

NRF Client Briefing

Sovereign immunity from direct taxation: consultation on policy design



UK government consultation on sovereign immunity for direct taxation: some clarity, but not without reform

The government has published a consultation on a proposed reform of the UK rules regarding sovereign immunity from direct taxation. While the release of the consultation was largely a surprise for tax practitioners given the lack of fanfare surrounding the announcement, it signals that changes may be on the horizon that could have wide ranging tax consequences for foreign governments and heads of state investing into the UK.

The government cites three main reasons for introducing reform:

bringing the UK's sovereign immunity regime more in line with the approaches adopted by other developed countries (essentially, limiting exemption to passive interest income);

making the scope of exemption proportionate to the scope and scale of the investments being made by sovereign investors into the UK; and

aligning the UK tax treatment of non-resident and sovereign investors more closely. While the consultation addresses all forms of sovereign investor (i.e. individual heads of state as well as various manifestations of government), in practice, it is sovereign wealth funds (SWFs) that are likely to be most impacted by these potential reforms, given their historic investment into the UK, particularly into UK real estate.

Of particular note for investments into UK real estate, the proposals would bring sovereign investors within scope of the UK's property developer tax and non-resident capital gains tax regimes.

Sovereign investors will also want to monitor the consultation outcome in respect of a number of regimes designed to encourage investment in the UK such as the new qualifying asset holding company (QAHC) regime, real estate investment trusts (REITs) and the UK participation exemption for companies owned by certain qualifying institutional investors.

The consultation proposes introducing the new rules from April 2024.

What is the current position?

The UK's current position reflects an international law principle that one sovereign state should not seek to apply its law to another sovereign state. In the UK this has been interpreted by case law and HM Revenue & Customs practice as meaning that all UK source income and gains

from the commercial activities of sovereign persons are exempt from UK direct tax. The process of assessing the availability of sovereign immunity is carried out by HM Revenue & Customs, with decisions made on a case-by-case basis by reference to the circumstances of the particular applicant.

What are the proposals?

The proposed changes to the scope and assessment of sovereign immunity from direct taxation are as follows:

- **Transparency on eligibility** – the government is proposing to pass legislation for the first time that sets out the eligibility criteria for qualifying for exemption from direct taxation as a sovereign investor, and the tax consequences of such qualification. Moving away from a case-by-case approach based on case law and common practice should provide investors with much needed certainty on the availability (or otherwise) of sovereign immunity.
- **Widening scope of availability** – alongside improving transparency, the government is proposing to widen the scope of persons that are able to benefit from sovereign immunity. Currently, federal states qualify as 'sovereign states' for tax purposes, but constituent territories are assessed on a case-by case basis. Going forward, the government is proposing that all constituent territories of federated states are eligible for sovereign immunity. The government is also seeking views on whether entities wholly owned and controlled by a state should be included in scope, potentially expanding options for different types of holding structures. While the general trend is for a widening of the scope of entities able to benefit from sovereign immunity, the consultation does raise the question of whether government pension schemes should benefit from sovereign immunity going forward, on the basis that other relief is generally available, such as registering as a recognised overseas pension scheme.

- **Limiting availability of immunity to certain types of passive income** – bringing the UK's position more in-line with the approaches adopted by many other countries (including the US and Australia), the government proposes limiting exemption to passive investment activity (i.e. excluding real estate). As the UK does not tax non-residents on UK source dividend income, the exemption would be limited in practice to UK source interest income to the extent that it does not relate to trading activities undertaken in the UK. Consequently, sovereign non-natural persons (such as SWFs) could become liable to UK corporation tax on:
 - profits attributable to trades of a UK permanent establishment;
 - all profits arising from dealing in or developing UK land for the purposes of disposing of such land;
 - all profits from a UK property business, including property income dividends received from real estate investment trusts and property authorised investment funds, and UK property income arising from interests in transparent for income collective investment vehicles (CIVs); and
 - chargeable gains arising on from the disposal of assets that are used in or for the purposes of a UK permanent establishment's trade or the permanent establishment itself, and from disposals of interest in UK land rights to assets, including interests in CIVs, that derive at least 75% of their value from UK land.
- **Potential consequential changes to 'qualifying investor status'** – a number of regimes within the UK tax code provide certain institutional investors with beneficial treatment, encouraging inward investment to the UK. Sovereign immune investors are deemed to be qualifying investors in some cases, particularly under the real estate investment trust legislation, qualifying asset holding company regime and substantial shareholding exemption. While the government has noted that the operation of these regimes will need to be considered carefully alongside a reformed sovereign immunity regime, the framing of the discussion in the consultation document hints that changes are unlikely to be made where the underlying rationale for deeming sovereign immune investors to be qualifying investors is to capture certain profiles of large institutional investor. It appears that changes (if any) are more likely to be

made where qualifying investor status is driven by identifying investors with tax exempt status and would risk undermining the proposed reforms.

- **Permanent establishment risk will be another important area to consider** if the proposed changes are introduced. Investors with a presence in the UK will need to consider whether they might be treated as trading in the UK through a permanent establishment and subject to UK corporation tax on profits attributable to that permanent establishment. It will also be important to consider the position of investment management activity undertaken in the UK and to ensure activities come within the investment manager exemption.

The consultation has now closed for responses, and we wait to see how the government responds to the concerns that have been raised.

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