Sovereign-Wealth Funds: Are They Welcome in Canada?

Michael Kandev
mkandev@dwpv.com

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*Michael N. Kandev**

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With the emergence of globalization, sovereign-wealth funds (SWFs) have become major actors in international financial markets. In this article, the author considers from an income tax perspective the question of whether foreign SWFs are welcome to invest in Canada.

1. Introduction

Although sovereign-wealth funds (SWFs) have existed for decades,[1] in recent years they have proliferated both in number and size[2] and have expanded their cross-border investments to the extent that now, especially since the beginning of the recent global economic crisis, the importance of their role in international financial markets is indisputable.[3] In an environment where SWFs are a major source of investment capital, this article considers the question of whether foreign SWFs are welcome in Canada. It does so from an income tax perspective.

SWFs typically do not pay tax in their home countries and when they invest abroad they invariably seek to minimize the non-recoverable tax cost of their foreign activities. Accordingly, the issue of whether SWFs are welcome in Canada is analysed by this article in terms of Canada's tax treatment of the Canadian-source income of foreign SWFs. Specifically, after providing some relevant background, this article discusses, in turn, the public international law doctrine of sovereign immunity, the domestic tax treatment under Canada's Income Tax Act (ITA)[4] and the application of Canada's tax treaties to foreign SWFs.

2. Background

2.1. What are SWFs?

The expression "sovereign-wealth fund" is not a term of art; it has variable content and does not have a universally accepted meaning. SWFs have defined themselves as follows:

> 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. (emphasis added)[5]

A distinction is sometimes made between an SWF in a narrow sense[6] and the broader concept of "state-owned entity" (as used by the OECD) or "sovereign investment vehicle". In this respect, the concept of SWF, proper, would exclude, inter alia, foreign currency reserve assets held by monetary authorities for the traditional balance of payments 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.[7] In this regard, Maslakovic makes the following distinction:

> Both SWFs and other sovereign investment vehicles are government owned investment entities that seek to generate financial returns for the nation. Their funding, operations and objectives however differ.
>
> *SWFs*
>
> *Stabilization funds* are set up by countries rich in natural resources to provide budgetary support and protect the national economy from volatile commodity prices. These funds are built up in times of favourable commodity prices and drawn upon in cases of low commodity prices or shortage of reserves.
>
> *Savings funds* have longer term wealth creation as a goal and are intended to share wealth across generations. For countries rich in natural resource, savings funds transfer non-renewable assets into a diversified portfolio of international financial assets to provide for long-term objectives.
>
> *Other sovereign investment vehicles*
>
> *Sovereign and public pension reserve funds* represent investment vehicles funded with assets set aside to meet the government's future entitlement obligations to its citizens.

* **LLM (International Tax, Leiden) and Partner, Davies Ward Phillips & Vineberg LLP, Montreal.** **The author would like to thank his wife, Noura Karazivan, LLD cand. (University of Montreal), for her input in respect of the doctrine of sovereign immunity, Jack Fattal, articling student, Davies Ward Phillips & Vineberg LLP, Montreal, for his research assistance and Nathan Boidman, partner, Davies Ward Phillips & Vineberg LLP, Montreal, for his general comments on the subject of this article.** **The author can be contacted at mkandev@dwpv.com.**

1. The first SWF, the Kuwait Investment Board, was founded in 1953.
2. See A.H.B. Monk, "Sovereignty in the Era of Global Capitalism: The Rise of Sovereign Wealth Funds and the Power of Finance", *Social Science Research Network* (10 April 2010), available at http://ssrn.com/abstract=1587327 and M. Maslakovic, "Sovereign Wealth Funds 2010", *International Financial Services London* (March 2010), available at: www.ifsl.org.uk/media/2172/CBS%20Sovereign%20Wealth%20Funds%202010.pdf.
3. See for example, "Special Report: The rise of state capitalism; Coming to grips with sovereign-wealth funds", *The Economist* (18 September 2008).
4. Income Tax Act, R.S.C. 1985 (5th Supp.) c. 1, as am.
5. International Working Group of Sovereign Wealth Funds, "Sovereign Wealth Funds: Generally Accepted Principles and Practices 'Santiago Principles'" (October 2008) ("the Santiago Principles"), Annex 1. This definition was also adopted by the OECD in the 2010 Commentaries (see new Para. 8.5 of the Commentary on Art. 4 of the OECD Model).
6. SWFs advocate this narrow definition and this is understandable (see 2.4.).
7. The Santiago Principles, supra note 5. Some of these exclusions are questionable. For example, the exclusion of "government-employee pension funds" is contradictory, considering that the world's second largest SWF is Norway's Government Pension Fund. The exclusion of "assets managed for the benefit of individuals" is also somewhat meaningless, considering that government assets should, at least indirectly, all be for the benefit of individuals.

Government investment funds are funds established to invest official Government reserves. Often, the assets in such arrangements are still counted as reserves.

Government development funds allocate resources for funding priority socioeconomic projects, such as infrastructure.

Government owned enterprises are companies over which the state has significant control. This category includes a wide variety of entities, including manufacturing and financial firms. State-owned enterprises can themselves undertake foreign investment.[8]

This article uses a broad concept of an SWF that includes most types of sovereign investment vehicles. In this regard, for the purposes of this article, SWF means any actively managed government-owned pool of capital that is invested cross-border.[9] It is also assumed that SWFs do not pay tax in their home jurisdiction either by reason of a specific legislated tax exemption or because of the domestic principle of sovereign immunity from taxation.

2.2. Who are SWFs?

Asian and Middle Eastern countries each account for close to 40% of SWF assets; Europe accounts for most of the remainder.[10] By far the world's largest SWF is the Abu Dhabi Investment Authority (ADIA), with an estimated USD 627 billion of assets under management, representing 18% of the global total.[11] Norway's Government Pension Fund comes in second with approximately USD 445 billion under management and 12% of the global total, and Saudi Arabia's SAMA Foreign Holdings is ranked third with approximately USD 431 billion and 11% of the global total.[12] Other well-known SWFs include the China Investment Corporation, the Kuwait Investment Authority and Temasek Holdings.[13]

The funding of SWFs comes from various sources: SWFs are typically the result of current account surpluses from exports of oil and other commodities or manufactured goods, fiscal surpluses, public savings or privatization receipts. SWFs are generally classified into one of two major categories: (1) commodity funds, funded predominantly from oil and gas revenue; and (2) non-commodity funds, funded mainly from official foreign exchange reserves and in some cases from pension reserves.

2.3. What do SWFs do?

In 2009 SWFs, in the narrow sense of the term, held approximately USD 3.8 trillion in assets and sovereign investment vehicles, more generally, held an estimated USD 6.5 trillion.[14]

The substantial size and high liquidity of SWFs makes them a major international investor group. Increased SWF cross-border investment activity has been evident since 2003. In this period, there has also been a gradual shift from passive to active investment strategies reflected in the acquisition of control of companies through cross-border mergers and acquisitions or the taking of substantial minority positions. Such investments totalled approximately USD 187 billion between 1995 and June 2009.[15] SWFs acquired majority stakes in respect of nearly one third of this total amount.[16]

Most recently, since the start of the economic downturn, there have been three distinct periods of investment activity by SWFs:

(1) At the outset of the credit crisis, in the second half of 2007 and first quarter of 2008, SWFs invested over USD 60 billion in European and US financial institutions that were experiencing difficulties. In this period, major investments were made by Middle Eastern and Asian SWFs, such as ADIA and Temasek Holdings, in Citigroup, UBS, Merrill Lynch and Morgan Stanley. In just a few months, the rapid fall in the value of US and European equity markets, particularly banking stocks, saw SWFs making substantial losses on some of these investments.[17]

(2) In the second half of 2008 and first half of 2009, SWFs cut back on their foreign spending and returned to domestic investment to help stabilize domestic banks and financial markets, which were starting to be affected by the economic downturn and fall in commodity prices.[18] This reversal of trends also reflected the public criticism faced by SWFs in their home countries following a string of losses on their foreign investments earlier in the year.

(3) The second part of 2009 saw a renewed interest by SWFs in foreign investment.[19] Despite the slow start to 2009, with only USD 10 billion invested, investments picked up in the second half to the tune of USD 50 billion.[20] Much of this total was allocated to

8. Maslakovic, supra note 2, p. 4.
9. See Joint Committee on Taxation, "Economic and U.S. Income Tax Issues Raised by Sovereign Wealth Fund Invests in the United States" (JCX-49-08), 17 June 2008, p. 1.
10. Maslakovic, supra note 2, p. 3.
11. Id.
12. Id.
13. This is the complete list of countries that are members of the International Working Group of Sovereign Wealth Funds (see 2.4.) with their SWFs: Australia: Australian Future Fund; Azerbaijan: State Oil Fund; Bahrain: Reserve Fund for Strategic Projects; Botswana: Pula Fund; Canada: Alberta Heritage Savings Trust Fund; Chile: Economic and Social Stabilization Fund/Pension Reserve Fund; China (People's Rep.): China Investment Corporation; Equatorial Guinea: Fund for Future Generations; Iran: Oil Stabilization Fund; Ireland: National Pensions Reserve Fund; Korea (Rep.): Korea Investment Corporation; Kuwait: Kuwait Investment Authority; Libya: Libyan Investment Authority; Mexico: Oil Stabilization Fund; New Zealand: Superannuation Fund; Norway: Government Pension Fund; Qatar: Qatar Investment Authority; Russia: Reserve Fund/National Wealth Fund; Singapore: Temasek Holdings Pte Ltd/Government of Singapore Investment Corporation Pte Ltd; Timor-Leste: Petroleum Fund of Timor-Leste; Trinidad and Tobago: Heritage and Stabilization Fund; United Arab Emirates: Abu Dhabi Investment Authority; and United States: Alaska Permanent Fund.
14. Maslakovic, supra note 2, p. 4.
15. Id., p. 6, Chart 11.
16. Id., p. 6, Chart 12.
17. Id., p. 7, Chart 14.
18. Id., pp. 6-7 and "Sovereign-wealth funds: From torrent to trickle; The flows are neither as big nor as scary as they once seemed", *The Economist* (22 January 2009).
19. B. Erman, "Sovereign wealth funds back on prowl", *The Globe and Mail* (18 September 2009), B8 and "Sovereign-wealth funds: Cash in hand; State-backed investors are coming back into the spotlight", *The Economist* (17 June 2010).
20. Maslakovic, supra note 2, p. 7.

> foreign markets, primarily Europe and North America, but this time a larger proportion of funds was injected in industry, infrastructure and other non-financial services sectors (financial services accounted for less than a fifth of investments). The China Investment Corporation was particularly active during 2009 with some USD 15 billion invested internationally, mostly in energy, metals and agricultural commodities as well as alternative assets, such as hedge funds and private equity.[21]

Maslakovic is of the view that, in light of recent SWF transactions, acquisitions will be smaller and more diverse in the future with more focus on diversifying portfolios by investing in real estate, commodities and emerging markets.[22]

2.4. International regulation of SWFs

It is clear from the previous sections that SWFs have in recent years been recognized as well-established institutional investors and important participants in the international monetary and financial system. Some governments have, however, expressed reservations regarding SWFs because of the limited disclosure and transparency of some SWFs. Another concern has been that SWFs may invest to secure control of strategically important economic sectors for political rather than commercial reasons and could use these investments to advance their own national interests.

These matters were highlighted by the International Monetary and Financial Committee (IMFC) of the International Monetary Fund (IMF)[23] when, in October 2007, it expressed the need for further analysis of key issues for investors and recipients of SWF flows, including a dialogue on identifying best practices for SWFs. In order to do so, the International Working Group of Sovereign Wealth Funds (IWG) was established in the spring of 2008 under the aegis of the IMF. In the course of 2008, the IWG met on three occasions to identify and draft a set of generally accepted principles and practices (GAPP) that properly reflect the investment practices and objectives of SWFs. At its third meeting in October 2008, the IWG agreed on these voluntary GAPP, which became known as the Santiago Principles.[24] In order to facilitate an understanding of the Santiago Principles and SWF activities, the International Forum of Sovereign Wealth Funds was established by the IWG as a voluntary group of SWFs that meets annually to exchange views on issues of common interest.

In carrying out its work on the Santiago Principles, the IWG benefited from direct input from the OECD. In this regard, on 11 October 2008, the OECD presented the IMFC with its guidance on recipient country policies towards SWFs, arguing that recipient countries should strive to avoid protectionism and uphold fair and transparent investment frameworks.[25]

Separately, on 25 November 2009, Working Party 1 of the OECD's Committee on Fiscal Affairs issued for public discussion draft commentaries to the OECD Model Tax Convention (the "OECD Model") in a report entitled "Application of Tax Treaties to State-Owned Entities, Including Sovereign Wealth Funds". A modified version of these proposed changes to the OECD commentaries was included in the 2010 update to the OECD Model (the "2010 Commentaries"), which was first issued in draft on 21 May 2010 and was approved by the OECD Council on 22 July 2010.[26] The 2010 Commentaries that relate to SWFs are discussed in detail further in this article.

3. The Canadian Tax Treatment of SWFs

3.1. In general

SWFs do not pay tax in their home countries and, therefore, are unable to recover at home the taxes paid to foreign governments. Accordingly, any such foreign taxes paid by an SWF become a net cost. Understandably, SWFs are particularly sensitive to, and their cross-border investment decisions are affected by, the tax treatment afforded to them by the potential investee countries.

This section discusses from an income tax perspective whether or not foreign SWFs are welcome to invest in Canada. The issue is analysed in terms of whether Canada's tax system allows a preferential tax treatment in respect of the Canadian-source income of foreign SWFs. The discussion first looks at whether or not foreign SWFs may completely escape the Canadian tax net under an application of the public international law doctrine of sovereign immunity. If this is not the case, the analysis then focuses on the tax treatment of foreign SWFs under the ITA. Finally, this section considers whether or not Canada's tax treaties reduce or eliminate any Canadian tax payable by foreign SWFs under the ITA.

3.2. Sovereign immunity

Domestically, the governments of Canada and each of its provinces (typically referred to as "the Crown"), including their agencies (such as most domestic SWFs), are generally immune from taxation unless expressly rendered taxable by statute. The basis for this is the common law immunity afforded to the sovereign, the immunity expressly stated at Sec. 17 of the Interpretation Act[27] and the rule that no tax is exigible without clear authority.[28]

With regard to the Canadian tax treatment of foreign SWFs investing in Canada, the first question is whether or not they enjoy sovereign immunity from Canada's

21. Id.
22. Id.
23. The IMFC comprises representatives – typically ministers of finance and central bank governors – of all 185 IMF Member countries.
24. Santiago Principles, supra note 5.
25. See the documents available at www.oecd.org/document/19/0,3343,en_2649_34887_41807059_1_1_1_1,00.html.
26. Available at www.oecd.org/dataoecd/23/43/45689328.pdf.
27. R.S.C. 1985, c. I-21 as am.
28. P. Lordon, *Crown Law* (Toronto: Butterworths, 1991), Chap. 12.

taxing jurisdiction.[29] In this regard, the 2010 Commentaries note the possible application of the doctrine of sovereign immunity to SWFs. The OECD explains that, according to this principle of customary international law, "a sovereign State (including its agents, its property and activities) is, as a general rule, immune from the jurisdiction of the courts of another sovereign State".[30] The 2010 Commentaries go on to note that there is no international consensus on the precise limits of the doctrine of sovereign immunity in tax matters:

> Most States, for example, would not recognise that the principle applies to business activities and many States do not recognise any application of this principle in tax matters. There are therefore considerable differences between States as regards the extent, if any, to which that principle applies to taxation. Even among States that would recognise its possible application in tax matters, some apply it only to the extent that it has been incorporated into domestic law and others apply it as customary international law but subject to important limitations.

Domestically, in Canada there is very little on the application of the public international doctrine of sovereign immunity in tax matters.[31] The principle has not been codified in the ITA[32] and there do not seem to be any tax cases that have addressed the issue directly.[33] Only a couple of Canada Revenue Agency (CRA) technical publications refer to sovereign immunity.[34] In this respect, Information Circular 77-16R4 "Non-Resident Income Tax" (11 May 1992) is the principal and most detailed government document on the subject. It states the following:

> 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*. (emphasis added)[35]

The Circular goes on to list three conjunctive conditions for the application of sovereign immunity to the Canadian-source investment income of a foreign state:

(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.

These conditions closely correspond to those set out in new Para. 6.39 of the OECD Commentary on Art. 1 of the OECD Model, which reads as follows:

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

The criteria for the application of sovereign immunity in tax matters as set out in Information Circular 77-16R4 and as discussed by the OECD leave several unanswered questions, primarily: (1) what are governmental functions as opposed to industrial or commercial activities; and (2) what are portfolio dividends as opposed to direct dividends from a company in which the foreign government has a substantial or controlling equity interest?

With regard to the first issue, the question of what are "functions of a governmental nature" was considered by the Tax Court of Canada (TCC) in *Cloutier v. Canada*.[36]

29. It should be noted that there are different types of jurisdiction recognized in public international law: prescriptive, adjudicative, enforcement. Accordingly, the type of immunity follows the type of jurisdiction. See V. Lowe, "Jurisdiction", in M. Evans (ed.), *International Law* (Oxford: Oxford University Press, 2003), Chap. 10. The public international doctrine of sovereign immunity is considered to relate essentially to adjudicative and enforcement jurisdiction.
30. Para. 6.38 of the Commentary on Art. 1 of the OECD Model. See also I.A. Shearer, *Starke's International Law* (11th ed.) (London: Butterworths, 1994), pp. 191-199; D.J. Harris, *Cases and Materials on International Law* (6th ed.) (London: Sweet & Maxwell, 2004), p. 306 et seq.; J.-M. Arbour and G. Parent, *Droit International Public* (5th ed.) (Cowansville (Que): Yvon Blais, 2006), p. 331 et seq.; H. Fox, "International Law and Restraints on the Exercise of Jurisdiction by National Courts of States", in Evans, supra note 29, Chap. 11; and H. Fox, *The Law of State Immunity* (Oxford: Oxford University Press, 2002).
31. See, however, discussion regarding Canada's tax treaties in 3.4.
32. By way of comparison, see the US Internal Revenue Code, Sec. 892, which codifies the concept of sovereign immunity for US tax purposes.
33. In *Wenger's Ltd. v. Canada*, 92 D.T.C. 2132 (TCC), the taxpayers imported goods from two former-USSR state-controlled entities on credit. The taxpayers failed to deduct and remit withholding tax on interest on accounts payable to the former-USSR exporters. The taxpayers' main argument was that the payments to the former-USSR entities were not interest subject to withholding tax. If the payments were interest, the taxpayers argued in the alternative that they were made to a foreign state and under the doctrine of sovereign immunity the foreign government is not subject to Canadian income tax laws. However, the appellants did not lead any evidence that the former-USSR entities were part of the government of the former Soviet Union and did not pursue this line of argument at trial.
34. There are several CRA letters on sovereign immunity published in the period 1980-1992. The lack of such documents since then appears to indicate that the government has ceased publishing documents in this area. Most of the published documents do not provide any guidance as they are substantially redacted. The only documents of interest are the following: Document rrrr53 (13 January 1982), which rejected the application of sovereign immunity to government-owned broadcasters, and Document HBW 9412-2-3[C] (25 October 1989), which stated that, in applying the doctrine of sovereign immunity, the nature of the investment income of a foreign government (passive versus substantial control) must be determined with regard to the entire government and not just an agency thereof. Document EACC9204 (27 March 1990) regarding a government-owned foreign superannuation fund stated that the doctrine of sovereign immunity does not apply to political subdivisions or local authorities of sovereign states.
35. See also Information Circular 72-17R5, "Procedures Concerning the Disposition of Taxable Canadian Property by Non-residents of Canada – Section 116" (15 March 2005), which states: "63. 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 ...", and Information Circular 76-12R6, which states at Para. 11: "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): 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".
36. 2003 D.T.C. 317. This was an informal procedure case and it, therefore, has limited precedential authority.

In this tax treaty case, the taxpayer, a US citizen but resident of Canada, worked as a public school teacher in the United States during the 1999 taxation year. She reported the employment income in her Canadian income tax return, but claimed an exemption under Art. XIX of the Canada–United States tax treaty. This provision states that:

> [r]emuneration, 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.[37]

The TCC agreed with the CRA's decision to deny the exemption on the basis that the taxpayer was not employed in the discharge of functions of a governmental nature within the meaning of Art. XIX of the Canada–United States tax treaty. Angers J. began his analysis by observing that the term "services of a governmental nature" is not defined under the Canada–United States tax treaty. In this respect, Para. 1 of the Technical Explanation accompanying Art. XIX of the Canada–United States tax treaty provides that "[w]hether functions are of a governmental nature may be determined by a comparison with the concept of a governmental function in the State in which the income arises". The TCC went on to decide the case based on the Technical Explanation to the parallel provision in the US Model Tax Convention (Art. 19) in the following terms:

> The phrase "functions of a governmental nature" is not defined. In general it is understood to encompass functions traditionally carried on by a government. It would not include functions that commonly are found in the private sector (e.g. education, health care, utilities). Rather, it is 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 these functions.

In holding for the government, Angers J. also referred to the CRA's Income Tax Treaties Reference Manual,[38] which states that governmental functions include executive, legislative and judicial functions and, in particular, involve the formulation, determination, implementation and carrying-out of policies of the government. The TCC did not appear to address the appellant's argument that Art. XIX of the Canada–United States tax treaty creates a dichotomy between services of a governmental nature and "services rendered in connection with a trade or business carried on by a Contracting State or a political subdivision or local authority thereof"[39] and that the taxpayer's services fell in the first category. To sum up, *Cloutier* is Canada's only tax authority on what are functions of a governmental nature. In this case, the TCC agreed with the government's narrow interpretation of this notion,[40] but it must be noted that the precedential authority of the decision is limited, as the case was decided under the TCC's informal procedure.

With regard to the second question, the ITA does not provide a clear indication of what Canada's interpretation would be on the distinction between portfolio dividends and direct dividends, neither of which is a term of art under the ITA. On the one hand, Part IV of the ITA suggests that the threshold separating these types of dividends is a share interest representing 10% of votes and value. On the other hand, Part VI.1 of the ITA defines a "substantial interest" in a corporation as a shareholding representing 25% or more of the corporation's votes and value.

Subject to these issues, the criteria for the application of sovereign immunity in tax matters as set out in Information Circular 77-16R4 reflect two principles. First, the requirement of reciprocity appears to have been adopted by Canada as a fundamental basis for sovereign immunity.[41] Second and most importantly, the requirement that the income be of a passive nature and be derived by the foreign government in the course of exercising a governmental function are two sides of the same coin and reflect the adoption, for Canadian tax purposes, of the doctrine of restrictive immunity instead of that of absolute immunity. The question discussed next is how restrictive the application of sovereign immunity should be for Canadian tax purposes.

Historically, sovereign states enjoyed an absolute immunity from the jurisdiction of another state. This is because in international law it was accepted that a sovereign should not be "embarrassed" by subjection to the control of a foreign judiciary.[42] Absolute immunity was at its peak in the 1920s[43] and was mainly favoured by English courts.[44] Over time, however, and in particular with socialist-country (and especially in the former Soviet Union) governmental entities entering into the commercial arena, the doctrine of absolute immunity became viewed by Western-bloc courts as an unfair shield for commercial traders (from the former Soviet bloc) operating under the umbrella of state ownership or control.[45] The common law responded by developing the theory of restrictive immunity, whilst the former Soviet-bloc countries and other developing nations understandably continued to favour absolute immunity.[46] Under the restrictive approach to state immunity, courts would extend immunity only to acts of a governmental

37. This provision indirectly reflects the principle of sovereign immunity. Similar provisions are found in many Canadian tax treaties.
38. 94 ITC 301.
39. See Art. XIX, second sentence Canada–United States tax treaty.
40. See, for example, for a similarly restrictive position by the Australian Taxation Office (ATO) on what constitutes "governmental function", ATO Interpretative Decision 2010/189 (16 September 2010), to the effect that a US pension fund set up by a US local government body for the purpose of providing retirement, survivor and disability benefits to local government employees is not "one of the Contracting States ... a political or administrative sub-division or local authority thereof, or ... any other body exercising governmental functions" for the purposes of the interest withholding tax exemption in Art. 11(3)(a) of the Australia–United States tax treaty.
41. *Starke*, supra note 30, p. 192.
42. *Re Canada Labour Code*, [1992] 2 S.C.R. 50 at 71; see also id.: "*Par in parem non habet imperium*. One sovereign power could not exercise jurisdiction over another sovereign power, but only over inferiors."
43. Harris, supra note 30, p. 306.
44. *Starke*, supra note 30, p. 191. This is understandable considering Britain's status at the time as the dominant global empire.
45. *Re Canada Labour Code*, supra note 42 and Harris, supra note 30, pp. 306-307.
46. Currently, China and India continue to favour absolute immunity. See Harris, supra note 30, p. 307.

nature (*jure imperii*) and not to commercial acts (*jure gestionis*).

Beginning in the late 1970s, several countries moved to codify the principle of restrictive immunity: the United States passed the Foreign Sovereign Immunities Act of 1976; the United Kingdom enacted its State Immunity Act 1978; and Canada adopted its State Immunity Act in 1982.[47] Significantly, all these statutes provide a "commercial activity" exception to sovereign immunity.[48] Specifically, Sec. 5 of the Canadian State Immunity Act provides that "A foreign state is not immune from the jurisdiction of a court in any proceedings that relate to any commercial activity of the foreign state". Implicit in this provision is that any non-commercial activity by a foreign government is, a priori, a governmental activity that enjoys the protection of state immunity.

Sec. 2 of the Canadian State Immunity Act defines "commercial activity" to mean "any particular transaction, act or conduct or any regular course of conduct that by reason of its *nature is of a commercial character*" (emphasis added). This key definition is inherently circular.[49] In interpreting it according to a textual, contextual and purposive approach,[50] first consideration should be given to the ordinary sense of the word "commerce", which, according to *Merriam-Webster's Collegiate Dictionary*, means "the exchange or buying and selling of commodities on a large scale involving transportation from place to place". The word "commerce" is synonymous with "business", which is defined in the same dictionary as:

> usually commercial or mercantile activity engaged in as a means of livelihood... a commercial or sometimes an industrial enterprise;... dealings or transactions especially of an economic nature.

In light of the word's ordinary meaning, it would be absurd to define as "commercial" any for-profit activity, even if it were exercised by a government as part of its governmental function.[51] However, the Quebec Court of Appeal has warned (in a non-tax case) that the expression "commercial activity" in the Canadian State Immunity Act should be given a broad ambit and should not be confused with the notion of "commerce" in private law.[52]

Whether or not a particular state act is commercial in nature must be determined based on its objective nature and character.[53] However, in *Re Canada Labour Code* – the leading Canadian case on point – the Supreme Court of Canada (SCC) clarified that the subjective *purpose* of an activity is to have "*some place* in determining the character of the relevant activity" (at 74) (emphasis added). In this respect, the SCC referred to the US decision in *De Sanchez v. Banco Central de Nicaragua*,[54] in which sovereign immunity was applied in respect of sales of US dollars by Banco Central, where it was stated (at 1393):

> Here, Banco Central's purpose in selling dollars – namely, to regulate Nicaragua's foreign exchange reserves – was not ancillary to its conduct; instead, it defined the conduct's nature. Banco Central was not merely engaging in the same activity as private banks with a different purpose; in a basic sense, it was engaging in a different activity. It was performing one of its intrinsically governmental functions as the Nicaraguan Central Bank.

The SCC in *Re Canada Labour Code* summarized the proper approach to the Canadian statutory restrictive immunity model as follows (at 76):

> ... the proper approach to characterizing state activity is to view it in its entire context. This approach requires an examination predominantly of the nature of the activity, but its purpose can also be relevant. As at least one Canadian academic has suggested, if a consideration of the purpose of an activity is helpful in determining its nature, Parliament has not excluded the possibility of doing so; see Emanuelli, "Commentaire: La Loi sur l'immunité des États" (1985), 45 R. du B. 81, at pp. 100-101. (emphasis added)

Considering the foregoing, it is arguable that the doctrine of sovereign immunity should have a broader application in Canadian tax matters than the CRA's technical publications and the *Cloutier* case suggest. This is so for the following reasons.

First, Information Circular 77-16R4 states that the government of Canada recognizes a foreign state's immunity only if the other country would provide a reciprocal exemption to the Canadian government. However, in *United States of America v. Dollfus Mieg et Cie SA*, [1952] AC 582, Lord Porter said, at 613, that reciprocity is neither a basis of, nor a limit to, the immunity of a state.[55]

Second, the CRA is of the view that for state immunity to apply, the income must be derived by the foreign government in the course of exercising a function of a governmental nature and may not be income arising in the course of an industrial or commercial activity carried on by the foreign authority. This view is correct in light of the Canadian State Immunity Act, but does not answer the question of what constitutes commercial activity and, conversely, what functions are of a governmental nature. An "entire context" approach to the concept of

47. R.S.C. 1985, c. S-18. Since 1978, sovereign immunity has also been on the UN's agenda. In this respect, in 1991 the International Law Commission recommended to the General Assembly that an international conference consider its Draft convention on state immunity. On 2 December 2004, the General Assembly of the United Nations adopted the "United Nations Convention on Jurisdictional Immunities of States and their Property", GA Res. 59/38 UN GAOR, 59th Sess., Supp. No. 49 UN Doc. A/59/49 (2004) (the "UN Convention"). The UN Convention is not yet in force, as it currently has only 28 out of the 30 required signatories. Canada is not a signatory to the UN Convention.
48. The English statute provides a list of specific exceptions – an approach different from that prevailing in North America, where a general definition of "commercial activity" is provided.
49. *Republic of Iraq v. Export Development Corp.*, [2003] R.J.Q. 2416, at Para. 10 (Q.C.A.).
50. *Canada Trustco Mortgage Co. v. Canada*, [2005] 2 S.C.R. 601, at Para. 10.
51. Against, see Arbour and Parent, supra note 30, p. 337.
52. *Republic of Iraq*, supra note 49, at Para. 13. Consider also the definition of "commercial transaction" in Art. 1(c) of the UN Convention, which reads as follows: "(i) any commercial contract or transaction for the sale of goods or supply of services; (ii) any contract for a loan or other transaction of a financial nature, including any obligation of guarantee or of indemnity in respect of any such loan or transaction; (iii) any other contract or transaction of a commercial, industrial, trading or professional nature, but not including a contract of employment of persons". Art. 2 also clarifies that "In determining whether a contract or transaction is a 'commercial transaction' under paragraph 1(c), reference should be made primarily to the nature of the contract or transaction, but its purpose should also be taken into account if the parties to the contract or transaction have so agreed, or if, in the practice of the State of the forum, that purpose is relevant to determining the non-commercial character of the contract or transaction".
53. *Re Canada Labour Code*, supra note 42.
54. 770 F.2d 1385 (1985).
55. *Starke*, supra note 30, p. 192.

state immunity may suggest a possibly broader ambit for a state's governmental functions and a corresponding narrower ambit for its commercial activities than *Cloutier* indicates. This can be explained as follows. For a long time, absolute immunity was the norm in international law as governmental activity was pretty much limited to the sovereign taxing his or her subjects, waging war and engaging in diplomacy. Absolute immunity was abandoned by Western countries because former Soviet-bloc governments adopted a different and much larger role for themselves. Accordingly, the adoption of restrictive immunity in the 1920s is unsurprising considering that communist governments banned private enterprise and engaged in all sorts of activities, in addition to making bombs and training an army, including growing tomatoes and selling watches.[56] However, matters are different now. On the one hand, the end of the 20th century saw the implosion of the former Soviet bloc and the demise of communism. On the other hand, the post-World War II era saw the emergence of the welfare state as the norm in most Western societies. In this respect, in many countries it is now expected that the government, as part of its general governmental function, not only provide military security, but also ensure the nation's social and economic security.[57] Consequently, governments must offer social benefits, such as employment insurance and old-age pensions, and are counted on to support and protect the nation's economy through strategic investments in key economic sectors, both domestically and abroad. In order for a government to effectively achieve such policies, it must dedicate the necessary funds – whether or not from surpluses – and invest them appropriately. In this context, a state's investment activity may fall squarely within its governmental function. Accordingly, there is an argument to be made that in the modern context states have broader governmental responsibilities than before the advent of the welfare state and that their purely commercial functions are, correspondingly, narrower.

Third, Information Circular 77-16R4 states that state immunity may be applied only in respect of interest on an arm's length debt and portfolio dividends on listed company shares. In contrast, the circular specifies that income, such as rentals, royalties and dividends, from a company in which the foreign government has a substantial or controlling equity interest are not covered by state immunity. Arguably, this position is unduly restrictive and does not reflect the ordinary meaning of the notion "commercial activity". As discussed previously in this section, the word "commerce" is synonymous with "business", which suggests a level of economic activity greater than that of passive investment.[58] In this respect, the distinction between income from a business and income from property is fundamental to Canadian tax law and may be useful in determining whether an SWF has engaged in commercial activity in Canada. Since rentals, royalties, interest and dividends,[59] unless they are part of a business or an adventure in the nature of trade, are typically considered income from property for Canadian tax purposes, it may be argued that such items of income should, a priori, be covered by a state's immunity. Conversely, it stands to reason that if a foreign SWF carries on a business in Canada directly (which would be rare)[60] or as a member of a partnership, such an SWF would be seen to engage in a commercial activity that is not immune from Canadian taxation.

To conclude on the point of sovereign immunity, the available authorities indicate that Canada applies the public international law doctrine of sovereign immunity restrictively – generally and in matters of tax law. In this respect, Canada definitely does not treat foreign SWFs on an equal footing as domestic SWFs. Yet, as discussed in this section, there are several persuasive theoretical arguments that may be advanced in favour of a broader scope for sovereign immunity in respect of the tax treatment of foreign SWFs investing in Canada. The unanswered question is to what extent such arguments may in practice find their way before Canada's courts, considering that the matter of sovereign immunity is a political and highly sensitive one.

3.3. Domestic tax law

As discussed in 3.2., the governments of Canada and each of the provinces are generally immune from taxation under the ITA. Sec. 149 of the ITA also specifies that governmental entities and corporations substantially owned by them are exempted from federal income tax.[61] In this regard, Sec. 149(1)(c) provides that a Canadian municipality, or a municipal or public body performing a function of government in Canada, is exempt from taxation under Part I of the ITA. The provisions of Sec. 149(1)(d) to (d.6) of the ITA also set out specific rules exempting certain government-owned corporations, commissions, associations (and their subsidiaries) and certain municipal corporations (and their subsidiaries) from Part I tax. Conversely, the ITA makes taxable certain "prescribed federal Crown corporations" to remove

56. *Wenger's Ltd.*, supra note 33.
57. See *Québec (Communauté urbaine) v. Corp. Notre-Dame de Bon-Secours*, [1994] 3 S.C.R. 3 for a parallel in respect of the development of the interpretation of tax statutes. In essence, the SCC consecrated the move away from strict interpretation of tax statutes in favour of a textual, contextual and purposive approach and did so in light of taxation's changing function. Whereas traditionally taxation was seen as a quasi-penal expropriation by a sovereign of his or her subjects, modern tax statutes are considered to be important socio-economic tools that allow governments to redistribute wealth and return what was taken from taxpayers in the form of various governmental services.
58. See the dichotomy between "services of a governmental nature" and "services rendered in connection with a trade or business carried on by a Contracting State" in Art. XIX of the Canada–United States tax treaty as observed by the taxpayer in *Cloutier*, supra note 36. Against, see Art. 1(c)(ii) of the UN Convention, which appears to apply to investment activity and also Arbour and Parent, supra note 30, p. 336.
59. Of course, a Canadian corporation paying such dividends would, presumably, be fully taxable in Canada.
60. For a Canadian non-tax case where sovereign immunity was denied based on the "commercial activity" exception in Sec. 5 of the Canadian State Immunity Act, see *Ferguson v. Arctic Transportation Ltd.*, [1995] 3 F.C. 656, which involved the Panama Canal Commission (an instrumentality of the US government), that carried on directly the business of operating the Panama Canal.
61. This either confirms Crown immunity from taxation or applies to entities that, although Crown-owned, are not formally part of the government.

any unfair competitive advantage enjoyed by such government-owned corporations that carry on a business in competition with privately owned firms.[62] This is arguably a domestic application of the commercial-activity exception to sovereign immunity.

None of these provisions of the ITA apply to foreign governments and their agents.[63] Accordingly, foreign SWFs are subject to the normal Canadian tax rules applicable to non-residents. In this respect, a non-resident is liable to Canada's mainstream income tax under Part I of the ITA only if it carries on a business in Canada or disposes of "taxable Canadian property" (TCP).[64] Part XIII of the ITA also imposes a final withholding tax of 25% on certain listed types of property income, such as interest, dividends, rents and royalties, derived by a non-resident of Canada. The domestic rate of withholding tax may be reduced under Canada's tax treaties.

Two recent changes have made inbound investment in Canada, including by foreign SWFs, much more attractive than it previously was. First, with effect from 4 March 2010, the scope of the definition of TCP was significantly restricted. TCP now means mainly real property situated in Canada and the property of a business carried on in Canada. Previously, TCP also included shares in any private Canadian corporation and a variety of other entity interests. However, the 2010 Canadian federal budget has now restricted the definition of TCP so that a share of a private corporation, an interest in a partnership or an interest in a trust is TCP only if, at any particular time during the 60-month period that ends at the time of disposition of the property, more than 50% of the fair market value of the share or interest was derived, directly or indirectly, from Canadian real estate or resource properties.[65] The effect of this change is that an investor in a non-real estate Canadian company may altogether escape Canadian taxation on a disposition of shares without the need for a treaty exemption.

Second, with effect from 1 January 2008, Canada eliminated its withholding tax in respect of all arm's length, non-participating interest. Accordingly, a non-resident creditor, including a foreign SWF, holding bonds or other debt of an unrelated Canadian debtor is generally not subject to Canadian withholding tax on interest.

Considering that Canadian domestic tax law does not afford any special tax treatment to foreign SWFs, the application of Canada's tax treaties to such investors is next examined in this article.

3.4. Tax treaties

3.4.1. Overview

Canada is a Member country of the OECD and its tax treaties are generally based on the OECD Model; however, some provisions in Canada's tax treaties reflect Canada's particular treaty policy. Accordingly, the following discussion is mainly based on the articles of the OECD Model, but reference is made to specific provisions in Canada's tax treaties. In particular, this section considers, where relevant, the terms of Canada's tax treaties with countries that are home to the world's major SWFs: China (People's Rep.), Kuwait, Norway, Russia, Singapore and the United Arab Emirates. Significantly, although Canada has over 80 tax treaties in force, it has not concluded a tax treaty with Libya, Qatar and Saudi Arabia, all of which have major SWFs.

3.4.2. Treaty benefits

The benefits of a tax treaty are generally available to persons who are residents of one or both of the contracting states.[66] The main concern regarding SWFs[67] has been whether or not they qualify as a "resident of a Contracting State", considering that an entity that does not pay tax in its home country may not be "liable to tax" therein. To address this issue, since 1995, Art. 4(1) of the OECD Model has explicitly provided that the contracting states themselves, their political subdivisions and their local authorities are included in the definition of "resident of a Contracting State" and are, therefore, entitled to the benefits of a tax treaty. In any event, the OECD comments that this has been the general understanding of most of its Member countries prior to the inclusion of the specific reference in Art. 4(1) of the OECD Model.[68] The residence concern, however, remains for SWFs that are not considered to be a part of the contracting state or its political subdivisions or local authorities. In this regard, the 2010 Commentary on Art. 1 of the OECD Model observes that, in order to clarify the issue, some states modify the definition of "resident of a Contracting State" to include in that definition a "statutory body", an "agency or instrumentality" or a "legal person of public law" ("*personne morale de droit public*") of a state, a political subdivision or local authority, which would, therefore, cover wholly owned entities that are not considered to be a part of the state or its political subdivisions or local authorities.[69]

With regard to this, Canada should generally treat a contracting state, a political subdivision or local authority thereof and their agencies and instrumentalities as resi-

62. Sec. 27 ITA. Prescribed federal Crown corporations are deemed by Sec. 27(2) of the ITA not to be "private corporations" and the exemptions otherwise applicable under Sec. 149(1)(d) to (d.4) are withdrawn in relation to them. Amongst those few taxable Crown corporations are Canada's public broadcaster, the Canada Broadcasting Corporation, and the national passenger rail company, VIA Rail.
63. But note the exemptions in Sec. 149(1)(a) and (b) of the ITA for officers and servants (essentially, diplomats) of foreign governments.
64. See Sec. 2(3) of the ITA and the definition of "taxable Canadian property" in Sec. 248(1). With regard to non-resident individuals, Sec. 2(3) of the ITA also extends to employment in Canada.
65. With regard to shares in public corporations or mutual fund corporations or units in mutual fund trusts, there is an additional threshold requirement for TCP status, i.e. at any time during the 60-month period, the taxpayer (or non-arm's length parties) must have owned 25% or more of the issued shares or units of any class.
66. Art. 1 OECD Model.
67. As to whether or not a SWF is a "person", based on the non-exhaustive definition at Art. 3(1)(a) of the OECD Model, the term "person" has a very wide sense, which should include a contracting state and its instrumentalities. See also Para. 2 of the Commentary on Art. 3(1) of the OECD Model.
68. Para. 8.4 of the Commentary on Art. 4 of the OECD Model.
69. Para. 6.36 of the Commentary on Art. 1 of the OECD Model. See also Para. 8.5 of the Commentary on Art. 4 of the OECD Model.

dents for treaty purposes.[70] In terms of Canada's treaty practice in question, some recent tax treaties explicitly treat as resident the contracting states themselves, their political subdivisions and local authorities and their agencies and instrumentalities.[71] However, other Canadian tax treaties, including some recent ones, do not contain such references.[72] Canada's inconsistent treaty practice in this regard is reflected in its tax treaties with the main SWF countries. Accordingly, the residence article of the Canada–United Arab Emirates tax treaty contains a very detailed inclusion for governments, their agencies and instrumentalities and goes as far as specifically naming ADIA as a resident of the United Arab Emirates.[73] The Canada–Norway tax treaty adopts an approach similar to that of the OECD Model and, as part of Art. 4(1), contains the more standard reference to "that State or a political subdivision or local authority thereof or any agency or instrumentality of any such State, subdivision or authority". Canada's tax treaties with China (People's Rep.), Russia and Singapore, on the other hand, do not contain explicit inclusions for governments and their instrumentalities.

For SWFs that are not part of the government, strictly speaking, but are nonetheless tax-exempt, a specific treaty inclusion in the residence article is most useful, but in the absence of such provision, this type of SWFs should still be able to rely on Canada's policy to consider as treaty resident any person to the extent the person's worldwide income is subject to a contracting state's full taxing jurisdiction, even if that state does not levy tax on the person's taxable income.[74]

Finally, treaty benefits may also be subject to a limitation on benefits (LoB) clause. Canada's only tax treaty with a comprehensive LoB clause is that with the United States. In this respect, Art. XXIX-A(2)(b) of the Canada–United States tax treaty states that "a Contracting State or a political subdivision or local authority thereof, or any agency or instrumentality of any such State, subdivision or authority" is a "qualifying person" under the LoB clause and, hence, entitled to all of the benefits of the tax treaty. Accordingly, US SWFs investing in Canada should be eligible for all the benefits of the tax treaty.

3.4.3. Special distributive provisions applicable to SWFs

The OECD Model does not contain any distributive provisions applicable specifically to SWFs. However, the 2010 Commentaries observe that many states include specific provisions in their tax treaties that grant an exemption to other states and to some state-owned entities, such as central banks, with regard to certain items of income, such as dividends and interest.[75]

With regard to dividends, new Para. 13.2 of the 2010 Commentary on Art. 10 of the OECD Model states:

> 13.2 Similarly, some States refrain from levying tax on dividends paid to other States and some of their wholly-owned entities, at least to the extent that such dividends are derived from activities of a governmental nature. Some States are able to grant such an exemption under their interpretation of the sovereign immunity principle (see paragraphs 6.38 and 6.39 of the Commentary on Article 1); others may do it pursuant to provisions of their domestic law. States wishing to do so may confirm or clarify, in their bilateral conventions, the scope of these exemptions or grant such an exemption in cases where it would not otherwise be available. This may be done by adding to the Article an additional paragraph drafted along the following lines:
>
>> Notwithstanding the provisions of paragraph 2, dividends referred to in paragraph 1 shall be taxable only in the Contracting State of which the recipient is a resident if the beneficial owner of the dividends is that State or a political subdivision or local authority thereof.

With regard to Canada's treaty practice on this point, the Canada–Norway tax treaty is Canada's only tax treaty in force that contains a source country exemption for dividends paid to "the other Contracting State or a political subdivision or local authority thereof or to any wholly-owned agency or instrumentality of that State, political subdivision or local authority".[76] However, this provision applies only as agreed from time to time between the competent authorities of Canada and Norway. In this respect, on 20 September 2010, the CRA published a notice of agreement between competent authorities to the effect that, with effect from on 1 January 2010, Art. 10(3) of the Canada–Norway tax treaty applies only to the extent that: (1) the dividend recipient owns less than 25% of the payer of the dividends; and (2) the funds invested result from the performance of functions of a governmental nature. The notice also specifies that Art. 10(3) of the Canada–Norway tax treaty also applies, in the case of Norway, to the Central Bank of Norway, the Government Pension Fund-Global and the municipality of Bærum.

70. The third protocol, signed in 1995, to the Canada–United States tax treaty modified Art. IV to deem the government of one of the countries or a political subdivision or local authority thereof or an agency or instrumentality thereof to be a resident of a contracting state. The Technical Explanation accompanying the protocol describes the amendment as confirmatory, stating that this is "implicit in the current Convention and in other US and Canadian tax treaties, even where not specified". See also *TD Securities (USA) LLC v. Canada*, 2010 DTC 1137 (TCC), at Para. 39.
71. See, for example, the Canada–Colombia tax treaty, signed in 2008, and the Canada–Greece tax treaty, signed in 2009.
72. See, for example, the Canada–Turkey tax treaty, signed in 2009.
73. Art. 4(2) of the Canada–United Arab Emirates tax treaty states that "the term 'resident of a Contracting State' shall include:
(a) the Government of that Contracting State or a political subdivision or local Government or local authority thereof;
(b) any corporation, Central Bank, Abu Dhabi Investment Authority, fund, authority, foundation, commission, agency or other entity that was established under the law of that Contracting State and that is wholly-owned and controlled by the Government of that Contracting State or a political subdivision or local authority thereof, by any entity referred to in this subparagraph or by any combination thereof; and
(c) any entity established in that Contracting State all the capital of which has been provided by the Government of that Contracting State or a political subdivision or local authority thereof either alone or together with the governments of other states."
The Canada–Kuwait tax treaty is drafted very similarly, but does not explicitly refer to the Kuwait Investment Authority.
74. Income Tax Technical News 35 (26 February 2007). See Para. 8.5 of the Commentary on Art. 4(1) of the OECD Model.
75. Para. 6.37 of the Commentary on Art. 1 of the OECD Model.
76. Art 10(3) Canada–Norway tax treaty. On 22 October 2010, Canada and Switzerland signed a protocol to the Canada–Switzerland tax treaty, which will, once the protocol is in force, be amended to include a limited withholding exemption in respect of dividends paid to the Bank of Canada or the Swiss National Bank.

With regard to interest, Para. 7.4 of the 2010 Commentary on Art. 11 of the OECD Model states:

> 7.4 Some States refrain from levying tax on income derived by other States and some of their wholly-owned entities (e.g. a central bank established as a separate entity), at least to the extent that such income is derived from activities of a governmental nature. Some States are able to grant such an exemption under their interpretation of the sovereign immunity principle (see paragraphs 6.38 and 6.39 of the Commentary on Article 1); others may do it pursuant to provisions of their domestic law. In their bilateral conventions, many States wish to confirm or clarify the scope of *these exemptions* with respect to interest or to grant such an exemption in cases where it would not otherwise be available. States wishing to do so may therefore agree to include the following category of interest in a paragraph providing for exemption of certain interest from taxation in the State of source:
>
> *a*) is that State or the central bank, a political subdivision or local authority thereof;
>
> (underlined text indicates changes)

With regard to Canada's treaty practice on this point, in contrast to dividends, several Canadian tax treaties include, in their interest article, a withholding exemption for interest paid to government authorities.[77] However, Canada's approach in this regard is not consistent. Accordingly, with regard to the main SWF countries, Art. 11(3) of the Canada–United Arab Emirates tax treaty has a broad exemption for interest paid to "the Government of the other Contracting State including a political subdivision and a local authority thereof, the Central Bank of that other State or any financial institution wholly owned by that Government".[78] The Canada–Norway tax treaty has a more standard exemption for interest arising in a contracting state and paid to the other contracting state or a political subdivision or local authority thereof or to any wholly owned agency or instrumentality of that State, political subdivision or local authority. However, as with the dividend withholding exemption in this tax treaty, the interest exemption applies only as agreed between the competent authorities.[79] The Canada–Russia tax treaty has a very limited exemption available only to the central bank of each contracting state. Finally, the Canada–Kuwait and the Canada–Singapore tax treaties do not contain a state exemption from interest withholding.

Considering this, it is clear that Canada's tax treaties should not affect in any way the possible application of the customary international law principle of sovereign immunity. This is the view of the OECD, as expressed in the 2010 Commentaries,[80] and is also confirmed by the protocol to the Canada–United Arab Emirates tax treaty regarding Art. 10.[81]

In addition, those Canadian tax treaties that provide a specific government exemption on interest or dividends may be regarded as confirming the applicability of the sovereign immunity doctrine[82] and, potentially, expanding its scope. Accordingly, with regard to interest, Canada's tax treaties that offer a government exemption normally do not include a requirement that the interest be paid on arm's length debt. This is in contrast to Canada's domestic withholding tax exemption and the CRA's statements in Information Circular 77-16R4. Consequently, this makes debt financing a preferred approach for SWFs.

With regard to dividends, the recent competent authority agreement under the Canada–Norway tax treaty specifies that the government exemption is available to the extent that the dividend recipient owns less than 25% of the payer of the dividends. This agreement appears to offer a more favourable treatment than that otherwise available under the criteria in Information Circular 77-16R4. First, it clarifies the distinction between portfolio dividends and direct dividends by adopting the higher threshold of 25%.[83] Second, the agreement does not retain the requirement that dividends be paid on listed shares to be eligible for the government treaty exemption.

3.4.4. Application of normal treaty distributive rules to SWFs

Subject to what is stated in 3.4.3., the normal distributive rules found in Canada's tax treaties otherwise apply to SWFs. In this regard, as noted in 3.4.1., Canada's treaty policy is generally in line with the provisions of the OECD Model. The following discussion addresses two specific matters of particular relevance to SWFs.

First, there could be an issue of whether an SWF is eligible for the low 5% withholding rate on dividends. This rate applies where the recipient is a company that owns a minimum percentage (usually 10% in Canada's tax treaties) of the payer's capital. The word "company" is defined in the OECD Model and Canada's tax treaties as "any body corporate or any entity that is treated as a body corporate for tax purposes". In this regard, the question relates to whether or not a SWF that forms an integral part of government and is not incorporated is a company for treaty purposes. Arguably, in applying its tax treaties, Canada should treat such SWF as a "company" based on a Canadian interpretation of the notion of "body corporate".[84] This is because the government has been described in Canadian case law as a "non-statutory corporation sole".[85] Nonetheless, in appropriate situations, it may be preferable to structure an investment by an SWF through a regular corporation to deal with any uncer-

77. See Appendix.
78. Art. 11(4) of the Canada–United Emirates tax treaty further clarifies that the terms "the Central Bank" and "financial institution wholly owned by the Government" include, in respect of the United Arab Emirates, the ADIA.
79. There has not been any competent authority agreement on this point.
80. Para. 6.38 of the Commentary on Art. 1 of the OECD Model.
81. Art. 3 of the protocol to the Canada–United Arab Emirates tax treaty reads: "With reference to Article 10 of the Convention, it is understood that nothing contained therein affects the fiscal privileges available under the doctrine of sovereign immunity to the Government of a Contracting State or local Governments, and their agencies and institutions".
82. See, for example, the requirement that the item of income be derived from activities of a governmental nature.
83. It is not clear what is meant by the word "owns" in respect of 25% of the payer corporation. Arguably, this refers only to value and not to votes.
84. Art. 3(2) OECD Model.
85. *Canada v. Newfield Seed*, (1989) 63 D.L.R. (4th) 644 at 660 (Sask. C.A.). See Lordon, supra note 28, p. 5.

tainty[86] on this point and ensure access to the low treaty withholding rate on intercorporate dividends.

Second, SWFs that provide pension benefits to government employees, such as Norway's Government Pension Fund, may be eligible for any distributive rules in Canada's tax treaties specifically applicable to pension funds.[87] In this regard, several Canadian tax treaties contain provisions specifically dealing with the tax treatment of interest and/or dividends derived by a pension fund. Over 20 of Canada's tax treaties offer a specific withholding tax exemption on interest for pension funds.[88] Typically, such exemption is available only where the pension plan is generally exempt from tax in its state of residence and the interest is not derived by the pension plan from carrying on a trade or a business or from a related person. Notably, however, since 1 January 2008, this treaty exemption has effectively lost its relevance, considering that the ITA no longer imposes withholding tax on arm's length, non-participating interest.

In contrast, only a few of Canada's tax treaties offer a withholding tax exemption on dividends derived by a pension plan.[89] Typically, such exemption is available only in limited circumstances where: (1) the pension plan is generally exempt from tax in its state of residence; (2) the shares on which the dividends are paid are held as an investment; (3) the pension plan does not own, directly or indirectly, more than 5% of the capital or 5% of the voting stock of the company paying the dividends; and (4) the class of shares of the company on which the dividends are paid is regularly traded on an approved stock exchange. Significantly, however, Art. XXI of the Canada–United States tax treaty provides a much more generous exemption on dividends received by a tax-exempt pension plan, requiring only that the dividends not be from carrying on a trade or business or from a related person.[90]

3.4.5. *Treaty shopping*

Although Canada has over 80 tax treaties in force, as noted in 3.4.1., some states that are home to major SWFs do not have a tax treaty with Canada. The issue that may be relevant to an SWF from such a non-treaty state is whether or not it may structure a potential investment in Canada in a way that accedes to the benefits of a tax treaty between Canada and a third country. Such tax planning techniques, known pejoratively as "treaty shopping", are controversial and have given rise to extensive debate in the international tax community.[91]

In this regard, the Canadian authorities to date appear to support inbound treaty shopping. The TCC in Canada's first decision on point, *MIL (Investments) S.A. v. Canada*,[92] clearly suggested that treaty shopping to minimize tax, on its own, cannot be viewed as abusive. In December 2008, the government-mandated Advisory Panel on Canada's International Tax System seemed to endorse the idea that treaty shopping is not inherently objectionable, by stating that "businesses should be able to organize their affairs to obtain access to treaty benefits".[93] Most recently, the Federal Court of Appeal (FCA) in *Prévost Car Inc. v. Canada*[94] clearly rejected the CRA's attempt to challenge what it apparently perceived as improper treaty shopping by denying the status of "beneficial owner" for treaty purposes.

Nonetheless, the law in relation to treaty shopping is changing rapidly and non-treaty state SWFs that are considering such planning, should carefully analyse all variables. In this respect, the FCA decision in *Prévost* is significant in that it has opened the door to the use of later OECD Commentaries in interpreting pre-existing tax treaties and, eventually, to the potential application of the various treaty anti-abuse ideas advocated by the OECD, mainly in the 2003 Commentaries on the OECD Model. Consequently, the CRA may consider it desirable to rely more often on an inherent general anti-abuse rule regarding improper treaty use. Similarly, it may be expected that the CRA will not be discouraged, at least until the pending appeal in *Velcro Canada Inc. v. Canada*[95] is decided, from using the OECD's interpretation of "beneficial owner" to challenge perceived abusive treaty shopping. Finally, despite the CRA's setback in *MIL (Investments)*, it is expected that the CRA will continue to use the GAAR in cases it regards as abusive treaty shopping.

86. The uncertainty arises from other case law that has described the Canadian government as a "physical person". See Lordon, supra note 28, p. 4.
87. This possibility was specifically noted by the OECD in Para. 6.37 of the 2010 Commentary on Art. 1 of the OECD Model, which reads: "Treaty provisions that grant a tax exemption with respect to the income of pension funds (see paragraph 69 of the Commentary on Article 18) may similarly apply to pension funds that are wholly-owned by a State, depending on the wording of these provisions and the nature of the fund".
88. Such an exemption is contained in Canada's tax treaties with Austria, the Czech Republic, Denmark, Germany, Hungary, Iceland, Ireland, Korea (Rep.) (in the protocol and subject to the exchange of notes, which has not occurred), Luxembourg, Mexico, Moldova, Namibia, the Netherlands, Oman, Slovenia, South Africa, Sweden, Switzerland, Tanzania, Trinidad and Tobago, Ukraine, the United States and Zimbabwe.
89. Such an exemption is contained in Canada's tax treaties with Denmark, Korea (Rep.) (in the protocol and subject to the exchange of notes, which has not occurred), Luxembourg, Oman, Sweden, Switzerland (not yet in force) and the United States.
90. Art. IV(2) of the recent protocol to the Canada–Switzerland tax treaty will modify that tax treaty to include a dividend exemption for tax-exempt pension plans, which will be subject to the following conditions:
"(iii) each pension or retirement plan provides benefits primarily to individuals who are residents of that other Contracting State;
(iv) the dividends are not derived from carrying on a trade or a business or from a related person; and
(v) the competent authorities of the Contracting States agree that each pension or retirement plan generally corresponds to a pension or retirement plan recognized for tax purposes in the first-mentioned State".
91. For a detailed analysis of Canada's perspective on treaty shopping, see M. Kandev, "Treaty Shopping After *Prévost Car*: What Does The Future Hold?" *International Tax Seminar, 2009* (Kingston, Ont.: International Fiscal Association (Canadian Branch), 2009), 3:1-25.
92. 2006 D.T.C. 3307 (TCC), aff'd 2007 D.T.C. 5437 (FCA).
93. Advisory Panel on Canada's System of International Taxation, "Enhancing Canada's International Tax Advantage: Final Report" (Ottawa: APCSIT, December 2008), available at www.apcsit-gcrcfi.ca/07/cp-dc/pdf/finalReport_eng.pdf. In this regard, see N. Boidman, "Reforming Canada's International Tax Regime: Final Recommendations, Part 1", 53 *Tax Notes International* 3 (19 January 2009), p. 247 and "Reforming Canada's International Tax Regime: Final Recommendations, Part 2", 53 *Tax Notes International* 4 (26 January 2009), p. 345.
94. 2009 DTC 5053 (FCA) aff'g 2008 DTC 3080 (TCC).
95. 2007-1806(IT)G.

4. Conclusions

SWFs have become major actors in international financial markets and an important source of inbound investment in developed countries, including Canada. As SWFs generally do not pay tax in their home countries, their cross-border investment decisions are invariably influenced by the tax treatment afforded to them in potential investee countries.

Although Canada does not treat foreign SWFs as well as its domestic SWFs, which are generally immune or exempt from tax, Canada's application of the public international law doctrine of sovereign immunity, the provisions of the ITA and Canada's tax treaties provide tax incentives that, arguably, welcome investment in Canada by foreign SWFs. In particular, Canada does apply the public international doctrine of sovereign immunity in tax matters to the effect that portfolio dividends on listed shares and arm's length interest are generally tax free. In this respect, it is argued in 3.2., that a broader application of sovereign immunity should, theoretically, be possible, but this remains untested.

With regard to Canada's domestic tax law, the ITA does not offer foreign SWFs any special treatment. However, recent legislative changes providing a domestic exemption on gains on the sale of shares in many Canadian corporations and interest on arm's length debt, have made inbound investment in Canada, including by SWFs, much more attractive than it previously was.

With regard to the application of Canada's tax treaties to SWFs, many Canadian tax treaties offer a general exemption on all interest received by government entities, which makes debt financing a preferred approach for SWFs. For SWFs that offer pension benefits, the special distributive rules applicable to pension funds in some of Canada's tax treaties, especially those that deal with dividends, may also offer a withholding tax exemption in certain limited cases.

Finally, the Canadian authorities to date appear to support inbound treaty shopping to the effect that an SWF from a non-treaty state may be able to structure its investment in Canada in a way that accedes to the benefits of a tax treaty between Canada and a third country.

Accordingly, the following summarizes Canada's position on SWFs:

– Foreign SWFs making portfolio investments in Canadian public corporations and lending to arm's length Canadian borrowers should generally expect tax-free treatment on income from and gains on such investments.
– Foreign SWFs acquiring substantial or controlling interests in Canadian corporations should generally expect to be taxable on dividends, but, depending on the underlying activities of the investee corporation, may be domestically exempt on capital gains on a disposition of the share investment. Significantly, it may be possible to reduce the overall Canadian tax cost of such types of investment through tax-free deductible interest on associated debt financing.
– Foreign SWFs engaging in business operations through a permanent establishment in Canada, either directly or through a partnership, are generally fully taxable in respect of such activities.

Appendix

Country	Provision	Limitation on identity of recipient
Algeria	Art. 11(3)(b)	state, political subdivision, local authority or wholly owned institution
Austria	Art. 11(7)(d)	central bank
Azerbaijan	Art. 11(3)(a)	state, political or administrative-territorial subdivision, local authority, central bank or the State Oil Fund of the Republic of Azerbaijan
Belgium	Art. 11(3)(b)	state, political subdivision or local authority
Brazil	Art. 11(3)	state, political subdivision, local authority or wholly owned agency (including a financial institution)
Bulgaria	Art. 11(3)(b)	government or wholly owned central bank
China (People's Rep.)	Art. 11(3)	state, central bank or wholly owned financial establishment (subject to agreement)
Denmark	Art. 11(3)(b)	payments from central bank to central bank
Ecuador	Art. 11(3)(a)	state, political subdivision, local authority or central bank
Egypt	Art. 11(3)(a)	state or tax-exempt instrumentality
Estonia	Art. 11(3)	state, political subdivision, local authority or central bank
Finland	Art. 11(3)(b)	payments from central bank to central bank
France	Art. 11(3)(b)	payments from central bank to central bank
Gabon	Art. 11(3)(a)	state, political subdivision, local authority, or wholly owned agency or establishment exercising government functions
Germany	Art. 11(3)(d)	state, political subdivision or central bank
Guyana	Art. 11(4)	state or tax-exempt instrumentality
India	Art. 11(3)(a)	central bank or instrumentality (subject to agreement)
Indonesia	Art. 11(7), (8)	state, political subdivision, statutory government body or financial public institution (subject to agreement)
Italy	Art. XI(3)(b)	state, political subdivision, local authority or wholly owned institution
Ivory Coast	Art. XI(3)	state, political subdivision, local authority or wholly owned agency exercising government functions
Jamaica	Art. XI(7)	state, political subdivision, local authority or tax-exempt instrumentality carrying on government functions
Japan	Art. 11(3)	state, political subdivision, local authority, central bank or wholly owned financial institution
Jordan	Art. 11(3)(a)	state or tax-exempt instrumentality of the state
Kenya	Art. XI(3)	state, political subdivision, local authority, central bank, tax-exempt wholly owned agency or other entity (subject to agreement)
Korea (Rep.)	Art. 11(3)	state, political subdivision, local authority, central bank or wholly owned financial institution performing government functions
Latvia	Art. 11(3)	state, political subdivision, local authority or central bank
Lithuania	Art. 11(3)	state, political subdivision, local authority or central bank
Malta	Art. 11(3)	state, central bank or Malta Development Corporation
Netherlands	Art. 11(3)(c)	state, political subdivision, local authority, central bank or state-controlled instrumentality
Nigeria	Art. 11(3)	state, political subdivision, local authority or instrumentality
Norway	Art. 11(3)(d)	state, political subdivision, local authority or wholly owned instrumentality (all subject to agreement)
Oman	Art. 11(3)(a)	state, political subdivision or local authority
Pakistan	Art. XI(7)	central bank or government-controlled financial institution (subject to agreement)
Poland	Art. 11(3)	state or public body of the state (subject to agreement)
Portugal	Art. 11(3)	state, political subdivision, local authority or institution with regard to a financing between the states
Russia	Art. 11(3)(a)	central bank
South Africa	Art. 11(3)	central bank
Thailand	Art. 11(3)	state, political subdivision, local authority, central bank or wholly owned Thai institution (subject to agreement)
United Arab Emirates	Art. 11(3), (4)	state, political subdivision, local authority, central bank, wholly owned financial institution (subject to agreement) or ADIA