

UK Government Proposals to Revise Sovereign Immunity from Direct Taxation: The Potential Impact for Sovereign Wealth Funds

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Sovereign Wealth Funds (SWFs) are amongst the largest global institutional investors, many of them with significant portfolios in the UK, across a broad range of assets. Despite the importance to the economy of such a valuable investor class, the UK Government has opened a consultation looking at ways at ways to limit the current exemption available to them from taxation on UK income and gains.

Sovereign Immunity Under Current UK Law

Based on a principle of public international law that one sovereign should not subject another to its municipal laws, the UK has traditionally provided foreign sovereigns with broad immunity from direct taxation (i.e. income tax, capital gains tax and corporation tax). This immunity covers all UK sourced income and gains provided they arise to and for the sole benefit of a foreign Head of State (such as a reigning Monarch or President), the spouse of a foreign Head of State, or a foreign independent government.

In the case of foreign governments, there can be some complexity in determining which parts of the government, and which extensions of the government, are eligible, and some challenges in seeking exemption for entities that are owned by foreign governments. But once eligibility has been established, the immunity is broader than the targeted forms of exemption available in many other countries that attract SWF investment.

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As many SWFs are acutely aware, the position in the United States, for example, is that foreign sovereigns are not entitled to exemption from taxation on income derived from so-called “commercial activity”, which term is defined broadly to include effectively any profit-oriented activity other than investment in equities, securities and related derivatives – and a foreign governmental entity that engages in any commercial activity at all, anywhere in the world, is at risk of entirely forfeiting its right to exemption from US taxation.

Why Change Anything?

On 4 July the UK Government launched a consultation, seeking views on proposals to broaden the range of sovereign persons eligible for the exemption, but to limit the income capable of benefitting.

The consultation document suggests two reasons for limiting the scope of income subject to exemption. The first reason given is that the current UK approach is overly generous by international standards. Reference is made to the United States as well as to Australia and France, amongst other countries, as examples of regimes that provide forms of sovereign exemption that do not extend to commercial activities.

The second reason given is the growing size and diversification of SWF investment into the UK which, coupled with the evolution of UK taxation of non-residents (in particular the extension of taxing rights in relation to UK real estate), raises issues of proportionality and fairness when compared to other institutional investors with similar structures and activities.

What is Being Proposed?

Format

As an initial matter, the UK Government is proposing to place sovereign tax immunity rules on a statutory footing rather than relying on more abstract principles for determining the persons for whom, and the income in respect of which, exemption is available. That is a sensible idea.

Eligible Persons

When it comes to eligibility, the Government intends to stick with current processes for identifying whether a foreign State is recognised as such. A welcome potential development is a proposal, in relation to federal States – such as the United States, or Switzerland – to automatically grant exemption to all individual constituent states or territories. This would replace the existing system which involves a case-by-case consideration by reference to the particular circumstances of the relevant constituent territory.

A broader question posed is how the new regime should identify eligible limbs of a foreign government, like government funds, government departments and agencies, government pension schemes and central banks. The consultation document leaves the question open, merely requesting views from stakeholders as to the advantages and disadvantages of a broad definition, and focusing in particular on government pension schemes and controlled entities (*i.e.* entities that are wholly owned and controlled by the State). SWFs will have a keen interest in how this aspect of the consultation develops.

Eligible Income and Gains

As a matter of principle, the Government proposes to “refocus” the sovereign exemption on income from investment activity and, specifically, investment of a more passive nature in assets that are commonly held as part of the undertaking of sovereign functions. In the Government’s view, this means income from debt and equity investments.

Since there is a generally applicable rule of UK law that excludes non-residents from direct taxation on income and gains from investment activity (as opposed to trading activity), save in certain specific cases, and since the UK does not have a dividend withholding tax, achieving this outcome would simply involve an exemption from withholding tax on interest income from debt investments. This is the full extent of the exemption proposed.

The main consequences for sovereign non-natural persons would be new liabilities to UK corporation tax

on income and gains from trading (as opposed to investment) activity carried on through a UK permanent establishment, income from UK real estate, distributions from UK REITs, and capital gains from the sale of UK real estate (including from the sale of real estate rich SPVs).

For foreign sovereigns investing in UK real estate, this could have a significant impact. Sovereigns might also need to start thinking more carefully about the dividing line between trading and investment activity, in particular in the context of lending into the UK. Some recently-published (and helpful) guidance from HMRC on the circumstances in which loan origination and other lending activity by investment funds would be treated as investment activity, in the context of a new regime for qualifying asset holding companies (QAHCs), may prove valuable here too.

Other Tax Benefits for Sovereigns

Aside from the question of sovereign immunity, the Government consultation also considers the fact that some sovereign investors are able – together with other kinds of institutional investors – to access various other UK tax benefits. For example, companies wishing to qualify as QAHCs have more flexibility in meeting applicable ownership conditions where they are held by certain categories of investor, including persons qualifying for sovereign immunity from tax.

The Government seems reluctant to change all these rules, but the consultation document suggests that in certain cases (such as a limb of the UK's participation exemption from capital gains on share disposals, which applies where the selling UK company is owned by qualifying institutional investors), allowing sovereigns to continue to qualify could undermine the proposal to narrow the scope of the new general sovereign exemption. No recommendations are made, but the consultation requests information on the scale of foreign sovereign investment into these kinds of structures with a view to testing what might happen if in future they were to be denied qualifying investor status.

Next Steps

The consultation runs until 12 September – and we plan to actively participate with a view to supporting the interests of our SWF clients. It is proposed that any new rules would come into effect from April 2024.

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