Tax Planning, Investor-State Dispute Settlement, and the Challenge of Corporate Nationality[*]

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Abstract

Bilateral investment treaties (BITs) allow states to extend additional protections, and access to arbitration, to firms from strategically selected partner states. However, corporate nationality is not straightforward. A parent firm may be separated from its final investment by an ownership chain that involves several subsidiary firms, which are often incorporated in different states, and the parent firm may thus have access to protection from the host country under multiple BITs. In an increasingly common practice that I call "arbitration by proxy," parent firms use the standing gained through their foreign subsidiaries to file investment disputes against host states, even though the host states have never signed a BIT with the firm's home state. For host states, this practice internationalizes BITs' costs without internationalizing their benefits. In this paper, I argue that proxy arbitration is a byproduct of firms' efforts to minimize their tax burden. Firms establish indirect ownership structures in order to be able to book their profits in low-tax jurisdictions, and in order to take advantage of the network of bilateral tax treaties (BTTs) that reduce the taxes levied on transfers across borders. Subsidiaries established for tax purposes can be used to gain BIT protection if a dispute arises. I test hypotheses derived from my theory using novel data on the ownership structure of ISDS claimant firms. The results highlight the limits of bilateralism as a tool for regulating multinational firms, and suggest that IPE scholars should treat corporate structure as an outcome (and input) of theoretical interest.

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1   Introduction

In late 2012, a Dutch firm called MNSS B.V. and a firm incorporated in Curaçao called Recupero Credito Acciaio initiated arbitration against Montenegro under the rules of the World Bank's International Center for the Settlement of Investment Disputes (ICSID). The firms, who had taken ownership of Montenegro's formerly state-owned electric arc furnace steel mill, alleged that the government engaged in various acts to restrict their access to capital which eventually resulted in the steel mill's bankruptcy and subsequent transfer to a different private owner.

The firms had access to arbitration against Montenegro via the 2002 bilateral investment treaty (BIT) signed between the Federal Republic of Yugoslavia and the Netherlands. In truth, however, both MNSS and Recupero Credito Acciaio are holding companies owned by the British private equity firm Ethemba Capital. During the arbitration, Montenegro's counsel challenged the tribunal's jurisdiction and claimed that "...Montenegro's incentive in entering into the BIT was to procure Dutch direct investment **and not to further raise the Netherlands' relevance as a haven for shell companies through which third country entities would funnel their investment into Montenegro**."[1] The arbitrators dismissed Montenegro's jurisdictional challenge, arguing that the Netherlands-Yugoslavia BIT does not preclude such arrangements as long as the claimant firms are incorporated in the Netherlands.

This case illustrates a problem that lies at the core of the international investment regime. BITs and other international investment agreements (IIAs) extend legal protections to investors based on their nationality; for example, the Cyprus-India BIT allows Cypriot investors to sue India and vice versa. However, many of these investors are firms, and corporate nationality is not straightforward. Unlike natural persons, firms can select the state in which they'd like to incorporate, they can hold multiple nationalities simultaneously

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[1] *MNSS B.V. and Recupero Credito Acciaio N.V. v. Montenegro*, ICSID Case No. ARB(AF)/12/8. Award, par. 177. Boldface not present in the original.

through complex chains of subsidiaries, and they can pay lawyers, accountants, and management consulting firms to help them optimize this process. IIAs offer little guidance on how arbitrators should determine the nationalities that should or should not apply to a given firm, and heuristic strategies that have arisen – such as assigning nationality based solely on the state of incorporation – can produce puzzling results as firms' corporate structures grow increasingly complex.

The result of this disconnect is that – while capital-importing states such as Montenegro originally thought that BITs would allow them to offer *targeted* benefits (specifically, access to arbitration) to investors from their treaty partner state in return for increased investment[2] – in practice, the malleability of corporate nationality has made it very difficult for states to prevent third party firms from reaping the benefits of their bilateral agreements. This means that not only are capital-importing host states exposed to much more legal liability than they signed up for, they are also extending BIT protections to investors from states with which they have never signed an agreement, depriving them of the reputational and financial benefits associated with signing additional treaties (Kerner, 2009; Neumayer and Spess, 2005). Host states' inability to prevent third party firms from filing arbitration against them may explain part of the recent backlash against (and termination of) investment treaties (Haftel and Thompson, 2018; Peinhardt and Wellhausen, 2016; Poulsen and Aisbett, 2013).

In this paper, I explore two related questions. First, why do some firms make their foreign investments "indirectly" through third party subsidiaries in a way that allows them to claim additional nationalities? Second, why do investing firms engage in the phenomenon that I label "proxy arbitration," wherein a parent firm from State A (such as Ethemba Capital) uses its subsidiary incorporated in State B (such as MNSS B.V.) in order to file ISDS against a host state? Scholars of international law (Skinner, Miles and Luttrell, 2010; van Os and Knottnerus, 2012) and more recently political science (Betz, Pond and Yin, 2020; Gray, 2020) have posited that firms may engage in investment treaty shopping, tailoring their ownership

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[2]See Elkins, Guzman and Simmons (2006).

structures in order to gain access to ISDS. According to the treaty shopping hypothesis, firms take the investment treaty network into account when planning their investment; if their home state does not have a treaty with the potential host state, they route their investment through a holding company in a third state that does have a treaty with the host state.

I propose a different explanation, namely that trends in indirect investment and proxy arbitration can be explained by firms' efforts to legally avoid taxation (which are referred to as "tax planning" in the business world). Investment treaty shopping is not the only reason that a firm may wish to invest abroad indirectly via one or more third party intermediaries. Firms may create foreign "conduit" subsidiaries in order to exploit other states' lax corporate tax rates, as well as the network of bilateral tax treaties (BTTs) that allows firms to channel capital through intermediary states in order to lower their total tax bill (Arel-Bundock, 2017); Zucman (2014) estimates that 20% of U.S. corporate profits are booked in tax havens, and that this figure has grown by a factor of 10 since the first ISDS case was filed in the 1980s. Once firms have established foreign intermediaries for tax purposes, access to arbitration via BITs becomes a side benefit. For example, note that the claimants in *MNSS v. Montenegro* were incorporated in the Netherlands and Curaçao, nations that tax shifted corporate profits at the extremely low rates of 9% and 0% respectively (Tørsløv, Wier and Zucman, 2019).

In order to evaluate predictions drawn from my theory, I introduce a new dataset on the corporate ownership structures of over 1,000 claimant firms that have filed ISDS cases between 1987 (the year of the first modern ISDS case) and 2015. Consulting a wide range of sources – including case filings, business databases such as Orbis, SEC filings, national corporate registries, and offshore data leaks such as the Panama and Paradise Papers – I determine whether or not each of the claimants involved in 726 distinct ISDS cases was the direct and/or the ultimate owner of the disputed assets, and if not I determine who *was*. This allows me to categorize the investment and arbitration strategies of each parent firm: I find that 41% of ISDS cases contain at least one claimant that is investing indirectly

through one or more third party-incorporated subsidiaries, and that 27% of all cases are proxy arbitrations in which the claimants are themselves subsidiaries of a third party-incorporated parent. Further, in 8% of cases, the true parent investor is actually a national of the host state and the investment has simply been "roundtripped" through a foreign subsidiary.

I present a range of descriptive and observational evidence in support of the tax planning hypothesis. In brief, I find that parent investors are much more likely to invest indirectly via conduit entities – and to file ISDS using them – when the potential tax benefits to doing so are largest. To highlight two central results, I find that (1) parent investors from states with a high corporate income tax rate are substantially more likely to invest indirectly and to file ISDS cases using their subsidiaries; (2) conditional on making the decision to invest indirectly, investors' choice of the state in which to incorporate their "conduit subsidiary" is heavily influenced by the network of bilateral withholding tax rates. These findings strongly suggest that firms' ownership structures are driven by tax planning considerations, and that firms' ownership structures in turn affect their ability to file ISDS against the host state.

This study makes three primary contributions to the IPE literature. First, I highlight another "limit of bilateralism" in international politics (Arel-Bundock, 2017): variation in bilaterally-negotiated withholding tax rates not only allows firms to pay fewer taxes by adopting fragmented ownership structures, but the fragmented ownership structures also increase the costliness (and arguably decrease the utility) of third-party states' BITs by expanding the number of firms that are protected by them. Second, I identify another channel through which corporate tax avoidance hurts national governments: the same arrangements that companies make in order to minimize their tax burden can be repurposed to file multi-billion dollar ISDS cases[3] against the governments that host them – who tend to be mostly developing, capital-importing nations. Third, I illustrate the risks inherent in equating the state in which a firm is incorporated with its nationality. Scholars of IPE are typically interested in the latter; for example, we want to know about relationships between co-national

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[3]See e.g. *Venezuela Holdings and others v. the Bolivarian Republic of Venezuela*, ICSID Case NO. ARB/07/27.

firms,[4] or how firms' operations are affected by the policies of their home governments.[5] However, our data typically only tell us about the former. I join recent studies in underlining the importance of "piercing the corporate veil" – identifying the state in which a firm is *managed*, rather than simply the one in which it is incorporated – prior to linking companies to their home states (Betz, Pond and Yin, 2020; Gertz, 2018).

The paper is organized as follows: first, I review literature on states and firms in the international investment regime. Next, I introduce a theory of tax planning, ownership fragmentation, and proxy arbitration, and draw from it testable hypotheses. I then describe the original dataset of ISDS claimant ownership structure and provide some graphical intuition. Finally, I proceed to test the hypotheses econometrically using a combination of my original data and detailed tax/BIT data from a variety of sources.

2 BITs, states, and firms

The first BITs were signed in the late 1950s and early 1960s in order to solve a problem: MNCs from the developed world wanted to invest in developing states but feared expropriation or mistreatment by host governments, developing state governments wanted foreign direct investment (FDI) but could not credibly commit not to expropriate, and attempts to regulate international investment multilaterally had failed (Allee and Peinhardt, 2014). Substantively, BITs provide formal regulations for investors (e.g., which types of inward investment are allowed) as well as standards for the treatment of foreign investors (e.g., investors must be allowed to repatriate profits back to their home country), and often they also allow firms access to arbitration in the event that the standards are violated. These bilateral treaties diminish the risk to firms of investing in developing states in two primary ways: first, the potential for arbitration raises the cost to the host government of expropriating foreign investors (Simmons, 2014). Second, BITs' formal investment protections can

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[4]Aisbett, Busse and Nunnenkamp (2018); Johns and Wellhausen (2016); Moehlecke, Thrall and Wellhausen (2019).

[5]Jensen and Malesky (2018); Thrall (2020).

serve as legal focal points in diplomatic negotiations, diffusing developed state standards of property rights protection to the developing world (Poulsen, 2019).

Bilateral contracting has many advantages: first, fewer members means lower bargaining costs (Koremenos, Lipson and Snidal, 2001). Second, bilateralism allows states to choose their partners *a la carte*. States may choose partners in order to compete for investment from their partner's firms (Elkins, Guzman and Simmons, 2006), or to advance their foreign policy interests (Gertz, 2018; Poulsen and Aisbett, 2016). In any case, states who sign a BIT together make a calculated tradeoff: in exchange for the prospect of increased foreign investment, signatory states extend a set of special protections to each other's firms and open themselves up to costly investor-state arbitration in the event that these protections are violated.

However, there is evidence that states did not fully understand the nature of this tradeoff during the early decades of the bilateral investment treaty regime (1959-1987). Poulsen (2014) argues that, while states knew that their BITs left them liable to be sued by foreign investors in a process called investor-state dispute settlement (ISDS), they did not foresee how costly ISDS would prove to be. Other research suggests that only once states face arbitration themselves do they begin to question the utility of their treaties, deciding not to sign further BITs (Poulsen and Aisbett, 2013) or even renegotiating or terminating their current treaties (Haftel and Thompson, 2018; Peinhardt and Wellhausen, 2016). States who are taken to arbitration may cease to receive the increased inward FDI flows that BITs bring, making reevaluation a rational decision (Aisbett, Busse and Nunnenkamp, 2018; Allee and Peinhardt, 2011).[6]

Not only did states underestimate the frequency and intensity with which firms would file ISDS cases, they also failed to predict the variety of different ways that firms would use arbitration. Moehlecke (2019) demonstrates that firms can use arbitration in order to suppress the global diffusion of a regulatory measure, targeting early adopters in order to

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[6]Interestingly, there is substantial variation in reinvestment behavior among the very firms that file arbitration (Wellhausen, 2019).

"chill" other potential adopters. Similarly, Pelc (2017) points to investors' lack of success in arbitration as evidence that firms file low-quality cases not in order to win, but merely in order to make adopting unfavorable regulations more expensive for host governments.[7] Gray (2020) highlights the phenomenon of proxy arbitration, in which a parent firm gains access to arbitration against a host state via a foreign subsidiary. Gray posits that proxy arbitration is the result of treaty shopping, defined as the practice in which "nonstate actors such as firms structure their ownership to take advantage of other countries' arrangements" (Gray, 2020, 1). Betz, Pond and Yin (2020) provide support for the BIT/IIA-shopping hypothesis using fine-grained data on MNCs' subsidiary location decisions.

Extant work has argued convincingly that firms strategically tailor their ownership structures in order to ensure that their foreign assets are protected under at least one IIA. While such treaty-shopping surely occurs, I posit that it is not a sufficient explanation for firms' decisions to invest indirectly through conduit subsidiaries. First, the BIT-shopping hypothesis makes a strong claim about the value that firms place on IIA protection: specifically, the assumption is that the benefit of gaining access to ISDS offsets the costs of establishing and maintaining an indirect ownership structure. I argue that – while IIA protection may serve as a form of insurance against the unlikely event of host country mistreatment – the returns to IIA protection pale in comparison to the returns to tax avoidance, and thus the latter is more likely to drive firms' initial decision to invest indirectly. Second, the IIA-shopping hypothesis cannot explain the fact that, in 37% of observed proxy arbitration cases, the parent firm already had access to ISDS against the host and did not need to use a conduit subsidiary to gain standing. It also cannot explain the fact that, in 14% of all cases, the ultimate investor invested indirectly through a conduit subsidiary but did not use the subsidiary to file the dispute.

In the following section, I introduce an explanation for the observed patterns of indirect investment and proxy arbitration in ISDS: corporate tax planning, or tax avoidance.

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[7]However, see Johns, Thrall and Wellhausen (2020) and Strezhnev (2017) on the problems with making inferences from observed win-rates in ISDS cases.

3 Theory: tax planning and proxy arbitration

My basic argument is as follows: first, firms have a strong interest in minimizing their tax liabilities, as taxes cut directly into firms' profits. Second, firms pay attention to variation in national corporate tax rates as well as the bilateral tax treaty network when planning their investments. When the potential tax savings associated with indirect investment are larger, firms are more likely to invest indirectly. As a result, the distribution of investing firms' subsidiaries across countries is strongly influenced by tax considerations. Finally, in the relatively rare event that a firm believes its foreign assets have been mistreated by a host government, the firm's ownership structure will determine whether or not it has access to arbitration under an investment treaty.

3.1 Tax planning: why and how?

Taxes on corporate profits and payments are a key source of income for governments. In 2013, for example, the corporate income tax alone accounted for 10% of the U.S. government's total tax revenue (Zucman, 2014). However, taxation is highly costly for firms, whose profits may be taxed at rates of ≥35% in some states (including the U.S. until the passage of 2017's Tax Cuts and Jobs Act). The costliness of corporate taxation has given rise to the cottage industry of "tax planning," in which firms hire lawyers and accountants to help them lower their tax burden by structuring their assets and intrafirm transfers in ways that allow them to take advantage of differences in corporate tax rates and rules across states (Johansson et al., 2017). It should be noted that tax planning is not tax fraud (in most cases); it is more akin to legal arbitrage, in which firms pick and choose which tax rules to follow rather than breaking them.

There are two primary considerations for a tax-planning MNC. First, MNCs would like their profits to be taxed at the lowest nominal (or "statutory") rate possible. This is a state-level consideration: the U.S. taxes corporate profits at 21%, while Bermuda does not

tax corporate profits at all (Tørsløv, Wier and Zucman, 2019). Thus, MNCs who wish to reduce their tax burden may wish to "book" their profits in a low-tax jurisdiction in a process called "profit-shifting" (Hines Jr. and Rice, 1994). For a parent firm, this process may involve establishing a subsidiary in a low-tax state whose only purpose is to hold ownership of one of the firm's foreign assets; this type of subsidiary is sometimes referred to as a "conduit entity." (Wamser, 2011). In this case, the conduit subsidiary would book the profits generated by the asset in its own low-tax jurisdiction, reducing the parent firm's tax liability.

Second, a tax-planning MNC must take into account the problem of withholding taxation. Withholding taxes are levied on transfers that occur between states. For example, an interest payment sent by a Ukrainian subsidiary to its Canadian parent firm would be subject to a withholding tax from the Ukrainian government (Arel-Bundock, 2017). Withholding rates are important because, once profits have been shifted and booked by the subsidiary in the low-tax state, the parent firm would usually like to redistribute the capital within the firm so that it can be put to other uses. High withholding tax rates could eliminate the tax savings of profit-shifting if the withholding rate is equal to the statutory rate in the parent firm's home country.

Unlike statutory corporate tax rates, withholding tax rates vary at the directed-dyadic level; the withholding rate on interest payments made from Ukraine to Canada may be different from the rate on interest payments made from Ukraine to France, which may in turn be different from the rate on interest payments made from France to Ukraine. This variation exists because, similar to the investment treaty regime, international cooperation on issues of corporate taxation mainly occurs at the bilateral level in the form of bilateral tax treaty negotiations (Rixen, 2011).[8] Bilateral tax treaties lower withholding rates for transfers between the two signatory states, and evidence suggests that (similar to BITs) states pursued these treaties in order to compete for investment (Barthel and Neumayer, 2012). Thus, the tax-planning firm wants to book its profits in states with low statutory corporate tax rates,

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[8]The original purpose of the bilateral tax treaty was not tax competition but instead to simply solve the problem of double taxation; for a thorough explanation, see (Rixen, 2011).

but it also wants to be able to use bilateral tax treaties to avoid paying high taxes on intrafirm transfers. This can result in complicated organizational structures, such as U.S. technology giant Google Inc's infamous "double Irish Dutch sandwich" which involved booking profits in low-tax Ireland but also routing capital through a Dutch subsidiary to avoid withholding taxes.[9]

In sum, MNCs' tax planning strategies typically involve routing capital through at least one foreign subsidiary. Forward-looking MNCs set up these conduit entities prior to investing abroad, resulting in FDI that is (ironically) indirect (Wamser, 2011; Weichenrieder and Mintz, 2008). Further, there is substantial evidence that tax planning of this kind is common. Tørsløv, Wier and Zucman (2019) estimate that 40% of all global corporate profits are shifted to tax havens; Gumpert, Hines Jr. and Schnitzer (2016) find that 60% of U.S. MNCs and 20% of German MNCs have subsidiaries incorporated in tax havens. Firms care about both statutory corporate tax rates and the bilateral tax treaty network, and they take these factors into account when planning their investments.

3.2 Conduit entities and proxy arbitration

Thus far, I have argued that variation in corporate taxation across states is a key driver of MNCs' subsidiary location decisions. In the context of ISDS the most relevant type of subsidiary is the conduit entity, which exists solely to serve as an intermediary for investment sent from the home country of the parent firm to the ultimate host state. I claim that it is through these conduit entities, created for tax purposes, that most proxy arbitrations are conducted. Figure 1 provides two illustrative examples drawn from ISDS cases.

Figure 1 (a) demonstrates the ownership structure of *Mobil Argentina v. Argentina*, a 1999 ICSID case. The parent firm is American oil major Mobil (now ExxonMobil), and the state hosting the investment is Argentina. Mobil made this investment indirectly through a Dutch conduit subsidiary although the case was filed under the U.S. - Argentina BIT and the

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[9]For in-depth descriptions of this profit-shifting strategy, see Arel-Bundock (2017) and Zucman (2014).

Figure 1: **Tax benefits of indirect investment: two examples.**

(a) *Mobil Argentina v. Argentina*, 1999.　　　(b) *Accession Mezz. v. Hungary*, 2012.
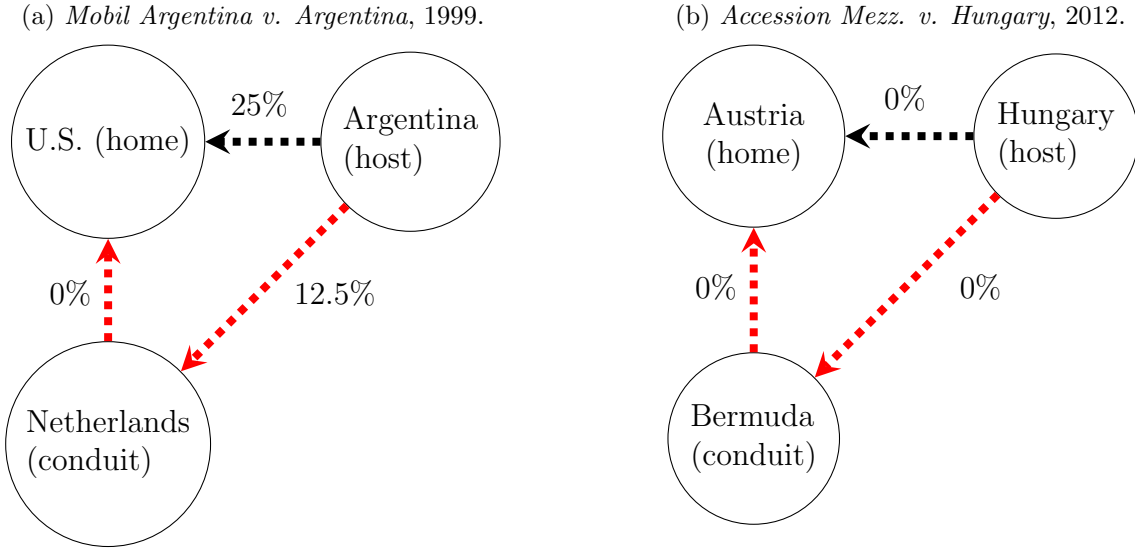
Black lines represent direct transfers from host state to home state, red lines represent the indirect path of transfers. Percentages indicate the withholding tax rate levied on interest payments made from State A → State B.

Dutch subsidiary was not a claimant on the case, making this a case of indirect investment but not proxy arbitration. Why? A look at the withholding tax rates is instructive. The U.S. and Argentina do not have a tax treaty together, and interest payments from Argentina to the US are taxed at a rate of 25%. However, the Netherlands has tax treaties with both Argentina *and* the U.S., opening up a favorable indirect route: interest payments from Argentina to the Netherlands are taxed at half the Argentina-U.S. rate (12.5%) and Netherlands-U.S. payments are not taxed, resulting in a 50% reduction of the effective withholding tax rate.

In *Mobil v. Argentina*, Mobil used its Dutch conduit to minimize its withholding tax bill, allowing it to cheaply reallocate capital within the firm. Figure 1 (b) illustrates the structure of a 2012 ICSID case, *Accession Mezzanine v. Hungary*, in which the ultimate investor used a conduit for a different tax purpose. In this case, the Austrian parent company routed its Hungarian assets through a Bermudan subsidiary. This indirect investment brought no withholding tax savings, as Austria and Hungary are EU member states and

most withholding taxes on intrafirm, intra-EU transfers have been abolished.[10] However, it did give the Austrian parent firm the opportunity to book some amount of its profits in Bermuda, a jurisdiction that levies no tax on corporate income.[11] Further, when a dispute arose the Austrian investor used the Bermudan subsidiary (and the UK-Hungary BIT, to which Bermudan investors have access) to file the case, making it an incident of proxy arbitration. However, the Austrian parent firm did not need to invest indirectly in order to gain access to ISDS; it could have filed the case directly under the Austria-Hungary BIT as well. Thus, the primary benefit that the investor received from indirect investment was the ability to lower its tax burden.

The above cases provide us with two distinct reasons that firms may decide to fragment the ownership structures of their foreign assets: (1) in order to minimize their withholding tax bill, and (2) in order to be able to shift their profits from high-tax to low-tax jurisdictions. In turn, as demonstrated in the example of *Accession Mezzanine v. Hungary*, firms that have invested indirectly for tax purposes may choose to engage in proxy arbitration in the event that a dispute arises.

When should we expect firms to invest indirectly for tax purposes? As Betz, Pond and Yin (2020) note, there are fixed costs associated with indirect investment (incorporation fees, accounting fees, consultancy/legal fees, etc) that dissuade many investors from pursuing this strategy. It follows that firms should invest indirectly when the tax savings of doing so are largest, such that the fixed costs of indirect investment are smaller than the associated tax benefits. This should be true in two situations: first, when the tax burden associated with transfers of capital from the host state to the investor's home state is highest. This is the case when host-home withholding tax rates are higher, or when the home state and host state do not have a tax treaty together. More formally:

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[10]https://ec.europa.eu/taxation_customs/business/company-tax/taxation-crossborder-interest-royalty-payments-eu-union

[11]It should be noted that I do not have firm-level tax data, and thus I cannot claim that Accession Mezzanine actually *did* book its profits in Bermuda.

Hypothesis 1: Parent investors are more likely to invest indirectly – and file ISDS through their conduit subsidiaries – when their home state does not have a tax treaty with the host state.

Hypothesis 2: Parent investors are more likely to invest indirectly – and file ISDS through their conduit subsidiaries – when the withholding tax rate on host-home capital transfers is higher.

Second, investors should be more likely to pursue an indirect investment strategy if their home state's corporate income tax (CIT) rate is higher. The higher the parent firm's CIT rate, the larger the relative gains of booking profits in a low-tax jurisdiction.

Hypothesis 3: Parent investors are more likely to invest indirectly – and file ISDS through their conduit subsidiaries – when their home state has a higher corporate income tax rate.

In order to evaluate the above hypotheses, I use novel data on the ownership structures of ISDS claimants. Before moving to the research design, the next section descibes the data, the data collection process, and provides some descriptive trends.

4 Ownership structures of ISDS claimants, 1987-2015

In order to explain trends in indirect investment and proxy arbitration, it is necessary to first identify the ISDS cases that are associated with these strategies. Doing so requires collecting two critical pieces of information about each claimant in each case:

1. Is the claimant firm owned **or controlled**[12] by an investor (firm or individual) from a third-party state? If so, what is the nationality of the ultimate/beneficial owner?

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[12]This distinction is important because firms can pursue various strategies to obscure *de facto* control by manipulating *de jure* ownership. Examples include reverse mergers (see *LARAH v. Uruguay*, ICSID 2019), or transferring nominal (but not effective) ownership to a third-party (for a flagrant example, see *Gallo v. Canada*, PCA 2007).

2. Does the claimant firm hold ownership of the disputed host state assets indirectly through one or more conduit subsidiaries? If so, where are these subsidiaries incorporated?

I collected this information for over 1,000 claimants in 726 ISDS cases filed between 1987 (the first modern ISDS arbitration) and 2015.[13] I consulted a wide range of resources in order to verify firms' ownership structures. First, as the ownership of the investment is often a salient issue in ISDS cases, I began by checking case documents for information about claimant ownership structures.[14] Next, I searched business databases such as Orbis, Mergent Online, and Dun & Bradstreet; SEC filings and their non-US equivalents (such as SEDAR filings in Canada, or Companies House in the UK); firms' own websites and investor reports; leaked data from offshore service providers;[15] and secondary sources including local news, investigative reports, and specialized media outlets such as *IA Reporter*.

After collecting information on claimants' ownership structures, I classify each ISDS case according to the diagram presented in Figure 2. If the claimant firm is both the direct and the ultimate owner of the host state assets, the case is one of direct investment. If the claimant firm is the ultimate owner but not the direct owner, the case is one of indirect investment but not proxy arbitration. As noted by Figure 2 (c), cases in which the ultimate owner and the direct owner are both claimants are still indirect investment but not proxy arbitration. Finally, if the claimant is owned or controlled by a third-party entity who is *not* a claimant on the case, the ultimate owner has engaged in both indirect investment and proxy arbitration. As Figure 2 (e) shows, whether or not the ultimate owner had access to ISDS against the host is irrelevant: if the ultimate owner files ISDS using a conduit subsidiary without joining the case as a claimant, it is an incident of proxy arbitration.

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[13]I chose to end my coding in 2015 for a practical reason: there is typically less information available about newer cases – no public case documents, few or no media reports, etc. The lack of information would likely make it relatively more difficult for me to identify indirect investment and proxy arbitration, resulting in lower quality data.

[14]Figure 6 provides an example of an ownership diagram (also called an "organigram") that was included in a case document.

[15]Accessed at https://offshoreleaks.icij.org/.

Figure 2: **Classification of ISDS cases according to claimant ownership structure and IIA coverage.**
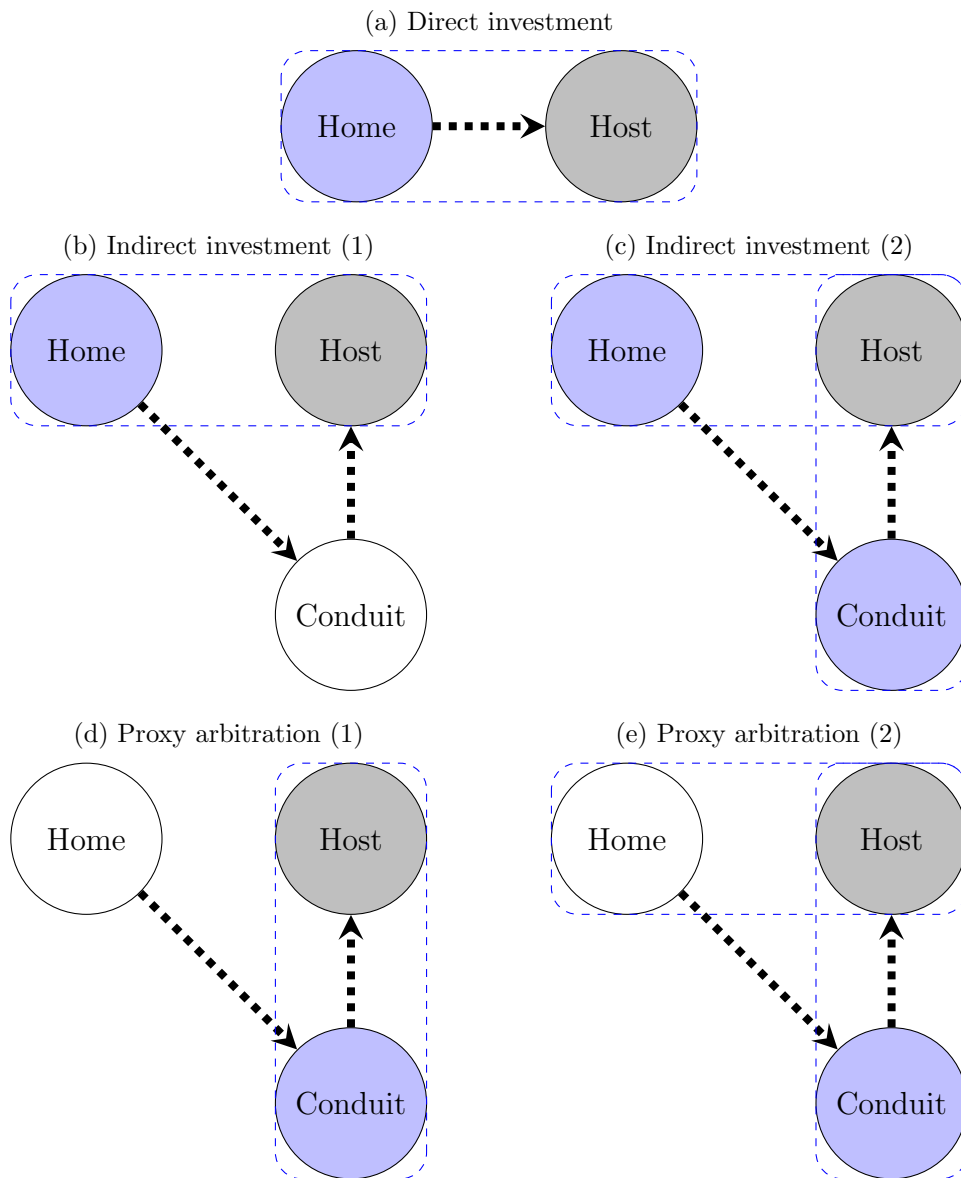
Grey nodes represent the host states where the disputed assets are located, and are the respondents in the ISDS case; blue nodes represent the firms that are claimants in the ISDS case; dashed arrows identify ownership relationships, pointing from owner to subsidiary; the blue dashed line surrounding two nodes indicates that an IIA exists between them, allowing for access to arbitration.

How common are indirect investment and proxy arbitration in the international investment regime? Figure 3 graphs both the absolute number of cases filed annually and the percentage of cases filed annually that involve indirect investment and proxy arbitration.[16]

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[16]I begin the time series in 1995 rather than 1987, as 1995 is the first year that a non-trivial number of

Figure 3: **Indirect investment and proxy arbitration in ISDS, 1995-2015**

(a) Count of cases filed annually

(b) Percentage of cases filed annually
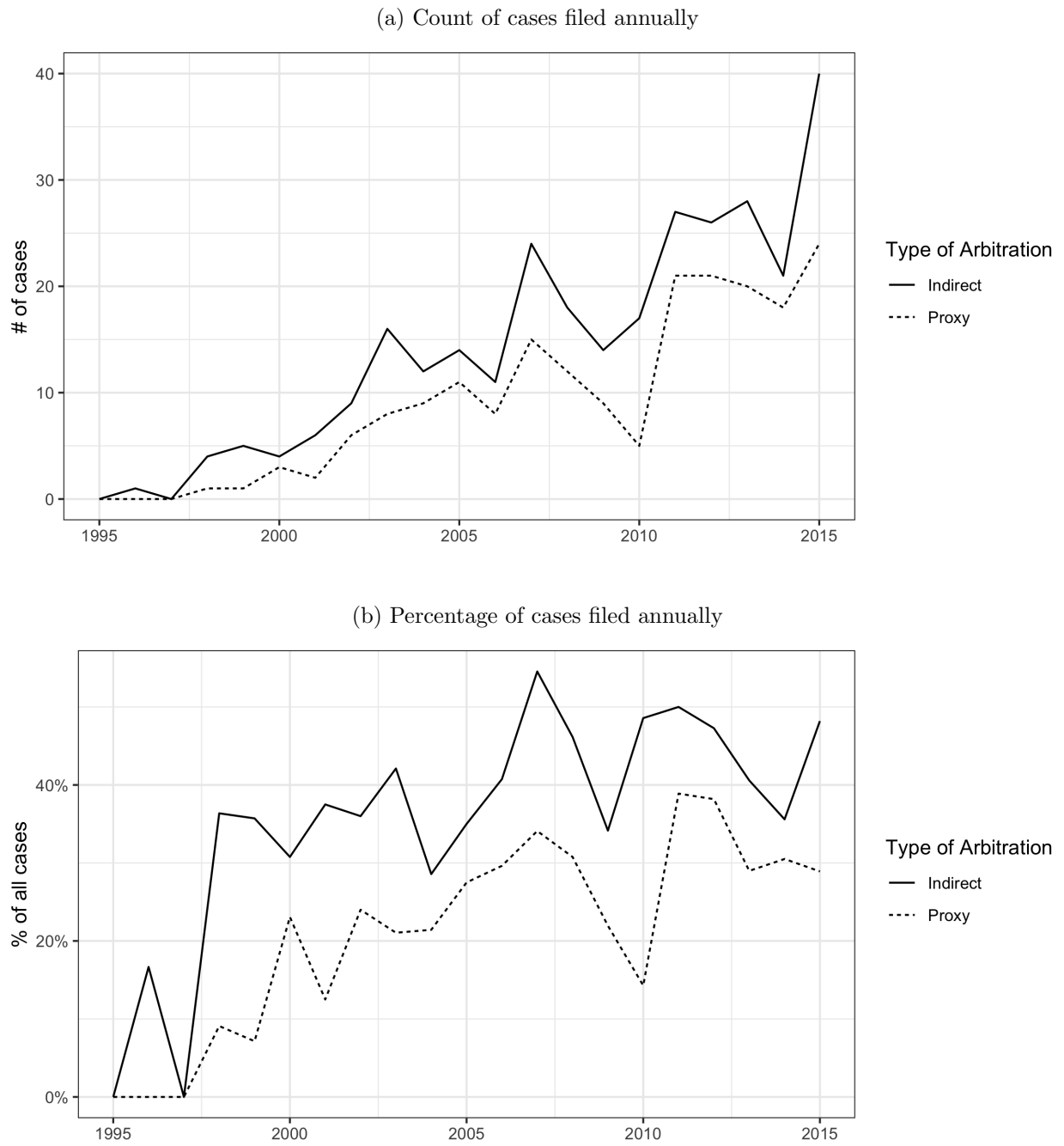
First, note that while indirect investment and proxy arbitration are growing increasingly common, both strategies have long been present in investment arbitration. Second, note that while the trends in indirect investment and proxy arbitration tend to move in tandem,

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cases were filed.

Figure 4: **How does proxy arbitration affect the distribution of claimant nationalities in ISDS?**
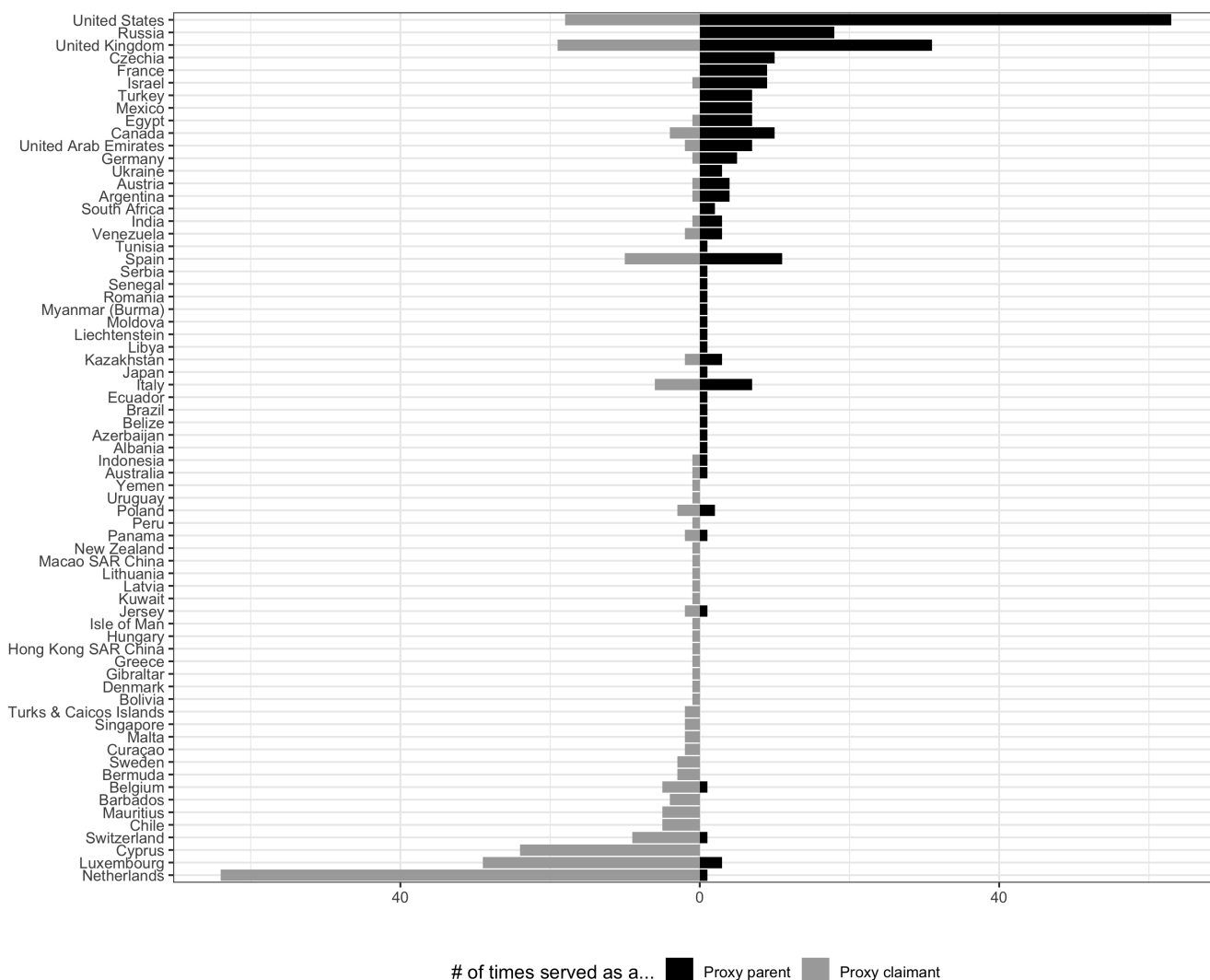
there remain a substantial number of non-proxy arbitration cases in which the claimant(s) nevertheless invested indirectly. Third, note that both phenomena are quite common: proxy arbitrations consistently comprise between one-fourth to one-third of all ISDS cases filed in a given year,[17] and indirect investment (of which proxy arbitration is a subset) is consistently present in one-third to one-half of all cases. Investing indirectly through conduit subsidiaries, and filing ISDS through them, are mainstream rather than niche corporate strategies.

By cloaking the true nationality of the parent investor, proxy arbitration biases our

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[17]This is largely consistent with Betz, Pond and Yin (2020)'s coding of all ICSID cases filed through 2016.

understanding of which states' investors are the primary beneficiaries of ISDS. Figure 4 demonstrates this by plotting two quantities for each state: the number of times an investor from that state has engaged in proxy arbitration as a parent firm (in black), and the number of times an investor filed ISDS indirectly using a conduit entity incorporated in that state (in grey). Official statistics thus *under*estimate the extent to which investors from states at the top of Figure 4 use ISDS, and *over*estimate the extent to which investors from states at the bottom of Figure 4 use ISDS.

Two points from Figure 4 merit particular attention. First, note that almost all of the states at the bottom of the graph – the states who are net hosts of conduit subsidiaries – are well-known facilitators of tax avoidance. While the Netherlands is by far the largest host of conduit entities,[18] other major players include low-CIT jurisdictions (Cyprus, Mauritius, Barbados) and financial centers with large tax treaty portfolios (Switzerland, Luxembourg). Second, while the US and the UK are two of the largest home states for investors who engage in proxy arbitration, they also host substantial numbers of conduit entities. This is not surprising: both the US and the UK are key faciliators of global tax avoidance (through Delaware[19] and BVI/Jersey/Monaco/Isle of Man, respectively).

Finally, Figure 5 plots three trends using panel data on national corporate income tax rates from the Tax Foundation. First, the shorter-dashed line indicates the downward trend in the world average corporate income tax rate between the years of 1995 and 2015. Second, the solid line indicates the average CIT rate imposed on the ultimate owners of the claimants who filed ISDS cases in a given year. While the average CIT rate faced by parent investors has trended downwards in proportion to the world average, note that the former is consistently five to seven percentage points higher than the latter. Finally, the longer-dashed line indicates the average *lowest* CIT rate that is available to parent firms who invest indirectly through conduit subsidiaries. For example, if the parent investor was Austrian (CIT rate

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[18]Thus validating prior qualitative work on the topic's focus on the Netherlands (van Os and Knottnerus, 2012).

[19]See e.g. Leslie Wayne, "How Delaware Thrives as a Corporate Tax Haven", *The New York Times*, 30 June 2012.

Figure 5: **Corporate income tax rates of ISDS parent firms and conduits, 1995-2015**
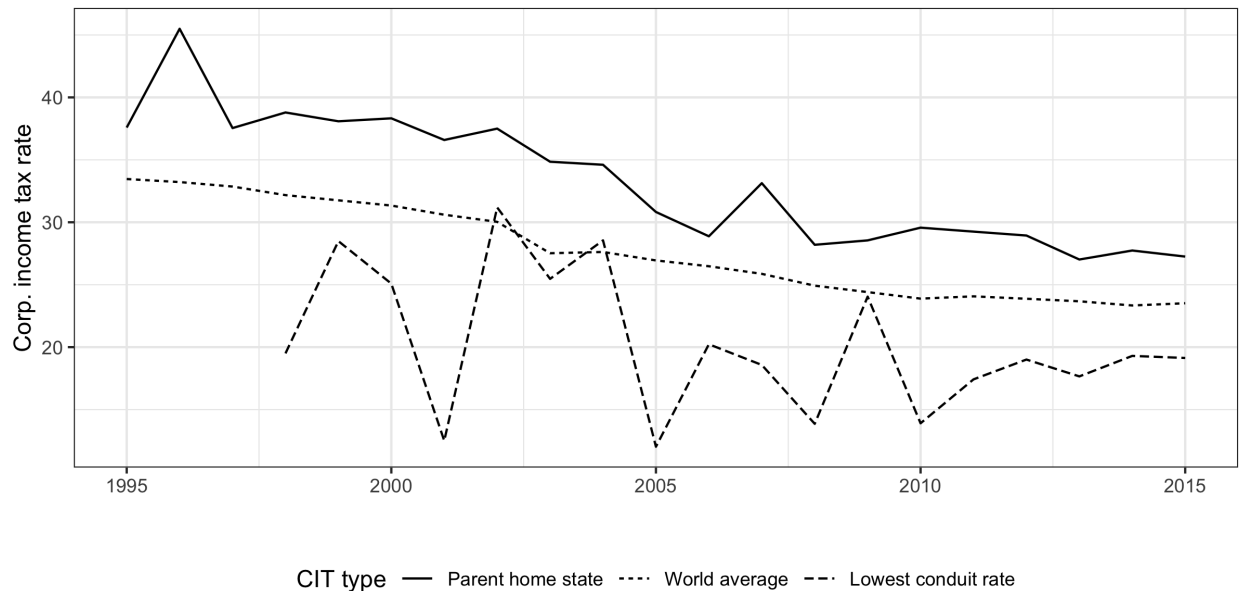
of 25%) but the investment was made indirectly through Bermuda (CIT rate of 0%), the lowest available CIT rate is 0%. Note that not only is the average lowest available CIT rate typically much lower than the average parent firm CIT rate, in most years it is lower than the world average as well; on average, indirect investors gain access to lower-tax jurisdictions.

5 Research design

The goal of this paper is to estimate the extent to which indirect investment and proxy arbitration are driven by tax planning considerations. To do so, I take three econometric approaches: first, for each *ultimate* parent investor-host state dyad, I determine whether tax considerations predict whether the parent firm will invest/file ISDS indirectly. This approach (the "parent-host" models, for short) ignores all information about the observed claimants/conduit entities, focusing only on home state, host state, and home-host characteristics. Second, for each observed ISDS case, I determine whether tax-related characteristics of the *claimant* firms (and the claimant-host relationship) can predict whether the case

involved indirect investment or proxy arbitration (the "claimant-host" models, for short). Unlike the parent-host approach, which requires *a priori* knowledge of the identities of the ultimate investors, these specifications tell us whether or not tax considerations can predict whether any given case involves indirect investment or proxy arbitration even if we know nothing about the claimants' ownership structures. Third, I limit my attention to most-likely cases of IIA-shopping – proxy arbitrations in which the parent firm did not have standing to file ISDS directly – and test whether tax considerations are predictive of conduit location choice in these cases (the "conduit location" models, for short).

5.1   Tax data sources

In addition to my original data on ISDS claimant ownership structures,[20] I use three other data sources to assemble my key independent variables. First, as previously mentioned I use panel data on national corporate income tax rates that was compiled by the Tax Foundation. To put together the panel (which spans the years 1980-2018), the Tax Foundation combined their own coding of government websites with yearly tax reports published by Big Four accounting firms and other academic tax databases.[21] I use this data to determine the CIT rate that would apply to each parent investor and conduit entity.

Second, in order to test hypotheses 2 and 3 I require dyadic data on tax treaties as well as directed-dyadic data on withholding tax rates. I gather these data from accounting/corporate services firm PricewaterhouseCoopers (PwC)'s publicly available territory tax reports.[22] For each territory,[23] PwC records the withholding rates for three types of transfers: interest payments, dividends, and royalties.[24] For each type of transfer, territories maintain both a

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[20]My data is built on the UNCTAD ISDS data.

[21]For more information, see: https://taxfoundation.org/publications/corporate-tax-rates-around-the-world/.

[22]For an example, see: https://taxsummaries.pwc.com/japan/corporate/withholding-taxes.

[23]Note that, because there is subnational variation in withholding tax rates (for example, England's withholding rates are different from those of the British Virgin Islands), the territory – rather than the nation-state – is the appropriate level of measurement.

[24]Some territories have additional rate categories, but none of the others are common enough to be broadly comparable.

non-treaty rate (the withholding rate that is applied when a transfer is made to a non-treaty partner state) and a set of (typically lower) treaty-specific rates that vary based on the treaty partner to which the transfer is being sent. For example, New Zealand's non-treaty rates on interest/dividends/royalties are 15%/15%/15%, but its treaty-specific rates for transfers made to Belgium are 15%/10%/10%.

Using the PwC data, I am able to determine both (1) which dyads have signed tax treaties together, and (2) the withholding rates levied on transfers made between each directed dyad. However, a limitation of the PwC data is that they are not longitudinal: they reflect only the withholding rates as of 2019. This adds noise to the measurement, as some rates have increased and some have decreased since the beginning of the sample period. Still, under the assumption that withholding rates change slowly, the 2019 rates for transfers between State A and State B should be a good approximation for the rates charged on A to B transfers over the past two decades.

While the CIT and withholding rates are two important considerations for tax-planning investors, I acknowledge that they are not the only considerations; financial secrecy, robust banking/financial service sector, and ease of establishing a business are just a few other variables that investors likely take into account when deciding whether (and where) to establish a conduit subsidiary. I thus use a less precise but more encompassing alternative measure in some of the conduit location models: a binary variable indicating whether or not a state is considered to be a "tax haven" by the U.S. Department of Treasury.[25]

5.2 Variable construction and controls

5.2.1 CIT variables

I create three variables using the Tax Foundation CIT data: first, for the parent-host models, I create PARENT CIT which is equal to the CIT rate in the ultimate parent investor's

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[25]Downloaded via the World Economics and Politics Dataverse. See the list here: https://fas.org/sgp/crs/misc/R40623.pdf

home state in the year the case was filed. For the claimant-host models, I create CLAIMANT CIT which is equal to the average of the CIT rates in the claimants' home states. Finally, for the conduit location models I create CONDUIT CIT which is equal to the CIT rate in each potential conduit state. In line with Hypothesis 3, I expect the coefficient on PARENT CIT to be positive and the coefficients on CLAIMANT CIT and CONDUIT CIT to be negative.

5.2.2 Withholding tax and tax treaty variables

I create several variables using the PwC data. For the parent-host analyses, I create a dummy variable to indicate whether the parent investor's home state has a tax treaty with the host state (TAX TREATY (DIRECT)). In line with Hypothesis 1, I expect a negative relationship between this variable and indirect investment/proxy arbitration. I also create INTEREST WHT (DIRECT) and DIVIDEND WHT (DIRECT), variables that measure the direct host-home withholding rates levied on interest payments and dividends respectively.[26] In line with hypothesis 2, I expect a positive sign on these variables: the higher the tax rate on direct host-home transfers, the stronger the incentive for indirect investment. I also create PARENT BTTs, a variable that measures the number of tax treaties to which the parent state is a signatory. I expect a positive sign on this variable, as additional tax treaties open up more potential indirect investment paths for parent investors.

For the claimant-host analyses, I create a measure of the claimants' BTT portfolio distinctiveness which I label CLAIMANT BTT DISSIM. To calculate this measure for a claimant i, I take the count of partner states that i's home state has signed a tax treaty with but which state j has not signed a treaty with; I do this for all states $j \neq i$, and take the average.[27] This provides a rough measure of claimant i's favorability as a conduit location, and thus I expect a positive sign on the CLAIMANT BTT DISSIM variable.

Finally, for the conduit location models, I create several variables. First, I create a

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[26]I choose not to include the royalty WHT rates, as they are highly correlated with interest WHT rates ($\rho > .8$).

[27]For cases with multiple claimants, I take the average of each claimant's value of this variable.

measure of the number of BTTs to which the potential conduit location is a signatory (CONDUIT BTTS). Second, I create variables to indicate whether there exists a tax treaty between the host state and the potential conduit (HOST-CONDUIT BTT) and whether there exists a tax treaty between the conduit and the home state (CONDUIT-PARENT BTT). I include a measure of the number of states with which the potential conduit state has a BTT but the parent state does not (CONDUIT-PARENT BTT DISSIM). All of these variables make a given conduit location more favorable, and thus I expect each of them to be positively signed. Finally, I calculate the effective withholding rate levied on interest and dividend payments were they to be routed from host to conduit and then conduit to the parent's home state (EFFECTIVE INTEREST WHT and EFFECTIVE DIVIDEND WHT, respectively). To do so, I follow Arel-Bundock (2017)'s method for both interest and dividend rates. For each home-host-conduit triplet ijk, the effective withholding rate on transfers made from i to j indirectly through k is equal to:

$$WHT_{ijk}^{E} = 1 - (1 - \tau_{jk})(1 - \tau_{ki}) \tag{1}$$

Where τ_{jk} is the withholding rate on transfers from host to conduit, and τ_{ki} is the rate on transfers from conduit to the parent's home state. I expect a negative sign on the effective rate variables: higher effective withholding rates make a given indirect path less favorable for the parent investor.

5.2.3 Control variables

The most important set of control variables address the possibility of investment treaty shopping, a practice that scholars have identified as a driver of indirect investment and proxy arbitration (Betz, Pond and Yin, 2020; Gray, 2020; van Os and Knottnerus, 2012). If the tax variables that I investigate are correlated with IIA-shopping concerns – for example, if conduits with many tax treaties tend to have many BITs as well – then a failure to control

for the latter would lead me to overestimate the effect of tax planning.

I include a separate control to measure BIT-shopping in each of the three sets of analyses. In the parent-host models, I include a measure of the average BIT dissimilarity of the parent investor's home state (PARENT BIT DISSIM), which is calculated the same way as the BTT dissimilarity variable discussed above. Parent firms who already have access to larger and more unique BIT portfolios have less incentive to IIA shop by investing indirectly, and thus we should expect a negative sign on this variable.[28] In the claimant-host models, I control for the average BIT dissimilarity of the claimants (CLAIMANT BIT DISSIM). In the conduit location models, I control specifically for the number of partner states with which the conduit state has a BIT but the parent state does not; this variable, used by Betz, Pond and Yin (2020), measures the number of new potential host states that the parent investor would be able to file ISDS against were they to invest indirectly through a given conduit. The IIA shopping theory would predict a positive sign on this variable, as the most desirable conduit locations should be those that expand the parent investor's IIA "coverage."

I also control for the per capita GDP of the host state (parent-host and claimant-host models) and the potential conduit state (conduit location models). Some models include year fixed effects to address unobserved temporal heterogeneity. Unfortunately, I lack financial information on the ISDS claimants and parent firms; however, I do include case fixed effects in some of the conduit location models which allows me to account for (but not explicitly model) the influence of firm-level factors.

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[28]In theory, I could also simply control for the presence of a BIT/IIA between parent and host. I choose not to do this due to the problem of sample selection: if the parent does not have standing against the host but it is still observed in the dataset, then it must necessarily be an incident of proxy arbitration. The coefficient on the parent-host IIA variable would thus drastically overestimate the effect of IIA shopping. Still, as a robustness check I run additional models that include this control, and results are robust. See Appendix Table 1.

6 Results

6.1 Parent-host analysis

Table 1: Parent-host models

	DV: Indirect investment			DV: Proxy arbitration		
	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
Parent CIT	0.590***	0.639***	1.049***	0.534***	0.581***	0.931***
	(0.216)	(0.219)	(0.244)	(0.185)	(0.186)	(0.208)
Tax Treaty (Direct)	0.069	0.051	0.051	0.037	0.039	0.028
	(0.042)	(0.043)	(0.044)	(0.036)	(0.037)	(0.038)
Interest WHT (Direct)	0.054	-0.037	-0.471	-0.290	-0.438	-0.572**
	(0.317)	(0.319)	(0.340)	(0.271)	(0.271)	(0.291)
Dividend WHT (Direct)	-0.380*	-0.380*	-0.207	-0.249	-0.237	-0.220
	(0.229)	(0.228)	(0.246)	(0.195)	(0.194)	(0.210)
Parent BTT Dissim		0.003**	0.003**		0.001	0.001
		(0.001)	(0.001)		(0.001)	(0.001)
Parent BIT Dissim		-0.001	-0.002**		-0.002**	-0.002***
		(0.001)	(0.001)		(0.001)	(0.001)
Host GDPPC (log)			-0.052***			0.001
			(0.018)			(0.015)
Year FE	N	N	Y	N	N	Y
Num.Obs.	732	729	709	732	729	709
R2	0.019	0.029	0.110	0.023	0.037	0.113
R2 Adj.	0.013	0.021	0.075	0.017	0.029	0.078

* $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$

The first set of models take as the unit of analysis each (ultimate) parent investor-host dyad; this means that if the claimants in a given case are owned by multiple investors of different nationalities, the case will result in multiple observations. I exclude cases where the ultimate investor shares a nationality with the host state, as "direct" foreign investment is not possible in such cases. Table 1 presents the results of six models estimated via OLS; in models 1-3 the dependent variable is a dummy indicating that the parent invested indirectly, and in models 4-6 the dependent variable is a dummy indicating that the parent invested and filed ISDS indirectly.

First, note that the coefficient on PARENT CIT is positive and significant across all models. This provides strong support for Hypothesis 3: investors from states with high corporate income tax rates are more likely to invest indirectly, and also more likely to engage in proxy arbitration. These effects are significant in magnitude, as well. Using the estimates from Model 3 and Model 6, a one standard deviation increase in PARENT CIT is associated with an 8.3 [5, 11.5] percentage point increase in the probability of indirect investment, and a 7.5 [4.2, 10.7] percentage point increase in the probability of proxy arbitration.

I find little support for Hypotheses 1 and 2. The TAX TREATY (DIRECT) variable is not significant in any model, and the withholding variables are either insignificant or negative and significant (contrary to the predictions of tax planning theory). However, the PARENT BTT DISSIM variable is positive and significant as expected in the indirect investment models, suggesting that parent investors with access to larger tax treaty portfolios are more likely to invest indirectly. The variable is not a significant predictor of proxy arbitration, however. Finally, note that the PARENT BIT DISSIM variable is negative and significant in most models, suggesting that – as the IIA shopping thesis would predict – investors from home states with smaller and less unique BIT portfolios are indeed more likely to invest indirectly and file proxy arbitration.

6.2   Claimant-host analysis

The second set of analyses take as the unit of analysis the ISDS case, and thus (unlike the parent-host models) each case is associated with a single observation. Since these models are "naive" in the sense that they do not incorporate information about claimants' owners or subsidiaries, I do not remove cases in which the nationality of the ultimate owner is the same as that of the host state. Table 2 presents the results of six models estimated via OLS, again with the first three predicting indirect investment and the second three predicting proxy arbitration.

The negative and significant coefficient on the CLAIMANT CIT variable provides fur-

Table 2: Claimant-host models

|	DV: Indirect investment			DV: Proxy arbitration		
	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
Claimant CIT	-0.626***	-0.589**	-0.521*	-1.226***	-1.315***	-1.285***
	(0.217)	(0.228)	(0.270)	(0.198)	(0.208)	(0.249)
Claimant BTT Dissim	0.000	0.002	0.001	-0.002*	-0.000	-0.001
	(0.001)	(0.001)	(0.001)	(0.001)	(0.001)	(0.001)
Claimant BIT Dissim		-0.001	-0.001		-0.001**	-0.001
		(0.001)	(0.001)		(0.001)	(0.001)
Host GDPPC (log)			-0.017			0.038**
			(0.017)			(0.015)
Year FE	N	N	Y	N	N	Y
Num.Obs.	712	705	682	712	705	682
R2	0.012	0.012	0.056	0.068	0.067	0.098
R2 Adj.	0.010	0.007	0.022	0.065	0.063	0.065

* $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$

ther support for Hypothesis 3: as the corporate income tax rate in the claimant's state of incorporation decreases, it becomes more likely that a given case involves both indirect investment and proxy arbitration. Again, the mangitude of this relationship is substantial: all else equal, moving from a claimant that is located in a state with a CIT rate of 20% (such as Croatia) to a state with a CIT rate of 0% (such as Bermuda) is associated with a 26 [22, 30] percentage point increase in the probability that a given case involves proxy arbitration.

Results on both the BIT and BTT dissimilarity variables are mixed, and typically not significant. However, this makes sense given the claimant-host data structure; since claimants include both ultimate direct investors (who presumably invested directly because they already had good BIT and BTT coverage) and conduit subsidiaries (who were presumably incorporated in a state that would give the parent access to superior BIT and BTT coverage), we should not expect a large difference in these variables between direct investment, indirect investment, or proxy arbitration cases.

6.3 Conduit location analysis

Figure 6: **Data structure for conduit location models**

Parent Conduit Host Chosen
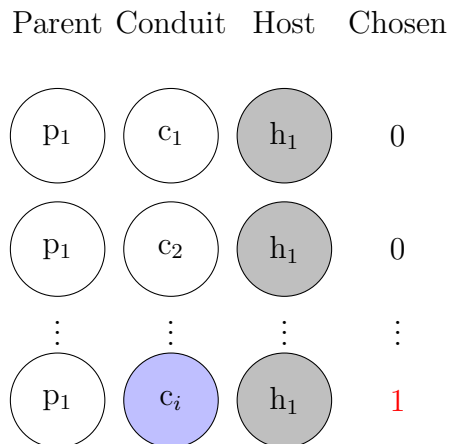
Each row of the diagram represents one row in the dataset. Again, grey nodes indicate the respondent state, and blue nodes are the observed claimants in the ISDS case.

The previous models demonstrated that tax variables predict the occurence of indirect investment and proxy arbitration. I now turn to what is arguably a tougher test of the tax planning explanation: if we limit the sample to most-likely cases of IIA shopping – proxy arbitrations in which the parent investor's home state *did not* have an IIA with the host state – can tax planning still help us understand investors' choice of conduit location? The IIA shopping theory would expect that treaty-shopping firms invest indirectly in order to maximize their IIA coverage, and thus they should choose to incorporate their conduit subsidiaries in states that offer the greatest expansion of their IIA portfolio. The tax planning theory, however, expects that firms will prefer to maximize tax savings over IIA portfolio expansion, selecting conduit states with low CIT rates and favorable tax treaties.

To test these predictions, I start by identifying the most-likely cases for IIA shopping: parent-conduit-host triplets in which the ultimate parent investor lacked the ability to file ISDS against the host directly, and thus filed ISDS *in*directly through a conduit subsidiary instead. There are 99 such triplets in the data.[29] Then, for each unique parent-host pair, I

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[29]I focus only on cases with a single conduit subsidiary between parent and host, as attempting to incorporate all potential indirect paths of length two or more would quickly become computationally infeasible.

Table 3: Conduit location models

	DV: Chosen as conduit location					
	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
Conduit CIT	0.073***	0.074***	0.095***	0.100***		
	(0.023)	(0.025)	(0.026)	(0.028)		
Tax Haven					0.033***	0.032***
					(0.011)	(0.011)
Conduit BTTs	0.000	0.000*	0.000	0.000		
	(0.000)	(0.000)	(0.000)	(0.000)		
Conduit-Parent BTT	-0.018***	-0.018***	-0.013**	-0.014**		
	(0.006)	(0.006)	(0.006)	(0.006)		
Host-Conduit BTT	0.001	0.001	0.005	0.007		
	(0.006)	(0.006)	(0.005)	(0.008)		
Effective Interest WHT	-0.102***	-0.103***	-0.053**	-0.026		
	(0.025)	(0.025)	(0.026)	(0.037)		
Effective Dividend WHT	-0.063***	-0.063***	-0.067***	-0.104***		
	(0.021)	(0.021)	(0.024)	(0.031)		
Conduit-Parent BTT Dissim	0.001**	0.001**	0.000	0.001		
	(0.000)	(0.000)	(0.000)	(0.000)		
Conduit-Parent BIT Dissim		-0.000	-0.000	-0.000	0.000*	0.000
		(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
Conduit GDPPC (log)			0.012***	0.011***	0.014***	0.014***
			(0.001)	(0.002)	(0.001)	(0.002)
Year FE	N	N	Y	Y	Y	Y
Case FE	N	N	N	Y	N	Y
Num.Obs.	4382	4382	4382	4382	4376	4376
R2	0.019	0.019	0.028	0.034	0.028	0.033

* $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$

identify all of the potential conduit locations that the parent investor could have also chosen. I operationalize potential conduit locations as the set of all states that had an active BIT/IIA with the host state at the time the case was filed, as investing indirectly through any of these states would give the parent access to ISDS against the host. The unit of observation, then, is the parent home state-potential conduit state-host state, and the dependent variable is a binary indicator of whether the investor actually chose to invest indirectly through the potential conduit state. Figure 6 represents the data structure diagramatically.

Table 3 presents the results of six models, estimated with OLS and presented with robust

standard errors clustered on the ISDS case. First, note that the CONDUIT CIT coefficient is *positive* and significant across specifications: holding all else equal, states with higher corporate income tax rates are more likely to be selected as conduit locations among this subset of cases. Rather than suggesting that firms actually find high CIT rates to be desirable, these results should be interpreted as suggesting that – in cases of proxy arbitration when the parent investor lacks direct standing – profit-shifting is not investors' primary concern.

However, the results do suggest that investors seek to minimize the withholding tax rates to which their indirect investments are subject. As predicted, both of the effective interest rate variables are negative and consistently significant: as the cost of routing interest or dividend payments indirectly through a given state *decreases*, the probability that investors establish a conduit subsidiary in that state *increases*.

Models 5 and 6 replace all of the detailed tax variables with a single dummy variable, TAX HAVEN, which indicates whether or not each potential conduit was labeled a tax haven by the U.S. Treasury. The coefficient on this variable is positive, significant, and substantial: tax havens are 3.3 [1.1, 5.5] percentage points more likely to be selected as conduit locations than non-tax havens, which is considerable given that the unconditional probability that any state is chosen as a conduit location is just over 2%. While the dummy variable approach is less fine-grained than my primary set of tax variables, the results provide reassurance that tax concerns do drive firms' conduit location choices.

Finally, note that the CONDUIT-PARENT BIT DISSIM variable is inconsistently signed and only once achieves significance at the $p < .1$ level. This suggests that, once tax variables are accounted for, parent investors do not select conduit subsidiary locations that maximize their IIA portfolios. This result does not necessarily imply that gaining access to ISDS is irrelevant to indirect investors. Rather, it can be interpreted as suggesting that what IIA shopping does occur is likely done to protect host state-specific assets, rather than the entirety of parent investors' portfolios.

6.4 Discussion

In general, the econometric results provide strong support for the paper's central claim: investors' decisions about whether and where to invest indirectly are driven by tax planning considerations, and these decisions in turn shape the distribution of observed ISDS arbitrations. In this section, I briefly evaluate each of the three hypotheses in light of the empirical evidence.

First, I find little support for Hypothesis 1: the presence or absense of a tax treaty between parent and host does not appear to drive investors' decisions to invest indirectly, or their decisions about where to locate their conduits, once one has controlled for the withholding rates themselves. This is somewhat of a surprising finding, given that other studies have found a positive and substantial effect of tax treaties on FDI inflows (Barthel, Busse and Neumayer, 2010; Betz, Pond and Yin, 2020). A possible interpretation is that tax treaties are not inherently attractive independently of their policy effects: unlike BITs, which despite their differences tend to contain most of the same substantive protections,[30] tax treaties vary substantially in their provisions and thereby their favorability to investors.

Turning to Hypotheses 2 and 3, I find that while withholding rates may not drive investors' initial decision of whether or not to invest indirectly, they do appear to influence indirect investors' choice of conduit location. Regarding CIT rates, results of the parent-host models suggest that parent investors who face higher CIT rates are more likely to invest and file ISDS directly; likewise, results of the claimant-host models suggest that claimants from lower-CIT states are more likely to be conduit subsidiaries themselves. However, results of the conduit location models suggest that – in potential IIA shopping cases – parent investors choose conduit locations that minimize their effective withholding rates, not locations that give them access to low-CIT jurisdictions. While investors clearly seek to minimize their income and withholding tax burdens, they may not be able to do both at the same time.

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[30]See Berge (2020) for an in-depth discussion.

7 Conclusion

All is not well in the international investment regime. States are terminating or renegotiating their investment treaties increasingly frequently,[31] and recent evidence suggests that public opinion towards the investor-state dispute settlement mechanism is quite negative (Hahm et al., 2019). Much of the discontent is likely driven by the disparity between what states expected to gain from signing BITs and the realities of modern investment disputes; as the quote from Montenegro's legal counsel at the beginning of this paper illustrates, proxy arbitration – present in over a quarter of all modern ISDS cases – was not what states had in mind when they signed what they believed to be truly *bilateral* treaties.

In this paper, I first introduce a comprehensive dataset on the ownership structures of ISDS claimants that allows me to assess the prevalence of indirect investment and proxy arbitration in the international investment regime. I find that these practices are quite standard: 41% of all cases filed between 1987 and 2015 involved indirect investment, 27% can be considered proxy arbitration, and 8% are proxy arbitrations where the ultimate investor is a national of the host state who simply "round-tripped" their investment through an offshore holding company.[32]

Next, I propose a theoretical explanation for these phenomena. Firms and individuals who invest abroad often do so indirectly (via third party subsidiaries) in order to minimize their tax burden; these "conduit" subsidiaries give investors access to lower effective withholding tax rates on intrafirm transfers, and access to low corporate income tax jurisdictions that can be used for profit-shifting. Once established, however, these subsidiaries can also be used to gain standing to ISDS in the event that a dispute arises with the host government.

In a series of empirical tests, I find support for the tax planning explanation: parent investors are far more likely to invest indirectly, and file ISDS via their subsidiaries, when

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[31]For studies of these phenomena, see: Haftel and Thompson (2018); Peinhardt and Wellhausen (2016); Thompson, Broude and Haftel (2019).

[32]Note that these percentages are not additive; rather, proxy arbitrations are a subset of cases involving indirect investment, and round-trip proxy arbitrations are a subset of proxy arbitrations.

their home state has a high CIT rate. Likewise, claimants who are incorporated in low-tax jurisdictions are more likely to be subsidiaries of a third party parent. Even when I limit my focus to a subset of most-likely cases for IIA shopping – proxy arbitrations in which the parent investor would not have been able to file ISDS against the host without their subsidiary – I find that investors choose subsidiary locations that minimize withholding tax rates rather than those that expand their IIA portfolio.

I highlight two implications of these results for the broader field of international political economy. First, scholars of IPE frequently study the causes and effects of bilateral (or small multilateral) treaty regimes: investment and tax (as in the present study), labor (Peters, 2019), trade (Baccini, 2019), and environmental (Mitchell et al., 2020), among others. However, while these agreements are negotiated and signed by states, all of them seek to affect the behavior of firms. As this study demonstrates, firms' strategies can be influenced by multiple overlapping treaty regimes: the network of bilateral withholding tax rates, created in large part by tax treaties, shapes firms' international legal strategies by expanding access to ISDS under bilateral investment treaties. Future studies of treaty-based regimes would thus be well-served by adopting a "general equilibrium" approach, considering how firm behavior (trade, investment, etc) might be driven by more than one type of regulation.[33]

Second, building on recent work that draws attention to the complex structure of modern foreign direct investment (Betz and Pond, 2019; Kerner, 2014; Reurink and Garcia-bernardo, 2020), this study underscores the conceptual importance of corporate structure in the international political economy. Just as modern multinationals are able to fragment their production networks into global supply chains – making intra-industry and even intra-*firm* trade salient concerns for trade scholars[34] – so too can they strategically fragment their ownership structures, gaining or shedding nationalities with the stroke of a lawyer's pen. In addition to creating measurement issues for the study of firms and foreign investment, complex ownership structures present an opportunity for IPE scholars to answer several im-

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[33]For two examples of such an approach, see Peters (2014) and Barthel and Neumayer (2012).

[34]See Kim and Osgood (2019) for a review.

portant questions: how do political factors influence firms' ownership structures? What are the consequences of corporate fragmentation for the international and domestic institutions that regulate business activity? What are the (re)distributive consequences of fragmentation, and who supports or opposes it?

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A   Appendix

A.1   Figures

Figure 7: Organigram from *Aguas del Tunari v. Bolivia*
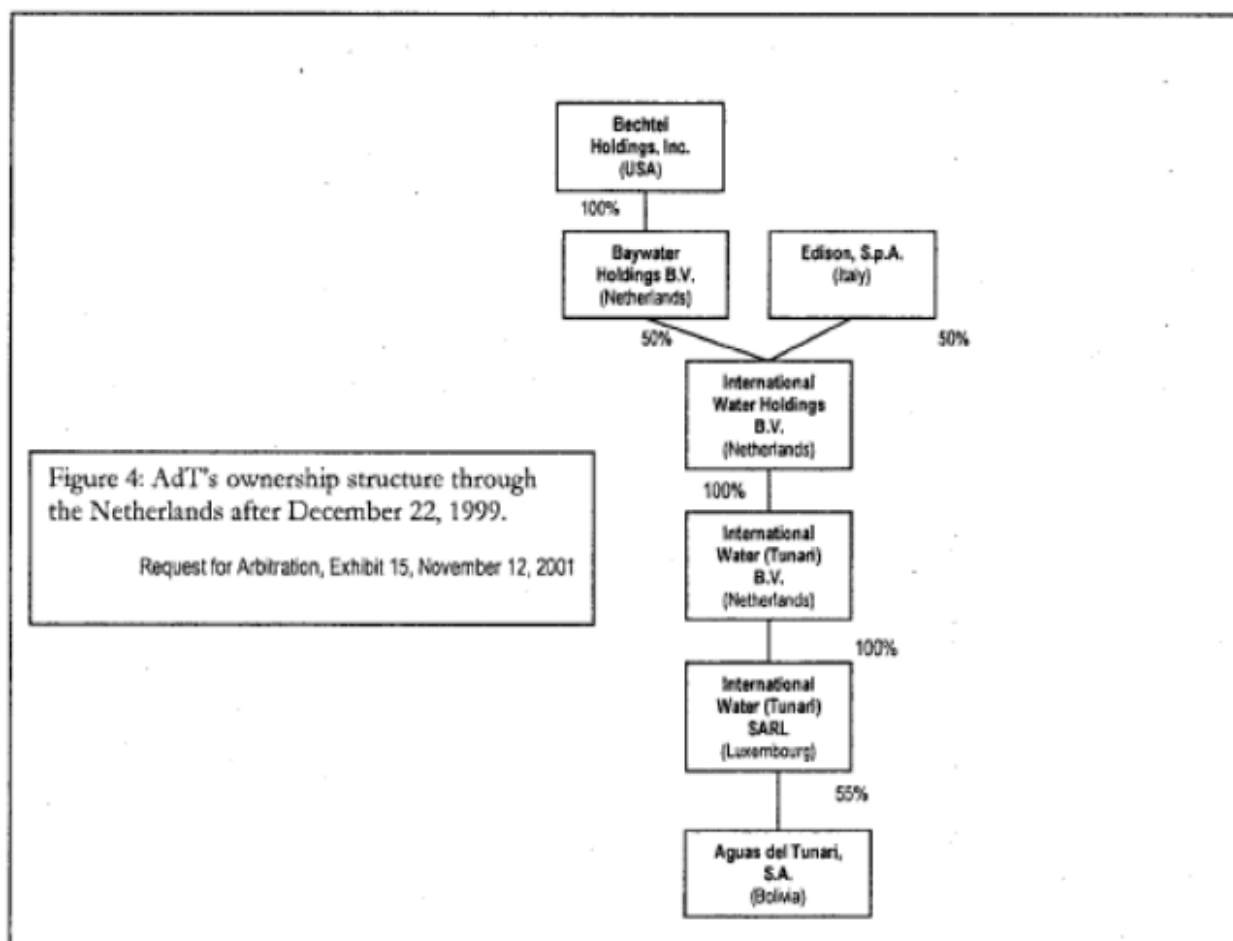
A.2   Tables

Table 4: Parent-host models with parent-host standing control

	DV: Indirect investment			DV: Proxy arbitration		
	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
Parent CIT	0.633***	0.650***	0.995***	0.579***	0.599***	0.850***
	(0.213)	(0.214)	(0.237)	(0.168)	(0.168)	(0.190)
Tax Treaty (Direct)	0.119***	0.095**	0.101**	0.119***	0.109***	0.102***
	(0.042)	(0.043)	(0.044)	(0.033)	(0.034)	(0.035)
Interest WHT (Direct)	-0.206	-0.245	-0.743**	-0.719***	-0.777***	-0.979***
	(0.312)	(0.313)	(0.334)	(0.246)	(0.247)	(0.268)
Dividend WHT (Direct)	-0.306	-0.308	-0.151	-0.121	-0.120	-0.136
	(0.223)	(0.223)	(0.240)	(0.176)	(0.176)	(0.192)
Parent BTT Dissim		0.003**	0.003***		0.002*	0.001
		(0.001)	(0.001)		(0.001)	(0.001)
Parent-Host Standing	-0.291***	-0.304***	-0.314***	-0.491***	-0.494***	-0.471***
	(0.049)	(0.049)	(0.050)	(0.038)	(0.039)	(0.040)
Parent BIT Dissim		-0.001	-0.001		-0.001	-0.001*
		(0.001)	(0.001)		(0.001)	(0.001)
GDP per cap (log)			-0.064***			-0.017
			(0.018)			(0.014)
Year FE	N	N	Y	N	N	Y
Num.Obs.	731	729	709	731	729	709
R2	0.067	0.078	0.159	0.205	0.213	0.262
R2 Adj.	0.061	0.069	0.124	0.200	0.205	0.232

* $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$