured, and certain record keeping requirements are satisfied. The failure to avoid commercial activity will be considered reasonable if: due diligence requirements are met; the value of assets used in the commercial activities was less than 5 percent of the total value of the entity’s assets; and the income earned from commercial activity was less than 5 percent of the entity’s gross income for that year.<sup>285</sup> The purpose of these regulations is to provide some relief to foreign government entities that may commit a “foot fault,” while still appropriately taxing income from commercial activity. Nevertheless, SWF investment in the United States requires careful structuring to isolate all investment that could be eligible for the section 892 exemption.<sup>286</sup>

One advantage of the American approach is that its legislative scheme avoids, to a great degree, the need to distinguish commercial from governmental activity using difficult to apply categories like nature and purpose (as discussed in Chapter 3). Instead, the US

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<sup>284</sup> United States, Internal Revenue Service, Internal Revenue Bulletin 2011-41 (November 28, 2011), Reg 146537-06. As of this date, the proposed regulations have not been adopted in final form, but the regulations indicate that taxpayers are permitted to rely on them until final regulations are issued.

<sup>285</sup> *Supra* note 257 at page 498.

<sup>286</sup> Henry Chong, “Canada-US Tax on Foreign SWFs” (2011) *Canadian Tax Highlights* 5 at page 6.

regulations essentially deem all income-producing activity commercial, unless it falls within one of the specific exemptions, such as the exemption for investment in stocks, bonds, and other securities. Presumably a SWF may make a wide variety of investments in securities without being engaged in “commercial activity,” although only interest, dividends, and capital gains from non-controlled entities will be eligible for the section 892 exemption.

### **5.3 The Australian Approach: Administrative Exemption**

Subject to reduction by tax treaty, Australia charges a gross withholding tax on passive payments at rates that vary based on the type of income. Unfranked dividends<sup>287</sup> are subject to a 30 percent tax, while interest is taxed at 10 percent.<sup>288</sup> Like Canada, Australia exempts certain passive income of foreign governments from tax on a case-by-case, administrative basis. The Australian practice is described in a private ruling of the Australian Tax Office.<sup>289</sup> It provides that dividends and interest income will be exempt from withholding taxes if the investor is a foreign government or agency of a foreign government, the money invested is and will remain government money, and the income is derived from non-commercial activity. According to the ATO:

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. [...] In relation to a holding of shares in a company, there

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<sup>287</sup> Australia’s imputation system for dividends provides integration of corporation and shareholder taxes through so-called “franked” dividends, which are dividends that have imputed tax credits for the underlying company tax. Unfranked dividends are dividends which are not paid out of a company’s after-tax income. See Australian, Australian Tax Office, “How dividends are taxed,” online: <https://www.ato.gov.au/Forms/You-and-your-shares-2013-14/?page=5>.

<sup>288</sup> Sally-Ann Joseph, “Taxing Sovereign Wealth Funds: Looking to Singapore for Inspiration” (2017) Fed L Rev 17 at 20.

<sup>289</sup> Australia, Australian Tax Office, ATO Interpretive Decision 2002/45, online: <https://www.ato.gov.au/law/view/document?src=qa&pit=99991231235958&arc=true&start=1&pageSize=10&total=1&num=0&docid=AID%2FAID200245%2F00001&cat=JA&dc=false&tm=phrase-docref-ATO%20ID%202002%2F45>

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.

Thus, the Australian practice is substantially the same as the Canadian practice, although it expressly applies to “agencies” of the foreign government and does not include a requirement of reciprocity. Australia, however, has historically been unsatisfied with the administrative approach.<sup>290</sup> In 1984, the Australian Law Reform Commission recommended that exemptions from tax should be resolved in substantive legislation, rather than indirectly through procedural immunity or administrative practice: “if a foreign state ought not to be taxed in a particular way, this should be reflected in the substantive taxation legislation rather than being achieved indirectly through a procedural immunity.”<sup>291</sup> In fact, the Australian *Foreign Sovereign Immunities Act 1985* provides that a foreign state is not immune in proceedings that concern an obligation or law with respect to taxation.<sup>292</sup>

In 2009, the Government proposed to codify the administrative exemption provided to SWFs and other sovereign investors, to which end they released a consultation paper, “Greater Certainty for Sovereign Investments.”<sup>293</sup> The proposals were expressly aimed at making Australia a more attractive destination for SWF investment by providing greater certainty regarding tax, with a view to emulating the United States’ legislation: “In codifying the current administrative practice it may be desirable to model the rules on those that apply

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<sup>290</sup> *Supra* note 269 at 64.

<sup>291</sup> Australian Law Reform Commission Report No. 24, “Foreign State Immunity” (1984), section 112, quoted in David Gaukrodger, *supra* note 177 at page 32.

<sup>292</sup> *Supra*, note 141 at s 20.

<sup>293</sup> Australia, The Treasury, “Greater Certainty for Sovereign Investments” (Consultation Paper, Australian Government, November 2009), online: [https://archive.treasury.gov.au/documents/1667/PDF/Consultation\\_paper.pdf](https://archive.treasury.gov.au/documents/1667/PDF/Consultation_paper.pdf).

in the US, given that it is the destination for most of the world's SWF investments.”<sup>294</sup> With the change of government in 2011, however, the proposals were scuttled.<sup>295</sup>

#### 5.4 The German Approach: No Exemption

Germany does not consider sovereign immunity applicable to the taxation of foreign governments.<sup>296</sup> SWFs that invest in Germany are treated like non-resident corporate taxpayers, and are subject to the same tax in Germany as all other non-resident corporations.<sup>297</sup> Foreign governments, including SWFs, however, are generally entitled to benefits under Germany's tax treaties.<sup>298</sup> Consistent with their overall approach of non-distinction, German tax treaties do not contain special provisions for foreign governments.<sup>299</sup>

As a net importer of capital in the second half of the twentieth century, the German policy was to tax non-resident investors very lightly in order to attract investment, and Germany continues to impose a relatively small tax burden on foreign capital. Although the gross withholding rate for dividends is 26.375%, nearly all inter-corporate dividends, including those paid to foreign corporations, are exempted from taxation.<sup>300</sup> Moreover, Germany does not generally tax foreign taxpayers on German-source interest. Capital gains

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<sup>294</sup> *Ibid* at page 2.

<sup>295</sup> Rhys Jewel, “Sovereign Immunity: Back to the Future: no legislated tax exemptions for foreign governments and SWFs,” *Mondaq* (10 April 2014), online: <http://www.mondaq.com/australia/x/304506/Income+Tax/Sovereign+immunity+back+to+the+future+no+legislated+tax+exemptions+for+foreign+governments+and+SWFs>

<sup>296</sup> Joint Committee Report, *supra* note 254 at page A-29.

<sup>297</sup> *Ibid* at A-30.

<sup>298</sup> Peter Blessing & Ansgar Simon, “Sovereign Immunity: A US and European View,” *International Tax Review* (February 2012) at page 28, online: <http://www.shearman.com/~media/Files/NewsInsights/Publications/2012/03/Sovereign-Immunity-A-US-and-European-View/Files/View-full-article-Sovereign-immunity-A-US-and-Eu-/FileAttachment/TXsovereignimmunityAUSandEuropeanView030112.pdf>

<sup>299</sup> There are some limited exceptions to this rule, e.g., exemptions for listed cultural institutions as contained in the Vienna Convention. See Joint Committee Report, *supra* note 254 at page A-29, Note 6.

<sup>300</sup> *Ibid* at page A-30.



are taxed only if they amount to a sale of a participation interest,<sup>301</sup> and in any case, nearly all of gains from the sale of a participation interest are exempted from tax if they are realized by a foreign or domestic corporation.<sup>302</sup>

## 5.5 Comparison of Approaches

As this brief overview of three different approaches indicates, countries deal with investment by foreign governments in different ways, which I have chosen to evaluate in light of their certainty, transparency, and ease of administration. Other factors, such as economic considerations and the conduct of international relations, are obviously at play as well, but these are not the focus of my evaluation.

In light of these goals, the administrative approach is the weakest. The requirement to obtain a private ruling or written authorization places a significant compliance burden on the foreign government investor. Meanwhile, because the private rulings are confidential, there is a lack of transparency with respect to the administrative criteria used in practice by revenue authorities. By way of example, secondary sources indicate that the CRA has issued rulings to the New Zealand Earthquake Relief Fund, but not to certain Chinese banks.<sup>303</sup> Because these rulings are not published, the truth of this claim cannot be verified, and as a consequence, it is difficult to determine what criteria the CRA is using to grant immunity. On the other hand, by using an administrative approach based on reciprocity, Canada has preserved its ability to use exemptions as a bargaining tool when negotiating its tax treaties.

A legislative approach, such as that used in the United States, would improve certainty, promote transparency, and, depending on the compliance method selected, may

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<sup>301</sup> A participation interest is defined as ownership of a minimum of 1 percent of all issued shares of the company over a five-year period. See Joint Committee Report, *ibid* at page A-31.

<sup>302</sup> *Ibid.*

<sup>303</sup> Joint Committee Report, *supra* note 268 at page A-4.

also reduce the administrative burden for SWFs and other sovereign investors who wish to rely on the exemption. As discussed above, the American legislative regime has also managed to sidestep complicated determinations of commercial vs governmental activity. Finally, by preserving sovereign immunity within the tax context, the legislative approach is consistent with the Canadian legal tradition and administrative practice to date.

The German approach is also certain. Its chief advantage, however, may be economic efficiency, as economic theory does not favour distinguishing between sources of capital based on non-economic considerations. There is some indication that SWFs and pension funds, due to their tax-exempt status, have an unfair advantage over private firms since they have a lower cost of production, which in turn leads to market distortion. Distinguishing between sovereign and non-sovereign investment capital, therefore, does not promote the overall efficient distribution of productive factors.<sup>304</sup> Furthermore, Germany's decision not to provide a tax exemption to foreign governments is made in the context of its overall very low tax on non-resident investors generally.

Given its continuity with Canadian tradition, a legislative approach that preserves sovereign immunity appears to be the best option, as it would promote certainty and transparency, as well as comity between nations.

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<sup>304</sup> Vijay Joy & Jack Mintz. "Sovereign Wealth and Pension Funds Controlling Canadian Businesses: Policy Implications," 6:2 *SPP Research Papers* (Calgary: School of Public Policy, 2013).

## **Chapter 6: Conclusions**

SWFs are an increasingly important group of investors that may benefit, under Canadian law, from a tax exemption on the basis of sovereign immunity, which is a principle of customary international law that prevents a host country from bringing the full force of its laws to bear on a foreign government. Such an exemption is available in many countries, and other jurisdictions have adopted legislative regimes that provide greater certainty and transparency to SWFs who invest in those countries. In Canada, there is a patchwork of rules found in domestic law, tax treaties, and the administrative policies of the CRA, all of which can be difficult to navigate. Canada would benefit from the adoption of legislation to clarify its policy and practice with regard to the taxation of SWFs. In this respect, the American legislative provides an attractive model to emulate.

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