The Treatment of (National) Taxes in Tax and Non-Tax (International) Agreements

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6th Meeting of the Asia-Pacific Foreign Direct Investment (FDI) Network

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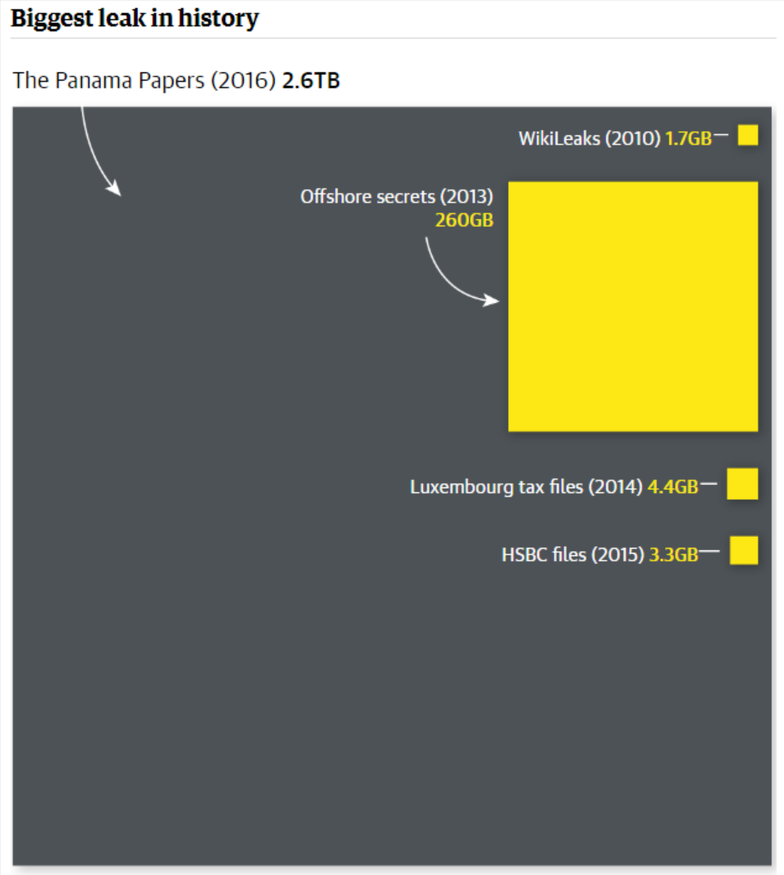
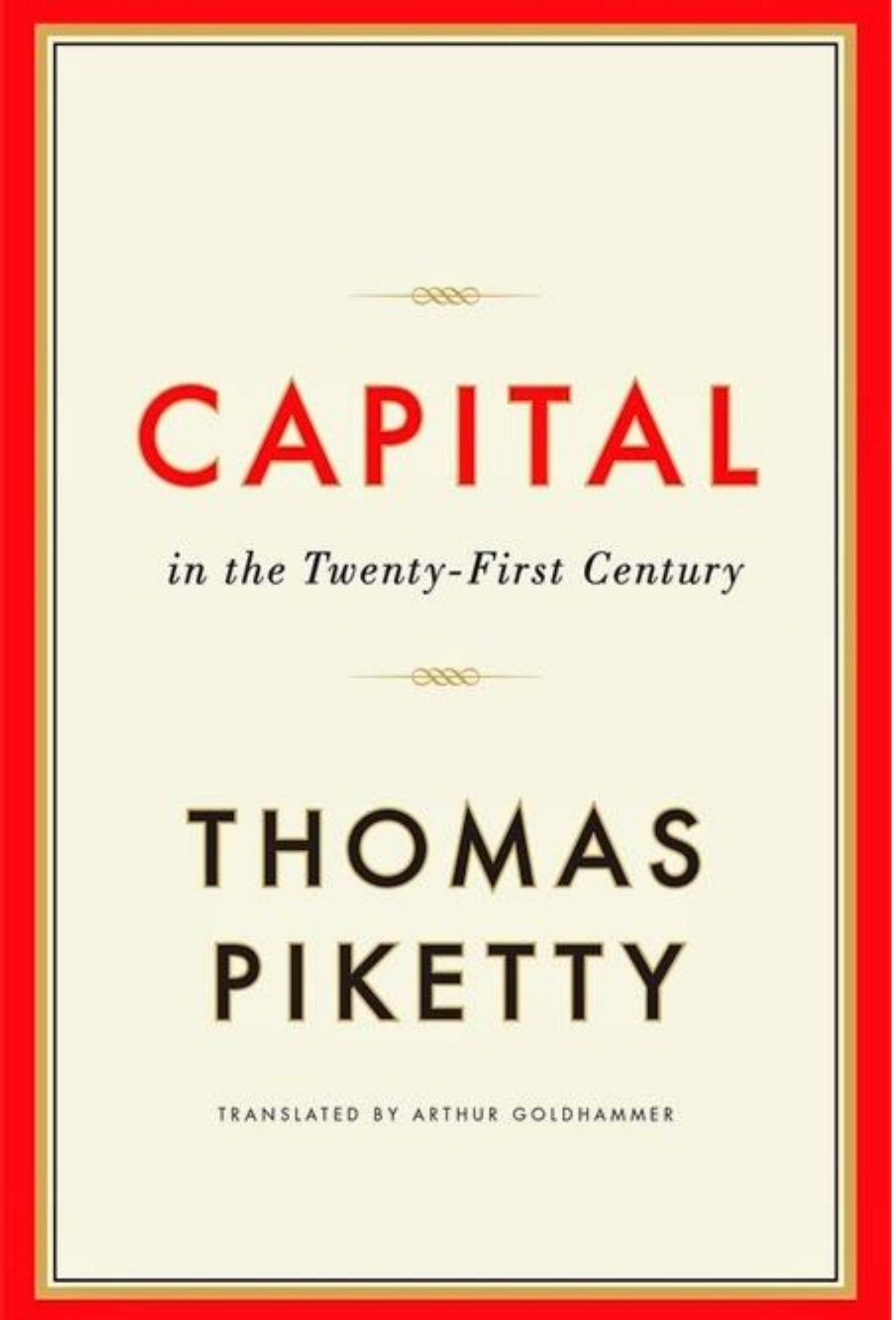
What generated the most buzz last years?
Tax evasion.

- If Your Name Is On These Lists, Prepare To Be Audited (Or Worse)



The Guardian, April 21, 2016



Shift in the focus of (international) economic policy, toward distributional questions

- Piketty derives a grand theory of capital and inequality.
    - As a general rule wealth grows faster than economic output
    - r > g (where r is the rate of return to wealth and g is the economic growth rate).
- Adoption a global tax on wealth, to prevent soaring inequality contributing to economic or political instability down the road.
    - Implicitly, *internationalization* of tax policy

Background: International Tax Law

Significant losses of national tax revenues

Sophisticated tax planning by MNES aimed at shifting profits in ways that erode the taxable base.

Most tax planning schemes legal: ‘outdated’ international taxation system.

Reaction is ‘BEPS’

OECD originated the Action Plan on tax base erosion and profit shifting

Main instrument: Mutual Agreement Procedures (MAPs).

Few constraints in terms of timeliness of MAP,

Little involvement on the part of taxpayers…

Background: International Tax Law

•Tax among last bastions of Westphalian sovereignty.

At first sight, taxation doesn't raise concern in terms of regulatory autonomy.

International tax law is centered on a network of more than 3,800 bilateral tax treaties.

Little progress had been made towards a multilateral tax regime, until recently.

New Deal for the International Tax Regime

The OECD's Package on Base Erosion and Profit Shifting (BEPS) (October 2015).

15 “actions”: countering harmful tax practices, treaty shopping, transfer pricing, interest deductibility, and transparency to exploring the tax implications of the digital economy

Implementation has begun (OECD report to G20, Shanghai, 26-27 February 2016).

Regulatory interactions tax-investment

Tax treaty law and the international investment treaties

- *Prima facie* appear to be two different worlds and two separate legal regimes.
- However, they overlap

More than 3,600 tax treaties

- Primary source of rights and obligations both for governments and tax payers
- Main objective of avoiding double taxation and double non-taxation of cross-border income and capital

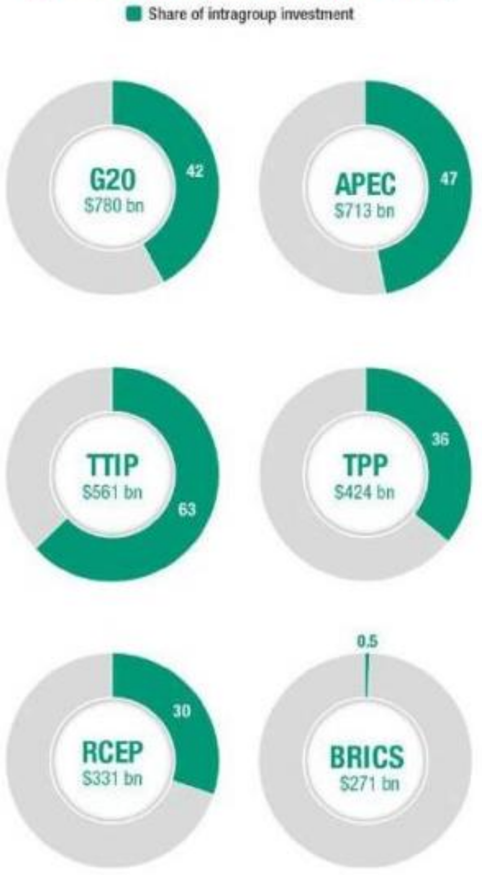
More than 2,850 investment treaties

- Protect and promote foreign investor
- Significant substantive rights

Is BEPS tax transfer pricing relevant to invest treaties?

Look at size of intra-group flows…

Figure 3. Major groups: total and intragroup FDI flows, annual average, 2010–2014
(Billions of dollars and per cent)



Source: ©UNCTAD.

In a nutshell

Does investor-state arbitration work better than tax dispute settlement?

Can tax disputes be shifted to investor-state arbitration?

Yes

- No systematic tax exception in investment treaties
- Trends in investor-state arbitration
- Likely increase of tax disputes

-- Exclusion of Taxation Issues from IIAs --

Complex regime of Taxation Exclusion from IIAs

If taxation isn't excluded, taxation is covered by investment treaties

- Host States' conduct to address tax erosion by investors can be restricted by substantive obligations derived from IIAs.
- Exceptions regime is (very) complex

They can be categorized into 7 main types:

- General exclusion (1),
- Limited exclusion (2)(3)(4),
- Tax veto to expropriation case (5),
- Priority of taxation treaties over IIAs (6).
- Sometimes types of exclusion and/or exceptions can be complexly combined in one investment treaty (7).

(1) General exclusion

Some investment agreements exclude tax matters from its scope of application without any reservation.

For example, Article 5(2) of the Argentina/New Zealand BIT (1999) provides as follows:

- "The provisions of this Agreement shall not apply to matters of taxation in the area of either Contracting Party. Such matters shall be governed by the domestic laws of each Contracting Party and the terms of any agreement relating to taxation concluded between the Contracting Parties."

The policy behind this exclusion is to leave taxation issues to taxation treaties.

- For example, the Colombia Model BIT (2004), which has the same type of exclusion, provides an accompanying explanation: 'It is policy of Colombia to treat tax matters in double taxation treaties.'

(2) Limited exclusion in relation to NT and MFN standards

Some BITs exclude the application of NT and MFN from treatments resulting from ‘any matter’ related to taxation.

For example, Article 3(3) of Austria/India BIT (1999) states as follows:

- (3) The provisions of paragraph (I) [i.e. NT and MFN] shall not be construed as to oblige one Contracting Party to extend to the investors of the other Contracting Party and their investments the present or future benefit of any treatment, preference or privilege resulting from [...] any matter, including international agreements, pertaining wholly or mainly to taxation

(3) Limited exclusion in relation to fair and equitable treatment

Some investment treaties exclude the application of the obligation of fair and equitable treatment (FET) on taxation measures.

A major example is NAFTA:

- Article 2103(1) stipulates that '[e]xcept as set out in this Article, nothing in this Agreement shall apply to taxation measures.'
- On the one hand, 'Articles 1102 and 1103 [i.e. NT and MFN] […] shall apply to all taxation measures,' and 'Article 1106(3), (4) and (5) [i.e. Performance Requirements] shall apply to taxation measures.'
- On the other hand, since there is no explicit reference to FET, arbitral tribunals have repeatedly interpreted that 'Article 1105 [i.e. FET] is not available in tax cases,' and 'the tax measures are excluded from consideration in the context of Article 1105.

(4) Limited exclusion based on the distinction between direct and indirect taxes

Some investment treaties restrict its application to limited types of taxes.

In other words, by providing a distinction between direct and indirect taxes, they limit their scope of some substantive obligations to indirect taxes.

- For example, Article 2103(4)(b) of NAFTA stipulates as follows:
- Articles 1102 and 1103 (Investment - National Treatment and Most-Favored Nation Treatment) […] 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 […]

(5) Tax veto to expropriation case

Some IIAs grant the tax authorities the competence to ‘veto’ a complaint by an investor alleging expropriation arising from a taxation measure by the host state.

For example, Article 2103(6) of NAFTA stipulates that an investor can submit a claim relating to expropriatory taxation to arbitration only if ‘the competent authorities [...] fail to agree that the measure is not an expropriation.’

The agreement of competent tax authorities on non-expropriatory character of a measure thus precludes the investor from initiating investment arbitration.

(6) Priority of taxation treaties over IIAs

Some BITs insert no express provision on exclusion of taxation from its coverage, but provide priority of taxation treaties over the investment treaty, which can be qualified as ‘explicit conflict clauses.’

For example, Article 20 of Japan/Iraq BIT (2012) stipulates:

Nothing in this Agreement shall affect the rights and obligations of either Contracting Party under any tax convention. In the event of any inconsistency between this Agreement and any such convention, that convention shall prevail to the extent of the inconsistency

This type of BITs still applies to taxation, but to the extent that is covered by taxation treaties, the latter shall prevail.

(7) Complex combination of exceptions within exclusion

All types of exclusion do not preclude each other.

In fact, some IIAs combine several exceptions within the exclusion, resulting in a complex structure, which requires careful scrutiny to identify the scope of application.

- For example, Article 12 of Canada/Ecuador BIT (1996) stipulates that '[e]xcept as set out in this Article, nothing in this Agreement shall apply to taxation measures,' but at the same time provides a priority clause (paragraph 2) and a tax veto (paragraph 4)

Tax and investment do not co-exist in clinical isolation

- Several IIAs exclude taxation issues from their scope of regulation, though the extent of exclusion may vary from one treaty to another.
- Some investment treaties still cover taxation.
- Host states’ sovereign power to taxation can be subjected to the scrutiny of investment arbitration.

-- Investor-state arbitration and tax disputes --

Tax disputes under IIAs are not accidents

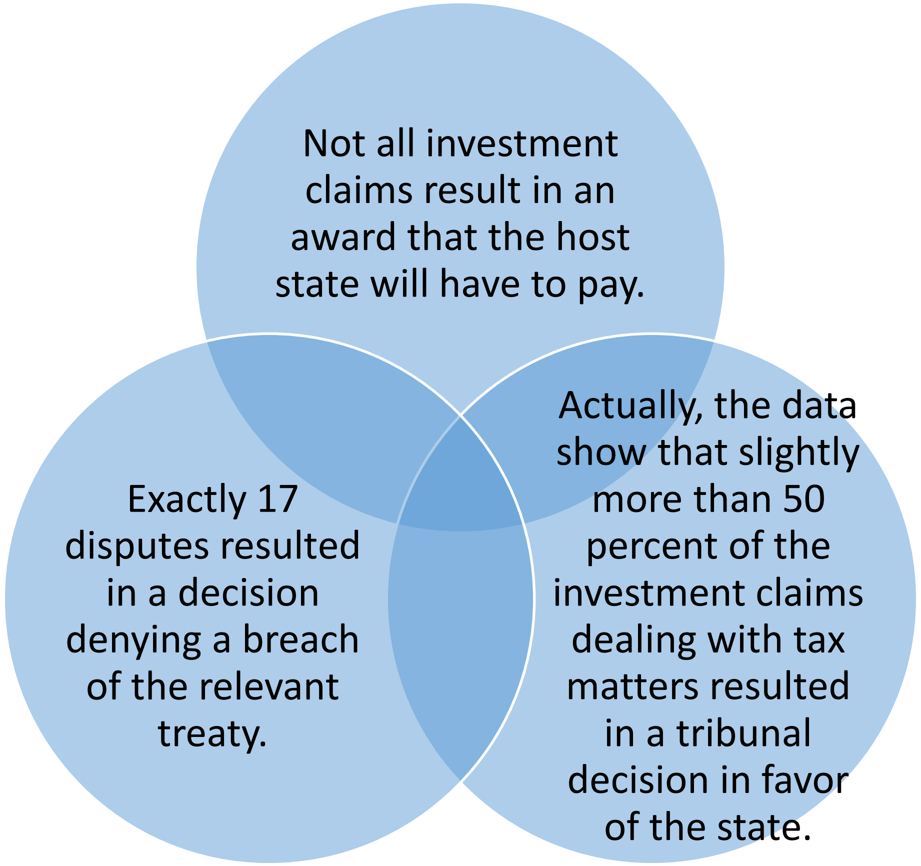
Since 1999, at least 32 tax-related cases have been brought to international investment arbitration

Foreign investors considered using investment treaties to complain against a number of countries and tax measures.

Typology of the tax disputes shows the diversity of tax measures reviewed by ISA.

CASE NAME	TREATY	AWARD DATE	ARBITRATION RULES
Feldman v. Mexico	NAFTA	December 16, 2002	ICSID AF
Goetz v. Burundi	Belgium– Luxemburg–Burundi BIT	January 29, 1999	ICSID
Enron Corporation & Ponderosa Assets LP v. The Argentine Republic	Argentine-USA BIT	May 22, 2007	ICSID
Occidental Exploration and Production Company v. Ecuador	USA–Ecuador BIT	July 1, 2004	UNCITRAL
Archer Daniels Midland Co. & Tate Lyle Ingredients Americas, Inc. v. United Mexican States	NAFTA	November 21,2007	ICSID AF
El Paso Energy International Company v. Argentina	Argentina–USA BIT	October 31, 2011	ICSID
Duke Energy v. Ecuador	USA–Ecuador BIT	August 18, 2008	ICSID
Hulley v. Russia	ECT	July 18, 2014	UNCITRAL
RosInvestCo v. Russia	UK–USSR BIT	December 22, 2010	SCC
Yukos Universal v. Russia	ECT	July 18, 2014	UNCITRAL
Mobil v. Venezuela	Netherlands–Venezuela BIT	October 9, 2014	ICSID
Quasar de Valores Sicav SA v. The Russian Federation	Spain–USSR BIT	July 20, 2012	SCC
Renta 4 v. Russia	Spain–USSR BIT	March 30, 2009	SCC
Tza Yap Shum v. Republic of Peru	China–Peru BIT	July 7, 2011	ICSID
Veteran Petroleum v. Russia	ECT	July 18, 2014	UNCITRAL
Corn Products International Inc. v. Mexican States	NAFTA	August 18, 2009	ICSID AF
Paushok v. Mongolia	Russia–Mongolia BIT	April 28, 2011	UNCITRAL
Burlington Resources v. Ecuador	USA–ECUADOR	December 14, 2012	ICSID
Phoenix Action v. Czech Republic	Croatia–Czech Rep BIT	April 15, 2009	ICSID
Noble Energy v. Ecuador	USA–Ecuador BIT	Settled	ICSID
Gottlieb v. Canada	NAFTA		UNCITRAL
TCW v. Dominican Republic	CAFTA	Consent Award/July 16, 2009	UNCITRAL
Lacich v. Canada	NAFTA	Withdrawn	DU
Link-Trading v. Moldova	USA–Moldova BIT	April 18, 2002	UNCITRAL
Tokios Tokeles v. Ukraine	Lithuania–Ukraine BIT	July 26, 2007	ICSID
EnCana v. Ecuador	Canada–Ecuador BIT	February 3, 2006	UNCITRAL
Plama Consortium Limited v. Bulgaria	ECT & Bulgaria–Cyprus BIT	August 27, 2008	ICSID
Grand River v. USA	NAFTA	January 12, 2011	UNCITRAL
Amto LLC. v. Ukraine	ECT	March 26, 2008	SCC
EDF v. Romania	UK–Romania BIT	October 8, 2009	ICSID
The Rompetrol Group N.V. v. Romania	Netherlands–Romania BIT	May 6, 2013	ICSID
Jan Oostergetel and Theodora Laurentius v. The Slovak Republic	Netherlands–Slovak Republic BIT	April 23, 2012	UNCITRAL

Tax Disputes not lost by the Host States



Tax Disputes Lost by the Host States

Out of the 32 disputes dealing with tax matters, 15 have been lost by the host states.

- These disputes are the most interesting because they show what can go wrong in terms of designing tax policy in accord with investment treaties.

The majority of cases (exactly nine awards) concluded with a finding of expropriation.

- However, two claims were consolidated into a single case for *Renta 4* and *Quasar de Valores v. Russia*.
- Also, as part of the *Yukos* case, three separate lawsuits by former Yukos shareholders were filed by Hulley Enterprises Limited (Cyprus), Yukos Universal Limited (Isle of Man) and Veteran Petroleum Limited (Cyprus).
- As a result, there are only six truly different tax disputes that resulted in a finding of expropriation.

However 6 other cases resulted in a breach of FET or NT

Typology

Great diversity of tax measures that are at the origin of the dispute:

- windfall profits tax,
- tax investigations,
- value-added tax,
- taxation of income trusts,
- import taxes,
- corporate income tax,
- tax stamps on cigarettes,
- duty-free regime, etc.

Unsurprisingly, the broad scope of application of investment treaties allows tribunals to look at a wide variety of tax measures.

Señor Tza Yap Shum v. Peru

- In 2002, Mr. Tza Yap Shum established TSG with a $400,000 investment.
- TSG purchased raw fish, delivered the fish to third-party factories to process into fish meal, and then exported the finished product
- In 2004, the Peruvian tax authority, the SUNAT, conducted a routine audit of TSG after TSG had requested sales tax refunds.
  - During the tax audit, the SUNAT decided that TSG had not properly declared the amounts and values of the raw materials it had purchased, which the SUNAT believed meant TSG had under-declared sales, as well.
  - The SUNAT issued a new tax assessment based on a “presumed basis” of $4M
- TSG did not agree with the assessment.
  - Shortly after the audit, the SUNAT also took so-called “interim measures” to enforce the tax assessment that had been imposed to secure money for the Treasury.
  - All banks in Peru were directed to retain any funds related to TSG passing to them and to redirect such funds to the SUNAT.
  - Almost immediately, TSG’s business became inoperable because the company was unable to pay suppliers or receive payments from its customers.

Señor Tza Yap Shum v. Peru

- In the *TSG* case, a tax auditor imposed an additional assessment of $4M on a company that was created just a few years prior with a $400,000 investment.
- Most likely, the company simply had no means of paying the assessment, even if it was justified.
- Instead of calmly going through the tax dispute process that exists under local laws to decide whether the claim was justified (note that both the appeal and the tax court procedure later resulted in a lower tax claim), the tax authority seized the bank accounts of the company almost immediately after the audit without respecting its relevant internal rules for taking such an exceptional action.
- The tax claim might have been justified, but the temporary enforcement measures taken before court proceedings had played out were so damaging to the operations of the company that the tax claim itself was rendered irrelevant, because the company could not survive the measures.
- That situation, the tribunal found, does violate the BIT, because it amounts to expropriation.

-- Tax as a barrier to investment --

Tax as the last barrier to investment (and trade)

Over the last three decades there has been a significant removal of many of the non-tax barriers to cross-border trade and investment.

The movement to remove non-tax barriers has been accelerated by the rapid expansion of free trade agreements

This objective is now almost achieved within the 34 OECD countries and some other major economies

In this new environment there is a real risk that tax could become “the last trade and investment barrier”, either by design or default.

Climate of tax uncertainty

Drivers:

The emergence of new players, the rapid development of new technologies, the more aggressive approach to tax planning on the part of some MNEs and the lack of a global consensus on what should be the international tax rules will lead to more tax uncertainty.

BEPS challenges:

It now appears unlikely that BEPS will lead to any fundamental review of the core features of the current international tax framework, with the positions of the OECD countries, the BRICS, other emerging economies, and developing countries diverging.

This lack of agreement will, at least in the short term, lead to a period of uncertainty:

lack of coherence and disputes between countries.

Climate of tax uncertainty

These disputes may be fuelled by tax authorities having unprecedented access to information on the global operations of MNEs

- Country-by-Country Reporting; Transfer Pricing Master and Local Files.
- This global access to information should, in the long term, lead to fewer disputes,

However, BEPS on short term could lead some tax authorities to adopt a more aggressive approach

- Some may be tempted to use this information to move towards a more global formula apportionment approach to transfer pricing.
- Investors will react by increasingly relying on ISA (Back-door)

-- The Treatment of (National) Taxes in WTO Law --

WTO as a World ~~Trade~~ Tax Organisation

- Trade policy review does indeed include the review of tax policies (i.e., trade and related policies) and that, under TPR and dispute settlements, the WTO has found some areas of non-compliance.

In terms of dispute resolution, almost 500 disputes have been brought under WTO rules, of which around 40 involved tax disputes.

In terms of the scope of the WTO rules that apply to taxes, they reflect the reality that internal taxes can have economic effects equivalent to those border taxes (tariffs) and other trade distortions.

Trade in goods

- From the perspective of taxation the most relevant provisions are:

- Article III of the GATT targets measures affecting internal sale.
  - The application of GATT rules to indirect taxes are clear but continue to be a matter of some dispute
  - In that respect, GATT Article I (MFN) treatment is also important.
- TRIMs, e.g., if local content rules are a prequalification for tax incentives.
- SCM Agreement prevents certain types of subsidies and is of particular relevance to taxation.

Trade in services

- MFN treatment (Article II provision), National Treatment (Article XVII), and the dispute resolution (Article XXII and Article XXIII).

NB: GATS was one of the few international agreements where tax policy makers were formally engaged in the process, although late in the day.

- One of the outcomes from this engagement was to insert limitations on the obligations related to tax.
- These took the form of certain exceptions to MFN treatment and measures intended to achieve an equitable and effective imposition or collection of direct taxes.

Argentina v. Panama, DS453, April 2016

- Argentina's law distinguished between "countries cooperating for tax transparency purposes" and "countries not cooperating for tax transparency purposes".

- It adopted four separate tax measures, as well as measures relating to access to the reinsurance sector, the capital market, and the foreign exchange market.
- It also imposed requirements with respect to the registration of branches of foreign companies.

The September 2015 Panel decision found, among other things, that the Argentine measures violated the MFN obligation of GATS Article II

- because they did "not accord, immediately and unconditionally, to services and service suppliers of non-cooperative countries treatment no less favourable than that which they accord to like services and service suppliers of cooperative countries".

Key “lesson” is no lesson…

- The Appellate Body overturned that ruling on the grounds that the Panel had used an erroneous “likeness” test.

In fact, it remains unclear whether WTO Members may take measures against countries that are considered to be “not cooperating for tax transparency purposes”.

In essence, BEPS encourages states to take measures to address tax transparency issues, while WTO has not decided whether WTO Members may take measures to address tax transparency issues…

This will have to be resolved in a future dispute, perhaps with other (bigger?) litigating parties…

G20 big push on tax is going to affect a lot of powerful people, so there will be pushback…

- In the meantime, re-thinking the complementarity tax-investment (and trade) treaties

Distinguish the two systems (consistency in the use of tax exceptions)

Establishment of dedicated tax tribunals is urgent but tax calls for greater reduction of regulatory autonomy

Growing number of international disputes that involve a tax issue.

Investment and trade treaties do provide for compulsory adjudication (albeit with limited tax carveouts) but are not the most appropriate fora to interpret and develop the meaning of complex tax rules.

Tax, trade, and investment spheres are increasingly overlapping.

Sovereign tax regulatory autonomy affected by the backdoor

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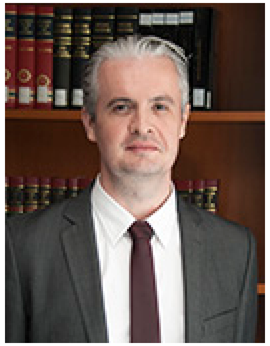

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