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ARTICLES

Investor-State Disputes: The Interface Between Treaty-Based International Investment Protection and Fiscal Sovereignty

Thomas Walde, Professor and Jean-Monnet Chair, CEPMLP, University of Dundee; Essex Court Chambers and

Dr. Abba Kolo, lecturer in energy/investment law, CEPMLP, University of Dundee[1]

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1. Introduction

Taxation of foreign investment is an important part of the interaction between foreign investors and host states (and to some extent, home states) in the international investment process. While every foreign investor accepts that tax is the price to pay to host states for being allowed to operate in their territory, governments view tax not only as a means of raising revenue but also of regulating foreign investment. But sometimes that regulatory authority might be exercised in a manner detrimental to the interests of the foreign investor by either undermining the economic function of its investment or rendering it uncompetitive *vis-à-vis* other investors, especially domestic investors. Thus, like all other regulatory instruments, taxation might be used by a host state to squeeze a foreign investor out of its property rights. For this reason and also in order to facilitate cross-border trade and investment, modern investment treaties do address in a limited way, the issue of taxation. However, unlike the high standards of discipline placed on other regulatory conducts of host states by modern investment treaties, most Contracting States seem unready (for political and economic reasons) to submit their tax measures to the same standard of discipline as in the case of other regulatory measures. In many cases, it is only the extreme case of 'confiscatory expropriation' that is subject to the investment treaties' full discipline with arbitration-based enforcement. But the emergence, over the last 20 years, of direct investor-state arbitration based on treaty (bilateral, but also multilateral such as in particular the Energy Charter Treaty and Chapter XI of the NAFTA) has for the first time provided foreign investors with a remedy that is no longer dependent on domestic courts (which are, with some reason, rarely trusted by foreign investors) nor the always politicised sponsorship of investment claims by the home state. This is a new development that has

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[1] Professor Waelde has acted frequently in tax-involving investment and contract disputes between foreign investors and governments, first during his tenure as UN interregional adviser on international investment, petroleum and mineral law and now as expert, strategic adviser in litigation, expert counsel, arbitrator and mediator in disputes under the ICSID Convention, the Energy Charter Treaty, bilateral investment treaties and contract-based disputes, in particularly (but not exclusively) in the field of oil and gas, energy, mining and infrastructure investment, both with respect to international tribunals and before domestic courts. Editor of TDM (www.transnational-dispute-management.com) and OGEL (www.gasandoil.com/ogel), academic and professional journals. Member of the Frankfurt Bar and various international arbitral institutions.

not, as yet, been fully appreciated in the investment arbitration community and even less so in the international tax community.

The purpose of this article is to provide an overview of the different ways of treating taxation in modern investment treaties and the underlying policies and tensions reflected in the variations of treaty regulation of tax disputes. We have to note that, unlike in the 1970s when the main issues were expropriation and transfer pricing by Multinational Enterprises (MNEs),[2] at present the economic role of the state has changed from direct to indirect intervention. It is no longer the exercise of public ownership or direct commands to supervised private operators, but the manipulation of the levers of economic, environmental and fiscal regulation which are the main instruments of influencing the economic environment. Direct public ownership has transformed itself into the 'regulatory state'.[3] Therefore, it is the regulatory function of the state and how it impacts on foreign investment that is most relevant. It is the ability of the state to use its taxing, environmental, labour and social regulatory authority, at times at the behest of dominant domestic political and financial groups, to affect adversely the economic interest of the foreign investor that is at the root of many if not most contemporary investment disputes. The classic 'expropriation' dimension of political risk has mutated into a regulatory and fiscal risk. Subtle use of the 'screws' of regulatory and tax regulation available to government and in particular the particular application to specific cases makes it much harder to detect the abuse of government powers against foreign investors that is at the basis of modern investment treaty disciplines. Recent tax-related arbitral awards and some of the pending ones together with the highly publicized *Yukos* case indicate the growing importance of tax disputes between foreign investors and host states and the increasing reliance by foreign investors on investment treaties for protection.[4] The provisions on tax in some of these treaties are on the way to being invoked by investors, disputed by governments and thus form the foundation of an emerging international jurisprudence on tax-related investment disputes. This area is the one explored in this article.

Section one sets the background for the discussion. It sets tax-related investment disputes in the political and economic context. It argues that under the current regulatory state, in which the function of the state has greatly ceased from that of controlling the 'commanding heights' of the economy to regulation, the tendency for it using the tax instrument to 'squeeze' foreign investors or for protectionist purposes is very attractive. Despite the stride made over the years in achieving greater protection for the rights of the foreign investor through investment treaties (particularly via the investor-state dispute settlement process), nevertheless, most states are unwilling to agree to submit their fiscal policy to international judicial and quasi-judicial scrutiny. Section two discusses the general scope of coverage of tax under investment treaties. It examines how tax is defined in some of the treaties and the shortcomings of those definitions, the type of taxes covered under the treaties and the underlying issues and tensions surrounding such coverage. Section three discusses, in an overview perspective, the applicability of core substantive investment protection provisions to tax and the underlying issues and tensions surrounding them. Section four examines the treaty formulations on expropriatory taxation and transparency and the policy reasons for the new trend in those areas.

2. The background: context and the political and economic dynamics of tax-related investment disputes

In past periods of large wide-ranging political and social upheavals, nationalization – i.e. the formal

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[2] This is demonstrated by the OECD Guidelines for Multinational Enterprises of the 1976 Declaration on International Investment and Multinational Enterprises (as revised) and the Draft United Nations Code of Conduct on Transnational Corporations of 1983. Annex 1 to the OECD Guidelines 1976. Reprinted in, P. Kunig, *et al.* (eds), *International Economic Law: Basic Documents* (Walter de Gruyter, Berlin, 1989), p. 559. For the 2004 version of the OECD Guidelines on Taxation, see www.oecd.org/dataoecd/25/26/35150230.pdf. For commentary on the Guidelines see, A. Fatouros, *The OECD Guidelines in a Global World* (1999), available at: www.oecd.olis.oecd.org/olis/1999doc.nsf, and the UN draft Code of Conduct, para. 34, reprinted in, Kunig, *et al.*, n. 2 above, p. 565. For commentary on the underlying issues surrounding the negotiations of the Code of Conduct, see, UNCTC, The Code of Conduct on Transnational Corporations, 22 ILM 177 (1983); S.K. Asante, 'The Concept of Good Corporate Citizen in International Business', 4 ICSID Rev.-FILJ, vol. 4, no. 1; N. Horn (ed.), *Legal Problems of Code of Conduct for Multinational Enterprises* (Kluwer, 1980). Whereas the draft Code of Conduct on MNEs urges foreign investors not to engage in tax avoidance, the World Bank Guidelines of 1992 avoided blaming foreign investors. Rather, it urges host states not to use tax incentives in order to attract foreign investment unless where a state felt doing so is necessary and in which case same should be extended to domestic investors in similar circumstances. See Art. 111(9) of the Guidelines.

[3] For a discussion of the 'regulatory state' character for investment disputes, see Waelde, *Report of the 2004 Hague Academy Research Seminar on International Investment law*; Waelde and Wouters, 'State responsibility in a liberalised world economy: state, privileged and sub national authorities' under the 1994 Energy Charter Treaty, an analysis of Articles 22 and 23', in Neth.Ybk Int'l. L.. Int'l. L, vol. 27, pp. 143–194.

[4] The main tax-related cases founded on BITs are: *Marvin Feldman v Mexico*, Award of 16 December 2002, 18 ICSID Rev.-FILJ 488 (2003); *Occidental Exploration & Production Co. v Republic of Ecuador*, Final Award, London Court of International Arbitration, Administrative Case no. UN 3467, Final Award; *Goetz and Others v Republic of Burundi*, ICSID Case no. ARB/95/3 issued on 10 February 1999, 5 ICSID Report 1, and *Link-Trading Joint Stock Co. v Moldova*, Final Award of 18 April 2002; Incana Corporation v Republic of Ecuador, LCIA Case no. UN 3481 (February 2006); *Corn Products International Inc. v Mexican States*, and *Archer Daniels Midland Co. & Tate Lyle Ingredients Americas, Inc. v United Mexican states respectively*; *Grand Rivers Enterprises Six Nations, Ltd et al, v USA; Enron Corporation & Ponderosa Assets LP v The Argentine Republic*, available at www.investmentclims.com or at <http://ita.law.uvic.ca/documents. The tax-related aspect of the Enron case was settled by the parties, hence the recent award issued by the Tribunal on 22 May 2007 did not discuss the tax-related issue. Older cases raising tax issues: *Borne v Thailand*, *Philipps v Norway*, *Tesoro v Trinidad and Tobago, Power and Traction Finance v Greece*, the three Jamaican bauxite cases before the ICSID (before settlement), *Petrola v Greece*, a not-identified investor against a Libyan client; a not identified US oil company against an African state, a European oil company against an African state have been reviewed in the very instructive study by S. Manciaux, *Changement de legislation fiscale et arbitrage international*, now available on TDM (www.transnational-dispute-management.com).

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expropriation of large swathes of foreign-owned industries – was frequent. This is not (yet) current practice. The ideological movement of socialism or the combination of nationalist with socialist, state-oriented ideological features, frequent then in developing countries and in particular after de-colonization, typically resorted to large-scale nationalizations.[5] But the cycles of foreign investment have not disappeared: promotion to obtain foreign investment, privatization, and then mounting dissatisfaction with what is seen as foreign control and its exploitation in domestic politics followed by revocation of rights once necessary to encourage investment, but now seen as excessive, no longer necessary and often as corrupt, followed by decline of investment, economic stagnation, dissatisfaction with state-owned enterprises and a renewal of the cycle.[6] The use of taxation – not necessarily only to service the ever present and pressing needs of government and politics – inscribes itself into such cycle. It offers itself as a less conspicuous way of revoking incentives that in an earlier phase of the cycle were considered necessary without head-on confrontation with international business, investors' home states and the legal framework of investment protection that has evolved over the last twenty years. Squeezing foreign investors by taxation is less conspicuous; the abuse of government power inherent in such tax squeezes is, in the light and darkness of fiscal complexity, much harder to identify than, say, a tangible, formal, uncompensated expropriation. Using tax can constitute a 'velvet' revocation of contractually conceded investment incentives, and it can be escalated up to the level of what is the economic equivalence of a direct expropriation.[7] It is a more sophisticated way of assault on foreign investor's proprietary positions that is harder to scrutiny. It is also a method that was used, and is being used, in situations where the state aims, often with private and state actors closely intermeshed, to destroy the economic foundation of foreign (or of disliked national) groups, sometimes in a power struggle or for ethnic discrimination reasons, but wishes to camouflage the deployment of legal machinery under the control of the state by an apparently and seemingly at least formally correct application of legal rules and procedures.[8]

Nobody will question that states, to ensure their survival in the external (security) and internal (welfare) dimensions need to possess and exercise effective tax powers; this is even more so as globalization with its companions of more easy re-deployment of capital and regulatory and fiscal competition make it more difficult for governments to capture tax potentialities, nowhere more so than from companies headquartered abroad.[9] The investor's home state – traditionally its chief protector both through diplomatic protection and through its contribution to the international investment protection regimes – will be much more ambivalent about

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5 I. Seidl-Hohenveldern, *Internationales Konfisckations-und Enteignungsrecht* (Tubinger, 1952); N. Girvan, *Corporate Imperialism: Conflicts and expropriation – Transnational Corporations and Economic Nationalism in the Third World* (M.E. Sharpe Inc., New York, 1978); G. Neff, *Friends but not Allies* (Columbia Univ. Press, 1990); T. Anderson, *Multinational Investment in Developing Countries: A Study of Taxation and Nationalisation* (Routledge, London, 1991); S. Kobrin, 'Foreign Enterprise and Forced Divestment in LDCs', 34 Int'l. Org., vol. 34, no. 65. For an account of the ideological cycle between state control and liberalization of the economy in both developed and developing countries post World War II, see, D. Yergin and J. Stanislaw, *The Commanding Heights: The Battle between Governments and Market Place that is Remaking the World* (Simon & Schuster, 1998).

6 K. Vandevelde, 'The Political Economy of a Bilateral Investment Treaty', 92 AJIL vol. 92, pp. 621–623; Amy Chua, 'The Privatisation-Nationalisation Cycle: The Link between Markets and Ethnicity in Developing Countries', 95 Col. L. Rev. 1995, p. 223.

7 This is exemplified by the imposition of 'windfall' taxes and coerced renegotiation of the fiscal regime governing investment agreements (usually by a subsequent government) when the private (especially foreign) investor is making what is perceived by the host state to be excessive profits. T. Walde and A. Kolo, 'Renegotiating Previous Governments' Privatisation Deals: The 1997 U.K. Windfall Tax on Utilities and International Law', Northwestern J. I. L. & Bus. 1999, vol. 19, p. 405; T. Daintith and I. Gault, 'Pacta Sunt servanda and the Licensing and Taxation of North Sea Oil Production', Cambrian L. Rev. 1977, vol. 8, p. 27; S. Zorn, 'Unilateral Action by Oil-Producing Countries: Possible Contractual Remedies of Foreign Petroleum Companies', Fordham Int'l. L. J. 1985–1986, vol. 9.

8 From 1917 onward, the US Government, mainly through its ambassadors in Mexico, protested against Mexican post-revolutionary attempts to make the mining rights of US investors meaningless; such attempts were dressed up as retroactive legislation restricting the scope of mining rights or exploiting tax power – see S. Randall, *United States Foreign Policy since World War I*, in particular pp. 51–58 (2005). See also the cases, mainly pre- and post-World War II, surveyed by: G.C. Christie, 'What Constitutes a Taking of Property Under International Law', BYIL 1962, vol. 38, p. 307; 'Aryanisation', in Nazi Germany, used similar legally camouflaged procedures for taking or squeezing out Jewish ownership, see: Saul Friedlaender, *Nazi Germany and the Jews, Vol I (1933-39)* (Harper Collins, New York,1977); Harold James, *The Deutsche Bank and the Nazi Economic War Against the Jews* (2001), p. 61; the famous *Barcelona Traction* case involved manipulation of foreign exchange restrictions – prohibition to transfer foreign exchange to pay debt accumulated by General Franco's protégé Juan March – to contrive a bankruptcy which then allowed Juan March, with the support of Spanish judicial and governmental authorities, to purchase Barcelona Traction on the cheap – see the excellent case study recently re-published on TDM 2006 (John Brooks, *Annals of Finance I and II*). The ICJ in the end declined jurisdiction; arguably, together with the *ELSI* case (*US v Italy*), both decisions confirmed that the ICJ and inter-state litigation was not a suitable method for resolving investment disputes and thus helped to bring about direct, treaty-based investor-state arbitration as we know it now. The method – a legally camouflaged expropriation covered by on the surface correct looking legal procedures creating a squeeze on the foreign investor – has arguably inspired the take-over, in 2004, by the Russian Government of Russian (and partly foreign-owned) oil company Yukos; its techniques – exorbitant tax bills imposed in a way that singles out Yukos, combined with a rapid-fire auction at a fraction of the market value to the benefit of state-owned company Rosneft – look like a script copied from Juan March's strategy to take over Barcelona Traction. There is a special section on TDM with an increasing number of expert opinions and analyses of the *Yukos* case.

9 Globalization enhances capital mobility and since the taxing power of states is territorial, states are constrained in using their tax power to net in such mobile capital. See, M. Webb, 'Global Markets and State Power: Explaining the limited Impact of International Tax Competition', in M. Stephen (ed.), *Globalisation and its Discontents* (Praeger, New York, 2000), p. 113; D. Swank, *Global Capital, Political Institutions and Policy Changes in Developing welfare States* (CUP, 2002), chap. 7; R. Citron, 'The Future of Tax in the 21st Century: A Practitioner's Perspective', BTR 2002, pp. 161 and 162; S. Picciotto, *International Business Taxation: A Study in the Internationalization of Business Regulation* (Quorum Books, N/York, 1992), p. 309; A. Easson, *Taxation of Foreign Direct Investment: An Introduction* (Kluwer, The Hague, 1999), pp. 156–157.

On the other hand, some commentators have argued that, the increasing percentage of tax revenue as against non-tax receipts to GDP among OECD Member Countries suggests that globalization has not seriously undermined the capacity of states to impose taxes. See, M. Wolf, 'Does Globalisation render States Impotent?', BTR 2000, p. 537.

providing defence against host state tax claims than against outright expropriation. The home state itself battles with the need to raise taxes from ever changing sources to satisfy ever rising domestic political expectations in the face of a much more volatile, internationally fluid tax base undermined by internal corporate transactions, the risk of redeployment of capital and tax competition. This ambivalence of the capital-exporting and economically dominant home states to provide far-reaching and effective treaty protection against tax squeezes comes through very conspicuously in the forward-backward, extension but restriction, protect, but only so far, character of virtually all bilateral and multilateral investment protection treaties and their special tax procedures which we analyse in this article.

Investment protection treaties are not the only international law instrument available to deal with tax-related investment disputes. There is a well-established practice of intergovernmental tax treaties in the form, primarily, of double-taxation treaties and to some extent also more recently tax cooperation agreements.[10] These treaties, however, do not deal with the type of investment disputes at issue where investors allege the abuse by host governments of their taxation powers; they rather deal with either exchange of information between tax authorities to combat tax evasion or to develop jointly instruments against undesirable tax avoidance. In the main, however, they try to avoid double taxation by tax rules being coordinated between the two governments. There has been, most recently, an effort to develop arbitration as an inter-governmental method to resolve tax treaty disputes.[11] The working document so far available is curious: in some way it seems to touch the issue of tax-related investor disputes by providing a method (right?) to individuals (presumably including foreign investors) to initiate an inter-governmental arbitration procedure. But the concern of almost total government control is reflected in the exclusion of the individual as a claimant and party to the process; the working draft also requires the individual to give up recourse to national courts or other procedures (presumably investment treaty-based arbitration). The tax arbitration is between the tax authorities of the two governments. There is no guarantee – comparable for example to the strong enforcement guarantees of the ICSID Convention and the Energy Charter Treaty – that the host state would comply with an award in case it loses the case. On the basis of the current proposal, the investor would lose its tax-related investment arbitration right under investment treaties by having recourse to a much weaker inter-governmental procedure (comparable to the one available in investment treaties) with little influence and little solid chance of compliance.[12] Authoritative commentators have, properly, described the mutual agreement procedure under most tax treaties as unsatisfactory. According to Park and Tillinghast:

> 'The task of resolving disagreement on the treaty interpretation falls either to national courts or to the joint efforts by the tax administrations to work out differences on a voluntary basis. Neither alternative is wholly satisfactory. Judicial proceedings lack political neutrality and yield inconsistent results. And the process of mutual agreement among competent fiscal authorities is fraught with delays and uncertainty.'[13]

In our opinion, the OECD tax arbitration proposal would therefore, not substantially enhance the legal position of the taxpayer *vis-à-vis* the state nor provide him with an effective mechanism of resolving some of the most important tax-related investment disputes. The proposal seems to aim for a result (legal instrument) similar to the European Arbitration Convention, perhaps with a much broader scope of application than the Convention. The European Arbitration Convention provides for arbitration of

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[10] Klaus Vogel *et al.*, *Double-Taxation Conventions*, 3rd edn. (Kluwer, London, 1999); the OECD Committee on Fiscal Affairs and the related OECD secretariat services monitor and analyse developments, www.oecd.org.

[11] OECD, Proposals for improving mechanisms for the resolution of tax treaty disputes, February 2006, OECD Centre for Tax Policy and Administration, www.oecd.org. The proposal was approved by the OECD on 30 January 2007 and is to form part of Art. 25, para. 5 of the 2008 OECD Model Tax Convention on Income and Capital. See A Gildemeister, 'Arbitration of Tax treaty Disputes: The 2008 Model for Income Tax Treaties will contain Arbitration Clause', TDM 2007 (forthcoming). A US-Germany Protocol (signed on 1 June 2006) to amend the 1989 US-Germany Tax Treaty, that was recently sent to the US Senate for approval, does contain for the first time, a provision for mandatory arbitration of certain tax disputes which the two government officials are unable to resolve through negotiation. See, Kevin Rowe, 'How the New protocol has Changed the US-Germany Tax Treaty', www.internationaltaxreview.com (July/August, 2006). For a wider discussion of the interface between arbitration and tax see the papers presented at a *CREDIMI/Dijon colloquium in Rev de l'Arbitrage* (2001), pp. 371–388 (summarised by J.P. Le Gall); also Le Gall, *Fiscalite et arbitrage, Rev de l'Arbitrage* (1994), pp. 3–38 and 253–278. The emphasis has been here rather on commercial arbitration cases, though Dr. Manciaux's recent paper presented in the 2001 CREDIMI colloquium provides a first study focused on investment disputes and tax. See also the authoritative survey by B. Hanotiau, 'L'Arbitrabilite', 296 Recueil des Cours 2002, vol. 296, 29, p. 171 with further references.

[12] Gildemeister, n. 11 above, at p. 5 (noting that under the new procedure, 'the taxpayer has no right to arbitration against the common will of both competent authorities, and that even in cases where the reached agreement does not represent a correct application of the substantial provisions of the treaty. No arbitration will take place unless at least one of competent authority defends the interests of the taxpayer. For the taxpayer, the arbitration provision therefore does not stipulate a genuine legal recourse').

[13] Park and Tillinghast, *Income Tax Treaty Arbitration* (sad fiscale & Financiele Vitgerers, Amersfoort, 2004), p. 8; Vogel *et al.*, see n. 10 above, note 13, at pp. 1364–1377; A. Jones, *et al.*, 'The Legal Nature of the Mutual Agreement Procedure under the OECD Model Convention (pt. 1)', BTR 1979, pp. 333 and 337; M. Zuger, 'Mutual Agreement and Arbitration Procedures in a Multilateral Tax Treaty', in M. Lang *et al.* (eds), *Multilateral Tax Treaties: New Developments in International Tax Law* (Kluwer Law International, London, 1998), pp. 155 and 183; R. Green, 'Anti-Legalistic Approaches to Resolving Disputes between Governments: A Comparison of the International Tax and Trade Regimes', 23 Yale J. Int'l. L. 1998, vol. 23, p. 79, at p. 99 and authorities cited in n. 95 therein; E. Bruggen, '"Good Faith" in the Application and Interpretation of Double Taxation Conventions', BTR 2003, p. 25.

transfer pricing disputes between the Member States.[14] However, even this Arbitration Convention did not go far enough in safe guarding the rights of the taxpayer. Apart from its limited scope of application (to only transfer pricing disputes), it does not give the taxpayer any right of a party to the dispute and the tax authority has discretion whether or not to take up the taxpayer's complaint ('if the complaint appears to it to be well-founded').

Constitutional[15] – or international law[16] – controls on taxation have never been very effective. As a learned commentator said: 'Existing legal rules have not been effective in curbing the fiscal appetites of governments'.[17] But external disciplines on taxing powers have grown, both in constitutional law[18] and in international law, primarily through jurisprudence of the European Court of Justice and the European Court of Human Rights.[19] The budding discipline on unfettered taxing powers in investment (and trade) law inscribes itself into this trend.

The quite limited disciplines investment treaties impose on governments with respect to tax do not aim at the same high level of integration which, for example, the European Union has achieved and continues to develop. While in EU law the same tensions as in investment treaties, between national sovereignty and international controls exist, the development and enforcement of international disciplines has gone much further. They are represented in the main by the European Commission and the European Court of Justice. Without an easy analogy possible, one cannot, however, ignore the increasingly rich jurisprudence by the European Court of Justice; it is in particular the application of non-discrimination rules and the progress towards an integrated single market which are the guiding principles here.[20] Behind the application of the 'freedom of movement' rule in the EC Treaty is a concept that is very close to the 'national treatment' principle one finds throughout modern investment treaty practice.[21] The tax-related jurisprudence of the ECJ (as possibly also the European Court of Human Rights) is therefore the closest one get to a comparable method of international disciplines on fiscal conduct by national authorities, apart from the equally relevant jurisprudence of the WTO dispute institutions.[22] These avenues of more in-depth comparative investigation will, however, have to be left to subsequent research efforts.

Notes

14 L. Hinnekens, 'The European Tax Convention and its Legal Framework (pt 1 & 2)', BTR 1996, pp. 132 and 272; Zuger, in Lang *et al*., see n. 13 above, note 15, at pp. 165–167; C. Wallace, *The Multinational Enterprise and Legal Control: Host State Sovereignty in an Era of Economic Globalisation* (Martinus Nijhoff, The Hague, 2002), p. 944; Green, see n. 13 above, at pp. 99–100 and 103; J.M. Henckaerts, 'International Arbitraiton and Taxation – the EC Arbitration Convention for Transfer Pricing Disputes', J. Int'l Arb 1993, vol. 10, pp. 111–119.

15 Even in a constitutionalized country such as the US, the constitutional limitation on taxation (such as contained in the fifth amendment which curtails the state's eminent domain power) has rarely been successfully invoked by tax payers although the decision of the US Supreme Court in *Eastern Enterprises v APFEL and Commissioner of Social Security*, 524 US 498, 118 S. Ct.2131 does suggest such a possibility. See, R. Epstein, *Takings: Private Property and the Power of Eminent Domain* (1985); Epstein, 'Taxation, Regulation and Confiscation', Osgoode Hall L. J. 1982, vol. 20, p. 433; C. Massey, 'Takings and Progressive Rate Taxation', Harv. J. L. & Pub. Policy 1996, vol. 20, p. 85.

16 Albrecht, 'Taxation of Aliens under International Law', BYIL 1952, vol. 29, p. 145; Easson, see n. 9 above; F. Beveridge, *The Treatment and Taxation of Foreign Investment under International Law* (Manchester Univ. Press, 2000), pp. 64–77.

17 See 'Comment, Constitutional Constraints on Governmental Taxing Power', in *Wirtschaftspolitische Blaetter* 1989, 2 with reliance on Brennan and Buchanan, 'Towards a Tax Constitution for Leviathan', *Journal of Public Economics* 1977, vol. 8.

18 E.g. the German Federal Constitutional Court decision of 22 June 1995 (B Verfg 2 Bv/37/91) in which it held that the impugned wealth tax was unconstitutional because it was discriminatory and violated the principle of equal sharing. In the US the main constitutional limitation comes from the application of the Interstate Commerce Clause (Art. 1, s. 8, Clause 3 of the US Constitution) which seeks to establish a common market among the states by prohibiting obstacles (including taxation) to interstate economic transactions, see Epstein, n. 15 above, note 7, pp. 129–144; D. Coenen and W. Hederstein, 'Suspect Linkages: The Interplay of State Taxing and Spending Measures in the Application of Constitutional Anti-discrimination Rules', Mich. L. Rev. 1997, vol. 95, p. 2167; W. Anderson, *Taxation and the American Economy: An Economic, Legal and Administrative Analysis* (Prentice Hall, New York, 1951); R. Sedler, 'The Negative Commerce Clause as a Restriction on State Regulation and Taxation: An analysis in terms of Constitutional structure', Wayne L. Rev. 1985, vol. 31, p. 886.

19 On some of the latest tax-related jurisprudence of the ECJ, see: Case C- 196/04 *Cadbury Schwepps v Commissioners of Inland Revenue* (judgment of 12 September 2006); Case C-446/03, *Mark & Spencer v H.M. Inspector of Taxes* (judgment of 13 December 2005; Case C-334/02, *Commission v France* (2004) ECR-I-0000; Case C-319/02, decision of 7 September 2004; D. Oliver, 'Tax Treaties and the Market-state', Tax L. Rev. 2002–2003, vol. 56, p. 587; L. Hinnekens, 'The Search for the Framework Conditions of the Fundamental EC Treaty Principles as Applied by the European Court to Member States' Direct Taxation', EC Tax Rev. 2002, vol. 11, p. 112; Wallace, n. 14 above, chap. XV; J. Schuch, in Lang, see n. 13 above, p. 35; D. Sandler, *Tax Treaties and Controlled Foreign Company Legislation* (Kluwer, 1998); Terra and Wattel, 'The EC Court's Attempts to Reconcile the Treaty Freedoms with International Tax Law', CML Rev. 1996, vol. 33, p. 223; E. Keeling and A. Shipwright, 'Some Taxing Problems Concerning Non-Discrimination and the EC Treaty', Euro. L. Rev. 1995, vol. 20, p. 580.
On the jurisprudence of the ECHRR, see: *Jasi_nienì v Lithuania*, no. 41510/98; *Wasa Liv Omsesidigt, et al v Sweden*, 10 EHRR 132 (1988); *Eko-Elda Avee v Greece*, Case no. 10162/02 (Judgment of 9 March 2006); *Weissman v Romania*, Case no. 63945/00 (Judgment of 24 May 2006); *PM v United Kingdom*, Case no.6638/03 (Judgment of 17 July 2005); *Darby v Sweden*, 13 EHRR 774; P. Baker, 'Taxation and the European Convention on Human Rights', BTR 2000, p. 211.

20 Although in principle, sovereignty over direct taxation remains with Member States of the EU, yet in practice both national and tax treaty of the Member States must be compatible with EC law. Thus, in Case C- 35/98, *Staatssecretaris van Financien v Verkooijjen* (2000) ECR I-4071, para. 32, the court noted that 'It must be borne in mind at the outset that, although direct taxation falls within their competence, the member states must nonetheless exercise that competence consistently with community law'. Case 270/83, a Voirfiscal, (1986) ECR 273, para. 26; Cases C-397/98 & C-410/98, *Metallegesellschaft & ors* (2001) ECR I-1727; Case C-311/79 *Royal Bank of Scotland* (1999) ECR 1-2651, para. 19; Case C-319/02 *Manninen* (2004) ECR 1-7477, para. 19. On the greater sensitivity of international controls on national taxation and a discussion of ECJ tax jurisprudence, see J. Snell, Non-discriminatory Tax Obstacles in Community Law, 56 I.C.L.Q. 2007, p. 339.

21 Note here Joseph Weiler's view of the comparability of national treatment principles in WTO and EU law: 'Epilogue: Towards a Common Law of International Trade', in J. Weiler (ed.), *The EU, the WTO, and the NAFTA*, pp. 201, 230, 231 (OUP 2000).

22 S. Zarilli, *Domestic Taxation of Energy Products and the Multilateral Trading System*, OGEL (2004) at www.gasandoil.com/ogel; R. Quick and C. Lau, 'Environmentally Motivated Tax Distinctions and the WTO', in JIEL, vol. 2, p. 419.

3. General scope of coverage of tax under investment treaties

A. Definitional problem?

Although it is very common to find the definition of key terms in the definition section of an investment treaty which conveys the Contracting Parties legislative intentions,[23] none of the treaties we have come across in the course of working on this article contains a working or substantive definition of tax. This omission empowers its definition to evolve over time. For example, one important issue is distinguishing a 'tax' from 'fees', i.e. payments for an, often obligatory, public service. In energy/resource related disputes, the definitional issue is even more acute as some countries, in particular the US, distinguish between the 'tax' that is paid, on profits or sales, as a general contribution for being allowed to do business in the host state, on one hand, and, on the other, special levies (often called 'royalties') which are presumed to be rather paid for the special privilege of getting access to the subsoil resources owned by the state.[24] Such royalties are sometimes paid as percentage of the gross value of production extracted, but they are confusingly also sometimes formulated as an additional, profit or profitability-based tax.[25] It is therefore open to debate if such taxes on 'mineral rent'[26] representing a sort of sale of subsoil resources by government to investors can be subsumed under the investment treaty term 'tax'.[27]

According to the *Oxford English Dictionary*, 'tax' is a 'compulsory contribution to the support of government levied on persons, property, income, commodities, transactions, etc, now at fixed rates, mostly proportional to the amount on which the contribution is levied'. If one adopts this impression and regards tax as 'a compulsory unrequited payment to the government', the question arises whether the term includes national insurance contributions,[28] payment for access to transit facilities for energy products, penalties or surcharge levied by the tax authorities for late payment or submission of tax returns, for making false declarations, security, educational or similar levies paid by natural resources companies in volatile countries or in developing countries.

As investment treaties usually do not provide for a definition of taxation, it typically devolves upon an arbitral tribunal to make the determination of what is a tax. This question is important in an investor-state arbitration not only for establishing the jurisdiction of an arbitral tribunal, but also in determining whether the cumulative rate of taxes amount to confiscation of property.[29] In our opinion, when a question arises as to whether or not a measure is a tax, one should look at the substance of the measure rather than its form.[30] It is the effect of the measure on the investment rather than the name given to it by the host government that matters the most. If the measure has the effect of neutralising the investment or rendering it unviable, then it becomes irrelevant whether it is called an environmental tax, social security contribution or

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[23] For example, terms such as 'investment', 'territory', 'dispute', 'transfer' 'investment agreement' are usually defined either in a broad or restrictive manner, and such definitions assist tribunals in the interpretation of the treaties.

[24] This issue underlies US foreign tax credit rules for the oil industry and has led to significant litigation before the US tax courts, see only: Van Brauman *et al.*, 'Resource Rent Taxation as a Basis for Petroleum Tax Policy by Foreign Governments and its Relationship to US Foreign Tax Credit Policy and Tax Law', JENRL 2000, vol. 20, pp. 19–52; Waelde is prevented by client confidentiality to provide more specific details on some of such, US-based, litigation.

[25] R. Garnaut and A. Clunies Ross, *Taxation of Mineral Rents* (Clarendon, Oxford 1983); James Otto (ed.), *Mineral Taxation* (Kluwer, 1994); the concept of the 'resource rent tax' as a special tax arguably representing the value of access to the state owned subsoil resources has been the subject of a large-value recent international plus domestic arbitration which for reasons of client confidentiality can at present not be identified.

[26] The issue of appropriateness of mineral rent has deeper issues related to foreign investment. As noted by one commentator: 'The ownership of natural resources such as the electromagnetic spectrum and sites for dams and harbours vests in the people and their government. The resource rent is defined as the difference between market price and the efficient costs of exploitation of the particular resource at a particular time and place. The resource rent depends on scarcity of the resource and its quality. Resource rent tax systems and auctioning procedures have been designed to extract the highest proportion of such resource rent to the government. If these are effective, there is no reason to discriminate between FDI and domestic investment in production or use of such resources and consequently to put FDI limits on the former.' Arvind Virmani, 'Foreign Direct Investment', *Occasional Policy Paper* (April 2004, http://www.icrier.org/pdf/FDI04e.pdf).

[27] There are arguments in favour, mainly that the objective of stability and security of investment terms underlying all modern investment treaties suggests a wide, and not a restricted notion of tax. For a resource investor, the stabilization of such special resource taxes is arguably even more important than the stability of taxes that are incumbent on everybody.

[28] Unlike classical taxes such as on income, national insurance contributions are payments for benefits to be derived later. Nonetheless, it is compulsory just like income tax in many jurisdictions.

[29] In fact, such a question was raised by Argentina in the *Enron* case, in which it contended that the total taxes imposed by the provinces were within the range of 1 per cent to 2 per cent of the total contract value, the rest being penalties and interests which, it argued, were not taxes. On the other hand, the claimant argued that all the assessments, including the penalties and interests should be regarded as taxes the cumulative effect of which amounted to indirect expropriation of the investment. According to the tribunal, that question will be determined at the merit stage of the case. *Enron v Argentina*, Decision on Jurisdiction, 14 January 2004, paras. 27–30. A similar question might arise in case the backdated tax assessments (with the possibility of 250 per cent fine plus penalties for late payment) by Venezuela on oil companies become an international legal dispute between the companies and the government. See, D. Vis-Dunbar, 'Conflict in the Horizon: Oil Companies in Venezuela consider Arbitration', www.iisd.org/investment/invest_sd/news.asp. For example, in the tax prosecution by the Russian government in 2004 against Yukos, back-tax claims were multiplied by the use of penalties and interest charges up to close to 100 per cent of total sales (i.e. not net profits) over a three-year period, while payment of such tax claims was made impossible (taking a page from the Barcelona Traction case) by seizure of the shares Yukos would have needed to sell to pay the tax claims, see: P. Clateman *et al.*, on TDM; Leutheusser-Schnarrenberger, *Report of special rapporteur for Council of Europe*, on TDM.

[30] We note the distinction between types of form requirements endorsed by the arbitral tribunal in the case of *Waste Management v United Mexican States (1)*, Award, 2 June 2000, para. 22: 'A distinction has traditionally been drawn between so-called *ad substantiam* or *ad solemnitatem* and *ad probationem* formalities. The former are those that require a class of legal act in order to exist or come into being. In their case, form is substance, in that the transactions, dealings or acts do not exist as such, unless they are executed in the legally regulated form. The *ad probationem* form is only required as evidence of legal transactions, dealings or acts. It in no way conditions the effectiveness of legal acts, other than in the sense of being thoroughly "legitimated", whereby it is established that it may only be proved by means of the legally prescribed form.' Seen this way, a measure must comply with *ad substantiam* form in order to qualify as a tax.

penalty or any other name,[31] unless the contrary is provided for by the treaty.[32] The OECD and UN Model Double Taxation Conventions provide for an alternative approach, which looks at the domestic laws of the host state.[33] The problem with an approach which looks to domestic law is that it would enable a host state to intentionally change its tax laws in order to legitimate an otherwise abusive tax campaign. That would lead to uncertainty in the legal regime, the very problem sought to be solved by investment treaties.[34]

B. Types of taxes covered

Some investment treaties provided for a distinction between direct and indirect taxes by restricting the application of some of the treaty obligations to only indirect taxes, but subjected questions relating to direct taxes to double taxation treaties.[35] Treaties that contain such a distinction include: the ECT, NAFTA, and US FTAs. Each of these investment treaties carve out direct taxation measures out of the substantive investment protection obligations of national and most favoured nation treatment but allows (by implication) for application of these treaty obligations to what may be regarded as indirect taxes. Thus NAFTA, Art. 2103(1) states: 'Except as set out in this Article nothing in this Agreement shall apply to taxation measures'. It then goes on to provide for the exceptions in Art. 2103(4)(b) which states that the National Treatment (NT) and Most-Favoured-Nation (MFN) standards shall apply to 'all taxation measures other than those on income, capital gains, or on the taxable capital of corporations, taxes on estates, inheritances, gifts and generation-skipping transfers . . .'.[36]

These provisions suggest that the NT and MFN disciplines shall apply to all other taxes apart from the stated ones or 'substantially similar taxes' (under Art. 21(7)(b) of the EC Treaty). The question is: why did the parties exclude these types of taxes under the respective treaties? The US Government position is that tax matters generally are excluded from the country's investment treaties 'based on the assumption that tax matters are properly covered in bilateral tax treaties', or 'should be dealt with in bilateral tax treaties'.[37] To some extent, this is correct in that, Arts. 1, 2 and 4 of the Revised UN (2000) as well as the OECD Model Double Taxation Conventions (on which most countries' double taxation treaties are based) state that the Convention applies to taxes on income and capital and to 'any identical or substantially similar taxes' imposed by the parties. Under Art. 2 of each of these Conventions, income and capital taxes include those imposed on 'total income, on total capital, or on elements of income or of capital, including taxes on gains from alienation of moveable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation'.[38] One possible reason why tax matters are better dealt with in a focused treaty is the need to coordinate treaty provisions with domestic taxation legislation. Thus, in the US, procedures for the negotiation and ratification of tax treaties are somewhat

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31 This point is derived, by analogy, from the decisions of domestic courts in some countries such as Germany and the US. For example, in the *Re Special Turnover Tax* case, Case I 62/69A (1973) CMLR 687 at 690, the German Finazgericht Dusseldorf held that the tax agency cannot impose a retroactive duty on export contract by describing the levy as a turnover tax rather than a duty. What matters is the substance of the levy rather than its label. US courts have also taken similar position in respect of taxes imposed by state governments in violation of the US Commerce Clause. See, Coenen and Hederstein, n. 18 above.

32 One of such is the express stipulation in some treaties excluding customs duties from being regarded as taxes. Another one is provided in Art. 16(6) of the Canada Model BIT (2004) which vests the tax authorities of the two parties the right to decide within six month period, whether a disputed measure is a taxation measure, failing which a tribunal seized of the matter would decide.

33 Article 3(2) of each of these Conventions provide that in the absence of a definition of a term by the treaty, the term shall have the meaning given to it under the domestic law of the country to apply the treaty unless the context requires otherwise. B. Arnold and M. McIntyre, *International Tax Primer*, 2nd edn (Kluwer Law International, The Hague, 2002), p. 114.

34 A look at the preamble of any modern investment treaty would reveal that the main objective for signing the treaty is to create a predictable commercial framework for business planning and investment. From the foreign investor's perspective, that means greater security and predictability backed by the investor-state dispute settlement, in dealing with host governments. See T. Weiler, 'Foreign Investment and the United States: You Can't Tell the Players without a Score Card', Int'l. Law. 2003, vol. 37, pp. 279, 303; C. Brower and L. Steven, 'Who Then Should Judge?: Developing the International Rule of Law under NAFTA Chapter 11', Chi. J. Int'l. L. 2001, vol. 2, p. 193; J. Byrne, 'NAFTA Dispute Resolution: Implementing True Rule-based Diplomacy through Direct Access', Texas Int'l. L. J. 2000, vol. 35, p. 415.

35 The distinction between both types of taxes is not easy either: *IBFDs International Tax Glossary 2005* by Barry Larking (see http://www.ibfd.org/portal/Product_itg.html) gives the following definitions of direct and indirect tax: 'There is no generally accepted distinction between a direct and indirect tax. John Stuart Mill gave the following definition: "A direct tax is one which is demanded from the very persons who it is intended or desired should pay it. Indirect taxes are those which are demanded from one person in the expectation and intention that he shall indemnify himself at the expense of another". The distinguishing feature may therefore be said to be whether the taxpayer is or is not the person on whom the economic burden of the tax is expected to fall. In this respect, a tax may be said to be direct either in the sense of assessment or collection. Thus, income tax is generally assessed directly on the taxpayer but collection is becoming increasingly indirect (e.g. by way of withholding). An important distinguishing feature of direct taxes is sometimes said to be their capacity to take into account the circumstances of individual taxpayers. This suggests there may also be a relation between indirect taxes and "in rem" taxes, the latter not generally taking into account personal circumstances. Another approach (adopted by the United Nations in its System of National Accounts) bases the distinction on whether the tax is levied at regular intervals on sources of income such as employment or property (direct taxes), or on producers in respect of the production, sale, etc. of goods and services, which they charge to the expenses of production (indirect taxes). A common accepted (if not comprehensive) distinction may be made on the basis of whether the tax is a tax on income (including capital gains and net worth (direct) or on consumption (indirect). Indirect taxes are considered to be one of the oldest sources of government revenue. Examples of taxes generally regarded as indirect include value added tax, sales tax, excise duties, stamp duty, services tax, registration duty and transaction tax. While gift tax, death duties and property tax are generally considered direct taxes, some forms of death duties may be considered as an indirect tax.'

36 Article 21(3) of the EC Treaty; Art. 21.3(4)(b) of the DR-CAFTA (similar provisions are found in other US FTAs); Art. 21(2) of the US-Uruguay BIT.

37 See the explanatory notes to the US-Ukraine BIT (1996), US-Georgia BIT (1994) and other contemporaneous ones available at: www.tcc.mac.doc.gov/cgi-bin/doit.cgi?

38 Reprinted in UNCTAD, International Investment Instruments, vol. VI, available at www.unctad.org.

different from that followed in the case of other types of treaties.[39] One should bear in mind that the reference to double taxation treaties essentially means that the effective protection by direct investor-state arbitration in investment treaties[40] is, in double tax treaties, replaced by various forms of essentially diplomatic protection. These, at best, allow the two tax authorities to engage in a collegial dialogue.[41] The current OECD discussions concern the possible introduction of arbitration, but only of a form that is inter-governmental arbitration, with a weak role for the foreign investor. From an investor perspective, it would be very disadvantageous if the introduction of such forms of inter-state arbitration would become a reason for either not extending, or even for restricting, the limited coverage of tax under modern investment protection treaties.

Parties to an investment treaty wish to provide a reasonable level of protection to their investors by levelling the playing field between domestic and foreign investors and by according foreign investors a direct right of action against host states. Nevertheless, none of the parties is prepared or willing to surrender its rights of taxation, or subject it to scrutiny by international tribunals under the search light of investment disciplines such as indirect expropriation, National Treatment (NT), Most Favoured Nation treatment (MFN), and Fair and Equitable treatment (FET. This is partly so because most capital exporting countries, especially the OECD Members, rely heavily on direct taxes to meet their budgetary requirements, particularly the financing of the substantially expanded welfare state – itself at present the major source of political opposition to economic and financial reform. Surveys conducted by the OECD among its Member Countries reveal that since 1965 the ratio of tax to GDP of most members of the organization has been rising, with the bulk of the tax revenue coming from income taxes, taxes on goods and social insurance contributions – with taxes and related levies accounting up to about 40 per cent of GDP in most European members of the organization. Because of such dependence on taxes, it is not surprising that most of these countries severely limit the scope of coverage of tax from their investment treaties, essentially only to in extremis situations such as confiscatory taxation.[42]

Moreover, in addition to raising revenue for the state, many countries use taxation to achieve other social and political objectives, such as redistribution of wealth, support for domestic industry or equalization of regional differences.[43] Subjecting this right to international judicial scrutiny would be seen as surrendering a country's fiscal sovereignty to an unelected and unaccountable body[44] rather than to national parliaments which are accountable to the public, i.e. much more subject to the influence of domestic pressure groups. In other words, subjecting the taxing powers of the parties to an independent tribunal might undermine state sovereignty and curtail the states' discretion over tax policy.[45] This point is buttressed by the provision in most investment treaties which state that nothing in the treaty shall affect the rights and obligations of a party under any tax convention; it is usually provided that in the event of inconsistency between the investment treaty and any such tax convention, the convention shall prevail to the extent of the inconsistency.[46] The underlying rationale

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[39] While most US treaties are negotiated primarily by the US State Department, tax treaties are negotiated primarily by the International Tax Counsel of the US Treasury Department with State Department assistance. For ratification, in addition to the traditional Senate Foreign Relations Committee, tax treaties are examined by the House Committee on Ways and Means and the Senate Finance Committee. See, R. Avi-Yonah, 'International Tax as International Law', Tax L. Rev. 2004, vol. 57, p. 483. The central role of the treasury department in the negotiation of tax treaties is probably same across many countries including the UK. See, R. Bartlett, 'The Making of Double Taxation Agreements', BTR 1991, p. 76.

[40] Modern investment treaty arbitration essentially vests in the private foreign investor the right to directly challenge the actions of the host state before an international tribunal just as it would under domestic administrative law with the former exercising a disciplinary role over the latter. See G. Van Harten and M. Loughlin, 'Investment Treaty Arbitration as an Aspect of Global Administrative Law', Euro. J. Int'l. L. 2006, vol. 17, p. 121; T. Walde, 'Investment Arbitration as a Discipline of Good Governance', in T. Weiler (ed.), *NAFTA Investment Law and Arbitration* (Transnational Publishers, 2004).

[41] However, some US tax treaties, following a precedent established in the 1989 Treaty with Germany, include provisions allowing the competent authorities of the treaty countries to resolve disputes with respect to interpretation of treaties through arbitration. These provisions are also provided for in the US treaties concluded with France, Ireland, Kazakhstan, Mexico and the Netherlands.

[42] On the results of the surveys, see, P. van den Nor and C. Heady, *Surveillance of Tax Policies: A Synthesis of Findings in Economic Surveys* (OECD Economic Department Working Paper no. 303, 2001); OECD, 'Tax and the Economy: A Comparative assessment of OECD Countries', *Tax Policy Studies* no. 6; J. Owens, 'Tax Reform: An International Perspective', Presentation at OECD Conference, San Francisco, 31 March 2005, all of which are available at: www.oecd.org; James & Nobles, (2004/2005), note 6, at pp. 146–148.

[43] European Commission, *Tax Policy in the European Union* (Luxemburg, 2000) available at:http//ec.uropa.eu/publications/booklets/move/17/txt_en.pdf.

[44] The Declaration of the Rights of Man, approved by the French National assembly on 26 August 1789, provides in Art. 13 that: 'A common contribution is essential for the maintenance of the public forces and for the cost of administration. This should be equitably distributed among all the citizens in proportion to their means'. This provision in this revolutionary document squarely places taxation within the domestic realm.

[45] Park and Tillinghast, see n. 13 above, at p. 11; Wallace, see n. 14 above, at p. 884. Even the United State of America which champions openness in international trade and investment together with strong legal protection for foreign investors, seemed unwilling, during the Uruguay Round on trade negotiations, to accept international judicial scrutiny of its taxing powers. See Green, n. 13 above, at p. 103. This is evident from the long legal battle it has had with the EU over its export tax subsidies law which culminated in a 2002 WTO decision in Appellate Body Report, US Tax Treatment for Foreign Sales Corporations, WT/DS 108/AB/RW (14 January 2002) available at: www.wto.org; Y. Brauner, 'International Trade and Tax Agreements may be Coordinated, but Reconciled', Va. Tax Rev. 2005, vol. 25, p. 251.

[46] Article 21.3(2) of DR-CAFTA; Art. 21(4) of US Model BIT (2004); Art. 2103(2) of NAFTA; Art. 21 and Art. 16(1) of Canadian Model BIT. Another pointer towards this reluctance of the Member Countries to part with their fiscal sovereignty is the treatment of tax in the OECD initiated (and never completed) Multilateral Agreement on Investment (MAI) in which only the transparency and expropriation disciplines were made to apply to tax matters; this caution again was due to concern over tax sovereignty (in other words: the strong resistance of national tax authorities against international accountability). UNCTAD, *International Investment Agreements: Key Issues*, vol. II, (2004), p. 216 available at: www.unctad.rog.

or policy reason for the primacy of tax conventions over investment treaties is not only because tax conventions are more specific to tax than investment treaties (and so should, by virtue of the *lex specialis* rule of interpretation, prevail over the more general investment treaties) but also because tax conventions do not constraint the taxing powers of the contracting parties as much as investment treaties might do.[47]

In addition to the above limitation of tax treaties, questions of expropriation and capital transfers are rarely (if at all) covered in tax treaties even between countries that have not entered into a parallel BIT.

4. Application of substantive investment obligations to tax matters

This section discusses to what extent the substantive investment protection principles of national treatment, most favoured nation, fair and equitable treatment, full protection and security, and currency transfers apply to tax matters and some of the policy issues and tensions surrounding them. A preliminary issue worth mentioning is arbitrability: can treaty-based (or other) tribunals decide over tax issues which are at the core of state sovereignty? In domestic tax law, tribunals are as a rule not empowered to decide on tax issues – though they may have to deal with tax issues that constitute 'legal facts' relevant for deciding other, in particular contract issues (e.g. allocation of the burden and risk of paying tax among contract parties).[48] But it is no longer disputed that foreign investors and governments can agree – by contract or through consent by way of investment treaty – that tax issues can be adjudicated by arbitral tribunals.[49] It would be against good faith and '*venire contra factum proprium*' if a state would first consent to arbitrate such disputes and then later turn around and question the validity of its consent. States do have the power to qualify their own public policy as arbitrable.

A. National treatment and most favoured nation treatment

These two standards are mentioned together in the same clause or in different but closely related clauses of an investment treaty. They oblige each party to accord to investors of the other party treatment not less favourable than that accorded to its investors or to that accorded to any third state investors who are in the same circumstances, whichever is more favourable to the investor concerned. However, with regard to tax matters, most investment treaties provide, as one of the exceptions to the NT and MFN treatment standards, that none of the Contracting Parties is obliged to extend to investors of the other Contracting Party tax advantages or privileges granted to investors of a third state by virtue of a tax treaty or any arrangement relating wholly or mainly to taxation,[50] or any domestic legislation relating wholly or mainly to taxation.[51] In other words, if a Contracting Party accords special advantages to investors of any third state by virtue of an agreement on the avoidance of double taxation, it shall not be obliged to accord such advantages to investors of the other contracting party.[52] The UK Model BIT goes further to deny investors of the other Contracting Party tax privileges granted to nationals or third state investors under domestic legislation of the host state.[53] This meant that the NT and MFN provisions of the treaty apply to tax matters but they cannot be used as a basis for extending to investors of either party tax benefits or advantages granted by either party to third state investors pursuant to a double taxation agreement or any domestic legislation of the party.

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[47] For instance, although tax conventions contain provisions on non-discrimination, nevertheless, the enforcement mechanism is not as favourable to private individuals (who are usually the actual victims of the discriminatory measures) as the investor-state dispute settlement procedure obtainable under most investment treaties. Under most tax treaties (e.g. Art. 25 of the UN Model Tax Convention), any alleged violation of the treaty by a party in respect of an individual can only be addressed through the mutual agreement procedure involving the tax officials of the parties or by the domestic courts of the offending state with all its attendant shortcomings.

[48] Le Gall, *Fiscalite et arbitrage, Rev de l'Arbitrage* (1994), pp. 3–38 and 253–278; Hanotiau , *Recueil des Cours* 2002, vol. 296, pp. 177, 179; Ad hoc tribunal, *ASA Bulletin* 1989, p. 382, arbitrability of dispute relating to tax stabilization clause.

[49] S. Manciaux, 'Changement de legislation fiscale et arbitrage international', on TDM 2006 at p. 4; two cases affirming this have been cited by E. Gaillard, *L'arbitrability des litiges fiscaux dans les investissements internationaux, Rev Prat Dr Ent.* 1999, pp. 42–43; *Amco Asia v Indonesia*, jurisdictional decision of May 1988, p. 143.

[50] Article 3(6) China-Netherlands BIT (no date); Art. 3(4) Germany Model BIT (1998); Art. 7 UK Model BIT (1991); Art. 4 Netherlands Model BIT (1997); Art. 21 (3)(a) and (7)(a) of the EC Treaty; Art. 21.3(4)(c) of DR-CAFTA; Art. 2103(4)(c) of NAFTA; Art. 4 Denmark Model BIT (no date); Art. 3(4) Japan-Turkey BIT (1992); Art. 4 Korea-Bolivia BIT (1996).

[51] Article 7 of the UK-Argentina BIT (1990) states that the national treatment and the most favoured nation treatment standards shall not be construed so as to oblige one contracting party to extend to the nationals or companies of the other the benefit of any treatment, preference or privilege from any international agreement or arrangement relating wholly or mainly to taxation or any domestic legislation relating wholly or mainly to taxation. See also, Art. 4(1)(b) Brazil-Finland BIT (1995); Art. 4(3) Lithuania-Kuwait BIT (no date); Art. 7 UK-Angola BIT (2001); Art. 2(4) Kazakhstan-Turkey BIT (1992); Art. 4 India Model BIT (1992); Art. 7 UK-Vanuatu BIT (2003); Art. 3(3)(b) Saudi Arabia-Malaysia BIT (2000); Art. 3(2)(b) Egypt-Malaysia BIT (1997); Art. 7 Korea-Nigeria BIT (1997); Art. 3(3) Chile-UK (1996); Art. 3(5) Korea-Saudi Arabia BIT (2002); Art. IV(3) Indonesia-China BIT (1994); Art. 3(3) Italy-Tanzania BIT (2001); Art. 3(2)(b) Malaysia-Ghana BIT (no date); Art. 3(3) Italy-Philippines BIT (1988).
In fact, the Italy-Tanzania BIT makes specific reference to incentives granted domestic investors by Tanzania 'in order to stimulate the creation of local industries' which should not be regarded as inconsistent with the national treatment standard. However, Tanzania undertook to progressively eliminate them. This gives an idea as to the rationale behind most of the exceptions listed herein.

[52] Article 4(4) Swiss Federation Model BIT (1986/1995).

[53] Article 7 of the 2005 Model BIT did not depart from the same Article of the 1991 version.

The underlying policy objective for such a provision is: to try to strike a balance between the core obligations of non-discrimination on one hand and fiscal sovereignty of state parties to negotiate new treaties and enact new legislation that would provide for better or more favourable treatment of third state or domestic investors without breaching the NT and MFN obligations owed to a Contracting Party under an investment treaty. This enables parties to an investment treaty to take advantage of changing economic and political circumstances and negotiate or legislate for tax benefits to third state or domestic investors without fear of violating ones treaty obligations. It also reflects the much lower level of economic integration aimed at by bilateral investment treaties as compared to the much higher level aimed at and largely now achieved by the EU treaties.[54]

Another policy reason for such an exception is to avoid upsetting previous deals struck between the foreign investor and the host state so as not to permit the investor 'obtain benefits which he did not obtain through the quid pro quo of negotiations such as lower tax terms in energy licenses and related agreements'.[55]

The UK Model BIT which exempts from the NT and MFN treatment tax benefits granted to third state investors or nationals under domestic legislation is aimed at providing maximum discretion to the Contracting Parties in tax matters as it enables them to grant privileges to third state investors or their nationals not only under a tax treaty but also under domestic legislation. It leaves, however, tax measures under the coverage of the investment treaty when the issue is discrimination between nationals and (usually) their foreign competitors, both when such discrimination is explicitly contained in and ascertainable in the regulatory regime and when – as may be most relevant in practice – it is rather to be found in the application of tax law. This involves difficult comparisons between the factual situation of the domestic comparator – in a 'like situation' with the foreign investor, identification of a relevant 'difference in actual treatment' and examination of possibly legitimating reasons for such different treatment.[56] Special problems can again arise with respect to natural resources/energy concession and related contracts. These will often provide a project-specific fiscal regime, incorporating both special rules for general taxation and for the component of the fiscal regime which can be seen as the equivalent of a 'price' for the access to the subsoil resource. If such contracts are incorporated into legislation and the BIT exempts an explicit legislative special tax regime, then it seems difficult to raise a NT/MFN claim. But even if they are not incorporated into legislation it is not easy to argue that the NT/MFN standard should be applied and in effect export a specially negotiated quid-pro-quo deal responding to the characteristics of a resource project to other projects. Even if one were to apply the NT/MFN test in general, most efforts to 'export' a specific project deal embodied in a concession-type contract (production-sharing/ license etc.) would stumble either at the comparability (or 'likeness') test or at the then ensuing phase of search for criteria that can legitimate different treatment.[57]

In addition to the exclusion of the NT and MFN obligations in respect of tax advantages or privileges granted investors of a third state pursuant to a tax treaty or economic union arrangement (e.g. EU), a few other investment treaties also provide that the NT and MFN obligations do not apply:

- to any taxation measure aimed at ensuring 'equitable' and 'effective' imposition or collection of taxes and that does not arbitrarily discriminate against an investor (goods or services) of another Contracting Party or (arbitrarily restrict benefits accorded under the investment treaty).[58]

  This provision gives host states and their tax agencies maximum discretion in enacting tax laws, regulations and taking other relevant measures aimed at enhancing collection of taxes without violating the NT and MFN obligations. Whether or not a taxation measure adopted by a host state is 'equitable' or 'effective' depends on the circumstances of each case.
- to a non-conforming provision of any pre-existing taxation measure,[59] including to the continuation or prompt renewal of a non-conforming provision of any existing taxation measure[60] and to an amendment to a non-conforming provision of any

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[54] Terra and Wattel, *European Tax Law* (1997).

[55] T. Walde, 'International Investment under the 1994 Energy Charter Treaty', in T. Walde (ed.), *The Energy Charter Treaty* (Kluwer Law International, London, 1996), pp. 251 and 287.

[56] It is in the area of discrimination that one finds similarities between investment treaties, GATT rules (Art. III), European Convention on Human Rights (Art. 14), freedoms provisions of the EC Treaty and Art. 24 of the OECD Model Tax Treaty. Although these treaties differ in details, they all share same underlying objective, which is: to prevent unreasonable discrimination between domestic and foreign investors of goods and services; and they all apply to both direct and indirect discrimination.
For an overview of the application of national treatment: T. Weiler, in T. Weiler (ed.), *NAFTA, Investment Law and Arbitration* (Transnational Publishers, 2004); T. Walde and M. Desta are currently working on a study on the application of national treatment in investment disputes. The main cases where discriminatory treatment in tax-related cases so far was found are *Feldman v Mexico* and *Occidental v Ecuador* (www.investmentclaims.com).

[57] For the difficulty a times, of deciding discrimination where it is not apparent from the text of the tax law see H. Gribnau (ed.), *Legal Protection against Discriminatory Tax Legislation: The Struggle for Equality in European Tax Law* (Kluwer, London, 2003).

[58] See NAFTA Art. 2103(4)(g); EC Treaty Art. 21(2)(b), (3)(b); DR-CAFTA Art. 21.3(4)(g) and similar provisions in US FTAs; Panama-Taiwan FTA Art. 20.06(5)(VI).

[59] NAFTA Art. 2103(4)(d); DR-CAFTA Art. 21.3(d); Art. 21(2)(d) US Model BIT (2004).

[60] NAFTA Art. 2103(4)(e); DR-CAFTA Art. 21.3(e); Art. 21(2)(e) US Model BIT (2004).

existing taxation measure to the extent that the amendment does not decrease its conformity, at the time of the amendment, with any of those Articles.[61]

What these Articles seek to achieve is to preserve any existing tax laws and regulations or measures which are otherwise inconsistent with the treaty. As with any other exceptions in treaties, these provisions enable the parties to maintain certain tax measures that are inconsistent with the treaties but which are considered too important to give up now. They legitimise tax measures which otherwise would be unlawful under the treaty. However, the provisions do not seem to give the parties the freedom to enact new non-conforming tax measures possibly because of the distortion they might cause in terms of competition. They are comparable to the 'stand-still' obligations in international trade law; they do not allow new restrictions, but immunize existing restrictions from the treaty disciplines.

To sum up, in current BIT practice, there is, at times, application of the national treatment and most-favoured nation standard, but there are frequent exceptions, mainly to avoid the export of special tax arrangements per double taxation treaty, by regional economic integration (i.e. mainly EU) and by legislation and by special project agreement. The main field of application of both standards is probably in situations where a government, accidentally or, more likely, intentionally discriminates between domestic investors with strong political influence on one hand and foreign investors, often in competition with domestic investors.[62] Other scenarios will be – as currently under litigation in several cases – application of otherwise general and non-discriminatory tax rules in a way to intentionally damage to a foreign investor, e.g. discriminatory ways of interpretation, of tax auditing, or tax prosecution. In these cases, a factually detailed comparison has to be made between the situations – in fact and practice – of comparable domestic investors with the situation of foreign investors targeted by tax enforcement measures.[63]

B. Application of the 'fair and equitable treatment' obligation to tax matters (FET)

An important element of foreign investment protection is the obligation of IT partners to accord 'fair and equitable treatment' to each other's investors in their respective territory. However, by generally excluding tax matters from coverage under an investment treaty, that has the effect of also excluding from the treaty the obligation of fair and equitable treatment from being applied to tax matters.[64] But where there is no general exclusion of tax matters under the treaty or where only the NT and MFN were explicitly excluded from application to tax matters,[65] or in some other way, limited in their application to tax matters, there will be no presumption of exclusion of the FET obligation. Rather, the presumption would be that the parties intended the FET obligation to apply by virtue of both the restrictive and effective rules of interpretation of treaties.[66]

Some investment treaties expressly provide for the application of the FET to tax matters while others exclude it together with other substantive investment protection provisions. For example, Art. X(1) of the US-Ecuador BIT (1993) states: 'With respect to its tax policies, each Party should strive to accord fairness and

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[61] NAFTA Art. 2103(4)(f); DR-CAFTA Art. 21.3(f); Art. 21(2)(f) US Model BIT (2004).

[62] That was the situation in the *Feldman v Mexico* case, www.naftaclaims.com. The *Feldman* case illustrates the point that, it is important for an arbitral tribunal or court adjudicating on claim of discriminatory taxation to embark on a critical analysis of the tax law and/or its enforcement to discover whether formal neutrality in treatment between different taxpayers might in fact hide different effects upon the parties, i.e. whether it reflects 'raw political power of parochial interests as opposed to the pursuit of some public value.' See, W. Twyman Jr, 'Justice Scalia and Facial Discrimination: Some Notes on Legal reasoning', in Va. Tax Rev. (Summer 1998), pp. 103 and 118; Epstein, see n. 15 above, at pp. 134–136. Although this method of interpretation involves an exercise of high level of discretion by the adjudicating authority (and so might sometimes lead to contradictory decisions), nevertheless, it is an important approach to interpretation of tax laws that has been adopted by the ECJ in numerous cases: e.g., Case 302/86 *Commission v Denmark* (1988) ECR 4607; Case 145/88 *Torfaen Borough Council v B & Q Plc* (1989) ECR 765; *Commission v Germany (Re Insurance services)* (1986) ECR 3755; Beveridge, n. 16 above, note 16, at pp. 121–122.

[63] That is, for example, the allegation made by partly-foreign owned Russian oil company Yukos in its case before the European Court of Human Rights and by its shareholders in an Energy Charter Treaty based case against Russia. Discrimination by way of tax auditing and assessment is also alleged in other, in 2006 pending, cases.

[64] For example: NAFTA Art. 2103(1) states in part: 'Except as set out in this Article nothing in this Agreement shall apply to taxation measures'; EC Treaty Art. 21(1): 'Except as otherwise provided in this Article, nothing in this treaty shall create rights or impose obligations with respect to taxation measures of the contracting parties'; Art. V Basic Agreement on ASEAN Industrial Joint Ventures (1987): 'The provisions of this Agreement shall not apply to matters of taxation in the territory of the contracting parties'; Art. 19(1) Japan-Vietnam BIT (2003): 'Nothing in this Agreement shall apply to taxation measures except as expressly provided for in paragraphs 2, 3, and 4 of this Article'; Art. 4(1), Chapter VII US-Vietnam Agreement on Trade Relations (2000): 'No provisions of this Agreement shall impose obligations with respect to tax matters,. . .'. Except otherwise stated, such formulations would have the effect of excluding all the substantive treaty obligations including the FET from being applied to tax matters.

[65] For example, Art. 3 of the France-Uganda BIT imposes the general obligation of FET on the parties, while Art. 4 contains the NT and MFN obligations. However, a proviso to Art. 4 states: 'The provisions of this article do not apply to tax matters'. This suggests that other relevant obligations such as FET (Art. 3) shall apply to tax matters; otherwise the parties could have excluded it as well.

[66] For example, Art. 4(4) of Belgo-Luxemburg Model BIT (no date) states: 'The provisions of this Article [NT and MFN] do not apply to tax matters'. UNCTAD, *International Investment Instruments: A Compendium*, vol. II, p. 271. A restrictive interpretation of this Article would mean that it should not be read as to extend the exclusion of the FET from being applied to tax matters otherwise it will render the FET provision of the treaty ineffective which might not be what the parties intended. And under the principle of restrictive interpretation, exemptions or exception clauses of a treaty are to be interpreted narrowly so as not to defeat the purpose of the treaty, while other terms are to be interpreted in a manner that enhances their effectiveness. This seems to be implicit from the decision of the Tribunal in *Occidental v Ecuador*, Decision of 1 July 2004, paras. 64–70. H. Lauterpacht, 'Restrictive Interpretation and the Principle of Effectiveness in the Interpretation of Treaties', BYIL 1964, p. 48; A. McNair, *The Law of Treaties* (1961).

equity in the treatment of investment of nationals and companies of the other Party'.[67] Similarly, Art. 19 of the Japan-Korea BIT (2002) states:

> 'Nothing in this Agreement shall apply to taxation measures except as expressly provided in paragraphs 2, 3, and 4 of this Article.
> 1. Articles 1 [Definitions], 3 [NT in access to justice], 7 [Transparency], 10 [FET & Expropriation], 22 [Sub-national authorities] and 23 [Date of commencement of the Treaty] shall apply to taxation measures.'[68]

In interpreting the above provision of the US-Ecuador BIT, the arbitral tribunal in *Occidental v Ecuador* held that the standard of treatment required by the Article is not devoid of legal significance. 'It involves an obligation on the host state that is not different from the [substantive] obligation of fair and equitable treatment ... even though this article had been couched in a less mandatory terms'. Accordingly, the Article involves a commitment that cannot be ignored by the parties in the implementation of their tax policies.[69] This interpretation relies on the US government's Explanatory Note to the treaty which stated that the Article 'exhorts both countries to provide fair and equitable treatment to investors with respect to tax policies'.[70] *Enron v Argentina* – chaired by the same president of the tribunal – confirmed that holding with a clarification that seems to suggest that if a claimant makes a – for jurisdiction – credible expropriation claim, then the otherwise excluded disciplines (fair and equitable treatment, national treatment) are fully applicable.[71]

C. Capital transfer and taxation (withholding tax)

Transfer of capital in the form of profits, dividends, royalties, interests on loans etc. by foreign investors is a vital element in the transnational investment process.[72] From the foreign investor's perspective, the essence of investing its money and taking on the risk associated with the foreign investment is to seek for greater returns on the capital invested. Hence, the average foreign investor will want an assurance from the host state that it will be able to repatriate the revenues, profits and proceeds of the investment to meet external commitments.[73] To an extent, this view is shared by the investor's home state as it might want the proceeds of the investment to be repatriated for its own economic reasons. Hence, both the foreign investor and its home state will be keen to secure and protect the right to repatriate capital. On the other hand, host states, in particular those with a weak and volatile economy exposed to domestic and global financial risk, have an interest that profits are reinvested in the local economy; they will often view repatriation as detrimental to their economy as it leads to a drain on the country's foreign exchange. Indirect repatriation, e.g. by transfer pricing, will affect the tax

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[67] For similar formulations, see Art. X US-Latvia BIT (1995); Art. VI US-Poland BIT (1990); Art. XI US Kazakhstan BIT (1992); Art. XI US-Armenia BIT (1992); Art. 2(4) Lithuania-Kuwait BIT. Adjudicated so far in Occidental – Ecuador and El Paso-Argentina (award on jurisdiction); *BP v Argentina* (decision on preliminary objection, 27 July 2006, paras. 132–134).

[68] See also Art. 19 Japan-Vietnam BIT (2003).

[69] *Occidental v Ecuador*, Decision of 1 July 2004, para. 70; *Enron v Argentina*, Decision of 14 January 2004, para. 65. However, the *BP v Argentina* tribunal expressed its doubt over such an interpretation. See paras. 132–134.

[70] See US Government Explanatory Note attached to the US-Ecuador BIT, available at:www.tcc.mac.doc.gov/egi_bin/doit.egi?. Interpreting the 'strive to accord' language as a normal, mandatory obligation is a significant step which the tribunal has not explained in details. Essentially, such language can be seen as having a purely exhortatory and aspirational devoid of legal meaning, if it can be interpreted strictly on its 'plain meaning', i.e. that there is an obligation of sorts ('should'), but of a quite flexible and not very specific character ('strive to accord'). Waelde has in another context suggested a plain meaning approach to the pre-investment obligations of the Energy Charter Treaty (Art. 10(2)), but these are, quite different from the: Ecuador-US BIT, formulated clearly as legally binding obligations ('shall'), though then, in the description of the specific substantive scope of the obligation expressed by 'shall', in the much more 'mellow' way of the US/Ecuador BIT: 'endeavour to accord' (Art. 10 (2)) and 'limit to a minimum' and 'progressively remove' (Art. 10(5) of the EC Treaty). For an early analysis of these provisions, see T. Waelde, 'International Investment Under the 1994 Energy Charter Treaty', JWT 1995, vol. 29, p. 5. Such language combining an 'obligatory' ('shall') and a 'fluid' or 'mellow' element – 'endeavour to accord' – are sometimes called 'soft law'. But such denomination does by itself contribute virtually nothing to an elucidation of the specific meaning. The *Occidental v Ecuador* tribunal's reading of 'should strive to accord' as legally binding seems, so far and at least in investment jurisprudence, very far-reaching: 'An obligation... not different from the fair and equitable treatment obligation ... though the obligation ... is admittedly "less mandatory". We are here at the borderline of legally binding language and mere exhortatory language which is used in treaty negotiations often as a compromise – to raise an issue, satisfy not overly careful home office reporting requirements, but not stipulate a clearly binding obligation'.

[71] At para. 66. A similar conclusion was reached by the tribunal in the *BP v Argentina* case, para. 136; Pan American v. Argentina, Decision on Preliminary Objections, 27 July 2006, para. 136, available at: http://ita.law.uvic.ca; C. Chreuer, Fair and Equitable Treatment (FET): Interactions with other standards (forthcoming).. *Occidental v Ecuador* and *Enron v Argentina* must therefore be seen as examples of a 'wide' view of both jurisdictional and even more so a 'wide' view of the substantive investment treatment obligations applicable by tax, very much in contrast to the *Encana v Ecuador* award which must be seen as a very restrictive application of the expropriation discipline, even retroactively and even with respect to an in effect fully economic deprivation of existing tax rights of the investor.

[72] See also Art. VI(1) of the 1992 World Bank Guidelines. This is because capital, especially private investment goes to where it can make profit (rather than where it is needed) to the benefit of its share holders, wherever they might be (through repatriation). Thus, exchange control regulations tend to inhibit cross-border trade and investment. C. Manduna, *An Evaluation of the Capital Controls Debate: Is there a case for controlling capital flows in the SACU-US free trade agreement?*, Tralac working paper no. 8/2003, available at www.tralac.org.; M. Desai, C. Foley and J. Hines Jr., 'Capital Controls, Liberalisations, and Foreign Direct Investment', The Review of Financial Studies 2006, vol. 19, p. 1433. For this reason and in order to promote international trade and investment, Art. VIII(2) of the IMF Agreement states that no member 'shall, without the approval of the Fund, impose restriction on the making of payments and transfers for current international transactions'. See also Art. XI GATS which places an obligation on a Member Country not to impose 'restrictions on international transfers and payments for current transactions relating to its specific commitments'. D. Siegel, 'Legal Aspects of the IMF/WTO Relationship: The Fund's Articles of agreement and the WTO Agreements', AJIL 2002, vol. 96, pp. 561, 598–607, 617–620.

[73] P. Muchlinski, *Multinational Enterprises and the Law* (Blackwell, Oxford, 1995), p. 620; Walde in Walde (ed.), *Energy Charter Treaty* (1996), p. 303, Wallace, n. 14 above, at 430.

base of the host state.[74] Central Bank officials and domestic investors might also view capital transfer as a source of fiscal instability or a sign of the preferential treatment accorded foreign investors over their domestic counter-parts, a treatment which is resented by domestic investors.[75] The issue harks back to the time when the convertibility relating to the pre-World War I gold standard had been abolished and been replaced by a complex system of foreign exchange and repatriation regulations; while these were gradually abolished in the OECD and EU countries under the influence of the various freedom of capital transfers rules, they persisted in many developing countries throughout the 1980s. The acid test of liberalized repatriation rules comes during a national (or regional) financial crisis (such as 1998 in Asia and Russia), 2001/2002 in Argentina); then, the treaty-based repatriation guarantees become both relevant, but also difficult if not impossible for the host state to comply with.[76]

These conflicting interests are usually balanced in the capital transfer provisions of investment treaties. Thus, a typical transfer clause in an investment treaty would provide for free transfer of capital in convertible currency subject to some exceptions such as reasonable and non-discriminatory delay in the event of balance of payment difficulties or currency crises and subject to withholding tax.[77] For example Art. 6 of the UK-Russia BIT (1992), guarantees capital transfer 'subject to the right of each contracting party in exceptional balance of payment difficulties and for a limited period to exercise equitably and in good faith powers conferred by its laws',[78] relating to specific situations and subject to its tax laws. This is similar to the new India-Singapore Model Agreement which contains an exemplary way of resolving the dilemma between shear impracticability to pay in a time of pervasive financial crisis and the investor's legitimate concerns; Art. 6.6 of the agreement essentially sets up a system of consultation guided by compliance with the IMF agreement and the principle of 'least-restrictiveness'.[79]

Article 14 of the EC Treaty[80] obliges each party to guarantee to each other's investors the freedom of transfer into and out of its territory. These include capital, returns on loans repayment, interest, earnings, remuneration, and proceeds from sale or liquidation of business etc. In order to forestall the possibility of a host state manipulating the exchange rate to the detriment of an investor, the EC Treaty provides that the exchange rate should be the market rate if it exists or the rate applied to inward investment or the rate used for IMF special Drawing Rights. However, additional restrictions might be placed by a host state to protect the rights of creditors or to comply with its

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[74] See UNCTAD, *Transfer Pricing* (1999) – highlighting in particular OECD work on transfer pricing. Some economists have argued that transfer pricing is more likely to be used by multinational firms located in countries with exchange controls and high tax rates than those located in liberalised economies with lower tax rates. See Desai *et al.*, see n. 72 above, pp. 1449–1457.

[75] On the other hand, exchange controls might raise interest rates and invariably the cost of capital, especially for local investors (who rely more on domestic sources of capital than their foreign counter-parts). See Desai *et al.*, n. 72 above; contrast with, C. Neely, 'An Introduction to Capital Controls', *Federal Reserve Bank of St Louis Review*, November/December 1999 available at: http://research.stlouisfed.org/publications.

[76] The Russian financial crisis in 1998 could have given rise to non-repatriation claims, but none was raised (at least not in public). However, there was a claim against Russia regarding its domestic bonds, which raised forex issues. The claim is briefly referred to on the Freshfields' website: http://www.freshfields.com/practice/arbitration/experience/idisputes; *Gruslin v Malaysia*, ICSID award 27 November 2000, ICSID Reports p. 483, raised the issue as a result of the Asian/Russian financial crisis in 1998, but the tribunal denied jurisdiction. *Fireman's Fund v Mexico*, preliminary decision 17 July 2003 involves a claim in which claimant's application to be included in a bond restructuring plan on the same terms as local currency-denominated bond holders was rejected by the Mexican authorities. Some of the current BIT claims against Argentina allege that Argentina breached free transfer provisions - e.g. *BP v Argentina*, decision of 27 July 2006; *ENRON v Argentina*, decision of 14 January 2004; *Gas Natural v Argentina*, decision of 17 June 2005 all which holding that claimants had demonstrated *prima facie* that they have been adversely affected by the measures complained of (including foreign exchange restrictions). In *CMS v Argentina*, the tribunal rejected Argentina's contention and held that the claimant had a right to a tariff calculated in dollars and converted into pesos notwithstanding the fact that the convertibility law had been repealed by Argentina (paras. 136–138) (all the cited cases are available at the ICSID website or at http://ita.law.unic.ca. On the other hand, in *Morris v OPIC*, award of 3 December 1987 (27 ILM 487) the claimant's demand for a better (official) exchange rate was rejected by the tribunal. The few cases decided by the Iran-US Claims Tribunal on the subject suggest that host states enjoy a high margin of appreciation with the foreign investor having to proof that the restrictions were disproportionate to the exigencies of the situation. See *Hood Corp. v Iran*, 7 Iran-USCTR 36; *Sea-Land Service, Inc. v Iran*, 6 Iran-USCTR 149; *Schering Corpn. v Iran*, 5 Iran-USCTR 361; *Dallal v Iran*, 3 Iran-USCTR 10. However, the apparently conflicting decision in *CMS v Argentina* on one hand and the *LGE v Argentina* and *Siemens v Argentina* on the other indicate the lack of unanimity in international law on the extent to which international tribunals should show some deference to governments when their actions are subject to international review. See, L. Peterson, 'Argentina liable for $217 million in investment treaty arbitration with Siemens', www.iisd.org/investment/itn, 19 February 2007; A. Reinisch, 'Necessity in International Investment Arbitration – An Unnecessary Split of Opinions in Recent ICSID Cases? Comments on CMS v Argentina and LG&E v Argentina', 3(5) TDM (December 2006); Y. Shany, 'Toward a General Margin of Appreciation Doctrine in International Law?', EJIL 2006, vol. 50, p. 907; S. Chill, International Investment Law and the Host State's Power to Handle Economic Crises: Comments on the ICSID Decision in LG & E v. Argentina, 24(3) J. Int'l. Arb. 2007 p. 265; W. Burke-White & A. von Staden, Investment Protection in Extraordinary Times: The Interpretation and Application of Non-Precluded Measures Provisions in BITs, University of Pennsylvania Law school Working Paper No. 152, 2007, available at: http://lsr.nellco.org/upenn/wps/papers/152.

[77] OECD, *Policy Framework for Investment* (2006), pp. 26–27 available at: www.oecd.org/investment; UNCTAD, Transfer of Funds, 2000, available at: www.unctad.org; J. Alvarez, Political Protectism and United States Internationa Investment Obligations in Conflict: The Hazards of Exon-Florio, 30 Va. J. Int'l. L. 1990, p. 1; K. Vandevelde, The Bilateral Investment Treaty Programme of the United States, 21 Cornell Int'l. L. J. 1988, p. 201, 244-256; A. Kolo, Treatment of Capital Transfers and restriction under Modern Investment Treaties (forthcoming).

[78] For an illustration of how the wordings are couched, see Art. 15 Framework Agreement on the ASEAN Investment Area 1998; Art. 6 UK-Argentina BIT (1990) while allowing for restriction in exceptional balance of payment difficulties, states that the restriction should not exceed a maximum period of three years during which the investor should have the opportunity to invest the capital in a manner that would maintain its real value; Art. 6(4) China Model BIT; Art. 6(5) Peru Model BIT.

[79] Surprisingly, the reference to the principle of non-discrimination (available in the 2003 India Model Agreement) has been dropped, perhaps on the reason that it is mentioned elsewhere (Art. 6.11) in the Agreement.

[80] One needs to bear in mind that the ECT does not provide an 'economic & financial force majeure clause'. It is an open question if such a clause can and should be read into the Treaty, see: Waelde, n. 70 above.

capital market laws and regulations.[81] And more importantly for our present purposes, Art. 21(6) of the EC Treaty states that the freedom of transfers guaranteed under s. 14 'shall not limit the right of a contracting party to impose or collect a tax by withholding or other means'. The phrase 'or by other means' leaves the door wide open for a host state to decide on the type of taxes to impose on capital transfers. The question is if governments can use the instrument of withholding taxes (legitimate and accepted in principle under the BIT repatriation rules), to achieve in effect the equivalent of an otherwise prohibited restriction on repatriation. For example, they might levy a withholding tax with such conditions and at such a level beyond what is normal practice so that it is impossible, or financially very un-attractive, for an investor to repatriate its earnings.[82] International investment law usually takes a 'material' approach in such matters and looks towards the economic reality and not the legal form, in particular if there the legal form is used to disguise the economic reality and intention. If the effect is therefore equivalent to a restriction on repatriation and the rate and modalities of the withholding tax way out of the ordinary, then it should be examined under the repatriation guarantee of the applicable investment treaty.[83] Indeed, the imposition of currency repatriation restriction on an investment (in law or in practice) could possibly amount to an expropriation of specific legal and contractual rights of the investor if it renders the investment worthless; such as where as a result of the restriction the investor is unable to meet its external debt obligations or pay its shareholders which resulted in bankcruptcy or a complete run down of the share price of the company. The more so if the 'trapped' funds cannot be reasonably reinvested in the host state economy as to cover such losses.[84]

Similar provisions (to Art. 14 of the EC Treaty) are found in many other investment treaties including the 1996 US-Ukraine BIT which provides in Art. IV(3) that the freedom of transfer does not derogate from the right of either party to maintain laws and regulations 'imposing income taxes by such means as a withholding tax'.[85] Some investment treaties do not expressly use the words 'withholding tax' but subject the right of transfer to the contracting parties 'laws, regulations and policies'; this expression could be regarded as broad enough to include taxes and other fiscal measures.[86]

However, there are many investment treaties which do not contain such restrictions on the freedom of transfer. For example, Art. 5 of the Kazakhstan-Netherlands BIT simply states that each Contracting Party 'shall guarantee that payments relating to an investment may be transferred', without providing for any exceptions relating to taxes or other conditions or circumstances as those stated above.[87] The question is: do such provisions forbid restrictions on freedom of transfer through taxes or during balance of payment difficulties, or should the provisions be construed as

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[81] Similar provisions are found in Art. 10.28(4) DR-CAFTA; Art. 11(4) Chile-Korea FTA (2003); Art. 14 Canada Model BIT (2004); Art. IX(3) Canada-South Africa BIT; Art. 7 US-Uruguay BIT (2004).

[82] Alternatively, a host state might in law and in principle, permit repatriation but in practice place administrative obstacles (e.g. the requirement to complete foreign exchange application forms which are not made easily available to all investors, provide insufficient or no foreign exchange to commercial banks, give wide discretion to the central bank to approve or reject foreign exchange applications, introduce an unreasonable burden or undue delay in the approval process) on the process as to make it impossible to effect capital transfers. Such were some of the arguments made by the American claimants before the Iran-US Claims Tribunal in the cases cited above; see, A. Mouri, Treatment of Rules of the International Law of Money by the Iran-U.S. Claims Tribunal, 3 Asian Y.B. Int'l. L. 1993, p. 71; Vandevelde, n. 77 above, at 244 ('Highlu burdensome restrictions on transferability of funds may constitute an expropriation, which would give rise to a right of prompt, adequate, and effective compensation'); A. Proctor, Mann on Legal Aspects of Money (6th ed, OUP, 2005); M. Shuster, The Public International Law of Money, OUP, 1973.

[83] According to F.A. Mann, '[a]n international tribunal ... "is entitled to be satisfied that the ... law is a genuine foreign exchange law ... and is not a law passed ostensibly with that object, but in reality with some object not in accordance with the usage of nations", or, in other words, is not abusive'. *The Legal Aspects of Money*, 4th edn (1982), p. 482 quoted by Holtzmann (Dissenting and Concurring Opinion) in *Sea-Land service, Inc. v Iran*, 6 Iran-USCTR 149 at 209; F.A. Mann, Money in Public International Law, 26 B.Y.I.L., 1949, p. 259.

[84] See the dissenting opinion of Mosk in *Schering v Iran*, p. 374 at p. 381 (noting that whether exchange restrictions constitute a taking under international law is 'dependent upon such factors as whether such restrictions are non-discriminatory, whether such restrictions are justified on bona fide economic grounds and whether such restrictions, in effect, extinguish a foreign national's enjoyment and use of its currency'); and that of Holtzmann in *Dallal v Iran*, pp. 17–33 and in *Sea-Land service v Iran*, pp. 207–212; P. Cameaux and N. Kinsella, *Protecting Foreign Investment under International Law: Legal Aspects of Political Risk* (Oceana Publications, 1997), p. 15. For a discussion of some exchange control related cases which also raised possible expropriation claims before US courts see, J. Gold, 'Exchange Control: Act of State, Public Policy, the IMF's Articles of Agreement, and other Complications', Hous. J. Int'l. L. 1984, vol. 7, p. 13.

[85] Article 7(1) India-Kazakhstan BIT (1996) states: 'Each party shall permit all funds of an investor of the other contracting party related to an investment in its territory to be freely transferred, without unreasonable delay, and on a non-discriminatory basis, subject to fulfilment of tax obligations by the investor'. See also, Art. 6 Germany-Hong Kong BIT (1996); Art. IV US-Romania BIT (1995); Art. IV US Ecuador BIT (1993); Art. 5 Germany-Bolivia BIT (1987); Art. 5 Germany-Bosnia and Herzegovina BIT (2001); Art. 6 Germany-China BIT (2003); Art. 6 Germany-Nigeria BIT (2000); Art. 5 Germany-Soviet Union (Russia) (1989); Art. 6 of the Malaysia-Saudi Arabia BIT (2000) which states that the right of transfer can only be exercised 'after all taxes and obligations have been met' by the foreign investor.

[86] Article 6(1) China-Kuwait BIT (1985); Art. 6(1) Malaysia-Kazakhstan BIT (1996); Art. 6 Italy-Korea BIT; Art. 6(1) Egypt-Malaysia (1997); Art. 6(1) Malaysia-Ghana BIT (no date); Art. VII China-Indonesia (1994); Art. VIII Italy-Philippines (1988) ('Transfers as stipulated in articles 4, 5, 6 and 7 shall be made without undue delay, in accordance with their respective national laws and regulations and consistent with their obligations with the IMF, after the performance of the fiscal burdens...' Art. 6(1) Italy-Bangladesh BIT (1990) ('Each contracting party shall guarantee that after investors have complied with all their fiscal obligations, as well as all relevant administrative procedures, they may transfer the following abroad...' Art. 6(1) Italy-Mongolia BIT (1993); Art. 6(1) Italy-Tanzania (2001).

[87] See also Art. 6 UK-Mozambique BIT (2004); Art. 5 Protocol of Colonia for the Promotion and Reciprocal Protection of Investment in Mercusor; Art. 4 Germany-Bangladesh BIT (1981); Art. IV Turkey-Kazakhstan BIT (1992); Art. 7 Korea-Kazakhstan BIT (1996); Art. 5 Netherlands-Venezuela BIT; Art. 6 UK-Bulgaria BIT (1988); Art. 6 Chile-UK Bit (1996); Art. 7 Germany-India BIT (1995); Art. 6 UK-Soviet Union BIT (1989); Art. 7 Lithuania-Kuwait; Art. 6 (1) Germany-Mexico BIT (no date); Art. 7 India Model BIT (2003); Art. 6(1) Argentina-Korea BIT (1994), but Art. 6(2) adds further that the restrictions imposed by a party 'shall not impair the substance of the rights set forth in this Article'. Presumably, this obliges the parties not to defeat the essence of the transfer through burdensome restriction such as by imposing prohibitive taxes that would effectively render the freedom to transfer unrealisable.

subject to a host state's right to impose taxes under customary international law?[88] The use of the words '*may* be transferred' could be viewed as suggesting some element of discretion in the host state to impose restrictions on transfers when necessary such as during balance of payment difficulties. Could such an interpretation be extended to cover imposition of taxes or would that be regarded as inconsistent with a party's obligations under the treaty which states 'it shall guarantee' capital transfer. In other words, does the obligation to 'guarantee' capital transfer exclude the imposition of taxes by a host state as that would amount to a breach of the guarantee? The question is if the use of the words 'shall guarantee' capital transfer means an absolute guarantee of transferability and if the governments have agreed to thereby forfeit their right to impose and collect taxes on capital transfers. After all, it is a sovereign right to impose taxes and a limitation of tax sovereignty should be read into investment treaties only with prudence. But then, the use of tax powers can be engineered to in effect achieve the equivalent of the otherwise prohibited restriction on repatriation; if the tax measures achieve such a threshold, then they should be seen as again controlled by the repatriation guarantee which aims at a material, and not only formal, prohibition of state measures achieving in effect and materially a restriction on repatriation.

D. Taxation and investment agreement/ authorization

More often than not, before a foreign investor undertakes any substantial business activity in a host state, it must obtain either the consent or authorisation of the host government (i.e. where the government has no direct interest in the business to be undertaken, such as the development of a housing estate for commercial purposes or a manufacturing plant) or sign an investment agreement with the host state or its state enterprise if the state has a direct interest in the commercial activity (e.g. the development of the country's natural resources or infrastructure such as an airport, water or electricity project).[89] Such investment agreements or authorisations sometimes contain provisions on the tax obligations of the foreign investor. Essentially, the investor – and its financial sponsors – will want to ensure that the fiscal regime (originating from central and sub national governments) does not throw up unwelcome surprises once the investment has been made. Most tax-related contractual commitments will therefore be a variation on the theme of the tax stabilisation clause.[90]

In the event of a dispute over an alleged breach of the tax provisions of an investment agreement or authorization by the host state, a question arises as to whether such a tax related dispute is excluded from the investor-state dispute settlement provision of the investment treaty? The question if a dispute relating to a tax stabilisation guarantee would fall under a tax carve-out or not can only be determined by a close analysis of the treaty at issue, the factual context, the role of a tax carve-out and the existence of an 'umbrella clause' in the treaty. In the case of a total carve out of tax matters from the treaty's disciplines; the foreign investor would have to seek recourse either

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88 It is an internationally accepted practice that when faced with balance of payment problems, states use exchange controls as a means to ameliorate the problem. Such a policy is sanctioned by Art. VI(3) of the IMF Agreement provided the measures adopted complied with international rules. See, J. Gold, '"Exchange Contracts", Exchange Control, and the IMF Articles of agreement: Some Animadversions on Wilson, Smithett & Cope Ltd v Terruzzi', ICLQ 1984, vol. 33, pp. 777, 778–781; S. Silard, 'Exchange Controls and external Indebtedness: Are the Bretton Woods Concepts still Workable?', Hous. J. Int'l. L. 1984, vol. 7, p. 53; Schuster, n. 77 above. However, the important question is whether the IMF Articles of Agreement is indicative of customary international law and whether it will prevail over an inconsistent but specific treaty commitment as reflected in these BITs? Similar questions were raised by Holtzmann in his dissenting opinion in *Dallal v Iran*, at p. 19 but declined to answer them because they were not raised nor argued by the parties to the case.

89 Under Art. 1 (Definitions) of the US-Uruguay BIT (2004), an investment agreement is defined as 'a written agreement . . . between a national authority of a party and a covered investment or an investor of the other party, on which the covered investment or investor relies in establishing or acquiring a covered investment other than the written agreement itself, that grants rights to the covered investment or investor:

a. with respect to natural resources that a national authority controls, such as for the exploitation, extraction, refining, transportation, distribution, or sale;
b. to supply services to the public on behalf of the party, such as power generation or distribution, water treatment or distribution, or telecommunication; or
c. to undertake infrastructure projects, such as the construction of roads, bridges, canals, dams or pipelines, that are not for the exclusive or predominant use and benefit of the government.'

See also, Art. 1, para. 8 of Italy-Jordan (1996).

Article 1 of the US-Uruguay BIT further states that: 'An investment authorisation means an authorisation that the foreign investment authority of a party grants to a covered investment or an investor of the other party'.

By footnote 5, the term 'written agreement' does not include (a) a unilateral act of an administrative or judicial authority, such as a permit, license, or authorization issued by a party solely in its regulatory capacity, or a decree, order, or judgment, standing alone; and (b) an administrative or judicial consent decree or order.

For tax purposes, one has to ask if this explanatory note would exclude documents such as 'consent letters' or 'rulings' issued by tax authorities from being relied upon by a private investor as creating an implied contractual relationship between a taxpayer and the tax authorities. The issue cannot be investigated here in greater depth. If such agreements are part of a main investment agreement, they would be covered – see also on the role of side-letter and ancillary agreements as part of an overall integrated investment arrangement, *Holiday Inns v Morocco*, ICSID case. Such legal instruments short of acquiring the quality of as formal agreement will play a role in the assessment of the existence of a 'Legitimate Expectation' of the investor, see Waelde's Separate Opinion in the NAFTA award *Thunderbird v Mexico*, at www.naftaclaims.com

90 Waede and Ndi, Stabilising International Investment Committments: International Law versus Contract Interpretation, 31 Texas Int'l. L.J., 1996, p. 215; M. Kantor, 'International Project Finance and Arbitration with Public Sector Entities', Fordham Intl LJ 2001, vol. 24, p. 1122. The main case relating to a tax stabilisation clause is *Revere Brass and Copper v OPIC* (relating to a Jamaican imposition, by legislation, of an additional bauxite levy ('royalty') against a contractual stabilization clause: *Revere Copper and Brass, Inc. v OPIC* ILM 1978, vol. 17, p. 1321. Stabilization clauses were also at issue in the three Jamaican bauxite cases before the ICSID (but later settled): John Schmidt, *Alcoa v Jamaica*, in Harv. Intl.L J 1976, vol. 17, p. 90; on other cases (*Petrola Hellas v Greece*, *Power and Traction Fiannce v Greece*): Manciaux, n. 4 above, at footnotes 34–37; also *Agip v Congo*, ICSID Arb/77/1.

in the domestic courts of the host state or to try to persuade its home state to invoke any available dispute settlement procedure of an available double taxation arrangement.

However, some investment treaties expressly subject an alleged breach of the tax provisions of an investment agreement or authorisation to the investor-state dispute settlement provisions of the treaty. For example, Art. 21.3(6) of DR-CAFTA states: 'Articles 10.7 [expropriation] and Article 16 [submission of a claim to arbitration] shall apply to a taxation measure alleged to be an expropriation or a breach of an investment agreement or authorisation'.[91] This means that notwithstanding the general carve out of tax matters from the substantive obligations of the treaty, nonetheless, where the taxation measure is alleged to be expropriatory or to constitute a breach of an investment agreement or investment authorization, such a claim is subject to the investor-state dispute settlement procedure. Any objection by the host state against an arbitral tribunal assuming jurisdiction over the matter on the ground that it is tax matter and so excluded from the treaty is unlikely to be sustained. This is because such a provision forms one of the exceptions to the general exclusion of tax matters under the treaty.

Two tribunals, headed by most respected international tribunal presidents and international law scholars, have recently grappled with the issues. The fact that as yet no persuasive jurisprudence has grown out of these two cases reflects the early stage of arbitral tribunals' confrontation with the tax issues. One should therefore not be too critical but praise the tribunals for identifying some of the key issues. A particular difficulty in these cases was the interaction between general tax regulation on one hand and, on the other, specific contracts of the investor with the state enterprise. These contracts, their specific content, the legitimate expectations they created and the conditions for contract tendering were inextricably linked with the general tax system. Both tribunals struggled valiantly with this link; their efforts at struggling with this interaction deserves respect, though the ultimate outcome and reasoning need to be seen more as pioneer efforts than a conclusive statement resolving the dilemmas of adjudicating on tax issues closely intertwined with contract issues. It is also noteworthy that both tribunals have reached opposite conclusions, both, perhaps, stretching the law or positioning themselves at the edges of interpretability to reach the preferred results. Tax and state sovereignty raise strong sentiments; attitudes towards the relation between state and a private investor are forced to reveal themselves.

In *Occidental v Ecuador*, the main issue was the interpretation of Art. X(2) of the US. BIT.[92] Ecuador contended that by virtue of that Article all taxation matters were excluded from the investor-state dispute settlement provisions except for the specifically mentioned three situations. That contention was rejected by the tribunal. It held that to accept Ecuador's argument would have the effect of rendering such an important Article in the Treaty meaningless which would not be what the parties intended at the time of the agreement. According to the tribunal:

> '[The] Respondent's view that all matters of taxation are exempted from dispute settlement under the Treaty, with the exception of the specific categories mentioned in Article X, is not persuasive. Even if certain matters could still be covered by this Article and thus not make it meaningless, as argued by the respondent, that interpretation would nonetheless constrain it to a quite marginal application. This is evidently not what the parties intended in placing an Article of such importance in a Treaty which is brief indeed.'[93]

The *Occidental* tribunal relied on two lines of reasoning to establish its jurisdiction: The first is that the VAT refund dispute was closely associated with an 'investment agreement' (here: the 'participation agreement' between Occidental and Ecuador); the dispute focused on the question if the 'factor X' used to calculate Occidental's financial participation assumes VAT reimbursement or not.[94] Thus, the general tax carve-out would not apply according to Art. X(2)(c) of the BIT. This gives a wide interpretation to this Article; a narrow one would have been to require that the core of the dispute focuses on Art. X(2)(c) – e.g. breach of a tax stabilisation clause. But the tribunal's position is in our eyes not unreasonable as the tax dispute cannot be understood without the Ecuadorean

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[91] Other US BITs that contain similar provisions include: Art. IX US-Albania (1995); Art. XIII US-Jordan (1997); Art. XIV US-Croatia (1996); Art. XIII US-Uzbekistan (1994).

[92] The relevant part of which states:

'... the provisions of this Treaty, and in particular Article VI (investor-state arbitration) and VII (state-state dispute settlement), shall apply to matters of taxation only with respect to the following:
(a) expropriation, pursuant to Article III;
(b) transfers, pursuant to Article IV; or
(c) the observance and enforcement of terms of an investment agreement or authorization as referred to in Article VI (1) (a) or (b) to the extent they are not subject to the dispute settlement provisions of a Convention for the avoidance of double taxation between the two Parties, or have been raised under such settlement provisions and are not resolved within a reasonable period of time'. For similar formulations, see also, Art. XII (2)(c) US-Argentina BIT (1991); Art. XI US-Armenia BIT (1992); Art. XI US Kazakhstan BIT (1992); Art. XI US-Kyrgyzstan BIT (1994); Art. XI (2)(c) US Zaire BIT (1983); Art. X (2)(C) US-Ukraine BIT (1996).

[93] Decision of 1 July 2004, para. 68.

[94] The issues are discussed in paras. 64–77

reductionist interpretation of the investment agreement.[95]

It is, however, less persuasive when the tribunal put forward (perhaps indicating lack of conviction in its first reason) a second, in our eyes weaker, fall-back line of reasoning. Its reasoning is not at all clear. In essence, it seems to carry out an intellectual operation which overcomes the plain meaning of Art. X(1) – that parties 'should strive to accord fairness and equity' – denoting a merely hortatory and not legally binding phrase.[96] As this on plain meaning clearly not legally binding exhortation is followed by the word 'nevertheless' introducing the tax carve out, it is hard to see how the parties could have wanted to apply the fair and equitable standard to tax-related disputes, when they clearly said that this was only a at most best-effort exhortation, without legally binding effect and equally clearly said that the tax carve-out covered the legally binding 'fair and equitable' obligation. Nor can the plain meaning be overridden by 'purpose and intention': a tax carve-out for 'fair and equitable' and 'national treatment' obligations (but not expropriation) is fairly common. Article X of the BIT is part of a general BIT practice which expresses the logic of the tax-carve out provisions: expropriation, for the investor the most serious issue expressing its greatest vulnerability, is included albeit with many procedural limitations (described in Art. X(2)(c). Fair and equitable and national treatment, on the other hand, are excluded because here the balance between tax sovereignty and investor vulnerability is different; in both cases, intrusion into the 'regulatory space' of the state is greater, while the investor exposure is – at least generally – less so than in the expropriation scenario. This part of the reasoning of the *Occidental* tribunal should therefore be seen as an *obiter dictum* not necessary to support the – reasonable (though with some strains) – conclusion that the dispute included enough substance from the investment agreement and so was not excluded by the tax carve-out. The *El Paso–Argentina* jurisdictional award[97] disagreed with this very wide reading, but left its determination to the merits phase; it assumed jurisdiction on the basis that the claimant made a *prima facie* showing of a tax dispute that was expropriatory and in breach of an investment agreement.

The subsequent *Encana* v Ecuador award dealt with the same government conduct under more or less identical conditions as in the *Occidental* case, but there was one crucial difference: It was based on the Canada (not US)/Ecuador BIT. This BIT (Art. XII) had a similar, but more extensive tax carve-out: it only allowed tax-related claims about a 'breach of an agreement between the central government authorities . . . and the investor' – while the US-Ecuador BIT did not use such a restrictive notion of the 'investment agreement'. (The agreement in both case was with Petro-Ecuador, not the central government.) The full tribunal (including the on confiscatory tax dissenting co-arbitrator) had no difficulty of considering the claims as mainly tax-related – and thus excluded (apart from the expropriation element) by way of operation of the tax carve-out.[98]

The explicit narrowing down of the exemption from the tax-carve out to disputes about breach of 'agreements with central government' (i.e., whatever its status under international law, not with Petro-Ecuador) supports the tribunal's conclusion in the face of claimant efforts to present the claim as not in the main about tax, but about oil contracts.

It seems from both the *Encana* and *Occidental* awards that no contract drafters, advocates, tribunals or commentators have so far been able to fully come to grips with the operation of the 'adaptation' (i.e. economic re-equilibration) component of tax stabilization clauses.[99]

5. Taxation and expropriation – tax 'filter/veto'

The tension between the need to protect investor rights on one hand and the taxing powers of governments on the other is most intense when it comes to the expropriatory tax provisions of modern investment treaties. Modern complex tax system with endless add-ons for reasons of social, economic and financial engineering, of anti-avoidance method and because of an infinite number of political pressures and lobbying will have difficulty to stand up to exacting and perfectionist non-discrimination and 'fair and equitable' standards; investors have learnt to accept – at home as well as abroad – that tax systems are complex,

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[95] It is another issue that claimant apparently did not formulate its claim as centering on the investment agreement, but on the tax issue; some might say the tribunal here helped to improve on the advocacy of claimant, but then it could rely on the fact that respondent seemed to have accepted that the dispute includes the 'factor X' formulations in the investment agreement. It would be too formalistic to require a tribunal to have to stare slavishly at the way a claim is formulated when the substance arising out of claim and defense indicates the contours of the dispute.

[96] It does not help that the tribunal omits that the expression 'strive to accord' – itself not very persuasive of a legally binding commitment – is introduced by the word 'should' which, in comparison to 'shall', must generally be seen as qualifying the otherwise ambiguous 'strive to accord' as a hortatory phrase devoid of legal commitment.

[97] Paragraphs 100 *et seq*., in particular 110. The tribunal clearly does not concur with the wide reading of the Occidental tribunal assigning some sort of opaque justiciability to the 'strive to accord' clause:' claimant considers that the fair and equitable treatment clause . . . is enforceable, though precisely on what basis one does not know'.

[98] Paragraphs 141–167. In the *Enron v Argentina* award, the tribunal was ready to view a series of inter-related contractual instruments as constituting an 'investment agreement', thus conferring jurisdiction on it under the restricted tax-related jurisdiction clause of the US Model BIT. Decision on Jurisdiction, paras. 70 and 71.

[99] K. H. Berger, 'Renegotiation and Adaptation of International Investment Contracts: The Role of Contract Drafters and Arbitrators', in *Vanderbilt Journal of Transnational Law* 2003, at p. 1347; available on TDM (www.transnational-dispute-management.com). Two AIPN research project reports in 2006 – by P. Cameron and M. Maniruzzaman – deal with stabilization clauses, though not in the context of taxation. See also, M. Coale, 'Stabilisation Clauses in International Petroleum Contracts', Denv. J. Int'l. L. & Pol'y. (2001-2002), vol. 30, p. 217.

with some volatility and not perfect in terms of equality and justice. They even have learnt that business opportunities can be created by regulatory and tax changes (e.g. current solar and wind power and other non-renewable business booms),[100] but also be destroyed by such changes (e.g. prohibition of tax avoidance models often associated with mini-booms in particular areas, e.g. various building industry types or fiscal discouragement of other industrial and commercial activities for, say, environmental or health and safety reasons). But what is hard to accept for investors is 'undue surprise', i.e. governmental action, usually following visible or invisible political pressures, that disappoints the 'legitimate expectation' of an investor that a particular tax treatment will continue[101] and thereby destroys all or most of the economic value of the investment. The facts of the *Barcelona Traction*[102] and *Yukos*[103] cases illustrate this well.

Both cases illustrate how the tax system – and in particular its application – can be used by governments, typically in collusion between leaders of government, the national judiciary, the tax authorities and often the subsequent beneficiaries – to destroy the economic value of an investment under the cover of what appears on the surface and at first sight formally proper application of tax (or foreign exchange) audit, tax assessment and tax collection procedures. Investors have made experience with such velvet forms of legally camouflaged expropriations in particular after both World Wars and in the inter-war and post-war periods. Often or inevitably, it is authoritarian regimes with a political, ideological or racist agenda which use the 'tax screws' to finish off political opponents, foreign investors or undesirable ethnic businesses in a way that can be presented internally and internationally as nothing but the normal pursuit of 'law and order'. It is for these reasons that, whatever the reluctance of ministries of finance and tax authorities to let private parties, private counsel and international tribunals interfere in their conduct, confiscatory tax ('fiscal expropriation', 'expropriatory taxation') is usually the one concept that remains in investment protection treaties, even if frequently with procedural qualifications to let at least joint action by home and host state tax authorities acting in a spirit of collegiality and consensus defeat an investor claim.

The difficulties in distinguishing an indirect expropriation from legitimate regulation with a significant economic impact on the investor's property has led recently to efforts (mainly by the US and Canadian) model BITs to provide more specific criteria. These often borrow from comparative constitutional law (in particular US 'regulatory takings' jurisprudence). Comparative constitutional law (including EU, ECJ and US jurisprudence) provides an already highly developed set of criteria; it is thus helpful for defining the boundaries of indirect expropriation.[104] In essence,

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[100] An example is the various initiatives in the United States of America to encourage private investment in wind power projects by using various forms of financial incentives (such as tax credits and loans) and regulatory mandates (requiring utilities companies to buy their electricity from wind power companies) See, E. Smith, 'US Legislative Incentives for Wind-Generated Electricity: Sate and Local statutes', JENRL 2005, vol. 23, p. 173; H. Anderson, 'The Federal Production Tax Credit: Will its Expiration end the United states Wind Industry?', in *Environmental Law Institute (ELI): The Environmental Law Reporter* 2002, p. 1.

[101] E.g. the scenario in the *Nykomb v Latvia* case, published on TDM, where environmentally favourable co-generation investment was encouraged by an electricity tariff premium promised for eight years to compensate for the technology risk, but also to protect from competition from low-priced ('dumped') imported Russian nuclear power. The state promised the 'double-tariff' by law; the state enterprise was to implement it by mandatory double-tariff based purchasing. But its own economic interest – to rather purchase cheap than expensive electricity – prevailed; it was judicially compelled to pay national co-generators the premium tariff, but refused to pay this tariff to the – only – foreign co-generation investor, thus converting a reasonably profitable business model into a loss-making operation unable to recoup the capital investment.

[102] Extensively researched and vividly described in John Brooks, 'Annals of Finance', republished in TDM. The foreign-owned power company had been operating reasonably well throughout several wars. Juan March, a very successful Spanish businessman closely linked to the Franco regime bought up its foreign debt; he then arranged for the government to impose a foreign exchange repatriation restriction on the company so that it was faced with foreign debt it could not pay because it was not allowed to repatriate its domestic income. With influence or even full control over the judiciary, he then instigated a bankruptcy procedure against the company which at least formally appeared as unable to pay its debt and managed in a rigged tender to acquire the company on the cheap. This is not the 'normal' application of 'normally' complex tax rules, but an extraordinary event where the 'taking' was engineered by connivance between the government, judiciary and the ultimate beneficiaries of the taking. The *Barcelona Traction* experience is likely to have influenced the Comment in the authoritative US Restatement (3rd), para. 712, Commentator note g. After recognizing that 'normal' – 'bona fide general taxation' – is not an expropriation, the comment continues: 'if it is not discriminatory... and is *not designed to cause the alien to abandon the property to the state or sell at a distress price*'. These conditions were met in both the *Barcelona Traction* and the *Yukos* case (and several cases reported by Christie, n. 8 above).

[103] In the 2004 *Yukos* case, the Russian Government – angered by the political opposition of Mikhail Khodorkovsky, the main Yukos shareholder and its founder – attacked tax practices (that were widely practised and had been tolerated or accepted by the tax authorities); it made the tax authorities carry out a re-assessment, with penalties and interest charges amount in the end to about 100 per cent of total sales (not net profits) of the company in the relevant three-year period. It then prevented the company from selling its shares to pay such tax debt and arranged an auction where the only bidder was a sham company acting for the state company Rosneft. Rosneft, through the sham company, then bought at about 50 per cent of a biased valuation and at a fraction (say 10-20 per cent) of the true market value. For an analysis of the *Yukos* case see the published expert opinions, studies and comments published on TDM.

For an analysis of modern-day theory of 'state capture' by politically influential private interest groups to the detriment of the welfare of the general public, we refer here in particular to the works of Daniel Kaufmann and his colleagues at the World Bank Global Governance Institute, easily available at: www.worldbank.org.

[104] T. Waelde and A. Kolo, 'Environmental Regulation, Investment Protection and Regulatory Taking in International Law', ICLQ 2001, vol. 50, pp. 811–848; Jon Stanley, 'Keeping big brother out of our backyard: Regulatory Takings as Defined in International Law and Compared to American Fifth Amendment Jurisprudence', Emory Int'l. L. Rev. 2001, vol. 15, p. 349. The new US/Canadian efforts to formulate international indirect takings law largely in reflection of US takings' law follow the position we have taken in the 2001 published article: see mainly Annex 10 to the DR-CAFTA; Annex B to the US Model BIT (2004); Annex B13(1) to the Canada Model BIT (2004). However, other countries do not seem to have embraced the American and Canadian position yet in their treaty practice as none of their post-2000 BITs contain similar guidelines – e.g. UK-Angola BIT (2001); UK-Mozambique (2004); Germany-Nigeria BIT (2000); Germany-Cambodia (2001); Japan-Korea BIT (2003); Japan-Mexico FTAs (2004). One needs to be cautious, however, in fully equating 'indirect expropriation' rules with for example US takings' jurisprudence. US takings' jurisprudence is far from clear and as most jurisprudence includes a 'wider' and a 'narrower' approach. International law protection is not identical with national constitutional protection: It protects an alien in a more vulnerable position and intends to use the instrument of investment protection to encourage foreign investors to invest in a for them alien environment where their ability to participate in the political process and manage successfully the informal political, legal, institutional and commercial processes is usually less than those of their domestic competitors, see my separate opinion in: *Thunderbird v Mexico*, www.naftaclaims.com.

it is the three-level test: Substantial deprivation – disappointment of legitimate, investment-backed expectations – character of the government measure (itself including in our view the 'police power' inherent limits of property). This test now shows up not only in US and Canadian model BITs, but also increasingly in new BITs based on these models and arbitral jurisprudence.[105]

With regard to taxation, the – incomplete – provisions of the 1998 draft MAI reflect quite pertinent attitudes among at least (and presumably not only) the OECD Member States on a careful approach towards confiscatory tax claims: Article VIII of the draft MAI states, among other things that, the mere fact that a taxation measure is burdensome on an investment does not constitute expropriation if it is generally within the bounds of internationally recognised tax policies and practices; more so if the tax measure applies to all taxpayers.[106] The more a singling-out of individual investors (presumably in particular foreign investors) is present, the weaker the presumption in favour of the non-expropriatory character of the tax. That itself takes up suggestions in general expropriation law where 'disproportionate burden' and discriminatory singling-out, without legitimate reasons, of individual, in particular foreign, taxpayers raises 'red flags' pointing towards expropriation.[107]

The draft MAI provision takes up a theme that one can also identify in 'Harvard Draft'[108] which sought to formulate the international law standard for indirect expropriation (Art. 10(3)):

> 'A "taking of property" includes not only an outright taking of property, but also any such *unreasonable interference* with the use, enjoyment, or disposal of property as to justify an inference that the *owner thereof will not be able to use, enjoy*, or dispose of the property within a reasonable period of time after the inception of such interference' (emphasis added).

Article 10(5) contains the significant qualification and specification:

> 'An uncompensated ... deprivation of the use or enjoyment of property of an alien which results from the *execution of the tax laws*; from a *general* change in the value of the currency; from the actions of the competent authorities of the State in the maintenance of public order, health or morality; ... shall not be considered wrongful, provided: (a) it is not a clear and *discriminatory violation of the law of the State* concerned; ....(c) it is *not an unreasonable departure from the principles of justice recognized by the principal legal systems of the world*; and (d) it is not an *abuse of the powers* specified in this paragraph for the purpose of depriving an alien of his property' (emphasis added).

The distinction between more general (and thus less likely to be expropriatory) and more specific (and thus with a 'red flag') taxation also appears in the US Restatement:

> 'A State is responsible as for an expropriation of property under subsection (1) when it subjects alien property to *taxation*, regulation, or other action that is confiscatory, or that prevents, unreasonably *interferes* with, or unduly delays, *effective enjoyment* of an alien's property. (...).[109]

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[105] E.g. the *Metalclad v Mexico*; *CME v Czech Republic*; *Tecmed v Mexico* awards. For a review of arbitral jurisprudence with respect to indirect expropriation: See C. Chreuer, 'The Concept of Expropriation under the ECT and other Investment Protection Treaties', followed by an instructive comment by K. Yannaca-Small, in C. Ribeiro (ed.), *Investment Arbitration and the Energy Charter Treaty* (Arbitration Institute of Stockholm Chamber of Commerce, 2006), p. 118; Yves Fortier and St. Drymer, 'Indirect Expropriation in the Law of International Investment', ICSID Rev.-FILJ 2004, vol. 19, p. 293 at p. 321; J. Paulsson and Z. Douglas, 'Indirect Expropriation in Investment Treaty Arbitrations', in N. Horn and S. Kroll (eds.), *Arbitrating Foreign Investment Disputes: Procedural and Substantive Legal Aspects* (Kluwer, 2004), p. 145; A. Newcombe, 'The Boundaries of Regulatory Expropriation in International Law', ICSID Rev.-FILJ 2005, vol. 20; OECD, Indirect Expropriation, 2005, available at:www.oecd.org/investment.

[106] Note here also the reflections of the *Encana v Ecuador* tribunal, para. 142 on the 'general' nature of taxation: 'The question whether something is a tax measure is primarily a question of its legal operation, not its economic effect. A taxation law is one which imposes a liability on classes of persons to pay money to the state for public purposes'. That suggests a priority of form over substance – and a readily available instrument to disguise actions against individuals (e.g. the *Yukos* and *Barcelona Traction* cases referred to earlier) as something that is 'general' in nature. The *Encana* tribunal did hedge therefore its formalistic approach: 'An arbitrary demand unsupported by any provision of the law of the host state would not qualify ...' (as a tax measure covered by the tax carve-out in the underlying BIT).

[107] It is useful to recall the pertinent interpretive note:

'When considering the issue of whether a taxation measure effects an expropriation, the following elements should be borne in mind:

a) The imposition of taxes does not generally constitute expropriation. The introduction of a new taxation measure, taxation by more than one jurisdiction in respect to an investment, or a claim of excessive burden imposed by a taxation measure are not in themselves indicative of an expropriation.
b) A taxation measure will not be considered to constitute expropriation where it is *generally within the bounds of internationally recognised tax policies and practices*. When considering whether a taxation measure satisfies this principle, an analysis should include whether and *to what extent taxation measures of a similar type and level are used around the world*. Further, taxation measures aimed at preventing the avoidance or evasion of taxes should not generally be considered to be expropriatory.
c) While expropriation may be constituted even by measures applying generally (e.g., to all taxpayers), such a general application is in practice less likely to suggest an expropriation than more *specific measures aimed at particular nationalities or individual taxpayers*. A taxation measure would not be expropriatory if it was in force and was *transparent* when the investment was undertaken.
d) Taxation measures may constitute an outright expropriation, or while not directly expropriatory they may have the equivalent effect of an expropriation (so-called "creeping expropriation"). Where taxation measure by itself does not constitute expropriation it would be extremely unlikely to be an element of a creeping expropriation' (emphasis added).

[108] 'Convention on the International Responsibility of States for Injuries to Aliens' by Professors Baxter and Sohn, reprinted in AJIL 1961, vol. 55, p. 545 (Walde is grateful for having served as Professor Baxter's research assistant and been Professor Sohn's student).

[109] American Law Institute, *Restatement of the Law Third, The Foreign Relations Law of the United States*, vol. 2 (1987), pp. 196, 200; B. Clagett and D. Poneman, 'The treatment of Economic Injury to Aliens in the Revised Restatement of Foreign Relations Law', Int'l. L. 1988, vol. 22, p. 35.

A state is not responsible for loss of property or for other economic disadvantage resulting *from bona fide general* taxation, *regulation* forfeiture for crime, or other action of the kind that is *commonly accepted as within the police power of states*, if it is *not discriminatory* (...) and is *not designed* to cause *the alien to abandon the property to the state or sell it at a distress price*'[110] (emphasis added).

We find the same the same reference to 'normal' government conduct (one should add the implied qualification of 'well governed countries' – something that was more explicit in the now obsolete earlier notion of 'civilized nations' that is now replaced by the 'principal legal systems of the world', in post-2004 US BIT practice (Art. 5) with its reference to the principal legal systems of the world, i.e. the general principles of international and comparative administrative (and thus also tax) law. The scrutiny of a tax practice asserted by claimant to breach an investment treaty discipline – and in particular the expropriation standard – thus will in most cases involve a benchmarking against 'good' and 'normal' tax practice in developed systems of law. These provide the yardstick to identify significant deviation; while a deviation may by itself express nothing by acceptable idiosyncracies of national law and legal culture, they come with a 'red flag'. It is then the government's burden to persuade and prove that such deviation is legitimate.

With the help of such authoritative instruments we can conclude that 'normal' state practice in countries seen as well governed[111] is unlikely to constitute an expropriatory taking; it rather reflects the toll that investors have to accept as a price for doing business and for getting access to the infrastructure of the host state's economy and society at large. On the other hand, when taxation goes beyond what is 'normal', a red flag attaches itself to such measure and the expropriation test (economic impact – legitimate expectation – character of the measure) need to be applied fully. The more a tax measures is 'out of the ordinary' – as compared to the tax practices of well-governed countries, the more there are elements of discrimination and singling-out which are not based on legitimate reasons as compared to a general tax measure and the more intentions (which can be read out of the design and architecture of the tax measure) to deprive foreign investors can be identified, the more the likelihood of an expropriation emerges. A tax or tax enforcement that singles out a particular investor (or group of investors)[112] becomes suspect, in particular if such singling-out and discriminatory enforcement correlates with political opposition between that investor and the powers controlling the state; the same applies when there are substantial indications that the tax discrimination (facially in law and *de facto* in prosecution, auditing and enforcement practice) is based on racial prejudice,[113] association of the foreign or domestic investor(s) with the former government or exclusively or primarily foreign-ownership (and ownership from specific countries with which the host state is in a hostile relationship). In such cases, the burden of showing a 'legitimate reason' has to be much higher than in cases of differentiated tax treatment where no particular suspect reason for the differentiation is available. It is possible to distil from such principles – or rather guidelines for assessing the tax and balancing the criteria for and against its expropriatory character – a system of presumptions (involving a burden of proof and legal persuasion). As 'red flags' attach themselves to a tax measure, the burden of proof and legal persuasion is on the taxing state to show that the measure is not discriminatory, has legitimate reasons and is not intended to harm foreign investors and carry out expropriation in legally camouflaged ways.

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[110] The latter situations referred to – a strategy to use tax and foreign exchange restrictions to force the alien to sell at a distress price (including contrived bankruptcy) are likely to refer to the *Barcelona Traction* experience then of recent date – and they would now be used to examine the *Yukos* case with its tax-induced sale of the company's major assets in a rigged tender at a distress price.

In the only tax-related case decided by the Iran-US Claims Tribunal, it was held the seizure of the claimant's liquor license and other properties by the US Inland Revenue Department in order to meet his tax liabilities did not amount to expropriation. *Too v Greater Modern Insurance Associates & the USA*, 23 Iran-US CTRT 378. *Gasus-Dossier v Netherlands* (1995) 20 EHRR 304 (decided under Art. 1, Protocol 1 of the European Convention on Human Rights) involving the seizure of a concrete mixer by the tax authorities in satisfaction of the buyer's tax liability where upon the court held that the seller cannot recover the property or compensation from the tax authorities even though he did not transfer legal title in the property to the buyer at the time of sale. The tax authorities' conduct was held not to be in violation of Art. 1 of Protocol 1 of the European Convention on Human Rights.

[111] The criterium of good governance is not that difficult to determine; it continues the now taboo qualification of 'civilised nations' (still found in Art. 38 of the ICJ statute) which has morphed into the 'principal legal systems of the world' in the new model US BIT. There are enough governance-ranking surveys (World Bank, EBRD; Transparency International; competitiveness surveys) which allow to define quite easily the upper echelon of what should be regarded as well-governed legal systems thus suitable for serving as a benchmark.

[112] Note the identification of the 'oil companies' as relevant group of investors in *Occidental v Ecuador* (itself not an unproblematic concept in the context of that particular case).

[113] In interpreting taxation provision of the US-Moldova BIT in the case of *Link-Trading v Moldova*, the arbitral tribunal noted that, 'not all fiscal measures necessarily constitute an expropriation, although their habitual effect is to cause the tax payer to surrender part of his income or property to the state. As a general matter, fiscal measures only become expropriatory when they are found to be an abusive taking. Abuse arises where it is demonstrated that the state has acted unfairly or inequitably towards the investment, where it has adopted measures that are arbitrary or discriminatory in character or in their manner of implementation, or where the measures taken violate an obligation undertaken by the state in regard to the investment' (para. 64); *Waste Management II v Mexico*, para. 99 with its reference (for Art. 1105 and thus, see *Feldman v Mexico*, relevant for the indirect expropriation analysis, to 'sectional and racial prejudice' 'arbitrary' and 'discriminatory'. A similar view has been expressed by Rosalyn Higgins and Sornarajah: R. Higgins, 'The International Law Perspective', in T. Daintith (ed.), *The Legal Character of Petroleum Licences: A Comparative Study*, (CPMLS, Dundee, 1981), pp. 35 and 56; *ibid*., 'The Taking of Private Property by the State: Recent Developments in International Law' (RDC-Collected Course (1982-III)), pp. 259 and 350; M. Sornarajah, *The International Law of Foreign Investment*, 2nd edn (Cambridge Univ. Press, Cambridge, 2004), pp. 393–394.

A. Recent arbitral jurisprudence on expropriatory taxation

There are few earlier awards dealing with taxes;[114] their relevance is less than modern treaties, the accompanying authoritative instruments (e.g. US Restatement, OECD Model Convention; MAI; Harvard Draft; World Bank Guidelines) and in particular recent arbitral jurisprudence. The modern practice can be understood as rejecting – at times quite explicitly and directly – the traditional public international law approach expressed, for example, in the 1932 *Kuegele v Polish State* case which completely exempted taxation from the here applicable treaty's scope.[115] One needs to appreciate that, to employ Philipp Bobbitt's terminology,[116] the earlier cases are embedded into the context and spirit of the extreme emphasis (if not obsession) with the nation state; touching tax powers meant touching the most sensitive part of the nation state. External and independently enforceable disciplines on states' tax powers are rather an indication of the gradual, and far from smooth, transition from the nation state to its modern form of market states. Subordination to international disciplines provides a competitive advantage to market states; simultaneously, it reinforces the effectiveness of domestic economic reform. The contrast between the post-World War I *Kuegele* case and the post-2000 *Feldman* case illustrates thus the transition from the pure nation state focus to acceptance of the new paradigm of market states in international economic law.

In recent arbitral jurisprudence, expropriatory jurisprudence has only been dealt with in few awards. In the earlier *Revere Brass and Copper* case the tribunal (as we discussed earlier) found expropriation because of the imposition of a new 'production tax' ('bauxite levy') contrary to a tax stabilisation clause. This case – often and incorrectly cited to support a narrow indirect expropriation concept – to the contrary marks a very extensive application. The tribunal (with a dissent) considered this tax expropriatory though the operation remained profitable and under factual control of the investor. The tribunal, operating under the then more narrow OPIC insurance contract which provided coverage only for expropriation, not for breach of contract, thus shoehorned the breach of contract into the expropriation concept. It should stand as authority that interferences into investors' right with a lesser economic impact can still be seen as expropriatory when a new tax breaches a prior tax stabilization guarantee. It should not, however, be seen as providing any authority for the proposition relied upon in both the *Methanex v US* and *Encana* v Ecuador awards that a regulatory measure (including a tax) becomes expropriatory only if contrary to a prior specific tax stabilisation commitment.

In *Encana* v Ecuador, the tribunal required, for 'indirect expropriation', that a tax law be 'extraordinary, punitive in amount or arbitrary in its incidence'.[117] It relied for its very restrictive result on the *Kuegele v Polish State* case of 1932[118] as the only precedent available that 'general' taxation can not constitute expropriation. But a review of the *Kuegele* decision suggests (on very bare facts reported) that the investor here was subject to an increase in license fees that appears to have been made in order to drive him out of business. It is questionable if such precedents (same as the often quoted *Oscar Chinn* case) are still relevant and have not been in effect superseded and revoked by the express references in authoritative instruments such as the Harvard Draft, the OECD Model Agreement, the US Restatement, the draft OECD MAI and the inclusion of in particular expropriatory taxation in most investment treaties to the fact that taxation should be considered expropriation if it has an effect equivalent to a taking. In particular, this practice – started in the 1950s and fully developed since the 1960s[119] – suggests an outright rejection of the position of the *Kuegele* tribunal that if something is labelled tax, then it cannot be expropriation as the 'trader' – at least in theory – could continue his trade and pay the tax. That such a disregard of the economic consequences of tax – in particularly if made intentionally to force a foreign investor to close down an operation – was even at the time – in 1932 – not considered tenable any more is evidenced by the in effect highly critical commentator's (and by no less than Hersch Lauterpacht) note in the *Kuegele* case which is worth quoting (and not mentioned in the *Kuegele* reference in the *Encana* award): 'But there is room for the view that an acquired right, protected by law, may become illusory and the object of a treaty defeated as the result of administrative action, including taxation'.

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[114] For a review, see in particular S. Manciaux, see n. 4 above – discusses a 1962 (it seems) inter-state arbitral commission decision – *Epoux Gilis v RFA* where a very far-reaching tax (over 50 per cent of net asset value) was not considered confiscatory as payment was stretched over 30 years. Coussirat-Coustere and P.Eisemann, *Repertoire de la jurisprudence arbitrale internationale* (Nijhoff Publishers, 1991), p. 902.

[115] R. Dolzer, 'Indirect Expropriations of Alien Property', *ICSID Review* 1986, p. 41, at p. 63, cites one case of confiscatory taxation – a rate of 99 per cent in Burma (now Myan-Mar) on certain gains.

[116] *The Shield of Achilles* (2003).

[117] Paragraph 177.

[118] At para. 176 and footnote 126; *Kuegele v Polish State* (1932), 6 ILR 69 (Upper Silesian Claims tribunal). Commented on by G. Kaeckenbeeck, 'President of the Tribunal', in *The International Experiment of Upper Silesia* (OUP, 1942), at pp. 116 and 117.

[119] See the references of the thinking underlying the emergence of investment protection instruments since about 1957 in T. Waelde, 'The 'Umbrella' Clause in Investment Arbitration', JWIT 2005, vol. 6, p. 183.

In *Occidental v Ecuador*, the tribunal was much more reticent than the *Encana* tribunal with respect to the quality of the 'tax refund right' to constitute an 'investment' protected against expropriation (para. 86). It did not separate the tax refund right out of the overall investment consisting of a bundle of property rights but rather looked at the economic effect of the denial of the tax refunds on the overall investment. This examination of the economic effect indicated that the overall investment was doing well and thus not 'substantial economic deprivation' took place (paras. 88 and 89). The tribunal's restrictive approach towards indirect expropriation was perhaps facilitated by the fact that it was not precluded (as the *Encana* tribunal was) to accept the claim for breach of national treatment/discrimination.

A comparison between both awards is instructive for several reasons. The *Encana* tribunal, by focusing on the tax refund right per se instead of looking at the overall 'economic unity' of the investment, would have been able to find a right that could be taken by direct expropriation, but used the lack of various criteria (bad-faith, 'final repudiation', obstruction of access to courts) to reject a conclusive 'taking'. The *Occidental* tribunal – in the end favourable to claimant – could afford to reject the expropriation claim – a frequently used satisfaction provided by tribunals to otherwise losing respondents, as it had been able to construct a jurisdictional and merits reasoning for the national treatment claim.

In *Goetz v Burundi*[120] the issue was a license to operate in an economic free zone entailing tax and import duty rebates. That license was withdrawn with prospective – not retrospective – effect. The tribunal considered the withdrawal of the license as an indirect expropriation under the applicable BIT. The case suggests that – except where specifically so regulated in the treaty – there is no particular respect due for tax-related measures; that is quite different from the *Encana* tribunal which placed a substantial number of additional conditions into the expropriation test, even if a tax-related pre-existing right was repudiated by the government and even if the repudiation by the government created a retrospective effect.

In *Link-Trading v Moldova*, the dispute concerned the withdrawal by the government of customs and tax exemption (contained in the country's investment law) granted to the claimant's retail customers for purchases of goods made in an economic free zone where the claimant conducted its business. The change in the customs and tax regime had a negative effect on the claimant's profitability for which it claimed compensation for alleged indirect expropriation. After analysing the parties' submission, the tribunal concluded that the disputed measure did not amount to an indirect expropriation of the claimant's investment. It noted that although indirect expropriation might occur through taxation measures, such a finding can only be made when the measures were found to be an 'abusive taking' which was not so in this case. According to the tribunal, the disputed changes were neither arbitrary nor discriminatory. Instead, they were changes of general application not directed specifically against the claimant. Further more, the tribunal found that the changes did not 'place the claimant in a worse competitive position than any other similarly situated businesses in Moldova'.[121]

Feldman v Mexico contains, next to *Encana*, the so far most extensive modern discussion of indirect expropriation and taxation. Different from *Encana*, which relies mainly on the 'direct expropriation' concept, the *Feldman* tribunal considered that indirect expropriation was the natural concept to apply to taxation.[122] It carried out an extensive analysis with considerable sympathy for the possibility of an indirect expropriation; in the end, it declined to award on the basis of Art. 1110 of NAFTA (expropriation) and chose instead Art. 1102 (national treatment). Reviewing the jurisprudence of other tribunals that grappled with the indirect expropriation concept (mainly *Pope-Talbot v Canada*), the tribunal focused on the existence of an acquired 'right'. If the acquired right were, in its economic impact, seriously affected, then, so one can read the award, it would have found an indirect expropriation. But it considered in the end that Feldman did not have an acquired right to receive a VAT refund under the specific circumstances of the case – a 'gray' market and unsatisfactory accounting for VAT paid, but rather a mere commercial expectation dependent on the evolution of the regulatory regime, but which had not grown into a secure legal right or a legitimate expectation that government conduct (at one time they paid a VAT refund) would remain stable. Furthermore, it saw no interference into the investor's control over his business. One should quote here the degree to which, in the tribunal's view, taxpayers have to tolerate inconsistent conduct by tax authorities:

> 'Unfortunately, tax authorities in most countries do not always act in a consistent and predictable way... As in most tax regimes, the tax laws are used as instruments of public policy as well as fiscal policy

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[120] Note paras. 102 and 124 in particular.

[121] Paragraph 72. The *Link-Trading* case is significant in the sense that, it indorsed the three-pronged criteria (economic impact, breach of investment-backed expectations, and discrimination) for determining indirect expropriation. However, with regard to breach of prior commitment (investment-backed expectation or acquired right), the tribunal held that the commitment that was breached, must have been made to the investor himself and not to third parties (such as suppliers, purchasers or contractors etc.) that have business ties with the investor.

[122] Paragraph 101: 'By their very nature, tax measures, even if they are designed to and have the effect of an expropriation, will be indirect, with an effect that may be tantamount to expropriation'.

and certain taxpayers are inevitable favoured, with others less favoured or even disadvantaged.'[123]

A review of the expropriation discussion in the award suggests three criteria that the tribunal thought key for determining expropriation:

1. the existence of an acquired right;
2. a restriction that is 'sufficiently restrictive' (with reference to *Pope-Talbot*); and
3. a finding that the authorities – legislative, administrative or judicial – behaved in a 'discriminatory or arbitrary (or perhaps unfair or inequitable) way.[124]

It would tend to be more ready to find indirect expropriation if one of these standards were breached in a particular intensive way – with a lessening of the intensity of breaches with respect to other criteria; it would also (referring to *Metalclad v Mexico*) be more ready to find an indirect expropriation if there was a breach of legitimate expectations (though the term is not used explicitly) created in particular by specific assurances without extensive ambiguity and on their face not inconsistent with Mexican law.[125] The *Feldman* tribunal considered the assurances received by Feldman (if at all) 'at best ambiguous and largely informal'. The treatment suggests that a breach of properly ascertained 'legitimate expectations' weighs heavily towards a finding of expropriation while an absence of such expectations, or their lack of reasonableness and legitimacy, will weigh against claimant.[126]

It is instructive to compare *Feldman* with the *Encana* award. On the basis of the *Feldman* criteria, *Encana* should have led to a finding of indirect expropriation: there was an acquired right, a legitimate expectation based on past conduct by Petro-Ecuador and the tax authorities and, it appears, underlying a transparent tender for the contracts with Ecuador. Feldman does not require bad-faith and/or the final, definitive, comprehensive repudiation by the administration and the courts which the *Encana* tribunal required.[127]

In *CSOB v Slovak Republic*,[128] an argument over taxes played a role, but only in the context of damages; respondent argued that had it complied with its obligations earlier, the claimant would have had to pay more taxes; that should, in its view, reduce the damages claim. The tribunal did not accept this tax-savings by way of breach of international obligation argument. In the *EL Paso v Argentina* jurisdictional award, the tribunal indicated that for an expropriatory tax claim, the taking of a 'specific legal right' was required;[129] is also found, at least for jurisdiction, enough connection between the tax-related dispute and the investor's concessions – here concluded with state-owned entities and granting 'rights to natural resources belonging to the host state'.[130]

B. The 'tax filter': joint tax consultation or joint tax veto as limitation on the expropriatory tax discipline

A very distinctive feature of the regulation of tax measures in modern investment treaties is the 'joint tax consultation', sometimes amounting to a 'joint tax veto' by the two tax authorities. This mechanism reflects again the particular sensitivity of the tax issue and the reluctance of the tax authorities to let outsiders – private parties, counsel and tribunals – participate in the international tax instruments 'owned' by the tax authorities in an inter-governmental forum. It is recognised that expropriatory taxation can be a particularly insidious way to take property in ways that look on the face lawful, but on the other hand the tax authorities do not want even in this egregious case give up their powers. This has led, in treaty formulations, to various forms for interposing the tax authorities (primarily acting jointly) between the parties and a tribunal. Either a joint tax consultation is, with recommendatory or binding effect of some sort, required before an investment claim becomes admissible or a 'joint tax veto' where the tribunal's power to determine the expropriatory character is in effect assigned to the two tax authorities acting jointly. This introduces an element of politics, as implicit in traditional diplomatic protection – an element to subordinate the adjudicatory power of investment treaty tribunals to the power of the governments when they act jointly. It recalls the power of the NAFTA Commission to issue legally binding interpretations to tribunals[131] and similar powers to issue legally binding

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[123] Paragraph 113.

[124] Paragraphs 99 and 141.

[125] Paragraphs 147, 148 and 149.

[126] See *ADT v Hungary* (2006), para. 304: a regulatory action having the effect of making contractual rights worthless were considered to be expropriatory; the fact that claimants 'legitimate expectations were thwarted' was identified by the tribunal as a key determinant in its analysis.

[127] Though the *Feldman* tribunal did suggest that getting a formal legal clarification from the competent government authority or recourse to a court would have helped to establish an acquired right – that then can be seen as being expropriated. (paras. 149 and 124). Different from *Encana*, it seems to have tried to use such recourse – administrative or judicial – as ways to establish if there was an acquired right or legitimate expectation.

[128] Paragraphs 365–368).

[129] Paragraph 107.

[130] Paragraph 108.

[131] Discussed in detail in the *Pope-Talbot v Canada* damages award.

opinions to tribunals of new US investment treaty models.[132]

The major investment treaties (NAFTA, ECT, DR-CAFTA) including the US-Uruguay BIT, US Model BIT (2004), Canada Model BIT (2004) and Japan-Mexico FTA,[133] vest in the competent tax authorities the power to filter or veto a complaint by the foreign investor alleging expropriation arising from a taxation measure adopted by the host state. In essence, the treaties require the investor to refer its complaint of expropriatory taxation to the tax authorities prior to or at the time of initiating the arbitration process. The tax authorities are given a time limit (six or nine months) within which to decide whether the taxation measure is not expropriatory[134] failing which the investor may proceed with the arbitration.[135] Thus, although the competent tax authority procedure cannot be used by the host state to unduly delay the arbitration, nevertheless, it may effectively prevent a purely legal issue from being determined by an arbitral tribunal.

To sum up, the expropriatory provisions of the more recent investment treaties reflect the tensions and conflicts between those who wish to preserve and possibly extend international disciplines on the tax and regulatory power of states on one hand and those – presumably in the main tax authorities, nationalistic governments and NGOs – who seek to minimize the impact of international, treaty-based disciplines on the domestic political process, i.e. a tension that is well illustrated in the 'Federalist papers' debate concerning the US constitution, i.e. between those in favour of a rule of law protecting minorities against favouring extensive constitutionally not checked powers of majority rule arising out of the political process.[136] In making a finding of confiscatory tax/indirect fiscal expropriation, it is not only the impact of the measure, but also the disappointment of legitimate expectations and the conformity (or not) of the tax measure at issue with accepted tax practices in the major legal systems which are determinative.

C. Taxation and transparency

As part of the increasing liberalisation of investment legislation and protection of foreign investors, a number of investment treaties impose on the Contracting Parties the obligation to make public their laws, regulations, judicial and administrative decisions and rulings relating to investment, and to promptly respond to inquiries from interested foreign investors.[137] Some investment treaties further require parties to receive and consider comments from interested individuals and groups regarding proposed legislation so as to enable those to be directly affected by the proposed legislation have a say in the law-making process.[138] These are general requirements of transparency which might not be directly applicable to taxation matters under such treaties in view of the exclusion of tax matters from coverage under most investment treaties; however, they will inform the way the generally applicable good-faith principle is applied to tax matters from which it is not, and arguably can not, be excluded. The 2002 Japan-Korea BIT and the draft MAI expressly provide that the

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[132] See here the new US–Peru/Colombia Agreements, Art. 10.21(3); Art. 10.23: 'Where a respondent asserts as a defence that the measure alleged to be a breach is within the scope of an entry set out in Annex I or Annex II, the tribunal shall, on request of the respondent, request the interpretation of the Commission on the issue. The Commission shall submit in writing any decision declaring its interpretation under Article 20.1.3 (Free Trade Commission) to the tribunal within 60 days of delivery of the request'. This mechanism allows a defendant state, facing a legal interpretation unfavourable to it, to try to persuade, within a fixed period, to rally the other states to its defence and thus decide the legal issue in lieu of the tribunal. As there is likely to be a collegial give-and-take between states, this mechanism creates considerable asymmetry in the equality at arms between claimant and respondent – and seems modelled on the joint tax veto mechanism. A decision issued by the Commission under para. 1 shall be binding on the tribunal, and any decision or award issued by the tribunal must be consistent with that decision. If the Commission fails to issue such a decision within 60 days, the tribunal shall decide the issue.

[133] NAFTA Art. 2103(6); EC Treaty Art. 21(5); DR-CAFTA Art. 21.3(6); US-Uruguay BIT Art. 21(3); US Model BIT (2004) Art. 21(2); Canada Model BIT Art. 16(4); Japan-Mexico FTA (2004) Art. 170(4). The procedure of 'reference' by domestic courts to the European Court of Justice under Art. 234 of the EC Treaty could be seen as comparable as well, but it is here to a proper judicial organ, and not two fiscal administrations.

[134] It is important to note that under NAFTA Art. 2103 the tax authorities can only give a 'negative opinion' – that the tax measure is not expropriatory, not that it is 'expropriatory' (that would, in view of the respondent state's normal position defending its tax measures not be likely anyway).

[135] For instance, under Art. XIII US-Azerbaijan BIT (1997), once the tax authorities have decided that the taxation measure is not expropriatory, the investor 'cannot submit the dispute to arbitration'. But it is not clear whether a negative decision by the tax authorities under NAFTA and the other investment treaties does have a similar effect or it will only have a persuasive effect on the arbitral tribunal. Under the Energy Charter Treaty (Art. 21(5)), the decision by the tax authorities only has (albeit quite powerful one) a persuasive effect (in that the arbitration tribunal is enjoined to 'take into account any conclusion arrived at by the competent tax authorities'), unlike that arrived at under NAFTA, DR-CAFTA or the Canadian Model BIT which is probably binding on both the tribunal and the investor. On arbitration of tax-related disputes under the ECT, see W. Park, Tax Arbitration and the Energy Charter Treaty (forthcoming).

[136] See Ron Chernow, *Alexander Hamilton* (2004) which includes a discussion of the debate in the Federalist papers; Jack Rakove, *Original Meanings, Politics and Ideas in the Making of the Constitution* (Vintage Books, New York, 1977). This debate continues between the proponents of investment arbitration (as well as WTO and even human right) as international adjudicated disciplines on political, regulatory and administrative conduct in host states and those who advocate a minimalist approach against such external control as unwarranted intrusion into the domestic political process and regulatory space. E.g. several key papers on that position (von Moltke, H. Mann) on www.iisd.org.

[137] OECD, *Policy Framework for Investment* (2006), at p. 23; OECD, *Fair and Equitable Treatment* (2004), pp. 37–39 available at www.oecd.org/investment; UNCTAD, *Fair and Equitable Treatment* (1999), p. 51; Unctad, *Transparency* (Geneva, 2004), p. 71 available at www.unctad.org; Waelde's Separate Opinion in the Thunderbird – *Mexico NAFTA* case – www.worldbank.org/icsid - includes an extensive discussion of the sources of transparency as a modern expression of the traditional good-faith principle in international law, including a review of relevant recent arbitral jurisprudence, e.g. *Maffezini v Spain*, *Tecmed v Mexico*; *OEPC v Ecuador*, *MTD v Chile*; see also the detailed dissenting opinion of Grigera Naon in the *Encana v Ecuador* case.

[138] E.g. Art. 12.11 DR-CAFTA; Art. 19 Canada Model BIT (2004); Art. 20 EC Treaty; Art. 1802 NAFTA; Art. XVI(2) Canada-Ukraine BIT (1994) (and same Art. in the Canada-South Africa, Canada-Armenia, and Canada-Latvia respectively); Art. 15 Japan-Russian Federation BIT (1998); Art. 3(2) Lithuania-Kuwait BIT; UNCTAD, Transparency (2004), n. 137 above; OECD, *Policy framework for Investment* (2006), n. 137 above, pp. 66–67.

provisions on transparency shall apply to taxation measures.[139] Article VIII(3) of the draft MAI states that, the transparency provision of the treaty shall apply to taxation measures, except that no party is obliged to disclose confidential information regarding a taxpayer as provided for under the country's domestic laws or international agreements.

Transparency, and, in its wake, the concept of legitimate expectations as a generally recognised principle of comparative administrative law of the principal legal systems of well governed countries, of international public law and international investment law, are therefore part of the legal order established by investment treaties applicable to tax matters – irrespective of the fact that some specific treaty disciplines – e.g. fair and equitable treatment or national/most favoured treatment – may be excluded from application to tax-related investment disputes. The rationale behind the application of these principles to guide the application of the treaty's specific disciplines is to contribute to rule of law[140] and prevent a manifest and substantial abuse of power by governments against foreign investors. That is part of the good-governance role of investment treaties; by external disciplines, they aim not just at protecting specific investors, but help host states upgrade their legal regime – both in formal and in substantial, practical terms.[141] The point of applying the transparency and legitimate expectations principles is to prevent host states from springing surprises on unwary or unsuspecting foreign investors and to curb possible abuse of tax legislation (especially through reinterpretation and rulings by tax authorities) in a manner that would adversely affect the economic interests of foreign investors. While international law is not meant to 'freeze' domestic regulation from evolving reasonably and in line with accepted standards, the principles of transparency and legitimate expectations are meant to keep the state from abusing its dual power as both seller/contract party and as sovereign regulator in undoing the terms of deals agreed upon freely. States have numerous possibilities at their disposal – enacting new law with retroactive effect, using their control over administrative agencies and courts to bring in a surprising fundamental re-orientation of the law under which the investment was made or applying existing law in a way that singles out the foreign investor(s) in a detrimental way to satisfy domestic political agitation. Legal certainty, transparency and reasonable respect for – reasonable – legitimate expectations are hence the essential constituents of the 'rule of law' in practical and effective, rather only in nominal and formalistic terms. The main concern therefore is, stability of the legal and business framework under which the investment was made and the protection of the legitimate expectations of the foreign investor.[142]

The application of tax law has to be constrained by the generally recognised principles of transparency, legal certainty and legitimate expectation. These principles can be based on the over-arching 'good-faith' principle of international law, but they are also nothing but key components of the modern concept of 'rule of law' and 'good governance'. It is nothing more but a modernization of standards that have been expressed over and over in authoritative international instruments (e.g. the Harvard Draft, the Commentaries to the OECD investment Model Agreement, the US Restatement, the World Bank Foreign Investment Guidelines, the draft MAI) and in modern arbitral jurisprudence. These principles also do not fall from the air or the interpreters' head: Most or all investment treaties explicitly mention liberalization of investment conditions and promotion of investment by greater predictability, certainty and transparency. It is sufficient to take the Preamble of the NAFTA (predictable commercial framework for business planning and investment), its list of objectives (promote conditions of fair competition, increase substantially investment opportunities) or the Energy Charter Treaty ('create a climate favourable to the flow of investment', 'a transparent and equitable legal framework for foreign investments' or a 'stable and transparent legal framework')[143] These objectives have, in accordance with Art. 31 of the Vienna Convention on Treaties, to guide the application of treaty disciplines to tax-related investment disputes. Comparative tax law thus serves as a tool to identify

Notes

139 Article 19(2) Japan-Korea BIT states that the provision on transparency together with the fair and equitable treatment standard and other specified obligations shall apply to taxation measures. By Art. 7(1) of the Treaty, 'each contracting party shall promptly publish, or otherwise make publicly available, its laws, regulations, administrative rulings and judicial decisions of general application as well as international agreements which pertain to or affect investment and business activities'. Under para. 2, 'each contracting party shall, upon request of the other contracting party, promptly respond to specific questions and provide that other contracting party with information on matters set out in paragraph 1 of this treaty'.

140 B. Tamanaha, *On the Rule of Law* (2004); S. Schill, *Fair and Equitable Treatment under Investment Treaties as an Embodiment of the Rule of Law*, IILJ Working Paper 2006/6, available at www.iilj.org.

141 T. Waelde, 'Investment Arbitration as a Discipline of Good Governance', in T. Weiler (ed.), *NAFTA. Investment Law and Arbitration* (Transnational Publishers, 2004).

142 For instance, in *Occidental v Ecuador*, the tribunal held that the reinterpretation of the tax law by the tax authorities and the demand on the claimant to pay back previous VAT refunds was inconsistent with the host state's international obligation not to alter the business and legal environment in which the investment had been made. Paragraphs 273–274. Although the tribunal did not expressly mention transparency, it is implicit from the decision that it was based on the principle which as we noted earlier, is an element of the fair and equitable treatment standard. Even the *Encana v Ecuador* tribunal – which in the end rejected the investor's claim (arguing it should have formulated its claim rather based on its economic stabilisation clause with Petro-Ecuador than as a tax-related claim), highlighted in careful analysis the various ways the Ecuadorian Government introduced by presidential pressure, the tax services efforts and ultimately by an 'interpretation law' an interpretation that was different from what was practised before and on which the investors' had based their tender offer for petroleum development contracts with state company Petro-Ecuador; one should note here the dissent by Grigera Naon highlighting the application of the principle of legitimate expectation.

143 From the 1991 'European Energy Charter' that is explicitly referred to in the 1994 Energy Charter Treaty, reprinted in T. Waelde (ed.), *Energy Charter Treaty* (1996), p. 603.

when tax surprises 'go too far'. Tax surprises can easily 'go to far' when governments rely on open-ended legislation (e.g. the function of anti-avoidance legislation to question virtually every transaction with a tax planning motive) involving considerable discretion.[144]

6. Conclusion

In this study, we have presented an overview of how tax matters are regulated in modern investment treaties, including the underlying policy issues that are reflected in the tension between international controls on one hand and tax sovereignty on the other. That tension is also mirrored in the much slower progress in tax treaties, where mere intergovernmental consultation seems to gradually give way to more formal procedures of inter-state arbitration, with a quite weak role of the individual taxpayer. In comparison to tax treaties, investment treaties have advanced further in imposing relevant external controls on domestic fiscal conduct. It seems to us that these tensions are indicative of the gradual and bumpy transition from the conceptual legal heritage of the nation state to the required legal approaches in the modern market state. Law and lawyers in particular are conceptually imprisoned by the legal tradition of the nation state, nowhere more than in public international law. As the development of law proceeds at a slow and majestic pace, new approaches – international disciplines – and traditional approaches – tax sovereignty – wrest with each other in treaty language, application and commentary. The resolution of these tensions can only progress gradually as legal innovation is backed by attitudinal and cultural acceptance.

This study has only been able to provide an overview of both modern tax-related investment treaty practice and some of the issues that arise when the specific treaty disciplines (in particular: fair and equitable, national treatment, indirect expropriation) are applied to tax-related investment disputes. Further more in-depth work is needed to use the full gamut of already available arbitral jurisprudence and academic commentary to the specific tax-related investment disputes we now see emerging.

Notes

144 G. Cooper (ed.), *Tax Avoidance and the Rule of Law* (1997); Carlos Taboada, Los Motiveos Economicos validos enel regimen fiscal de las reorganizaciones fiscales, in Estudios Financie ros, 62/2002 at 63..

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