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Item 3(p) of the provisional agenda
Relationship of tax, trade and investment agreements

Co-Coordinators' Report

Summary

This paper outlines the current and proposed work of the Subcommittee on the Relationship of Tax, Trade and Investment Agreements, as well as some relevant background to that work, in accordance with the workstreams of the Subcommittee agreed by the Committee at the Twenty-fourth Session.

The Subcommittee seeks *the Committee's views on the issues raised in this note, particularly on the draft outline for possible Committee guidance in this area at paragraph 10 of this note. The final version of a consultant's report on the relationship of tax and investment treaties commissioned by UNDESA is attached to this note as highly relevant background*. Both relate to **Workstream A** on the relationship of tax and investment agreements.

The Subcommittee also proposes to commence work on examining options for improving guidance on the interaction of tax treaties with the WTO General Agreement on Trade in Services ("GATS"), which comprises **Workstream B**, and views from the Committee on that issue are also sought.

Workstream C (Other Issues in Trade Agreements or Mixed Trade and Investment Agreement) has not yet commenced, as it is not yet clear what the content of that "gap-filling" third workstream would be, pending further work on Workstream A. The Subcommittee will collect information on possible issues for Workstream C and report back to the Committee at the Twenty-seventh Session.

Background and Subcommittee Mandate

1. Note E/C.18/2021/CRP.36 ("the 2021 Note") on the relationship of taxation with trade and investment agreements gave a history of the UN Secretariat work on the interaction of taxation policy and administration, including an earlier note E/C.18/2019/CRP.14 ("the 2019 Note") on similar issues. The 2021 Note recognized the work of the United Nations Conference on Trade and Development (UNCTAD) in that area, notably the March 2021 publication: International Investment Agreements and Their Implications for Tax Measures: What Tax Policymakers Need to Know. UNCTAD consulted with the Secretariat and others when preparing that document, and the UNCTAD publication itself acknowledges the 2019 Note.

2. The 2021 Note addressed the need for guidance to tax policymakers and administrators on a variety of issues about the interaction of trade and investment treaties with tax policy and administration, including, but not limited to, tax treaties.

3. At the Twenty-third Session, the 2021 Note was considered and the Report of that Session noted the presentations made and the general discussion on the subject. As also indicated in the Report, at para 114:

> The Committee agreed to establish a Subcommittee on the Relationship of Tax, Trade and Investment Agreements, with Ms. Kana, Mr. Ligomeka, and Mr. Roelofsen as Co-Coordinators, and with the following mandate:
>
> The Subcommittee is mandated:
>
> - To identify priority issues where guidance from the Committee may most usefully assist developing countries in differing situations, in particular, on the relationship of tax with investment and trade agreements, and initially report to the Committee on such issues at its Twenty-fourth Session, in 2022
> - Within the above context, to make proposals for consideration by the Committee, with a view to providing guidance at various points during the current membership of the Committee
>
> The Subcommittee may consult broadly, taking into account relevant work by other bodies in this area.

Meetings of the Subcommittee

4. Seventeen Members of the UN Tax Committee are currently participating in the Subcommittee. The first two meetings of the Subcommittee so constituted were conducted virtually on 26 January and 3 March 2022 to consider the following issues:

- The composition of the Subcommittee;
- A proposed workplan; and
- The outline of a report to the Twenty-fourth Session.

5. The outcomes of the first two Subcommittee meetings were outlined in the Co-Coordinators' report to the Committee's Twenty-fourth Session (E/C.18/2022/CRP.5). In particular the proposal of three workstreams:

- Workstream A – Tax and Investment Agreements;
- Workstream B – Tax and The General Agreement on Trade in Services (GATS); and
- Workstream C – Other Issues in Trade Agreements or Mixed Trade and Investment Agreements;

was accepted by the Committee at the 24th Session, as reflected in the Report of that Session.

As noted in the Report at para. 113: “The work would be continued with a view to undertaking whole-of-government approaches and bringing together tax, trade and investment communities.” At this stage, the focus has been on Workstream A, the relationship between tax and investment agreements.

6. The third Subcommittee meeting (held virtually on 29 September 2022) considered issues relating to the note for the Twenty-fifth Session and particularly discussed and gave feedback on a draft outline of a paper on the treatment of taxation in international investment agreements prepared by Mr. Alain Castonguay as a consultant to the Secretariat.

7. At the Committee’s Twenty-fifth Session, the Committee considered the paper presented to it and the discussions and conclusions were as follows, as indicated in the report of that session:

> 101. The Co-Coordinator of the Subcommittee on the Relationship of Tax, Trade and Investment Agreements, Mr. Roelofsen, presented a Co-Coordinators’ report on the topic (E/C.18/2022/CRP.18). He recalled that Workstream A addressed taxation policy and administration measures and their relationship with international investment agreements (IIAs) and that Workstream B referred to the relationship between tax treaties and the WTO General Agreement on Trade in Services (GATS). Workstream C would consider issues other than those addressed in Workstreams A and B, such as other tax-related issues in trade agreements or mixed trade and investment agreements.
>
> 102. Subsequently, the UNDESA consultant, Mr. Alain Castonguay, participating virtually, briefed the Committee on the draft outline for a report on the relationship of tax and investment treaties commissioned by UNDESA. Mr. Castonguay presented key features of that outline, among them, the impact of international investment agreements on taxation, proposals to tackle the issue of taxation in international investment agreements, and practical implementation of guidance in future IIAs. He emphasized that concerns of tax officials should be taken into account when countries negotiate investment agreements. The Consultant’s report intends to assist discussions within the Subcommittee on this topic.
>
> 103. Mr. Richard Bolwijn, the Director of the Investment Research Branch at the United Nations Conference on Trade and Development, briefed on UNCTAD’s work on international investment agreements, as referenced in E/C.18/2022/CRP.18. He highlighted key elements of the 2022 World Investment Report, including the international tax reforms and sustainable investment implications of BEPS Pillar 2 on investment policy. Mr. Bolwijn underscored the need to promote more coordination and collaboration between investment and tax communities. The other Co-Coordinator of the Subcommittee, Ms. Kana, agreed with Mr. Bolwijn on this aspect, which has been recognized in Subcommittee work so far, emphasizing the broader importance of building bridges in investment and tax: the tax world should learn about investment policies and vice versa.
>
> 104. A fruitful discussion followed. Members of the Committee and Observers commended the work of the Subcommittee and the paper outline, which will assist the Subcommittee in its own work, while stressing the need to create further awareness about investment agreements that cover taxes. One Member pointed out that dispute mechanisms in investment agreements have an impact of international tax agreements, while suggesting the Committee could examine such mechanisms going forward, especially as dispute panels can result in enormous financial consequences for countries.

> 105. Members and Observers noted that there was a significant distinction between old and new investment treaties in any analysis, and it was suggested that the Committee's work on fast-track mechanisms for updating bilateral tax treaties might also provide lessons for the investment community, as might the OECD Multilateral Instrument. While the Subcommittee did not propose dealing in any detail with issues from the investment side, such as whether investment agreements should be entered into, or investment treaty shopping, they could be mentioned to ensure awareness of the matter and the necessary context.
>
> 106. The Subcommittee thanked participants for the comments and suggestions and will consider them in taking forward the work.

8. The Subcommittee met virtually on 30 November 2022 to discuss and comment on an earlier version of the consultant's paper attached to this note. A smaller drafting-focused group set up at the 30 November 2022 meeting then met on 18 January 2023 and considered the possible form of Committee guidance on the relationship of tax and investment agreements. The following were seen as potential elements of such guidance, which could draw upon the consultant's report and other relevant materials:

- A practical focus;
- Relatively short – up to about 20 pages;
- Points to/ leverages off key messages in available guidance;
- But also addresses gaps in current guidance;
- Especially giving very practical guidance in dealing with;
  - Tax officials' possible roles in developing or improving investment agreement models;
  - Tax officials' possible roles in negotiating investment agreement;
  - Situations before a problem arises – assessing e.g., due process requirements;
  - Dealing with problems that have emerged; and
  - Improving whole of government approaches.

9. The Subcommittee met virtually on 7 February 2023 to consider the potential elements referred to in the preceding paragraph (paragraph 8) and an earlier version of the outline at paragraph 10 below.

10. The following is a draft outline of possible guidance for Committee Member discussion and guidance to the Subcommittee;

A Possible Outline for UN Guidance on Tax and Investment Agreements

1, Introduction and purpose of guidance, including the expected audience (principally tax officials, but also relevant to investment officials and tax practitioners).

2. What are International Investment Agreements (IIAs) and why are they often seen as important to the investment climate [making clear that this includes provisions in e.g., Free Trade Agreements and noting the difference of older and newer treaties, but the potential relevance of both].

3. Why are IIAs relevant to tax policy and administration and how do investment officials view them?

4. An overview of key tax-relevant provisions (brief – with references/ links to more detailed treatments, and possibly some brief examples, but noting potential risks to tax policy and administration):

- The overall coverage of IIAs;
- Definitions: "Investors of a Party" and "Investment";
- National Treatment (NT);
- Most Favoured Nation (MFN);
- Fair and Equitable Treatment (FET);
- Full Protection and Security (FPS);
- Expropriation;
- Transfer of Funds;
- "Umbrella" Provisions;
- Tax carveouts; and
- Investor-State Dispute Settlement and Enforcement Actions.

This should include a brief description and list of existing tools and approaches for evaluating and implementing IIA reform options and modernizing older treaties to address issues of the type noted in para. 4 (e.g. UNCTAD work such as the Investment Policy Framework for Sustainable Development, as well as the consultant's paper currently attached to this note. This could be an Annex.

5. Developing a general approach and an internal capability on tax aspects of IIAs at country-level, and examining practical possibilities for promoting whole of government approaches. Identifying and conveying within government the needed policy space for tax policy and administration, with an awareness of the perceived investment climate-related drivers (including the possible benefit of tax treaty expertise in dealing with e.g., IIA treaty shopping).

6. Specific possible actions for consideration at country level:

- Developing a relationship with investment officials in the same government;
- Surveying and responding to the existing landscape of agreements;
- Developing a tax-aware Country IIA Model and IIA negotiations;
- Coordinating tax-related IIA provisions and DTAs;
- Meeting tax-related commitments for new and older treaties (e.g., due process?);
- Once a potential dispute has been identified;
- When a dispute has commenced – the tax official's potential role in the whole of government response, including panel selection;
- Are tax expert witnesses needed and if so, how can they be identified; and
- Feeding the lessons back into policy and practice.

7. Conclusion – integrating tax and investment policy and practice with an awareness of the risk and of possible responses. Whole of government approaches for more informed and effective approaches.

The GATS issue

11. The **GATS issue (Workstream B)**, is outlined in [CRP.36] of this Committee Membership's first session (the Twenty-third for the Commission as a whole).

> "- In examining compatibility of tax and non-tax agreements on these points, the World Trade Organisation (WTO) agreements are relevant both in their own right and because most non-discrimination provisions in non-tax agreements are based in significant part on the WTO provisions. The General Agreement on Trade in Services (GATS) is a trade agreement but also, because the definition of modes of service covers, in effect, investment through "commercial presence", it also constitutes an investment agreement. When the GATS was negotiated, there was a concern that some tax measures where distinctions are made based on taxpayer resident might be in violation of the GATS National Treatment obligation. Both the OECD and UN Models note, in their commentaries to Article 24 (Non- Discrimination) that discrimination based on residence is not contrary to the National Treatment obligation.
>
> - The GATS has an exception allowing measures inconsistent with the National Treatment obligation where "the difference in treatment is aimed at ensuring the equitable or effective imposition or collection of direct taxes in respect of services or service suppliers of other Members". The GATS was amended, before its conclusion, to incorporate a footnote to that provision intended to illustrate with some degree of specificity what Members regarded as measures meeting the "equitable or effective" standard.
>
> - A provision was also included in the GATS stating that the National Treatment obligation could not be invoked under the Agreement's dispute settlement procedures: "with respect to a measure of another Member that falls within the scope of an international agreement between them relating to the avoidance of double taxation. In case of disagreement between Members as to whether a measure falls within the scope of such an agreement between them, it shall be open to either Member to bring this matter before the Council for Trade in Services".
>
> - The final decision in the event of a dispute as to whether a measure falls within the scope of a tax agreement between them is therefore made by the Council for Trade in Services, a high-level body of country representatives at the WTO in Geneva referring the matter to binding resolution under the WTO dispute settlement procedure.
>
> - To address that issue, in its 1995 Commentary on Article 25 the OECD Model Double Tax Convention proposed language for inclusion in tax treaties. The effect of the wording is to ensure that tax treaties concluded or amended since 1995 receive the same "grandfathered" protections as pre-1995 treaties. The UN Model picks up the language proposed, and the explanation of it. The OECD Commentary, as picked up in the UN Model, note the potential difficulties of leaving these tax issues to trade experts as follows:
>
> > "Contracting States may wish to avoid these difficulties by extending bilaterally the application of the footnote to paragraph 3 of Article XXII of the GATS to conventions concluded after the entry into force of the GATS. Such a bilateral extension, which would supplement— but not violate in any way—the Contracting States' obligations under the GATS, could be incorporated in the convention by the addition of the following provision: 'For purposes of paragraph 3 of Article XXII (Consultation) of the General Agreement on Trade in Services, the Contracting States agree that, notwithstanding that paragraph, any dispute between them as to whether a measure falls within the scope of this Convention may be brought before the Council for Trade in Services, as provided by that paragraph, only with the consent of both Contracting States. Any doubt as to the interpretation of this paragraph shall be resolved under

paragraph 3 of Article 25 or, failing agreement under that procedure, pursuant to any other procedure agreed to by both Contracting States.' "

- Surprisingly, very few countries, especially developing countries, make use of that provision. The decision on whether an issue is within the scope of a tax treaty is therefore left to non-tax experts in the WTO dispute settlement system.

- There is at least some question of whether the provision should be elevated from an option in the Model Commentaries to a provision in the text of the Convention itself. A similar provision may be useful in relation to other trade-related agreements, especially the increasingly common regional trade and investment agreements."

12. The Subcommittee proposes to consider possible options for improving guidance to countries in this area and to report further at the Twenty-seventh Session. Issues might include the practical likelihood or otherwise of problems arising and whether the guidance in the Commentaries to the UN Model should be adjusted and clarified or whether the provision currently in the Commentary should be included in the text of the Model itself. A broader provision addressing other agreements as well as the GATS may also be an option. The Subcommittee will liaise with the Subcommittee tasked with updating the Model.

Relationship to the Sustainable Development Goals

13. As noted in the Report of the Committee's Twenty-third Session, held in October 2021, the Committee agreed:

(a) To continue to discuss taxation and the Sustainable Development Goals regularly during sessions, as a permanent agenda item;

(b) To request the secretariat to provide regular updates on taxation and the Sustainable Development Goals, at each session:

(i) To preserve the focus of the Committee's work in the area;

(ii) To identify any gaps in guidance;

(iii) To establish priorities for technical work to be carried out by the secretariat; and

(c) To have subcommittees reflect on the link between their work and the Goals.

14. In addressing paragraph (c) of that conclusion, the subcommittee recognizes that by promoting fair and effective tax systems, which support both revenue and trade and investment for development, through guidance products and through advising UN DESA on capacity building activities, the Committee's work contributes to achieving the interlinked SDGs as a totality.

15. More specifically in relation to the work of the Subcommittee, an effective guidance effort in this area will promote the balance of revenue needs and the development-focused investment climate which many countries seek, by promoting whole of government and informed approaches to interlinked tax, trade and investment policy objectives. This builds greater certainty for all stakeholders in tax systems. While contributing to achieving all the interlinked SDGs, this will particularly contribute to SDG 16 (Peace, Justice and Strong Institutions) in terms of helping develop effective, accountable and transparent institutions at all levels and SDG 17 (Global Partnerships for the Goals), in terms of strengthening domestic resource mobilization, including through international support to developing countries, to improve domestic capacity for tax and other revenue collection.

Next Steps.

16. The Subcommittee proposes to continue work on Workstream A after this Twenty-sixth Session of the Committee and to commence work in earnest on Workstream B, prioritizing both. It also proposes to collect information on possible issues for Workstream C, as it is not yet clear what the content of that "gap-filling" third workstream would be. The Subcommittee will report back on all workstreams at the Twenty-seventh Session of the Committee.

17. The Subcommittee seeks *the Committee's views on the issues raised in this note, particularly on the draft outline for guidance at paragraph 10 of this note*.

ATTACHMENT

The Treatment of Taxation in International Investment Agreements: Issues Raised and Possible Policy Responses

Alain Castonguay

Prepared for:
Financing for Sustainable Development Office
Department of Economic and Social Affairs
United Nations, New York

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Introduction

1. International investment agreements (IIAs) are legally binding treaties concluded between states to encourage cross-border investment and economic growth. IIAs achieve this objective by conferring investors of a country protection in respect of investments made in the other country (the host country). Such protection is comprised of a number of standards such as non-discrimination, fair and equitable treatment and other specific commitments, which are legally enforceable through a dispute settlement mechanism between an investor and the host state. Such mechanism may be triggered by an investor who considers that a measure of the host country is contrary to one of more of the IIA's obligations.

2. Taxation measures are subject to the provisions of IIAs, as is evidenced by the fact that a sizeable portion of disputes that have arisen in the last 40 years under them have involved taxation measures. The increasing reliance by investors on IIAs to challenge taxation measures is cause for concerns among tax policy makers, in large part because of the central role that the exercise of taxation powers occupies in the fulfilment of the basic mission of the state and the fact that international arbitral tribunals lack specific tax expertise. From a substantive point of view, countries care about maintaining the integrity of their tax systems and are keen to understand how IIAs can impact them. From a procedural point of view, countries are concerned about the cost of litigation associated with the defence of taxation measures before international arbitral tribunals. The purpose of this Report is to describe the nature of such concerns, why they exist, and to set out realistic avenues for mitigating them and managing them in a concrete manner. While this Report is relevant for all countries, it is intended to fulfil a need that is especially acute in developing countries, the measures of which are disproportionately the object of litigations under IIAs.

3. This Report is published in a context where both the international tax architecture and important aspects of investment policies embodied in IIAs are the object of significant re-evaluation and reform. On the one hand, the OECD/G20 Inclusive Framework, through the multiple components of the BEPS project led by the Organisation for Economic Co-operation and Development (OECD), is proposing to introduce significant changes to international corporate taxation rules. On the other hand, signatories of IIAs and UNCTAD are considering ways to improve the functioning of IIAs, with a particular focus on its mechanism used to address disputes, in the light of criticisms voiced with respect to the operation of the investor-state dispute settlement process and the impact of its decisions on countries hosting foreign investment.

4. The Report is organized as follows: Section 1 describes the impact of IIAs on taxation and is divided in four subsections. After introductory remarks in subsection 1.1, subsection 1.2 provides a description of the main provisions of IIAs, and explains how they operate in practice. It also discusses the criticism that IIAs have attracted, in particular as regards the operation of its mandatory, legally binding dispute settlement procedures. Subsection 1.3 provides an analysis of how the provisions identified in subsection 1 can affect taxation measures and double taxation agreements (DTAs). Subsection 1.4 describes the risks for taxation associated with IIAs. First, the risk of litigation in respect of a taxation measure made possible under IIAs. Second, the potential implications for a government and, in particular, its conduct of tax policy, of an international arbitration tribunal ruling against a taxation measure.

5. Section 2 proposes solutions to address the issues described in the previous section. The introductory subsection 2.1 argues that it is possible to draft IIAs in a manner that minimizes their

impact on the ability of a country to formulate tax policy or on the integrity and operation of DTAs. Subsection 2.2 addresses how to adapt the content of IIAs for that purpose and sets out different approaches that can be adopted (and have been used in actual IIAs) when negotiating IIAs in order to address the treatment of taxation in a manner that takes into account the perspective of tax policy makers. From the variety of approaches identified, the subsection sorts out broad categories of approaches, that is, different ways to present taxation articles, together with a discussion of how each achieves a different balance of interests between the concerns of tax policy makers and the objectives of investment negotiators. Beyond the substantive obligations of IIAs, the subsection also addresses the issue of the settlement of disputes, in particular, whether further refinements to the investor-state dispute settlement procedure are desirable or feasible, or whether alternative approaches can realistically be contemplated. Finally, subsection 2.3 proposes the broad principle of a whole-of-government approach to the negotiation and operation of IIAs in order to ensure that the interests of tax policy makers are reflected at each stage.

6. Section 3 proposes concrete guidance, in the form of practical steps, in order to implement the principle described in subsection 2.3 within a government. Subsection 3.1 discusses the role of both tax policy experts and investment specialists in the formulation of the government's IIA policy, in the negotiation of IIAs and in the management of disputes related to taxation arising under IIAs. Subsection 3.2 concludes with views on how to address existing IIAs whose treatment of taxation is not satisfactory in view of the best practices discussed in this Report and briefly explores whether alternatives to the bilateral renegotiation of existing IIAs can realistically be envisioned.

1. Features of International Investment Agreements and their Impact on Taxation

1.1 Introduction

7. International investment agreements (IIAs) are treaties entered into between states for the purpose of creating a hospitable climate conducive to cross-border investment between their respective territories. While IIAs are generally bilateral, stand-alone agreements, the substance of such agreements is increasingly being incorporated in bilateral and plurilateral comprehensive free-trade agreements and the reference to IIAs in this Report should be understood to encompass the investment provisions of the latter as well.

8. While the terms of IIAs apply equally to both parties, the first generation of IIAs (between 1960 and 1990) were mostly concluded between two categories of countries with different objectives. The first, generally developing countries, that tend to be capital importing countries ("host countries"), keen to attract inbound investment to support economic growth and job creation, entered into IIAs to create a friendly environment for foreign investors established in their territory or seeking investment opportunities therein. The second, generally developed countries, that tend to be capital exporting countries ("home countries"), entered into IIAs to establish a legal framework within which their investors could invest in host states. The IIA framework confers investors with relative legal security and predictability against discrimination and lack of due process, above what might be otherwise available under the laws of the host country at the time of entry into force or later, and provides for the creation of an independent facility to examine and adjudicate any dispute that may arise between them and the government of the host country. Such decisions can then be enforced internationally.

9. There are more than 2,500 IIAs currently in force, including over 300 bilateral and plurilateral treaties that may have a broader operation but also include investment provisions[1]. The first IIA was signed in 1959 between Germany and Pakistan.[2] [3] It is generally understood that the first IIA to include legally binding investor-state dispute settlement provision was the Indonesia-Netherland IIA of 1968.[4] The number of IIAs grew considerably during the last 20 years of the 20th century, from 385 to more than 1,850, encompassing more than 170 countries.[5]

10. IIAs generally apply in respect of all measures of a party, with the term "measure" understood to include laws, regulations, administrative practices, etc. As such, unless expressly excluded from their scope, taxation measures are subject to, and may result in a breach of, the obligations of IIAs. The term "taxation measure" is either undefined in IIAs or, when it is defined, is given a wide meaning.

11. As will be seen in the next subsection, the various obligations found in IIAs have the potential to affect taxation measures, in the sense that a particular taxation measure, if successfully challenged by an investor before an arbitral tribunal, could be found to be inconsistent with one or more such obligations. Beyond the potential obligation to award financial compensation to the investor, IIAs could directly and indirectly impose limits on the conduct of, and updating of, a country's tax policy. Directly if an existing tax measure was successfully challenged by an investor; indirectly because countries may consider that IIAs impose constraints on their tax policy choices, as the range of potential policy responses is somewhat narrowed down for purposes of minimizing the risk that a taxation measure may be challenged by a foreign investor.

1.2 The Provisions of International Investment Agreements – Role and Effect

12. This subsection describes the most important provisions of IIAs, both generally and in the context of their application to taxation measures. The architecture of IIAs generally follows that of other international treaties. As such, they include a description of its object and its scope. It provides definition of key terms, most notably of the concept of "investors of a Party", "investment" and "measures". It then sets out country obligations, among them national treatment (NT), most favoured nation treatment (MFN), fair and equitable treatment (FET) or minimum standard of treatment (MST), the prohibition of unlawful expropriation, rules governing the transfer of funds, the prohibition of certain performance requirements associated with investment, and requirements regarding transparency. It includes reservations, exclusions and exceptions, including for taxation measures, in many cases a denial of benefit provision and detailed provisions setting out the process by which investors may submit a claim to arbitration, including how the arbitrators are chosen, applicable rules, and the venue for the formation

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[1] See UNCTAD's Investment Policy Hub, *International Investment Agreements Navigator*, available at: https://investmentpolicy.unctad.org/international-investment-agreements/.

[2] UNCTAD (2006), *The Entry into Force of Bilateral Investment Treaties (BITs)*, IIA Monitor No. 3 (2006), International Investment Agreements, United Nations, New York and Geneva. This publication includes statistics on the number of IIAs that were signed and entered into force during the 1990-2005 period.

[3] For a detailed review of the evolution of the IIAs network between 1959 and 2000, see UNCTAD (2000), *Bilateral Investment Treaty*, United Nations, New York and Geneva, available at: https://digitallibrary.un.org/record/431727?ln=en

[4] WIR15*. World Investment Report 2015: Reforming International Investment Governance.* Chapter IV: Reforming the International Investment Regime: An Action Menu. United Nations, New York and Geneva. Available at: https://worldinvestmentreport.unctad.org/wir2015/wir2015-ch4-reforming-the-international-investment-regime/
United Nations.

[5] *Ibid*, Figure 1, p. 1 and p. 4.

of an arbitral tribunal. It also includes provisions to address disputes between the contracting parties – the countries.

"Investors of a Party" and "Investment"

13. "Investors of a Party" and "investment" are generally given wide meanings in IIAs, encompassing tangible and intangible assets, direct as well as portfolio investment and direct and indirect ownership. Many definitions are open-ended. While the goal of a wide definition of investor and investment is to avoid putting undue limits on the types of investment that are covered, the open-ended nature of such definition also opens the door to unintended consequences. In particular, an investment in the host country may not need to be beneficially owned or controlled by an investor of the other country. An investor generally comes within the ambit of an IIA by simply incorporating in one of the contracting parties. This, coupled with the complex ownership structure of multinational enterprises, can make it difficult to ascertain the true owner of the asset and creates opportunities for a phenomenon well-know in the international tax world, "treaty shopping". Indeed, beyond the possibility of an investor of a third country availing itself of benefits of a bilateral IIA under a treaty shopping scheme, the most egregious form of abuse concerns investments in a host country held, through ownership structures that use the other contracting party, by investors of the host country, putting them in a position to use the IIA to sue the government of their own country.[6] Treaty shopping can be used to gain the protection of a particular IIA either when none naturally applies or, when an investor is already within the natural scope of an IIA, but seeks access to more favourable dispute settlement provisions of another IIA to which the host country is a signatory.[7]

14. More recent IIAs include denial of benefits provisions aimed at curtailing abusive treaty shopping.[8] Absent such provisions, arbitral tribunals are reluctant to limit the scope of application of IIAs, even when it is manifest that a corporate reorganization was undertaken with the goal of exploiting the benefits of an IIA. There are exceptions to this, however, leading tribunals to deny jurisdiction over claims, when such reorganization to access an IIA was undertaken at a time when a dispute between the investor and the host state was imminent or had commenced.[9] It appears that, with the growing

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[6] For a brief discussion of this issue, see UNCTAD (2021). *International Investment Agreements and Their Implications for Tax Measures: What Tax Policymakers Need to Know – A Guide Based on UNCTAD's Investment Policy Framework for Sustainable Development.* New York and Geneva: United Nations. Available at: https://unctad.org/webflyer/international-investment-agreements-and-their-implications-tax-measures-what-tax

[7] For a detailed discussion of treaty shopping, see Lee, Eunjung (2015) *Treaty Shopping in International Investment Arbitration: How often has it occurred and how has it been perceived by tribunals?* Working paper Series 2015 No. 15-167, Department of International Development, London School of Economics and Political Science, London. Available at: https://www.semanticscholar.org/paper/Treaty-Shopping-in-International-Investment-How-has-Lee/3a3dbc7504679fb9557d1cb719ec31a6b38a88e3

[8] Much like the issue encountered in the international tax world, this entails disregarding companies with little or no substance and spelling out a definition of what amounts to an acceptable "economic presence" or level of substantive business activity.

[9] See *Philip Morris Asia Limited v. The Commonwealth of Australia*, Award (8 March 2017), Case No. 2012-12. In November 2011, after years of public debate, Australia enacted a law that compelled the removal of brands, trademarks and logos from tobacco packaging in order to curb smoking. Earlier that year, in February, the direct ownership of Philip Morris Australia, a tobacco manufacturer controlled by Philip Morris International, was transferred from a Swiss company to a Hong-Kong company, Philip Morris Asia. Philip Morris Australia had previously opposed the law and the reorganization put its parent, Philip Morris Asia, within the ambit of the Hong-Kong-Australia bilateral investment treaty. On the day the law was enacted, Philip Morris Asia initiated proceedings under the treaty. The arbitral tribunal formed to address the dispute declined to hear the case, on grounds that reliance on the treaty constituted an abuse of rights, because the modification of the company's

reliance on treaty shopping to gain access to the benefits of IIAs, arbitral tribunals are increasingly open to arguments that aggressive forms of treaty shopping constitute an abuse of right that can result in a denial of jurisdiction, even absent an explicit denial of benefit provision in the IIA.[10] This is an area where IIAs may develop more along the lines of tax treaties.

National Treatment (NT)

15. National treatment is the non-discrimination standard which bars a different treatment of investors and investment on the basis of nationality. Thus, under this standard, an investment of a national of a country bound by an IIA with another (host) country, is guaranteed to be treated in the host country in a manner no less favourable than an investment in the same country of a national of that country. It is a relative standard: any measure of a country, be it favourable or detrimental towards a given economic sector, does not breach the NT standard as long as it does not apply less favourably to foreign investors and their investment relative to domestic investment. The provision is generally interpreted to prohibit both *de jure* discrimination (that is, a difference in treatment spelled out in a law or regulation) as well as *de facto* discrimination (reflected in a different application of a law or a policy).

16. As discussed in the next subsection, this standard differs from the one usually found in DTAs. The prevalent standard as applied in the tax world is explicitly qualified to take into account the fact that many provisions of income tax laws make distinctions based on the residence of the taxpayer.

17. Some (mostly more recent) IIAs refine the concept of NT by drawing upon trade law concepts when stipulating that the investors or investment being compared must be in "like circumstances" (or variations thereof). It is believed that this caveat, by refining the standard of comparison, confers on contracting parties an additional degree of freedom when called upon to defend measures, alleged to be discriminatory, to which can be ascribed legitimate policy objectives justifying a difference in treatment in relevantly different circumstances.[11]

Most Favoured Nation (MFN)

18. Most favoured nation (MFN) treatment is the non-discrimination standard which bars discrimination among different foreign investors and investment. Thus, under this standard, an investment of a national of a country bound by a IIA with another (host) country, is guaranteed to be treated in the host country in a manner no less favourable than an investment in the same country of a national of a third country. Like NT, MFN is a relative standard. It has been the cornerstone of the international trading system, in particular of the *General Agreement on Tariffs and Trade* (GATT).

19. A number of arbitral decisions have revealed that the concept is capable of interpretations that were not initially foreseen by IIA drafters. Basically, the MFN provision was intended to be triggered in circumstances where a country put in place a measure that provided a better treatment of investors of a given country or a given categories of countries. The rationale for the standard was that if an advantage is conferred on one, it must be available to all.

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corporate structure was made for the sole objective of benefiting from the treaty at a time when a dispute with the Australian government was foreseeable.

[10] See Chaisse, Julien (2015) *The Treaty Shopping Practice: Corporate Structuring and Restructuring to Gain Access to Investment Treaties and Arbitration*, 11 Hastings Bus. L.J. 225. Available at: https://repository.uchastings.edu/hastings_business_law_journal/vol11/iss2/1

[11] It is one of the policy options discussed by UNCTAD. See *World Investment Report 2015*, *supra* note 4.

20. While few actual measures (e.g., laws, regulations) were ever challenged under this provision, IIA provisions increasingly are. Investors, in the course of litigation under IIAs, began asserting that a country was in breach of the MFN obligation of an IIA if that country granted more favourable protection in another of its IIAs. Some investors also argued that the MFN obligation granted them the right to seek the application of the dispute provisions of another IIA that they perceived to be more favourable than that found in the applicable IIA. A number of arbitral panels in such instances ruled in favour of investors and granted access to an alternative dispute settlement procedure.

21. Since the above interpretations of the MFN standard has been cause for concern in the investment community, UNCTAD has proposed options to restore the original intent of the MFN provisions, in order to prevent the "cherry-picking" of IIA provisions, including the investor-state dispute settlement (ISDS) provisions.[12]

Fair and Equitable Treatment (FET)

22. The fair and equitable treatment (FET) provision is intended to protect investors against undesirable conduct of the state that would not be captured by other provisions of IIAs. Unlike the non-discrimination provisions, it sets an absolute standard of conduct, originally intended to guard against abusive treatment or the denial of justice. It has become the most often invoked provision of IIAs in disputes, including in tax-related disputes. One FTE claim out of four has been successful under ISDS cases.[13]

23. While the FET provision is intended, and understood, to be an objective standard, it has been given different interpretations by arbitral tribunals, in part because provisions of IIAs are not all similarly written and in part because there exist different views as to its meaning and scope. Indeed, "fairness" and "equity" can be elusive concepts when they are intended to set a definitive legal threshold in an international treaty. There are different declinations of the core elements of FET, but the prevailing view comprises the following elements:

(a) Prohibition of manifest arbitrariness in decision-making, that is, measures taken purely on the basis of prejudice or bias without a legitimate purpose or rational explanation;
(b) Prohibition of the denial of justice and disregard of the fundamental principles of due process;
(c) Prohibition of targeted discrimination on manifestly wrongful grounds, such as gender, race or religious belief;
(d) Prohibition of abusive treatment of investors, including coercion, duress and harassment;
(e) Protection of the legitimate expectations of investors arising from a government's specific representations or investment-inducing measures, although balanced with the host country's right to regulate in the public interest.[14]

24. It is the last element of the definition that has become the focal point of most litigation and the source of much uncertainty. Allegations that given measures frustrate the legitimate expectations of investors have put into question the ability of countries to legislate in the public interest when the

[12] *World Investment Report 2015*, *supra* note 4.
[13] UNCTAD (2021), *supra* note 6, at 27.
[14] UNCTAD (2012). *Fair and Equitable Treatment*, UNCTAD Series on Issues in International Investment Agreements II: A sequel, United Nations, New York and Geneva, at xvi. Available at: http://unctad.org/en/Docs/unctaddiaeia2011d5_en.pdf. This publication provides a detailed discussion of the FET standard.

implementation of the legislated policy has the effect of reducing the profitability of investments held by foreign investors. Investors' expectations at the time the investment was made are not formed equally: they may be based on specific promises or commitments made by the government of the host country or they may simply reflect assumptions made by investors that the regulatory environment would remain stable for the foreseeable future. Measures affecting investors that have been alleged to breach legitimate expectations may either be specific to them or their sectors or they can be of general application, and the public policy purpose behind the measure may be compelling or not.

25. Certain countries have rejected the notion that the FET obligation protects an investor's legitimate expectation, such as a right to a stable legal environment or reliance on commitments a government may have made and have sought to reduce the scope of the FET standard by reference to its very limited meaning under customary international law[15]. They take the view that this narrow customary international law meaning was the meaning intended in IIAs, not the more expansive reading of some tribunals. Arbitral rulings are inconsistent in this respect, even across different ISDS cases spawned by the same government measure.[16] On the other hand, arbitral tribunals have recognized in several decisions that in principle the FET standard does not prevent countries from exercising their powers to regulate in the public interest.

26. As will be discussed in the following subsection, the FET standard, in particular as regards challenges made under the guise of the breach of investor's legitimate expectations, is especially relevant to taxation measures and the conduct of tax policy.

Prohibition Against Expropriation

27. IIAs generally set out the conditions within which the expropriation of property by the state may be lawful. These conditions are that the expropriation must be for a public purpose, carried out in a non-discriminatory manner, under due process of law and against the payment of appropriate compensation. In IIAs, expropriation can either be direct or indirect. Direct expropriation refers to the outright takings or nationalizations of property through an official state act (law, decree) whereby title to the property is transferred to the state or an instrumentality thereof. In contract, indirect expropriation does not involve a transfer of ownership in the property, but is accomplished by actions of the state that are equivalent to direct expropriation in that they result in a total or near-total deprivation of an investment (through the investor's inability to control, manage or use it) or the destruction of its value. From the point of view of an investor, the taking of the fruits of the investment is no different from the outright taking of the investment.[17]

28. Investors are prone to relying on the expropriation provisions of IIAs to allege that a measure of a country that has affected the profitability of their investment amounts to an indirect expropriation. Contested measures have included safety, environmental and labour regulations, financial regulations, as well as alleged confiscatory taxation measures. However, such claims are not always successful

[15] For example, Canada and the United States. See OECD (2017). Gaukrodger, David, *Addressing the Balance of Interests in Investment Treaties the Limitation of Fair and Equitable Treatment Provisions to the Minimum Standard of Treatment under Customary International Law*, OECD Working Papers on International Investment 2017/03.
[16] Reynoso, Isabella, *Spain's Renewable Energy Saga: Lessons for international investment law and sustainable development*, Investment Treaty News, International Institute for Sustainable Development, June 27, 2019.
[17] For a comprehensive discussion of the issue, see UNCTAD (2012). *Expropriation*, UNCTAD Series on Issues in International Investment Agreements II: A sequel. United Nations, New York and Geneva. Available at: https://unctad.org/system/files/official-document/unctaddiaeia2011d7_en.pdf

before arbitral tribunals, because international law and relevant jurisprudence have established a distinction between measures that are indirect expropriation and measures adopted by a country in a non-discriminatory manner in the course of legislating or regulating in the public interest. The distinction between the two is necessarily fact-sensitive.

29. In short, in order to amount to an expropriation, a measure must have a destructive and long-lasting effect on the value of the investment, or must lead to the loss of effective (if not legal) control of the investment, and must be definitive and permanent. In contrast, a country may be able to demonstrate that a measure is not an indirect expropriation (despite the fact that it actually negatively affects foreign investors) by invoking the nature (whether it is a *bona fide* regulatory action), purpose (whether the policy objective being pursued is legitimate) and character (as regards the proportionality of the measure, its non-discriminatory nature and the existence of due process) of the measure at issue.[18]

Transfer of Funds

30. The purpose of transfer of funds provisions, found in most IIAs, is to ensure that no impediments exist to the free and prompt use by foreign investors of investment and returns on investment (in any form), either at the moment the investment is made, during the operating phase or at the time the investment is disposed of. The provisions found in older IIAs contain no qualification to such obligations. In contrast, newer IIAs contain exceptions to allow a country to impose certain restrictions to the transfer of funds in certain situations, such as when balance of payment issues arise, or to require compliance with a country's laws dealing with the integrity of the financial system, bankruptcy, securities, criminal offences and, less often, the payment of taxes.

31. Transfer of funds provisions are seldom invoked by investors, and they are not generally regarded as impeding the imposition or collection of taxes.

Umbrella Provisions

32. A so-called "umbrella provision" stipulates that a party to an IIA is required to observe obligations that it has undertaken (usually in contractual form) with respect to an investment made by an investor of the other party. In effect, the terms of any contract between the government of a country and a foreign investor of the other country governing an investment become, by virtue of this provision, enforceable under the dispute settlement provisions of the IIA in force between both countries.

33. Contracts between an investor and a government often include so-called "stabilization clauses" that commit a country to a stable legislative environment with respect to the specific investment that they cover. Such commitment may extend to ensure stable tax rules for the investor in respect of its investment over a certain period of time. The impact of an umbrella provision is effectively to override the dispute settlement procedures contained in the contract, by allowing the investor to invoke the ISDS provisions of the applicable IIA. Thus, a taxation measure that is the object of a stabilization clause may end up being litigated under ISDS procedures, irrespective of any exclusion otherwise set out for taxation measures in the IIA.

Investor-State Dispute Settlement and Enforcement Actions

34. The ISDS provision is a key feature of IIAs, because it ensures investors that disputes are adjudicated not under the domestic law and judicial system of the host state, but in an *ad hoc* neutral

[18] *Ibid*.

setting.[19] It also gives investors the sole (that is, without the need to involve or convince the government of its own country of the merit of the case) and unilateral (a country cannot sue an investor under an IIA) prerogative as to whether a decision is made to file a claim against a party to an IIA in respect of a disputed measure. The ultimate purpose of an ISDS claim is for the investor to obtain financial compensation from the government of the host country commensurate with the economic injury alleged to have been suffered by it as a result of the imposition by that country of the disputed measure.

35. When an investor is of the view that the host country has breached one or more obligations of an IIA, it can file a notice of intent to that effect. After a consultation period between the investor and the host state, an arbitral tribunal is formed to hear the dispute. A tribunal is typically comprised of three arbitrators, one chosen by the investor, one chosen by the respondent country and the third selected jointly (or by the two other selected arbitrators), paid by both parties. Arbitration takes place under a comprehensive body of rules set out by international agreements: the UNCITRAL Arbitration Rules[20] and the Rules of the International Centre for Settlement of Investment Disputes (ICSID), established by the Convention on the Settlement of Investment Disputes between States and Nationals of Other States[21].

36. Under most IIAs, disputes proceed directly to international arbitration, without any reliance on the domestic courts of the host country. Beyond the independence achieved by the formation of an *ad hoc* arbitral panel, this process is said to provide for a more rapid resolution of the dispute and result in a final (unappealable), legally binding decision that is readily enforceable. In exceptional circumstances, an investor that was awarded financial compensation by an arbitral tribunal can turn to the courts of any country to compel the host state to pay said compensation. Likewise, a country that was ordered by an arbitral tribunal to pay financial compensation to an investor may seek, in a court of law, to invalidate the award, generally on grounds that the IIA was misapplied in that particular case.

37. The ISDS process has come under significant criticism from different quarters. It has been said that "the ISDS system suffers from a legitimacy crisis"[22]. In particular, it has been argued that arbitrators may not have sufficient legitimacy to have the power to sanction legislative and regulatory actions taken by the state, given that their frame of analysis tends to focus on the effect of the disputed measure on investors, at the expense of the broader social or economic context that may have justified its adoption. Others have questioned the very integrity of the functioning of the system of international arbitration[23].

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[19] "…[t]here are diplomatic or political justifications for the ISDS system. Removing investment disputes from the realm of politics and diplomacy was a foundational goal of ICSID. ISDS aims to keep investment disputes away from diplomatic and political channels in a similar way that the WTO dispute resolution process aims to keep trade disputes from escalating into trade wars. By channeling disputes to arbitration and limiting claims to the involved parties, ISDS should avoid the escalation of investment disputes into diplomatic conflicts, economic sanctions, or military interventions." Samples, Tim R., *Winning and Losing in Investor–State Dispute Settlement*, American Business Law Journal, Volume 56, Issue 1, 115–175, Spring 2019, at 134.

[20] UNICTRAL. *UNCITRAL Arbitration Rules*, General Assembly Resolution 31/98. The rules, adopted in 1976, were developed by the United Nations Commission on International Trade Law (UNCITRAL), a subsidiary body of the General Assembly of the United Nations created in 1966.

[21] World Bank Group, *ICSID Convention, Regulations and Rules*, International Centre for Settlement of Investment Disputes, Washington, D.C. The Convention, which was developed under the auspices of what is now the World Bank Group, entered into force in 1966.

[22] UNCTAD (2018). *UNCTAD's Reform Package for the International Investment Regime*, 2018 Edition. United Nations, New York and Geneva. Available at: https://investmentpolicy.unctad.org/publications/1190/unctad-s-reform-package-for-the-international-investment-regime-2018-edition-.

[23] Eberhardt, Pia and Olivet, Cecilia, *Profiting from Injustice - How Law Firms, Arbitrators and Financiers are*

38. The number of arbitral cases has exploded over the last years, particularly since the beginning of this century. More than 1,100 ISDS cases were initiated over the 1987-2020 period against 124 countries and 740 had been concluded[24]. Among the latter, 37 percent were decided in favour of the defendant country, 29 percent in favour of the investor, while another 20 percent were settled between the parties. The rest of the cases were discontinued or did not give rise to an award. Ignoring cases that were dismissed for lack of jurisdiction, among cases decided on the merits, about 57 per cent were decided in favour of investors and resulted in monetary damages being awarded to them.

39. Like the number of ISDS cases, the amounts of damages awarded to successful claimants has grown significantly since the year 2000. Figures for cases settled before May 2020 show that investors that were successful, on average claimed some $1.2 billion[25] and were awarded $438 million[26] [27]. More than 50 cases produced awards in excess of $100 million.[28] Moreover, beyond the amount of financial compensation awarded, the cost of merely participating as defendants in ISDS proceedings (the cost of its own defense and the cost of the tribunal) can be significant. While estimates vary, it is said that the average cost of litigation for investors is $6.4 million and for respondent countries $4.7 million, but the cost of certain cases for defendants can be multiple times that latter figure[29] [30]. In addition, litigation can mobilize resources of defendants for years. The average length of ISDS proceedings is 4.4 years, but cases with amounts at play over $1 billion can take twice as much time to resolve.[31]

40. The criticisms leveled against the ISDS process deal with several dimensions inherent in the nature of IIAs and the functioning of ISDS and this Report can only scratch the surface of the multiple issues raised. Among them[32]:

- ISDS sets the enforcement of private (investor) rights against the right of the state to legislate or regulate in the public interest[33]. This can raise doubt as to the ability of governments to

Fuelling an Investment Arbitration Boom. Corporate Europe Observatory and the Transnational Institute, Brussels and Amsterdam, November 2012.

[24] UNCTAD (2021). IIA Issue Note No. 4, *Investor–State Dispute Settlement Cases: Facts and Figures 2020*. United Nations, September 2021. Available at: https://unctad.org/system/files/official-document/diaepcbinf2021d7_en.pdf.

[25] Unless otherwise indicated, all amounts cited in this Report are in US dollars.

[26] Matthew Hodgson, Yarik Kryvoi and Daniel Hrčka, 2021 Empirical Study: Costs, Damages and Duration in Investor-State Arbitration, Allen & Overy and BIICL, London, 2021, at 28.

[27] These figures are somewhat skewed upward by a series of high amounts (totalling $50 billion) awarded in compensation in connection with a singular series of controversial cases which arose as a result of the nationalization of Yukos by Russia in 2003. Removing such awards bring down the respective figures to $817.3 million claimed and $169.5 million awarded. In short, the Yukos case refer to claims made in 2005 by several foreign shareholders of the company under the *Energy Charter Treaty* that the government of Russia expropriated the company through several acts, taken starting in 2003, including taxes, fines and enforcement measures, that led to the company's bankruptcy in 2006. The case is exceedingly complex and highly unusual in many respects and it remains to this day under litigation is the courts of several countries. This Report will not consider it further.

[28] Bonnitcha, Jonathan and Brewin, Sarah, *Compensation Under Investment Treaties: What are the problems and what can be done?* The International Institute for Sustainable Development. Policy Brief, Winnipeg, December 2020. Figure 1 at p. 2 shows the progression over time of awards.

[29] Matthew Hodgson, Yarik Kryvoi and Daniel Hrčka, *supra* note 26, at 10.

[30]Anecdotal evidence suggests that countries incur high costs either on particular cases or because they must face multiple cases. For examples, see figures cited in Samples, Tim R., *supra* note 19, at 151-152.

[31] Matthew Hodgson, Yarik Kryvoi and Daniel Hrčka, *supra* note 26, at 32.

[32] For example, see Chaisse, Julien, *supra* note 10, Samples, Tim R., *supra* note 19 and UNCTAD (2018), *supra* note 22.

[33] For example, allegations made in multiple cases against several countries by the tobacco manufacturer Philip

regulate in the area of health, public welfare, the environment, etc. For a country to lose an ISDS case means not only a direct financial impact, but an infringement on its regulatory powers, ultimately forcing it to amend or withdraw the disputed measure. Moreover, investors are not hindered by any restraints when a decision is made to file a complaint, since they pursue uniquely their own economic interest; no regard is given by the investors to the underlying policy purpose of a disputed measures[34];

- Benefits and obligations are asymmetrical between states and investors. Substantive obligations of an IIA are a one-way street: countries bear them, but cannot win awards (only their own investors can). Investors have no substantive obligations but stand to win financially;

- By definition, the ISDS process confers on foreign investors substantive and procedural rights that domestic investors do not have, producing an uneven playing field;

- An arbitral tribunal is not bound by prior decisions made by other tribunals and, apart from the exceptional case of a petition for annulment in a court of law, decisions cannot be appealed by states. As a result, decisions are inconsistent across seemingly similar issues, as regards the decision to compensate investors, the reasoning used to arrive at that decision, as well as the manner used to calculate said compensation. In some cases, awards are calculated by reference to a hypothetical stream of future income in respect of a project that was never realized, creating a large gap between the award and the amount actually invested by the taxpayer;

- The confidential nature of the ISDS process is criticized as being secretive and non-transparent. This is in part due to the origin of ISDS procedures, based on how commercial arbitration is conducted between private parties.

41. As a result, the impetus for reforms of the ISDS process has grown in recent years and several countries have reacted by curtailing the inclusion of ISDS provisions in their IIAs, if not outrightly abandoning them altogether. In the latter case, this means that disputes may be addressed by domestic courts or possibly under a state-to-state dispute settlement procedure, although monetary damages would not typically be awarded to investors under such procedures. While a detailed review of options for reform is beyond the scope of this Report, the main elements proposed by UNCTAD can be summarized as follows[35]:

- Improving transparency, limiting investors' access, enhancing the contracting parties' control and introducing local litigation;

- Add new elements to the existing ISDS mechanism (e.g., building in effective alternative methods of dispute resolution, introducing an appeals facility);

Morris against laws that sought to curb tobacco consumption through changes made to cigarette packaging. For example, see *Philip Morris Asia Limited v. The Commonwealth of Australia*, *supra* note 9 and *Philip Morris Brands Sa`rl v. Oriental Rep. of Uruguay*, ICSID Case No. ARB/10/7, Award (July 8, 2016).

[34] A rebuttal argument can be made that such a narrow frame of analysis would equally be observed in litigation undertaken before a domestic court and that this simply suggests that the IIA is being applied as intended by the parties.

[35] From *World Investment Report 2015*, *supra* note 4.

- Replace the existing ISDS mechanism (e.g., by creating a standing international investment court, reliance on State-State dispute settlement and/or reliance on domestic dispute resolution);
- Adding new provisions, such as targeted public policy exceptions; and
- Eliminating/omitting/reformulating certain IIA provisions (e.g., scope of protected investment/investors, FET, indirect expropriation, MFN, umbrella clause).

1.3 The Impact of International Investment Agreements on Taxation

42. This subsection focuses on the impact of IIAs on taxation. Building on the analysis of the previous subsection, it examines how the key aspects of IIAs discussed above particularly affect taxation measures and DTAs. While the above findings have established the constraints imposed by IIAs on governments, this section examines the issue from the specific viewpoint of tax policy makers and tax administrators.

43. A number of countries now favour the negotiation of comprehensive free trade agreements which encompass investment provisions similar to that found in IIAs. Such agreements address several aspects of the bilateral (or plurilateral) economic relationship. Some of the additional disciplines included in such agreements, dealing for example with trade in goods, trade in services, digital trade, etc., raise their own issues as regards the treatment of taxation which need to be addressed in the agreement's taxation article. Hence, the design of the taxation article for inclusion in a free trade agreement requires a more thorough analysis of the agreement's provisions beyond the issue of investment. The examination of these additional issues is beyond the scope of this Report.

Definition of Investment and Investors

44. The previous subsection has revealed that the wide scope of the definition of "investors" and "investment" creates a potential for abuse of IIAs akin to the well-known issue of treaty shopping experienced in the context of DTAs. Therefore, it does open the possibility for a foreign investor with little substantive connection to the host country to use the ISDS of an IIA to challenge a taxation measure of that country. While this issue goes beyond the area of taxation, the implementation of any solution to address it (e.g., denial of benefit provision, requirement for a substantial economic presence of the investor), by restricting the ability of some investors to challenge measures of a party, would benefit taxation measures. Recent developments in tax treaty practices, in particular the reforms proposed and implemented under Action 6 of the BEPS project, may be helpful to address investment treaty shopping. The UN Model Tax Convention, at Article 29, already includes both a limitation-of-benefits provision and a general anti-abuse provision.[36]

National Treatment (NT)

45. The national treatment (NT) obligation of IIAs prohibits discrimination against investors and investment on the basis of nationality. Treatment afforded by a country to investors or investment of the other country must be "no less favourable" than that accorded respectively to its own investors or investment. In the language of some provisions, the standard is qualified by the addition of the term "in like circumstances" or "in similar situations". This addition is understood to require that the comparison

[36] UN (2021). *Model Double Taxation Convention Between Developed and Developing Countries*, New York: UN Publishing.

made between investors or investments take into account the totality of circumstances, including legitimate policy objectives pursued by the measure[37]. It remains uncertain, however, whether this qualification alone permits the types of distinctions usually found in domestic income tax laws.

46. Indeed, income tax policy encompasses several distinctions among taxpayers that are based on well-reasoned rationales which may, *prima facie*, be construed as being inconsistent with the NT standard described above. This is because the principle of full taxation, generally on a worldwide basis, rests on the concept of residence, which means that domestic income tax laws necessarily provide for different treatment between resident and non-resident taxpayers. Residence is also fundamental to the apportionment of taxing rights between contracting parties to a DTA. The residence criterion is not based on nationality: a non-national can be a resident and *vice versa*.

47. Income tax laws contain different categories of distinctions based on the residence of taxpayers. First, there are measures which are directed exclusively at non-resident taxpayers. The most common are in the form of dedicated collection mechanisms owing to the fact that non-residents are not subject to worldwide taxation. Hence, certain payments made to non-residents (dividends, interest, royalties, etc.) are subject to withholding at source on a gross basis (with the payor having the responsibility to withhold the tax and remit it to the revenue authorities). Since most non-resident recipients tend to be non-nationals, one could construe this mechanism as being *de facto* discriminatory under the NT standard of IIA. Another collection mechanism directed at the local permanent establishment (PE) of non-resident enterprises is the branch tax, the rationale of which is to approximate the amount of dividend withholding tax that could have been payable on profit distributions had the PE been a separate enterprise.

48. The second category of measures are those affecting resident taxpayers in respect of specific transactions entered into with non-resident taxpayers. In such a case, while the measure applies to a resident, it could be argued to constitute an indirect form of discrimination against a non-national. An example is thin capitalization rules, in substance anti-avoidance measures intended to protect the tax base, which may restrict the deduction of interest payments made to related non-resident creditors when such interest is in respect of what is regarded as "excessive" indebtedness. The goal of such measures is to prevent or restrict the extent of the stripping of taxable profits in the form of tax-deductible interest payments. Other examples are rules that limit certain benefits (like the deferment of tax) granted to resident taxpayers in computing taxable income or tax payable in respect of transactions entered to with resident financial institutions. For example, contributions made by a taxpayer to say, a pension fund, that may attract an income tax deduction in the year that they are made, may be deductible by the taxpayer only if the pension fund is within the jurisdiction of the country regulating the fund, which usually means that it must be resident of that country for tax purposes. Non-resident financial service providers that are non-nationals might regard this restriction as being discriminatory towards them.

49. Finally, the third category of measures are those which limit certain tax benefits to resident taxpayers. Among those are certain deductions and credits relevant to the calculation of personal income tax, such as those granted on the basis of civil status or family responsibility. These include, for example, deductions, credits or exemptions for spouses, children, old age, low-income taxpayers, or that pursue other social objectives. The premise of such benefits is that the taxpayer enjoying them is taxable on a worldwide basis and, therefore, that it would not be appropriate to extend them to non-resident individuals that are not so taxable. Other examples are credits granted under integration or

[37] UNCTAD (2021), *supra* note 6, at 21.

imputation systems intended to avoid or mitigate the economic double taxation that arise when profits are taxed at the corporate level and dividends paid out of such profits are taxed in the hands of shareholders. Again, such benefits are generally not granted to non-resident individuals (under domestic law), because they are not taxable on a worldwide basis in the country granting the benefit (and thus not subject to the income tax computed on a net basis that is relevant for the computation of dividend tax credits).

50. DTAs include non-discrimination provisions that take into account the type of distinctions described above. The first sentence of paragraph 1 of Article 24 (Non-Discrimination) of the UN Model reads as follows (emphasis added):

> Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State **in the same circumstances, in particular with respect to residence**, are or may be subjected.

51. The intent of the drafters of that provision is to make clear that rules that make distinctions based on residence are not intended to offend the non-discrimination provision set out by paragraph 1, and that one cannot argue that "a different treatment based on residence is indirectly a discrimination based on nationality for purposes of that paragraph".[38] The Commentary on paragraph 1 also specifies that the term "in the same circumstances" refers to taxpayers that are, in relation to applicable tax laws, in substantially similar circumstances both in law and in fact.

52. As regards a specific category of distinctions made in income tax laws discussed earlier, paragraph 3 of Article 24 is quite explicit in that the non-discrimination provision set out therein cannot be construed to oblige a country to grant non-residents "any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents".

53. While there can be justifiable policy reasons for income tax laws to make distinctions that can attract scrutiny under the NT standard if IIAs, the same cannot generally be said for other categories of taxes such as consumption taxes and excise taxes. In many instances, taxation measures challenged by investors are not income tax measures but valued added taxes or excise taxes, and in many cases, the disputed measure was found to be discriminatory under the NT standard. Annex 1 provides a summary description of selected ISDS cases where arbitral tribunals reached that conclusion.

54. Section 2 examines how IIAs can be adapted to ensure that well-founded distinctions based on residence in income tax laws are not prohibited because of a strict reading of the IIA's NT obligation.

Most-Favoured Nation (MFN)

55. The most-favoured nation (MFN) treatment provision of IIAs prohibits discrimination among foreign investors and investments on the basis of nationality. Treatment afforded by a country to investors or investments of the other country must be "no less favourable" than that accorded respectively to investors and investment of third countries. In some provisions, the standard is qualified by the addition of the term "in like circumstances" or "in similar situations". The MFN provision is a

[38] *Ibid*, paragraph 1 of the Commentary on Article 24 (Non-Discrimination)

fundamental obligation of international agreements regulating the cross-border trade in goods, such as the General Agreement on Tariffs and Trade (GATT).

56. The most obvious issue raised by the imposition of this provision to taxation is with respect to advantages granted under bilateral DTAs. The potential for "cherry-picking" exists because each DTA is unique, being the result of reciprocal compromises made in the context of a bilateral relationship. Absent any exception, the MFN provision could be read to allow an investor of a country to claim the advantages (say, a lower rate of dividend withholding tax) of a DTA that the other country has concluded with a third country. Such an outcome would not be in accordance with the intent of the parties to the IIA, as it would amount to subordinating the operation of DTAs to that of IIAs. For that reason, most IIAs contain an explicit exception to prevent it.

57. The IIA's MFN provision also applies to domestic taxation measures. The potential issues raised in this case are narrower compared to those that exist in connection with NT. However, domestic tax laws may contain provisions that could be regarded as inconsistent with the MFN obligation. Examples are provisions intended to combat international tax avoidance. A number of countries apply certain anti-avoidance rules, such as controlled foreign corporation (CFC) rules, to a subset of countries regarded as attractive destinations to set up subsidiary companies, because they impose little or no income tax. By channeling income through such subsidiaries, the payment of tax is deferred, sometimes indefinitely. So-called "black list" provisions, in respect of which CFC rules or other anti-avoidance provisions may apply, make distinction that are, on their face, not MFN-compliant. Other examples are provisions providing a reciprocal exemption for income derived by foreign companies from the operation of ships or aircraft in international traffic. Their aim is to prevent double taxation of such income. Because the exemption vis-à-vis a country depends on whether that country maintains such a similar exemption, the provision does distinguish among countries in a manner inconsistent with the MFN obligation.

Fair and Equitable Treatment (FET)

58. As discussed in the previous subsection, the FET provision is widely invoked by investors in IIAs disputes, whether tax-related or others, and its exact scope of application is uncertain.

59. One of the elements of FET found in open-ended provisions is the notion that a country must respect the legitimate expectations held by investors at the time of their investment. This is particularly relevant in the case of tax legislation and administrative practices. To assess the validity of a claim that a taxation measure is inconsistent with the legitimate expectations of investors, one must consider on what basis such expectations were formed and to what extent the disputed measure frustrates them.

60. At one end of the spectrum, an investor might have decided to carry out an investment in the country on the strength of a legally binding agreement with the government of that country setting out either the tax regime that will apply to its investment over a certain period in the future or granting a specific tax incentive supplementing the generally applicable tax system. Further down the spectrum are agreements struck with the host country's tax administration confirming the agreed interpretation of application of certain tax provisions, such as advance pricing agreements or tax rulings. Even further down are verbal assurances given by government officials pledging the stability of the tax system for the foreseeable future. Alternatively, investors might have concluded, absent specific commitments or assurances, that the tax rules would remain stable. Finally, at the minimum, investors expect that they will be treated by the government of the host country in good faith, not arbitrarily and with regard to due process.

61. Evidently, the more explicit the commitment made by the government of a host country to a foreign investor, the stronger would be a claim that reneging on such a commitment would constitute a breach of the FET obligation. Likewise, the more erratic and arbitrary is the conduct of a government towards the investor, the more credible would be a claim that the FET obligation is not being met. On the other hand, an investor claim would be less convincing when it merely rests on the view that any change to tax laws or administrative practices is a violation of their legitimate expectations, since it is quite normal for governments to amend tax laws and practices in response to genuine needs or a change in political direction. This is a particular issue for developing countries that wish to modernize their tax systems.[39]

62. The record shows that the applicability of the concept of FET is difficult to predict owing to the exact wording of the provision and the specific facts of the case, as well as the approach taken by a tribunal. The possible solutions to address this issue are not all specific to taxation matters, as will be seen in the next section, but some are.

63. In *Occidental v Ecuador*, an arbitral tribunal found that the denial by the government of VAT credits and refund to Occidental had frustrated the company's legitimate expectations regarding the commercial and economic conditions under which the investment was made and, therefore, constituted a breach of the FET obligation of the US-Ecuador IIA. In *Vodafone v India* and *Cairn v India*, arbitral tribunals found that the retroactive application of capital gains taxes also breached the FET obligation found in the applicable IIAs, essentially because of the retrospective nature of the income tax amendment that enabled the imposition of the tax. These cases are summarized in Annex 1.

Prohibition Against Expropriation

64. Disputed taxation measures are, more often than not, presented by investors in the course of ISDS proceedings as being tantamount to an (indirect) expropriation, because said measure resulted in an increased tax burden for them.

65. It has sometimes been said that taxation is confiscation without compensation. The reality, of course, is more complex. However, taxation can, in extreme cases, be used as an instrument of confiscation and thus, be regarded as expropriatory. It does not follow, however, that high taxation rates, *per se*, or abrupt increases in one's tax burden, are the equivalent of an expropriation of property. Nonetheless, in many ISDS cases, investors have been prone to make this very argument, on the basis that a significant tax policy change has significantly affected the profitability of their investment.

66. Tax measures that have been alleged to constitute an expropriation in ISDS cases include[40]:

- Non-payment of VAT refunds;
- Initiation of tax investigations/tax audit proceedings;
- Withdrawal of government subsidies;

[39] "The potential obligations arising for host States from an FET standard that is often drafted in a minimalist way in old-generation IIAs could be perceived as particularly onerous for developing countries, for example as they adapt their tax rules to new international tax norms. Notions and concepts that are not explicitly mentioned in the clause are emanating from ISDS awards over time, increasing the complexity and unpredictability surrounding the FET provision in IIAs. (…) It has not become a generally accepted practice by ISDS tribunals to consider the development status of a host State as a mitigating factor when applying the FET standard.", in UNCTAD (2021), *supra* note 6, at 26.

[40] UNCTAD (2021), *supra* note 6, at 31.

- Withdrawal of tax-free status;
- Withdrawal of or decision not to grant tax exemptions;
- Increases in windfall profit taxes and royalties;
- Large tax assessments;
- Withholding tax; and
- (Forcible) collection of taxes, customs or other liabilities.

67. In general, experience shows that most such claims made to arbitral tribunals are not successful. Tribunals tend to recognize that governments have a legitimate right to levy taxation to finance the missions of the state and to change their tax laws for valid policy purposes, such that a mere increase in an investor's tax burden is insufficient to prove the claim. In *Feldman v Mexico*, a US investor unsuccessfully argued under the NAFTA that Mexico's refusal to rebate excise taxes applied to cigarettes exported by its Mexican subsidiary had amounted to an indirect expropriation. Similarly, three US companies (ADM Company, Corn Syrups International and Cargill Incorporated), producers of high fructose corn syrup used in soft drinks, argued that the imposition by Mexico of a 20 percent excise tax on soft drinks and syrups was tantamount to an expropriation. In each case, the arbitral tribunals concluded that no expropriation took place, because the claimants remained in control of their investment and that the effect of the tax was not of sufficient intensity or duration to amount to an indirect expropriation. Finally, in *Occidental v. Ecuador*, a US company argued that the loss of VAT credits and refunds amounted to an indirect expropriation. The arbitral tribunal rejected the claim, on grounds that the investor was not deprived in whole or in significant part, of the use or expected economic benefit of the investment.[41] These cases are summarized in Annex 1.

68. Therefore, there appears to exist a high bar to meet for a taxation measure to be found to be an indirect expropriation. In essence, the effect of the taxation measure on the investment must be equivalent to what a direct expropriation measure would have achieved, that is, make the investment worthless. A measure that reduces the profitability of the investment while still leaving its control in the hands of investors is not the equivalent to an expropriation.

69. In general, the following principles can distinguish a legitimate taxation measure from a measure that amounts to an expropriation[42]:

- In principle, the imposition of taxes does not constitute expropriation and is within the regulatory powers of a state;

- Taxation measures which are consistent with internationally recognized tax policies, principles and practices do not constitute expropriation; and

- Taxation measures which are applied on a non-discriminatory basis, as opposed to being targeted at investors of a particular nationality or specific individual taxpayers, are less likely to constitute expropriation.

70. Section 2 provides guidance on how this issue can be addressed from both a substantive and a procedural point of view in IIAs.

[41] The most famous expropriation case is that of Yukos, *supra* note 27.
[42] UNCTAD (2021), *supra* note 6, at 32.

Transfer of Funds

71. The IIA provisions dealing with the transfer of funds, requiring that investors have unimpeded access to their capital and returns on investment, could raise the issue of whether such provisions might prevent the imposition of taxation measures, in particular at the time payments (dividends or interest) are made to non-residents or capital gains are realized. In general, such provisions are not understood to have this effect, as they do not actually prevent the transfer of funds. The fact that a payer withholds a portion of a payment made to a nonresident in satisfaction of a tax liability borne by that resident does not "impede" the transfer. On the other hand, some IIAs set out, in the transfer article, the circumstances in which a country may legitimately apply its laws (e.g., governing bankruptcy proceedings) in a manner that may otherwise be viewed as impeding the free transfer of funds. For greater certainty, this could encompass compliance with tax laws.

Umbrella Provisions

72. Umbrella provisions bring obligations undertaken by a country with an investor in respect of a specific investment within the fold of the IIA, in particular its ISDS provisions, thus overriding existing enforcement measure associated with such obligations. Depending on the exact language of such provisions, they may give rise to two types of concerns for tax policy makers and tax administrators.

73. First, the terms of an investment contract between the host country and an investor may implicitly or explicitly cover taxation rules – either a commitment by the country to a stable tax regime or a guarantee that certain tax incentives (tax holidays, reduced rate of tax, etc.) will be available for a certain period. While such provisions may be regarded as necessary to attract a given investment, they also impose a constraint on the ability of the country to adapt tax policies in response to changing circumstances. Thus, the pros and cons of such provisions need to be carefully weighed.

74. Second, to the extent that umbrella provisions are drafted in a manner that may encompass *any* agreement entered into between a government and an investor, then another concern may be the unintended consequences that such wording may have on types of "agreements" that are common between taxpayers and revenue authorities, namely tax rulings and advance pricing agreements (APAs).[43] It would come as a surprise for a revenue authority to discover that the terms of an APA or a tax ruling may be the object of a challenge by an investor under a IIA.

Investor-State Dispute Settlement

75. ISDS procedures found in IIAs are foreign to the international tax world. Most tax disputes between a taxpayer and a revenue authority are addressed by the domestic courts. This can be true of tax disputes with international implications. Where instances of economic or juridical double taxation arise, the traditional route is to seek relief, when a DTAs is applicable, through the process set out therein, the mutual agreement procedure (MAP). The differences between the ISDS process and the MAP are significant.

76. Unlike the ISDS process, the MAP is a state-to-state process. (While most IIAs do include a state-to-state dispute resolution mechanism, it is in fact rarely used[44].) Whereas taxpayers can present a case to the domestic tax authorities, the request may not lead to MAP proceedings with the other country that is party to a DTA. First, the tax administration must be satisfied that the request is justified;

[43] UNCTAD (2021), *supra* note 6, at 37.
[44] *Ibid*, at 41.

second, it may be possible for the issue to be resolved unilaterally.[45] Under the ISDS process, no such discretion exists: arbitration is compulsory once a notice of claims is filed by an investor; the cooling off period prior to the formation of the arbitral tribunal, during which consultation may take place between the investor and the host country, rarely if ever produces a resolution. Investors have little regard for the extent to which a disputed tax measure is regarded as "legitimate" from a policy point of view. Relations between countries are fundamentally different, since a country may exercise restraint in weighing whether to challenge the tax measure of another country. For example, no country collecting tax from non-residents through a withholding mechanism would think of alleging that the withholding tax regime of another country is discriminatory.

77. There are other differences between the ISDS process and the MAP. In the case of the latter, the goal is not to suppress the imposition of tax but to alleviate double taxation that may otherwise exist (or address taxation that is not in accordance with the DTA). Investors challenge tax measures under IIAs with the view of obtaining financial compensation for injuries that they allegedly suffered by the imposition of the disputed tax measure. Competent authorities under the MAP have an intimate knowledge of their respective tax systems and of the applicable DTA. Arbitrators under ISDS are not tax experts and may be invited to form a view on intricate tax policy or administration issues.

78. While legally binding arbitration provisions are gradually being integrated into the DTAs of a number of countries, such provisions do not replace or provide an alternative to the MAP. Instead, they are incorporated in the MAP provision as a backstop, when mutual agreement between the competent authorities cannot be achieved, usually within a given period of time. Arbitration under DTAs is a state-to-state process, in which taxpayers have little role, beyond ensuring that all the relevant information is available to the competent authorities. Arbitrators under a DTA arbitration generally have a significant degree of international tax expertise and have been appointed by the countries themselves

79. The previous subsection revealed that treaty shopping is an issue for IIAs. In addition, reliance on an IIA to address a disputed tax measure can also amount to "forum shopping", to the extent that relief could have been ordinarily available in the domestic courts or by invoking the MAP of the relevant DTA. While some view recourse to the IIA's ISDS as being desirable when the MAP does not produce a satisfactory solution[46], it is a possibility that should be discouraged, as it would undermine the integrity of DTAs. Indeed, this can lead to situations where taxation measures that are specifically permitted under the terms of a DTA may be challenged under an IIA. It cannot be the intent of a country to grant taxing rights to its DTA partner, only to see one of its investors challenge such rights under the ISDS provisions of an IIA.

80. Beyond forum shopping, there may also exist, in theory at least, difficult issues regarding the establishment of the respective jurisdictions of IIAs and DTAs over a particular dispute, in some circumstances. For example, both types of agreements include non-discrimination provisions. It is unclear which of the IIA or the DTA should apply where the obligations appear to be legally equivalent.

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[45] UN (2021), *supra* note 36. The first sentence of paragraph 2 of Article 25 of the UN Model reads: The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with this Convention.

[46] See Michael Lang et al. (Eds), *The Impact of Bilateral Investment Treaties on Taxation* WU Institute for Austrian and International Tax Law, European an International Tax Law and Policy Series, December 2017, Chapter 1, at 21-22.

Given this, a decision may be required to determine which agreement applies. Absent specific guidance, it is not clear under which agreement such a decision must be made.

81. Many in the literature have argued that, as regards the application of ISDS provisions under IIAs, taxation measures are fundamentally different from other government measures[47], because taxation is a "fundamental aspect of sovereignty"[48]. Under this view, a distinct treatment for taxation in IIAs may be warranted. Such concerns for tax sovereignty derive most directly from the (some say excessive) power granted investors to compel binding arbitration under IIAs, and perceptions of the skewed nature of the ISDS process, which can be ill-designed to adjudicate public policy issues such as taxation.

82. As will be discussed in section 2, a number of different issues are raised by the application of ISDS provisions to taxation measures and there exist a wide range of options available to address them. The seed of a state-to-state approach is already incorporated in the taxation articles of some IIAs, through the form of so-called "filters" that require the consideration of certain issues by officials with tax expertise prior to the issues reaching the ISDS stage.

1.4 Consequences of International Investment Agreements on Taxation

83. The ability of foreign investors to initiate a case under the ISDS procedure engenders two types of risks for governments: financial risks and the imposition of constraints on tax policy making. This subsection addresses them both briefly.

Statistics

84. According to 2021 data[49], there has been almost 2,000 disputes arising under IIAs. Of that number, 165 concerned taxation measures (as the main issue thereof or as an ancillary issue), that is, slightly more than 8 percent of all cases. Data does not reveal what proportion of all cases involving taxation measures are won by investors, but a recent analysis[50] of a sample of 32 tax-related cases reveals that slightly more than 50 percent of them were won by investors. Of these cases, 60 per cent were brought against developing countries. Investors from developed countries brought over 90 per cent of tax-related claims.

85. The main claims made by investors concern allegation of a breach of the NT obligation, the obligations as regards expropriation, as well as a breach of the obligation to provide investors and their

[47] For an extensive discussion of this point, see Bird-Pollan, Jennifer, *The Sovereign Right to Tax: How Bilateral Investment Treaties Threaten Sovereignty (2018)*. Notre Dame Journal of Law, Ethics and Public Policy, Vol. 32, No. 1, 2018. Available at SSRN: https://ssrn.com/abstract=3281741.

[48] Chaisse, Julien and Kirkwood, Jamieson (2021). *Foreign Investors vs. National Tax Measures: Assessing the Role of International Investment Agreements*. In Mosquera Valderrama, I. J., Lesage, D. and Lips, W. (Eds.) *Taxation, International Cooperation and the 2030 Sustainable Development Agenda*. United Nations University Series on Regionalism, Vol 19, Springer. Available at: https://link.springer.com/book/10.1007/978-3-030-64857-2. See Chapter 8, at 150.

[49] UNCTAD (2022). IIA Issue Note No. 1. *Facts on Investor–State Arbitrations in 2021: With a Special Focus on Tax-Related ISDS Cases*. United Nations, July 2022. Available at: https://investmentpolicy.unctad.org/publications/1266/facts-on-investor-state-arbitrations-in-2021-with-a-special-focus-on-tax-related-isds-cases. Annex provides a list of such cases spawning from 1987 to 2021.

[50] Chaisse, Julien and Kirkwood, Jamieson (2021), *supra* note 48, Chapter 8, section 8.3.

investment fair and equitable treatment. In many cases, all such obligations are alleged to have been breached.

Financial Risks

86. Financial risks associated with the ISDS process are two-fold: the cost of participating in the ISDS process as defendant and the cost of paying an award to a foreign investor when an arbitral tribunal establishes that a country has breached one or more provisions of an IIA. As was discussed in subsection 1.2, the cost of defending disputed measures can be substantial, in particular for small economies or developing countries. Indeed, it is disproportionately on such countries, as foreign investment hosts, that such costs fall. In some instances, foreign investors will be able to rely on more resources and more high-end expertise than defending developing countries are capable of mobilizing.

87. In exceptional cases, a single set of policy changes can trigger dozens of ISDS cases against a country, such as was the case of Spain, which has been sued over 40 times, under the *Energy Charter Treaty*, by investors since 2011 over the withdrawal by the government, starting in 2010, of incentives to encourage investments in the renewable energy sector, including the imposition of a 7 percent tax on the value of energy production. It is estimated that it has cost Spain over €100 million to participate in 25 ISDS cases for which such information is available[51].

88. Awards granted by tribunals to investors can also be substantial, depending on the extent of the injury sustained by them, as established by tribunals, as well as whether more than one investor has sued in respect of the same measure, as is often the case. A recent case concerning the imposition of capital gains tax by India saw an international tribunal award financial compensation of $1.2 billion to Cairn Energy, a UK company (see Annex 1). In a similar case brought by Vodafone International Holdings BV, a Dutch company, a tribunal ordered India to forgo the collection of $2.2 billion in taxes. Finally, it is estimated that in 21 cases brought against Spain, referred to in the previous paragraph, that were decided in favour of investors, the amount of awards to be paid to investors totaled €1.2 billion.[52]

89. In some cases, a tribunal's decision to award a financial compensation to a foreign investor is not the end of the matter if either the ruling or the amount of the award is contested by the host countries, further adding complexity and deepening litigation costs. There have been instances where investors have taken legal action after being awarded financial compensation to compel payment by the country that lost the ISDS case. A recent and high-profile example is that of *Cairn v India*, referred to in the previous paragraph, where Cairn Energy initiated court proceedings in multiple countries with the goal of seizing property held by the Indian government or Indian companies, in order to recoup the $1.2 billion financial compensation awarded to it by an arbitral tribunal over India's retrospective application of capital gains tax in respect of a business reorganization. This case is discussed in Annex 1.

[51] For a succinct explanation of the nature of the dispute, the cost of the various ISDS cases and the amounts of financial compensation awarded investors, see Bárcena, Lucia and Flues, Fabian, *From solar dream to legal nightmare: How financial investors, law firms and arbitrators are profiting from the investment arbitration boom in Spain*, Transnational Institute and PowerShift, May 2022. Available at: https://www.tni.org/en/publication/from-solar-dream-to-legal-nightmare. The central claim made in all cases was that the disputed measures were inconsistent with the FET obligation of the IIA, as they frustrated the legitimate expectations of investors. While generally included in lists of ISDS cases as "tax cases", the disputed measures thereof were mostly related to the withdrawal by Spain of non-tax incentives put in place to encourage investment.

[52] *Ibid*.

Impact on Tax Policy

90. The impact on the conduct of tax policy of the existence of IIAs is two-fold. First is the direct impact that stems from the finding by a tribunal that a disputed measure is inconsistent with the country's obligation under an IIA and that the country must pay an investor financial compensation determined by such tribunal. If the disputed measure remains in force at that time, it is conceivable that it could have a similar effect in respect of other foreign investors or in subsequent years. The prospect of having to pay additional financial compensation in respect of additional ISDS litigation would render the continued existence of the disputed measure unsustainable, with the result that the disputed measure would need to be amended or repealed.

91. The indirect impact stems from the mere prospect of investors challenging a proposed or an actual taxation measure that they view as negatively impacting their investment in the country. Naturally, countries bound by obligations imposed in IIAs must be aware of the limitations that such obligations impose on their conduct of tax policy and administration. This means that countries must exercise due diligence for the purpose of ensuring that tax policies and administrative practices do not run afoul of their international obligations under IIAs. This exercise, however, is not an exact science. Tax policy makers, especially in countries that tend to be host countries for foreign investment, are increasingly aware of other countries' (and especially their own) experiences with ISDS tax cases. This can lead countries to discard potential policy choices, for fear that implementing them might trigger litigation under an IIA.

2. Proposals to Address the Issue of Taxation in International Investment Agreements

2.1 Introduction

92. The previous section described the main elements of IIAs, how IIAs apply in respect of taxation measures and discussed issues and concerns under IIAs generally and, in the context of taxation measures in particular. In general, the issues raised in connection with taxation measures, especially with respect to FET and the ISDS process, go well beyond the issue of taxation. The intent of this Report is not to propose solutions to the issues affecting IIAs generally, while acknowledging that the implementation of potential broad-based solutions to such issues may go some way to alleviate concerns raised in the specific context of taxation.

93. This section, however, while acknowledging this broader context, focuses mostly on solutions tailored to address issues specific to taxation. It is argued that it is possible to accord taxation more deliberate attention in the crafting of the content of, and the negotiation of, IIAs in a manner that does not affect their basic goal of promoting cross-border investment, while taking into account the legitimate interest of tax policy makers and administrators.

94. Many IIAs, in particular older generation IIAs, contain very little by way of provisions addressing taxation measures, meaning that they contain few restrictions to the application of their obligations to taxation measures. This clearly reflects the fact that little attention was given to taxation issues when the first IIAs were negotiated, both by investment negotiators and by tax policy experts, who were mostly unaware of the possible implications of IIAs for taxation measures.

95. Starting in the early 1990s, with the negotiation of ambitious plurilateral trade liberalization agreements with strong provisions on investment protection[53], tax expertise was gradually brought to bear to explicitly address taxation issues. This confirmed that tax expertise was necessary to achieve a balance between the objective of encouraging cross-border investment and the preservation of flexibility in the conduct of tax policy. It also demonstrated that achieving such a balance did not weaken the effectiveness of IIAs in their promotion and protection of cross-border investment.

96. This section is divided into two parts. The first subsection discusses specific approaches that can be adopted to include provisions in IIAs that are specific to taxation measures. This discussion is itself segmented in two parts: first, a discussion of different approaches that can be considered to address individual provisions of IIAs; second, an overview of how such approaches have been implemented in IIAs. The second subsection lays out the process by which tax expertise can be integrated in (i) the crafting of a country's investment promotion and protection policy, including specific provisions of IIAs dealing with taxation, (ii) the process of negotiating IIAs with other countries, and (iii) in the handling of disputes arising under IIAs that concern taxation measures.

2.2 Proposals Regarding the Content of International Investment Agreements

97. This subsection begins with a review of the main provisions of IIAs and, in the light of the issues raised in the previous section, proposes approaches that can be considered to address taxation measures. There are markedly different approaches to address taxation in IIAs. They reflect the existence of different views regarding the extent to which tax policy flexibility needs to be preserved under IIAs. The guidance offered below applies equally to stand-alone IIAs and investment provisions of free trade agreements. As mentioned previously, this Report does not address the implications for taxation of the additional disciplines found in free trade agreements.

2.2.1 How to Address Specific IIA Provisions

National Treatment (NT)

98. As mentioned in the previous section, income taxation measures are potentially vulnerable to challenges under this provision given the extensive distinctions that income tax laws make on the basis of the residence of the taxpayer. Absent any dedicated provision addressing taxation, the only grounds on which one could defend a taxation measure from a NT-related allegation would be to argue that resident and non-resident taxpayers are not "in like circumstances" and, thus, that the difference in treatment alleged to exist between the foreign investor and an investor of the host country is not discriminatory. Relying solely on this line of defense to protect income taxation measures would leave a significant degree of uncertainty.

99. Alternatively, one could adopt an approach similar to that found in the first sentence of paragraph 1 of Article 24 (Non-Discrimination) of the UN Model, and explicitly affirm, in the text of the IIA, that resident and non-resident taxpayers are not "in like circumstances" for purposes of interpreting the NT obligation or, alternatively, that nothing in the agreement prevents the adoption of taxation measures that make distinctions on the basis of residence. For example, recent free-trade agreements concluded by the European Union (EU) include the following language in its taxation article [54]:

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[53] Namely, the *General Agreement on Trade in Services*, the *Energy Charter Treaty* and the *North American Free Trade Agreement*.

[54] *Comprehensive Economic and Trade Agreement (CETA) Between Canada and the European Union*, signed in

> Nothing in this Agreement shall be construed to prevent a Party from adopting or maintaining any taxation measure that distinguishes between persons who are not in the same situation, in particular with regard to their place of residence or with regard to the place where their capital is invested.

100. Several taxation articles include language originally found in the taxation article of the *General Agreement on Trade in Services*[55]. More recent language combines the latter with the provision set out above, as follows:

> (…) nothing in the Articles referred to in subparagraphs (a), (b) and (c) shall apply to:
>
> the adoption or enforcement of any new taxation measure aimed at ensuring the equitable or effective imposition or collection of taxes, including any taxation measure that differentiates between persons based on their place of residence for tax purposes, provided that the taxation measure does not arbitrarily discriminate between persons, goods or services of the Parties; (footnote: The Parties understand that this subparagraph must be interpreted by reference to the footnote to Article XIV(d) of GATS as if the Article was not restricted to services or direct taxes.)

101. While the above language means that taxation measures can be litigated under the NT provision of IIAs, the defendant country can invoke these provisions as a defense before an arbitral tribunal. The outcome of ISDS proceeding depends on the facts of the case.

102. Further down the continuum, another approach consists of subjecting taxation measures to the NT obligation, subject to specific exceptions set out in a list of reservations where specific non-conforming taxation measures would be identified. While the listed measures would be protected, such measures could not be amended in the future to be made less conforming to the NT obligation. This also means that prospective taxation measures would be subject to the NT provision, in any of the manners described in previous paragraphs. A variation of this would be to grandfather all existing taxation measures, thereby dispensing with the obligation to list non-conforming measures. Such an approach provides investors less transparency than a list of specific measures, but provides the parties more certainty that all existing non-conforming measures are immune from the NT obligation[56]. As in the case of a list of reservations, a general grandfathering rule does not allow a measure captured by it to be amended in a manner that makes it less conforming.

103. Finally, taxation measures may be entirely removed from the scope of the NT obligation: either income tax measures, income and other similar direct taxes, or alternatively, all taxation measures without distinction.[57] This is the approach that confers maximum certainty to tax policy makers and administrators, as both existing and future taxation measures are immune from NT discipline. While such an approach reduces the prospect that a taxation measure might be subject to an ISDS procedure, it does not entirely eliminate it, as the investor may still argue that a given measure does not fall within the scope of the exclusion as drafted. Investors might argue that such an approach leaves them at risk

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2018 (investment provisions not currently in force), paragraph 1 of Article 28.7. Available at: https://investmentpolicy.unctad.org/international-investment-agreements/treaty-files/3593/download. Similar provisions can be found in agreements signed or concluded by the EU with Japan, Mexico, New Zealand and Singapore.

[55] Article XIV(d).

[56] See, for example, subparagraph 4(f) of Article 28.7 of the Canada-EU CETA, *supra* note 54.

[57] One of the first occurrences of this approach was found Article 2103 of the *North American Free Trade Agreement (NAFTA)* (1992). Available at: https://www.italaw.com/sites/default/files/laws/italaw6187%286%29.pdf. It is also found in the *Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP)* (2018) and other agreements that follow this model. Available at: https://www.iilj.org/wp-content/uploads/2018/03/CPTPP-consolidated.pdf.

that taxation might be used as an instrument to discriminate against them and their investment, although this concern may be overstated, since DTAs include significant non-discrimination protection.

104. In comprehensive free trade agreements, NT discipline also applies in respect of cross-border services and service providers. This gives rise to its own issues, the examination of which is beyond the scope of this Report.[58]

Most Favoured Nation (MFN)

105. Generally, most IIAs explicitly provide either that, depending on the exact formulation, provisions of, or an advantage accorded by, a DTA, a convention, or an international agreement relating to taxation are not subject to the MFN provisions of IIAs. Given the emergence of multilateral agreements dealing with taxation[59], a wider formulation ("any international agreement relating to taxation") intended to capture agreements other than DTAs would be advisable.

106. Exclusions from the MFN obligation can be extended to domestic taxation measures, either by listing those that are inconsistent with the obligation or by excluding either all income tax measures, or all taxation measures from the scope of the provision. There does not exist a strong rationale in support of excluding taxes such as valued added taxes or excise taxes from the MFN obligation, as such "internal taxes" are already subject to WTO disciplines, in particular under the GATT.

Fair and Equitable Treatment (FET)

107. The treatment of taxation measures under the FET obligation is generally a binary proposition in IIAs: either taxation measures are completely excluded from its scope, by virtue of language that removes taxation measures from the scope of most IIA obligations, or they are covered. The latter approach is generally typical of the first generation of IIAs, presumably under the assumption held at the time that such an obligation, when properly interpreted, could only have innocuous consequences on taxation measures.

108. Since experience has shown otherwise, it is nowadays more common to completely exclude taxation measures from the scope of application of the FET obligation. However, this means that taxation measures are spared the application of what is regarded as a minimum standard of treatment under IIAs, a standard that tends to be drafted in recent IIAs in a manner designed to limit the expansive interpretation given to it by many arbitral tribunals over the years.

109. More recently, a few IIAs have taken the approach of subjecting taxation measures to the FET obligation, subject to an interpretative provision which attempts to define the circumstances under which a taxation measure would not ordinarily be inconsistent with the FET standard. One example of such an interpretation was included in a recent agreement[60]:

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[58] This particular issue may be examined in a subsequent report.

[59] In particular, the OECD *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting*, signed by over 100 jurisdictions, and which came into force on 1 July 2018, with the goal of implementing a number of tax treaty measures to update international tax rules aiming at curbing international tax avoidance.

[60] Paragraph 5 of the Canada-EU CETA, *supra* note 54. Also found in paragraph 3 of the taxation article of the text of the *European Union-Mexico Global Partnership*, agreed to in principle in 2018. Available at: https://policy.trade.ec.europa.eu/eu-trade-relationships-country-and-region/countries-and-regions/mexico/eu-mexico-agreement/agreement-principle_en.

> For greater certainty, the fact that a taxation measure constitutes a significant amendment to an existing taxation measure, takes immediate effect as of its announcement, clarifies the intended application of an existing taxation measure, or has an unexpected impact on an investor or covered investment, does not, in and of itself, constitute a violation of Article 8.10 (Treatment of investors and of covered investments).

110. Such language provides a more balanced approach than the total exclusion described previously, since the latter leaves, potentially at least, taxation as a tool to effect conduct that is otherwise prohibited under the FET standard. It addresses specifically the types of arguments made in past ISDS cases with respect to a taxation measure that allegedly offended the "legitimate expectations" of investors because the tax change was (i) unforeseen: (ii), implemented with little advance notice; or (iii) significantly affected the profitability of an investment. An arbitral tribunal would be expected to take the guidance set out in this provision into account when considering an investor allegation in respect of a taxation measure.

Prohibition Against Expropriation

111. Most IIAs subject taxation measures to the discipline of its expropriation provisions; in many instances, it is the only obligation of the IIA that is made to apply in respect of taxation. There are valid reasons to do so. First, such provisions are, together with the non-discrimination provisions, a core component of IIAs, intended to provide a basic level of protection to investors against the potentially abusive conduct of the host country. Second, taxation represents an apparent tool to implement the indirect expropriation of investment through the confiscation of its returns. As explained in the previous section, experience with investor allegations that taxation measures amounted to an expropriation has shown that arbitral tribunals are generally reluctant to side with investors, and tend to set a high bar to justify a finding that a taxation measure effects an indirect expropriation.

112. Yet, tax policy makers remain concerned with the potential that a taxation measure may run afoul of the expropriation provisions. In order to alleviate such concerns, two basic approaches have been used in IIAs. The less common one is to include language in the IIA intended to define the circumstances in which a taxation measure would not ordinarily be regarded as an expropriation. Such a provision is intended to guide an arbitral tribunal in its analysis of a specific case. It is unclear whether the efficacy of such an approach has ever been tested in an actual ISDS case. An example of such a provision is as follows[61]:

> The determination of whether a taxation measure, in a specific fact situation, constitutes an expropriation requires a case-by-case, fact-based inquiry that considers all relevant factors relating to the investment, including the factors listed in Annex 10-B and the following considerations:
>
> (a) the imposition of taxes does not generally constitute an expropriation. The mere introduction of a new taxation measure or the imposition of a taxation measure in more than one jurisdiction in respect of an investment generally does not in and of itself constitute an expropriation;
>
> (b) a taxation measure that is consistent with internationally recognised tax policies, principles, and practices should not constitute an expropriation. In particular, a taxation measure aimed at preventing the avoidance or evasion of taxation measures generally does not constitute an expropriation;

[61] *Free Trade Agreement between New Zealand and the Republic of Korea* (2015), Annex 10-E. Available at: https://www.mfat.govt.nz/assets/Trade-agreements/Korea-NZ-FTA/NZ-Korea-FTA-consolidated-text.pdf. Similar language is found in the *Free Trade Agreement between Australia and the Republic of Korea* (2014), Annex 11-I. Available at: https://www.dfat.gov.au/sites/default/files/korea-australia-free-trade-agreement.pdf.

> (c) a taxation measure that is applied on a non-discriminatory basis, as opposed to a taxation measure that is targeted at investors of a particular nationality or at specific taxpayers, is less likely to constitute an expropriation; and
>
> (d) a taxation measure generally does not constitute an expropriation if it was already in force when the investment was made and information about the measure was publicly available.

113. Another way to address this issue is to address investor allegations by the addition of a procedure that is triggered prior to the allegation reaching the arbitral tribunal for its consideration. This is generally referred to as a "filter", for reasons that will become apparent below. In its usual formulation, an investor who serves a notice of intent to a government alleging that a taxation measure is an indirect expropriation must, usually at the same time, refer the matter to "designated authorities" of the parties, usually defined as tax policy officials of the parties or competent authorities defined as such under the relevant DTA. The designated authorities are given a period of time, usually six months, to come to an agreement that the disputed taxation measure is not an expropriation (this being the only conclusion that they can jointly reach). If they so decide within the allotted time period, a tribunal formed to hear the dispute is precluded from considering the issue, as the decision binds the tribunal, meaning that the allegation is kicked out before the ISDS commences. Alternatively, if the designated authorities do not agree that the measure is not an expropriation, or fail to even consider the issue, within the allotted period of time, the allegation can proceed to the ISDS stage and its merit be considered by the arbitral tribunal. Below is the text of a recent occurrence of such a provision in aa free trade agreement[62]:

> 8. Article 9.8 (Expropriation and Compensation) shall apply to taxation measures. However, no investor may invoke Article 9.8 (Expropriation and Compensation) as the basis for a claim if it has been determined pursuant to this paragraph that the measure is not an expropriation. An investor that seeks to invoke Article 9.8 (Expropriation and Compensation) with respect to a taxation measure must first refer to the designated authorities of the Party of the investor and the respondent Party, at the time that it gives its notice of intent under Article 9.19 (Submission of a Claim to Arbitration), the issue of whether that taxation measure is not an expropriation. If the designated authorities do not agree to consider the issue or, having agreed to consider it, fail to agree that the measure is not an expropriation within a period of six months of the referral, the investor may submit its claim to arbitration under Article 9.19 (Submission of a Claim to Arbitration).

114. The rationale for this provision is to prevent (to "filter out") frivolous investor claims under the expropriation provisions from reaching the ISDS stage. The theory is that tax authorities are expected to readily agree that a taxation measure that is commonly found in the tax laws of most countries is not an expropriation[63]. The existence of the filter may even prevent frivolous claims from being filed by investors in the first place. The presence of a filter in a taxation article makes the inclusion of language discussed in paragraph 112 arguably unnecessary, since the decision is placed in the hands of tax experts.

Umbrella Provisions

115. As discussed earlier, an agreement entered into between an investor of a party and the government of the other party, which provides the investor a commitment toward regulatory stability, may include guarantees with respect to taxation rules. Umbrella provisions included in IIAs, under which the terms of such agreements can be enforced under the IIA's ISDS provisions, generally confer

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[62] Paragraph 8 of Article 29.4 of the CPTPP, *supra* note 57. Such a provision was first found in the NAFTA, *supra* note 57.

[63] This mechanism has been used at least once, under the NAFTA, *supra* note 57.

additional protections to investors that any written commitment made in respect of taxation rules will be enforced.

116. There is usually little downside to the inclusion of such umbrella clauses in IIAs from the perspective of capital exporting countries (many of which do not enter into such agreements), as they essentially serve to protect their own investors. The decision for host countries, in particular developing countries, as regards the specific aspect of taxation, is whether it is desirable for them to enshrine tax rules in individual agreements entered into with foreign investors. While the guarantee of tax policy stability may in some contexts, represent an important incentive to attract foreign investment, contractual obligations to maintain certain tax rules unchanged for a given period of time also reduce policy flexibility for the government of the host state, most directly with respect to investors covered by such obligations, but also possibly with respect to generally applicable taxation rules.

117. An examination of the pros and cons for governments of entering into investment agreements with individual investors is beyond the scope of this Report. However, it would be advisable, in drafting the language of the umbrella provision for inclusion in an IIA, to refer with precision to the types of agreements that they are intended to cover, and to avoid using overly broad or imprecise language that may inadvertently sweep in tax rulings issued by taxation authorities to taxpayers and APAs concluded between taxpayers and taxation authorities.

Other Issues

118. Most IIAs include provisions against the imposition of performance requirements.[64] In the tax articles of IIAs that tend to broadly exclude taxation measures, the performance requirement provisions generally do not apply to taxation measures. In the tax articles of IIAs that tend to subject taxation to some obligations of the IIAs, performance requirement provisions generally apply to taxation measures. There does not appear to exist a significant concern that an ordinary taxation measure would be inconsistent with obligations prohibiting the imposition of performance requirements, although, in at least two cases, a taxation measure was found by an arbitral tribunal to have been inconsistent with the obligation[65].

119. Finally, a few taxation articles of IIAs include provisions intended to protect the confidentiality of taxpayer information. For example[66]:

> This Agreement does not require a Party to furnish or allow access to information that, if disclosed, would be contrary to the Party’s law protecting information concerning the taxation affairs of a taxpayer.

[64] A “performance requirement”, in relation to the establishment or operation of an investment in a country, is a measure of that country that imposes on investors a requirement, or that makes access to an advantage (e.g., an investment incentive) conditional on a requirement to achieve specific objectives. Such objectives may include the export of a given level or percentage of goods, the achievement of a given level or percentage of domestic content, the purchase of locally produced goods or services, the transfer technology to a person in its territory, etc.

[65] See the *ADM* and *Cargill* ISDS cases in Annex 1.

[66] Paragraph 3 of Article 14 of the *Agreement between the Government of Canada and the Government of Burkina Faso for the Promotion and Protection of Investments* (2015). Available at: https://investmentpolicy.unctad.org/international-investment-agreements/treaty-files/3460/download. See also paragraph 7 of Article 14 of the *Investment Agreement Between the Government of the Hong Kong Special Administrative Region of the People’s Republic of China and the Government of the Republic of Chile* (2016). Available at: https://investmentpolicy.unctad.org/international-investment-agreements/treaty-files/5413/download.

120. The confidentiality of information relating to the tax affairs of taxpayers is generally protected by provisions of domestic tax laws and, when such information is shared with tax treaty partners, by the exchange of information provisions of DTAs. There exists a concern that complainants may seek from defendant countries, in the course of ISDS procedures, the production of taxpayer information, in particular in respect of other taxpayers, for purposes of establishing comparisons in support of its allegations. The above provision removes doubt in this respect and, *inter alia*, limits the ability of arbitral tribunals to compel the sharing of information the confidentiality of which is protected under a country's laws.

Coordination of IIAs with DTAs

121. IIAs and DTAs are both legally binding international treaties. While the two types of treaties pursue different objectives and do not generally overlap, there exists a theoretical potential for them to do so[67]. Thus, it becomes desirable to coordinate their respective applications to avoid legal uncertainty or confusion, or the real possibility of deliberate forum shopping on the part of investors.

122. This coordination is almost always achieved by the inclusion of a provision in IIAs. A typical formulation reads as follows[68]:

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

123. "Tax convention" is usually defined broadly to include DTAs and other international taxation agreements or arrangements and, as such, this definition is capable of encompassing multilateral tax instruments. The principle stated in this provision is straightforward: if a conflict arises in respect of a disputed taxation measure between the IIA and the applicable DTA, the latter is to prevail. However, it should be noted that, as written, it leaves certain issues unresolved, such as who would decide how this paragraph is applied in practice.

124. Recent IIAs include provisions that address this issue. There are essentially two variations: the first one requires that the issue of whether there exists an inconsistency between the IIA and an applicable DTA be referred to either the "designated authorities" (tax experts), or the "parties", in a manner similar to that of the expropriation filter discussed above. They are given a period of time to decide the issue and the referral pauses the ISDS process. A joint determination on their part is binding on a tribunal. If no such determination is made within the allotted period, the issue is to be addressed in the course of the regular ISDS process[69]. Under the second variation, the competent authorities under the applicable DTA are given sole authority to decide the jurisdictional issue. While in principle clear, such an approach creates some uncertainty. The role ascribed to the competent authorities is not explicitly linked to the ISDS process, meaning that nothing would prevent an arbitral tribunal from proceeding with the consideration of the broader dispute while the competent authorities consider the issue, which is less than optimal. Moreover, it does not provide a timeline for reaching a decision. Finally, it does not spell out what happens if the competent authorities do not come to a joint determination. For this reason, the first variation is seen as preferable.

[67] There is no evidence that a conflict of jurisdiction ever occurred between a DTA and a IIA over a given dispute involving a taxation measure.
[68] Paragraph 3 of Article 29.4 of the CPTPP, *supra* note 57.
[69] An example of such a provision is set out in the next subsection.

125. The standard of the provision set out in paragraph 122 is clear: if the application of the respective agreements produces different ("inconsistent") outcomes in respect of a disputed taxation measure, the outcome mandated by the DTA prevails. However, the question arises: what does "inconsistency" mean? At first glance, one may consider that the existence of an inconsistency between a IIA and a DTA, in respect of a disputed taxation measure, refers to a comparison of their substantive obligations, such as, for example, NT. Under this view, if the application of the NT obligations of the respective agreements results in the same substantive conclusion with respect to a disputed taxation measure, there would not appear to be an inconsistency between the agreements that need to be addressed under the above provisions, which means that the latter may not be capable of adjudicating jurisdiction. In reality, this view arguably construes the concept of "inconsistency" too narrowly. In fact, the language of the provision set out at paragraph 122 is sufficiently broad to allow a resolution of the matter. The analysis of taxation authorities regarding whether an inconsistency exists between a DTA and an IIA would arguably need to encompass the full effect of the application of the respective agreements to the factual situation, beyond the mere comparison of the one aspect they may have in common (say, NT), including how disputes are handled. In other words, based on a comprehensive comparison of all relevant provisions, it would be possible to conclude in this situation that an inconsistency does exist between the agreements (in favour of the application of the DTA to the extent of the inconsistency), meaning that the provision is, in fact, capable of producing an unambiguous solution in most cases.

Investor-State Dispute Settlement (ISDS) Procedures

126. While it is to be expected that taxation measures may potentially be subject to litigation under IIAs, the significant number of such disputes and the nature of the claims made by investors are directly attributable to the ease with which it is possible to launch such disputes under the ISDS process. It is not possible to isolate the impact of the availability of the ISDS provisions on the number of IIA disputes. However, it is notable that a major plurilateral agreement that includes similar disciplines in respect of investment in the services sector (the GATS), which provides exclusively for a state-to-state dispute resolution process, has seen few tax-related disputes and not a single one in respect of income tax measures since its entry into force in the mid-90s. Therefore, it can be inferred that the ease with which disputes can be initiated by investors explains in part their prevalence under IIAs.

127. Earlier paragraphs have described the use of filters to address a number of issues that may arise in connection with allegations made in respect of taxation measures: whether there is an inconsistency between the IIA and a DTA; whether a taxation measure is not an expropriation. Filters are also used to determine whether a disputed measure is, in fact, a taxation measure[70]. In IIAs with robust tax carve-outs, it is a matter of high importance to make that particular determination, where doubt exists, as it will determine whether the disputed measure will fall within the jurisdiction of the arbitral tribunal or not, by virtue of exclusions set out in the taxation article. In addition, in some recent IIAs, filters provide the opportunities for "the parties" to decide whether the disputed tax measure actually breaches an obligation of the agreement. A decision by the parties that no breach has occurred is binding on the

[70] See, for example, paragraph 4 of Article 16 of the *Agreement Between Canada and the Republic of Peru for the Promotion and Protection of Investments* (2006); paragraph 4 of Article 204 of the *Free Trade Agreement between the Government of New Zealand and the Government of the People's Republic of China* (2008) or paragraph 6 of Article 14 of the Hong Kong-Chile IIA, *supra* note 66. The first agreement is available at: https://investmentpolicy.unctad.org/international-investment-agreements/treaty-files/626/download; the second agreement is available at: https://investmentpolicy.unctad.org/international-investment-agreements/treaty-files/2564/download.

arbitral tribunal.[71] This means that, in theory, parties may have the power to prevent any allegation made in connection with a taxation measure from ever reaching the arbitral panel.

128. Two observations can be derived from the above discussion: first, newer IIAs increasingly incorporate sophisticated filters to address specific issues related to disputed tax measures, reflecting the preference of tax policy makers that tax-related disputes are best considered and resolved by officials with intimate expertise in the matter. Second, as the scope of such filters grows to address more and more issues, it is becoming apparent that, whether issues are referred to officials responsible for tax policy, tax administration, competent authorities under DTAs or simply the parties, filters *de facto* introduce into the ISDS process elements of a state-to-state approach to the resolution of disputes. This inevitably raises a threshold question: does this mean that, taking this trend towards its logical conclusion, tax-related disputes should be solely confined to a state-to-state dispute settlement process? This question is examined further in subsection 2.2.3.

2.2.2 Possible Approaches for a Model Taxation Article

129. The previous subsection has described a substantial sample of different approaches used to address taxation measures vis-à-vis specific obligations found in IIAs. This subsection considers how such approaches are set out in dedicated taxation articles included in IIAs and free trade agreements and attempts to sort out broad categories of taxation articles. Three categories of tax articles are described in what follows: targeted tax exclusion, broad tax exclusion and complete or near complete tax exclusion, and each category is illustrated with the language of actual tax articles found in IIAs. This subsection ignores IIAs that do not address taxation in a meaningful manner, generally, older generation IIAs, as it is assumed that, in all cases, it is advisable to include a taxation article in new IIAs.

Targeted Tax Exclusion

130. In taxation articles that fall under this label, the default position adopted therein is that the obligations of the IIA **do apply to taxation measures**, except as provided for in the article. Thus, the article essentially includes targeted exceptions, as well as interpretative language to be considered in respect of taxation measures. The article would typically:

- Set out the definition of terms used in the article;
- Provide an interpretation of the NT obligation as it applies to taxation measures;
- Provide that the agreement does not prevent the imposition of anti-avoidance measures;
- Exclude advantages granted under DTAs and similar agreements from the scope of the MFN obligation;
- Coordinate the jurisdiction of the IIAs with relevant DTAs, including setting out the participation of tax experts to determine, in specific cases, whether there exists an inconsistency between both agreements;

131. This approach has been adopted in recent free trade agreements concluded by the European Union. The tax article of one such agreement is set out in Annex 2.

[71] The language of this provision is set out in subsection 2.2.3.

Broad Tax Exclusion

132. The taxation articles described under this label can also be referred to as the "NAFTA model", as the first occurrence of this approach was first articulated in the NAFTA. Under this type of article, the default position is that the obligations of the IIA **do not apply to taxation measures**, except as set out in the article. Therefore, the parties identify clearly which obligations are made to apply to taxation measures and under what conditions. This type of article also contains more extensive filters mandating the participation of tax expertise to address particular issues. A typical article would:

- Set out the definition of terms used in the article;
- Set out at the outset that no obligations of the IIA apply to taxation measures, except as is set out in the article;
- Coordinate the jurisdiction of the IIAs with relevant DTAs and similar agreements, including setting out the participation of tax experts to determine, in specific cases, whether there exists an inconsistency between both agreements;
- Carve in those obligations of the IIAs that are to apply in respect of taxation measures. They are:
    - The NT obligation and the MFN obligation. Their application to taxation measures is qualified in three different respects: (i) it is limited to taxes other than direct taxes, be it income, capital gains and capital taxes; (ii) generally, the obligations apply only on a prospective basis, as existing taxation measures are excluded; and (iii) it specifies that the obligations do not prevent the adoption or enforcement of new taxation measures aimed at ensuring the equitable or effective imposition or collection of taxes;
    - The provisions prohibiting certain performance requirements, and those pertaining to expropriation;
- Exclude advantages granted under DTAs and similar agreements from the scope of the MFN obligation; and
- Provide a filter to allow taxation authorities to determine whether a taxation measure alleged to be an expropriation is, in fact, not an expropriation.

133. There are dozens of IIAs, in particular those included in broader free trade agreements, that include a variation of the above model, including the Agreement between the United States of America, the United Mexican States, and Canada (USMCA) and the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). The tax article of the latter is reproduced in Annex 3.

Complete or Near Complete Tax Exclusion

134. Taxation articles in this category stipulate that, unless as set out in the article, the obligations of the IIA **do not apply to taxation measures**. This category differs from the preceding one in that few provisions of the IIA are, in fact carved-in; usually, the NT and MFN obligations are not, meaning that taxation measures are completely immune from such obligations. In its most absolute form, the only obligation made to apply to taxation measures is that relating to transfers (and only because that provision includes an exception stipulating that transfers may be temporarily prevented in order to ensure compliance with tax obligations). In other instances, the provisions on expropriation are made

to apply to taxation measures. When the expropriation provisions are carved-in, the article may also include a filter similar to that found in taxation articles described in the preceding category. Therefore, this type of article produces a near complete exclusion of taxation matters from the scope of the IIA. Annex 4 sets out three examples of this type of tax article.

Comparison of the Three Models

135. The three types of taxation articles described in this subsection reflect the fact that different countries adopt significantly different positions about the extent to which they are prepared to subject taxation measures to the disciplines of IIAs. In arriving at a particular position, a country must consider two broad competing sets of interests: on the one hand, the basic objective being pursued by the IIA, that is, the provision of a legal framework to promote and protect cross-border investment and the necessity, for that purpose, of providing investors with a degree of legal security with respect to the treatment of their investments in the host country; on the other hand, from the point of view of the host country, the preservation of legitimate taxation measures and of sufficient policy space required to legislate in the tax area to meet the country's important economic and social objectives. Solutions that are situated at either end of the spectrum necessarily favour one set of objectives to the detriment of the other set.

136. Thus, IIAs that completely carve-out taxation measures from their scope fully preserve the ability of the government to legislate and administer tax laws according to its preferences, but such an approach leaves foreign investors uncertain regarding the theoretical prospect of taxation being used in an abusive manner and, should it materialize, without any legal recourse under the IIA.

137. The other two models for taxation articles attempt to achieve a balance between the competing objectives identified above. They differ in a few respects, in particular the degree to which they tailor the application of the provisions of the IIAs to taxation. Under the so-called "NAFTA model", parties know with precision which obligations, and to what extent, apply to taxation measures. It grandfathers existing non-conforming taxation measures vis-à-vis the NT and MFN obligations, and tends to distinguish between income/direct taxation measures and other taxation measures. This means that no ISDS litigation can take place pursuant to the NT or MFN obligation in respect of income taxation measures, a position that alleviates many of the concerns of tax policy makers identified in this respect in subsection 1.3. The targeted tax exclusion approach, on the other hand, subjects all taxation measures to the obligation of the agreement and makes no distinction among categories of taxes. This means that allegations of a breach of the NT and MFN obligations against an income tax measure can be litigated under an IIA, subject to the host country invoking the provisions of the taxation article that allows tax laws to make distinctions on the basis of the residence or to enact anti-avoidance measures. Thus, under this model, the balance tilts more in favour of investment protection than under the NAFTA model, at the expense of a relative loss of certainty for tax policy makers.

2.2.3 Thoughts on Refining the Dispute Settlement Process

138. Subsection 2.2.1 described the increased use of filters in more recent IIAs, for purposes of mandating a role for the parties (however defined) in the adjudication of selected issues prior to those issues being considered by an arbitral tribunal in the ISDS process. This increased reliance reflects the concern of tax policy makers with the rise of ISDS cases involving taxation measures and the somewhat unpredictable nature of the ISDS process itself. The fact that such filters generally grant the parties the power to prevent certain investors' allegations from reaching the ISDS stage, if they jointly determine that the allegations are unfounded, strongly suggests that fewer tax-related disputes might materialize

if they were confined to a state-to-state dispute settlement process, that is, if the government was first required to consider and vet the merit of allegations made by its country's investors.

139. Subsection 2.2.1 referred to the recent emergence of multi-purpose filters designed to refer to the parties all the issues addressed in more targeted filters found in certain IIAs. They mandate the parties to examine, as required by the investor's allegations, whether a measure is a taxation measure, whether a taxation measure is a breach of obligations in respect of NT, MFN, FET and expropriation and whether there is an inconsistency between the obligations of the IIA that are alleged to have been breached and those of a DTA. Such a provision appears to be the most comprehensive approach to date to ensure the involvement of relevant expertise to examine and potentially reject investor claims. The below sets out the provision found in the Canada-EU CETA:

> 7. (a) Where an investor submits a request for consultations pursuant to Article 8.19 (Consultations) claiming that a taxation measure breaches an obligation under Sections C (Non-discriminatory treatment) or D (Investment protection) of Chapter Eight (Investment), the respondent may refer the matter for consultation and joint determination by the Parties as to whether:
>
> > (i) the measure is a taxation measure;
> >
> > (ii) the measure, if it is found to be a taxation measure, breaches an obligation under Sections C (Non-discriminatory Treatment) or D (Investment Protection) of Chapter Eight (Investment); or
> >
> > (iii) there is an inconsistency between the obligations in this Agreement that are alleged to have been breached and those of a tax convention.
>
> (b) A referral pursuant to subparagraph (a) cannot be made later than the date the Tribunal fixes for the respondent to submit its counter-memorial. Where the respondent makes such a referral the time periods or proceedings specified in Section F (Resolution of investment disputes between investors and states) of Chapter Eight (Investment) shall be suspended. If within 180 days from the referral the Parties do not agree to consider the issue, or fail to make a joint determination, the suspension of the time periods or proceedings shall no longer apply and the investor may proceed with its claim.
>
> (c) A joint determination by the Parties pursuant to subparagraph (a) shall be binding on the Tribunal.
>
> (d) Each Party shall ensure that its delegation for the consultations to be conducted pursuant to subparagraph (a) shall include persons with relevant expertise on the issues covered by this Article, including representatives from the relevant tax authorities of each Party. For Canada, this means officials from the Department of Finance.

140. Of note, unlike other filters, it is the respondent party that triggers the provision; it can do so at any time prior to filing its response to the arbitral tribunal following an investor's allegations. Like other filters, proceedings of the arbitral tribunal must await either a joint determination of the parties or the passage of 180 days. Unlike other filters, the joint determination is not tasked with "designated authorities" or "competent authorities", but with the "parties". The last paragraph, however, does mandate the participation of tax expertise of the parties in the process.[72] Such an approach could provide a useful model to ensure the systematic involvement of tax authorities in the examination of investor's allegations prior to them reaching the ISDS stage. In essence, this approach mandates a state-to-state process prior to the dispute reaching the ISDS stage.

141. While not directly comparable, there is nonetheless a parallel to be made between filters and the two-step process inherent in the mutual agreement provisions of DTAs that provide for arbitration.

[72] It should be noted that one of the parties in this agreement, the European Union, is a supra-national organization. The tax authorities and competent authorities are under the responsibility of its member states.

In this context, the validity of taxpayers' claim that a taxation measure is not in accordance with the DTA is first considered and vetted by its own competent authority, before launching a MAP[73]. In DTAs that include arbitration provisions, cases that are unresolved after a certain period under the MAP proceed to legally binding arbitration. Unlike IIAs, the arbitration process remains strictly a state-to-state process.

142. The above discussion provides clues as to how the dispute settlement procedures applicable to taxation matters in IIAs could evolve, either on a stand-alone basis or as part of a broader reconsideration of the ISDS process under IIAs. The outline of a possible option, offered below to stimulate discussion, would be to take the filter mechanism described above an additional step forward in IIAs, such that the resulting mechanism would be inspired by the current functioning of the MAP. An approach analogous to that set out in DTAs, if implemented in IIAs in respect of taxation measures, could work as follows:

- When an investor files a notice of intent with a party alleging that a taxation measure is a breach of one or more provisions of the IIA, the government of that party would refer the issue to the designated authorities of that party (tax experts, whether from the tax authorities or pursuant to the relevant DTA, as defined by each party). Alternatively, the agreement may call for the referral to be made directly to designated authorities. The designated authorities may in turn refer the matter for consultation with the designated authorities of other party, the party of the investor;

- The investor may then be compelled, as necessary, to consult with the designated authorities of its own government. If those designated authorities reach the conclusion that the disputed measure is not a taxation measure, they would so inform the designated authorities of the other party. In view of the disagreement between designated authorities over this issue, the allegation would proceed to the usual consultation stage between the governments of parties and, ultimately, to the regular ISDS process. The defendant party would still be able to argue the position, before the arbitral tribunal, that the disputed measure is a taxation measure;

- If, however, the designated authorities of the party of the investor agreed with the other designated authority that the disputed measure is a taxation measure, the allegation would be placed on a different track, and would not proceed under the regular ISDS process. Such designated authorities would next determine whether the allegations have merit. If they jointly agree that they do not have any merit, the allegations would not proceed further under any dispute settlement process;

- If, on the other hand, the designated authorities of the party of the investors determine that the allegations have merit, then they would consult with the designated authorities of the other party (which enacted the disputed measure) to determine whether the issue can be resolved between them at that stage. The consultation period would be limited in time. The respective designated authorities may fail to come to a determination with respect to some portions of the allegations (e.g., with respect to NT) and come to a determination with respect to others (e.g., the alleged measure is not an expropriation). All allegations not the object of a joint determination and resolution at the consultation stage, or within the allotted time limit, would then proceed to the next step, a state-to-state arbitration process, under which the government

[73] This is the case of DTAs that follow the UN Model. Under the provisions of the OECD Model, a case may be presented to the competent authority of either country.

of the investor would defend the investor's position regarding alleged breaches of the IIA. At that stage, the "parties", not solely the designated authorities, would be involved.

143. This is only an outline, and many details would need to be addressed. Under such an approach, all filters currently included in taxation articles would become unnecessary, since the procedural role of the designated authorities would be set out in the dispute settlement provisions of the IIA. Taxation articles would focus exclusively on setting out the extent to which taxation measures are, or not, substantively covered by the substantive obligations of the IIA.

144. The above state-to-state mechanism assumes that ISDS provisions are included in the IIA. If not, the impetus for such a mechanism may not be as persuasive. Admittedly, such a mechanism for taxation measures would create a significant precedent in IIAs and may not constitute a realistic option, if considered on a stand-alone basis. However, it may constitute a useful starting point for discussion in the context of a broader reconsideration of the future of ISDS in IIAs.

2.3 Proposal Regarding the Respective Roles of Taxation Experts and Investment Experts

145. The absence of provisions dealing with taxation in many, mostly first generation IIAs (but not limited to them), points to the fact that taxation authorities were either not involved in their negotiation and/or not aware of the incidence of such agreements on taxation measures. As tax expertise increasingly became involved in IIA negotiations, it can be observed that more and more IIAs include taxation provisions and such provisions are becoming more sophisticated.

146. Based on the simple but important principle that all aspects of a government's policy should be evaluated and taken into account when a country is engaged in the negotiation of an international treaty with another country, the incidence of an IIA on taxation should be carefully evaluated when negotiating such agreements. From a governance point of view, this necessarily means the involvement of the part of the government responsible for the formulation of tax policy (we will refer to it as the "tax policy department").

147. The involvement of the tax policy department should concern all aspects of a country IIA policy:

- The analysis, by the tax policy department of the potential impact of the provision of the IIA on the national tax system, both with respect to existing measures and, more generally, the future conduct of tax policy and the administration of the tax system;

- Based on this analysis, participation by the tax policy department in the formulation of the national IIA policy, together with the department primarily responsible for developing such a policy, including the model IIA used by the country (or absent a model, the negotiating position), with a view to including tax provisions therein that take into account the concerns and preferences of the tax policy department;

- Participation by the tax policy department in the actual negotiation of IIAs, as the preferred position put forward by the country will be the object of negotiations with the other party to the negotiation. Ideally, this would lead to direct negotiations between tax experts of both countries, under the supervision of the lead negotiators; and

- Consultation between the tax policy department and the department tasked with handling disputes arising under IIAs when they concern taxation measures, with the view of ensuring

that the latter fully understand the issues being disputed and, as necessary, to contribute to the formulation of a position of the country as the respondent party to the dispute. The tax department would also be involved if the IIA contains "filters" and one or more of them are invoked in the course of the ISDS process.

148. The above describes how ideally taxation authorities should be involved in all aspects of IIAs. The next section sets out the practical steps that must be undertaken by the tax policy department to integrate the broader IIA process within its government.

3. Practical Guidance to Implement a Whole-of-Government Approach

149. Further to the principles enunciated in subsection 2.3, the next subsection describes in more detail how to implement, in practice, cooperation between tax policy makers and investment negotiators, with a view to developing an IIA policy that considers the interest of both groups and informs the negotiation of new IIAs. Subsection 3.2 discusses the issue of existing IIAs that are not consistent with this new IIA policy.

3.1 Implementing the Integrated Approach for Future IIAs

150. In order to achieve a whole-of-government approach to the negotiation of IIAs, all government departments holding policy or administrative responsibilities that are relevant under such agreements must participate in all aspects of the creation of IIA policy and the administration of IIAs that are in force. Applying this principle to the issue of taxation, two groups of people within the government must establish and maintain an on-going cooperative relationship: the department primarily responsible for IIA policy development and negotiation (usually the department responsible for foreign affairs or the department dedicated to international trade negotiations) and the department responsible for the formulation of tax policy (the department of finance or economic affairs).

Development of IIA Policy with Respect to Taxation

151. What follows is a description of the steps that must be implemented by the tax policy department to secure a role in the government's IIA policy, assuming that none currently exists. It is important to stress that the successful implementation of the following guidance requires ingredients that are essential in the development of any government policy: the existence of a clear commitment by the relevant authorities, backed as necessary by political will, and the allocation of sufficient human and financial resources to meet the stated objectives. It is acknowledged that the latter may be an issue in developing countries facing competing issues as regard capacity building in the tax policy and administration area.

152. The essential first step for the tax policy department is to recognize IIAs as a dedicated area of responsibility within the department. For the department's management, this means, at the minimum, designating one tax policy official with the formal responsibility to handle all aspects of IIAs that are relevant to the department; even better would be to create a section to hold that responsibility. In many instances, the personnel or section responsible for the negotiation of DTAs have assumed that role, but anyone within the tax policy department could be assigned to the task.

153. The initial duty of this official will be to gain expertise in the area of IIAs, for purposes of understanding how they operate and how they can impact taxation measures. Ideally, this should not be

done in a vacuum. Contact should be established at that early stage with the department responsible for IIA policy in order to inform them that the tax policy department intends to take interest in the negotiation of IIAs and to seek assistance in this respect. In developing countries, it may be advisable to seek outside expertise in order to build capacity in this area within the department.

154. In the course of acquiring expertise in the area of IIAs, that official must ensure that the relevant senior managers of its department are made aware of the main issues relevant to the department that arise in connection with IIAs negotiated or concluded by the government. This will then lead to the formulation of specific recommendations on how to address taxation in IIAs, to be submitted to the appropriate senior authorities within the official's department, up to and including, as appropriate, the political leadership (the minister and/or his/her office). To the extent that other parts of the department are also involved in IIA negotiations (e.g., experts responsible for policies governing financial institutions), consultation with them would also be warranted.

155. Once a preliminary position has been developed within the department, it must be communicated to the department responsible for IIA policy. As the early contacts between the two departments are to evolve into an on-going cooperative relationship, that department should ideally also designate an official to maintain the on-going liaison with the tax policy department. At that stage, the investment policy department must gain detailed knowledge of the concerns of its tax counterpart and form a view on how best to take them into account in the development of a taxation article.

156. The two departments will then engage in negotiations that will attempt to balance the competing interests of both departments. It is possible that agreement may be achieved at the officials' level. However, in cases where it is not possible, it may be necessary for the discussion to be elevated to a more senior departmental level or even the ministerial level. From this process will eventually emerge a compromise and the formulation of a taxation article that is acceptable to all parties. Internal decision-making processes vary among countries, but generally, the development of international treaty policy requires a formal approval process at the highest level of the executive branch (cabinet of ministers or office of the president). Such a process may likely apply with respect to the inclusion of provisions meant to address the treatment of taxation in IIAs. Once formally adopted by the government, that position can be formulated either as an unpublished negotiating position of the government or as part of a published model IIA.

Negotiating IIAs

157. Turning to the IIA negotiating stage, it is strongly advisable to ensure that the tax policy department be involved in the negotiation of the tax article with other countries. In practice, this may mean different things depending on the circumstances. At the minimum, this means that the representative of the tax policy department be informed of on-going negotiations with other countries. When negotiations are taking place in the home country, the representative of the tax policy department (the "tax expert") should be invited at the negotiating table to explain in detail the elements of the tax article that the government puts forward and the justification for each of its provisions. The more complex the taxation article is, the more likely both sides will wish to ensure the participation of their respective tax experts, and often they will be invited to negotiate the terms of the tax article together, either separately or in the presence of lead negotiators.

158. When negotiations take place abroad, it may not be possible for the tax expert to accompany the negotiating team to the negotiating round. In this case, two options are possible: either invite the tax expert to join remotely for the portion of the negotiation dealing with the taxation article; or provide

negotiators with specific instructions and speaking points to facilitate the presentation of the country's position on this issue.

159. There will be instances where differences of views between the tax experts of the respective parties are significant, with one side making proposals that are fundamentally at odds with the policy put forward by the other side. This may require the integrated negotiating team to reconsider elements of its negotiating position. To the extent that adjustments to the preferred language for the taxation article are required in order to reach a compromise with the other party, the tax and investment officials will need to confer to determine how much policy flexibility can be exercised, within the broad negotiating mandate issued by the government.

160. Depending at what point in the development of an IIA network a country finds itself, the negotiation of several IIAs at once may impose significant demands on the tax policy department. It will be necessary for the lead department responsible for IIA negotiations to be aware of resource constraints when scheduling negotiations. Equally, in order to continue to sustain the tax policy department's participation in the negotiation of IIAs, the government will need to allocate the necessary resources to that department for that purpose.

161. Realistically, from the point of view of the tax policy department, the implementation of the above process will take time, dedication, political support, and the allocation of appropriate human and financial resources. The most important decision to be made at the outset is for the tax policy department to recognize the importance of the issue and to assign it sufficient resources to ensure that the department's views are properly reflected in the government's IIA policy.

IIA Litigation

162. With respect to IIAs in force, it may happen that a foreign investor commences procedures under the ISDS of an IIA to challenge a tax measure of the host country. In such situations, the involvement of the tax policy department is strongly advisable to ensure the development of the best defense for presentation to the arbitral tribunal. This means that the department that holds primary responsibility to prepare the country's position must inform the tax policy department without delay and seek its input.

163. The role of the tax policy department may be two-fold: first, if the taxation article contains one or more filters that assign responsibility to "designated authorities" to decide a given issue (e.g., is the tax measure not an expropriation?), then the tax policy department is given, by virtue of the terms of the IIA, a statutory role in the dispute. Usually, as was described in the previous section, the responsibilities of the "designated authorities" are clearly set out in the taxation article, including how their role relates to the broader ISDS process.

164. Second, it will be necessary for tax experts to support the department tasked with the preparation of a responsive position to be filed to an arbitral tribunal. This will require close cooperation between departments in the drafting of the defense of the taxation measure. Tax experts are usually not involved in the actual proceedings of arbitral tribunals, but both sides in the dispute are given opportunities to set out their position in detailed written briefs. After the conclusion of ISDS proceedings, it will also be advisable (and sometimes necessary) for tax experts to participate in any post-mortem of the case within the government, especially if a tribunal's decision has had a direct impact on the disputed taxation measure.

3.2 Dealing with Existing IIAs

165. For countries deciding to formulate an explicit policy for addressing taxation in IIAs, as described above, there remains the issue of what to do with IIAs concluded in the past, that do not reflect that policy. In many cases, the treatment of taxation in such agreements will be deficient, if not non-existent. Such IIAs may have been concluded with the country's most important economic partners, accounting for a significant proportion of foreign inbound investment.

166. Unfortunately, there is no simple, quick, and universal prescription to address this situation. Addressing this issue requires difficult decisions informed by analysis based on assumptions and uncertain outcomes. The essential first step is to assess the magnitude of the potential problem associated with the existence of IIAs that do not reflect the current policy on taxation. This requires a risk assessment of each and every deficient IIA (including its core provisions, such as the scope of the FET provision, for example) and of the state of the associated bilateral relationship with the other party. In some cases, the risk to taxation will have already materialized: the country may have suffered a litigation loss and may be required to pay significant financial compensation to a foreign investor, in addition to having to reevaluate the conformity of the disputed taxation measures to its international obligations under this and other IIAs. In other cases, the exposure to litigation risk may be theoretical, but significant. Evaluating the likelihood that a taxation measure may be successfully challenged under a deficient IIA is far from an exact science.

167. The outcome of the risk assessment depends on the facts relevant to each bilateral relationship. The relevant parameters of each analysis must include: the volume of inbound investment from the IIA partner, the characteristics of the IIA (how the FET obligation is defined, the nature of the tax article, if any), the vulnerability of certain features of the country's specific tax policy or tax administration practices. In the latter case, the analysis may be informed by relevant precedents developed in previous IIA litigation involving other countries.

168. The conclusion of the risk assessment process also is a function of the country's tolerance towards identified risks and the net benefit that may result from a renegotiation of the terms of the IIA, given the likelihood that the IIA partner would arguably wish to condition the rewriting of the taxation articles to the securing of concessions in other parts of the agreement. In fact, the IIA partner may not be amenable to even revising the content of the IIA, in which case the cost-benefit analysis would require comparing the *status quo* to a situation where the IIA is terminated. Indeed, it has been the experience of some countries that the materialization of risks in the form of large financial compensations awarded by arbitral tribunals to foreign investors has led them to terminate several of their IIAs.

169. Realistically, credible alternatives to the bilateral renegotiation of IIAs, or their termination as the case may be, do not currently exist. The OECD has pioneered the adoption and use of a multilateral tax treaty to amend existing bilateral DTAs in order to speed up the implementation of a number of reforms stemming from the BEPS project[74]. The prospect of adopting such an approach to incorporate a revised tax article in the IIAs concluded among multiple countries seems extremely remote. Beyond the challenge associated with the mere feasibility of such an option, in particular if limited to the issue of taxation, it supposes that it would be possible to come to an international agreement on the wording

[74] The *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS* has 100 signatories and entered into force on 1 July 2018. As of June 2022, it had been ratified by 76 jurisdictions.

of a specific taxation article. This would appear to be a challenging proposition, given the wide range of approaches observed in IIAs that include taxation provisions.

170. However, if such an approach was ever to be contemplated in the context of a more general reconsideration of IIA policy, then it would be worth exploring whether such a vehicle could be used to address the issue of taxation.

171. The same remote prospect of success would be associated with any attempt to come to a multilaterally agreed interpretation, say in a MOU, of concepts such as the FET standard, if only because different IIAs contain different language. A bilateral MOU with the same aim may have a better chance of success, but it would be contingent on the willingness of the IIA partner to agree with the principle and its content, which may not be greater than its willingness to renegotiate the IIA in the first place. The exact legal standing of such a MOU before an arbitral tribunal would also be uncertain.

172. Therefore, the only realistic option, in the short term to address a deficient IIA is to seek its renegotiation and, should that not prove possible, to determine which of the *status quo* or termination of the IIA is the preferred alternative, basis on a thorough risk analysis.

Annex 1: Sample of arbitral tribunal decisions in respect of taxation measures

1. While a detailed analysis of ISDS decisions dealing with taxation measures is beyond the scope of this Report, it is useful to examine a few cases, in particular instances of multiple cases triggered by the same disputed taxation measure. The summary below cannot due justice to the complexity of each case, but provides a flavour of how arbitral tribunals have approached investor allegations that taxation measures were inconsistent with the terms of IIAs.

1. Mexico: Application of certain tax laws to the export of tobacco products which allegedly denied claimant's local company the benefits of a law that allowed certain tax refunds to exporters.

Facts

2. Starting in 1990, Mexico imposed a tax on the production and sale of cigarettes in the domestic market under the *Impuesto Especial Sobre Producción y Servicios* ("IESP") law, a special excise tax on products and services. The EISP imposed a tax, among other products, on the domestic sales and import of cigarettes; however, the tax did not apply to the export of cigarettes. To summarize a factually complex series of events, starting in 1993, the IESP required cigarette producers to pay the tax and pass it on to purchasers. The claimant, Mr. Marvin Roy Feldman Karpa[1], a U.S. citizen, was engaged, through a Mexican subsidiary company, in the business of exporting tobacco products, as well as alcoholic beverages, photographic supplies and other products. Feldman was not a cigarette producer and, unlike most other exporters, did not purchase cigarettes directly from producers but from volume retailers (what the tribunal would refer to as a "grey market"). That particular aspect, combined with compliance requirements of the IESP, meant that Feldman's subsidiary company could not comply with the administrative requirements (which was the same for all businesses, foreign or domestic) necessary for obtaining tax rebates under the IESP with respect to the export of cigarettes (even though it was by law entitled to the rebate). On the other hand, rebates on other exports of the claimant could be claimed.

3. In 1999, Feldman launched an ISDS case pursuant to the *North American Free Trade Agreement* (NAFTA), which contains an investment chapter similar to IIAs. He alleged that Mexico's refusal to rebate excise taxes with respect to cigarettes exported by its Mexican subsidiary effectively shut down its subsidiary's export business and constituted a breach of the NT, FET and expropriation obligations of the NAFTA.

Tribunal Decision

4. While the arbitral tribunal acknowledged that Feldman was no longer able to engage in his business of purchasing Mexican cigarettes and exporting them because of the disputed measure (thus deprived him completely and permanently of any potential economic benefits), a finding which could *prima facie* support the indirect expropriation claim made by Feldman, it ultimately ruled that no expropriation had occurred. The tribunal stated that Mexico was not required to accommodate, under its tax provisions, the particular business model pursued by Feldman (the purchase of cigarettes from retailers), which was regarded as a "grey market" for the exports of cigarettes. Therefore, according to the tribunal, it is doubtful that Felman ever possessed a "right" to export that has been "taken" by the

[1] *Marvin Roy Feldman Karpa v United Mexican States*, Award (16 December 2002), ICSID, Case No ARB(AF)/99/1.

Mexican government. It also noted that claimant's overall enterprise (through its other lines of business) remained under its complete control.

5. The tribunal stated:

> At the same time, governments must be free to act in the broader public interest through protection of the environment, new or modified tax regimes, the granting or withdrawal of government subsidies, reductions or increases in tariff levels, imposition of zoning restrictions and the like. Reasonable governmental regulation of this type cannot be achieved if any business that is adversely affected may seek compensation, and it is safe to say that customary international law recognizes this.

6. In addition, it stated:

> [N]ot all government regulatory activity that makes it difficult or impossible for an investor to carry out a particular business, change in the law or change in the application of existing laws that makes it uneconomical to continue a particular business, is an expropriation under Article 1110. Governments, in their exercise of regulatory power, frequently change their laws and regulations in response to changing economic circumstances or changing political, economic or social considerations. Those changes may well make certain activities less profitable or even uneconomic to continue.

7. The tribunal did find (despite limited evidence of discrimination on the record) that the disputed measure was inconsistent with the NT obligation. Feldman's Mexican subsidiary was denied the rebates at a time when at least three other companies in like circumstances were granted them. In the view of the tribunal, Feldman had established a presumption (which was not rebutted by the respondent) and a *prima facie* case that it had been treated in a different and less favourable manner than several Mexican-owned cigarette resellers.

8. Finally, the tribunal did not examine the FET claim on its merit, as it lacked jurisdiction to adjudicate it, given that the disputed measure was a "taxation measure" that was beyond the reach of the FET provision by virtue of the wording of NAFTA's tax article.

9. The tribunal awarded Feldman $0.75 million, plus interests.

2. Mexico: 2002 adoption of a tax on beverages containing high fructose corn syrup

Facts

10. Effective on January 1, 2002, the Mexican Congress amended articles of the *Ley del Impuesto Especial sobre Produccion y Servicios*, imposing a 20 percent excise tax on soft drinks and syrups and the same tax on services used to transfer and distribute soft drinks and syrups. This tax only applied to soft drinks and syrups that used any sweetener other than cane sugar; soft drinks and syrups sweetened exclusively with cane sugar were tax exempt.

11. Three US companies launched ISDS cases under the NAFTA. ADM[2], Corn Products[3] and Cargill[4], which produced and sold high fructose corn syrup, a sweetener that was impacted by the tax. All alleged that the tax violated the NT, expropriation and performance requirements of the NAFTA.

[2] *Archer Daniels Midland Company v The United Mexican States*, Award (21 November 2007), ICSID, Case No ARB(AF)/04/05.
[3] *Corn Products International, Inc. v. United Mexican States*, Award (18 August 2009), ICSID Case No. ARB(AF)/04/1. The award is not public.
[4] *Cargill, Incorporated v. United Mexican States*, Award (18 September 2009), ICSID Case No. ARB(AF)/05/2.

Cargill additionally alleged violation of the FET and MFN provisions of the NAFTA[5]. Claimants argued that the tax was designed and structured to discriminate in favour of the Mexican cane sugar industry, penalizing the use of high fructose corn syrup to the point that it substantially affected the beverage market for their product, and that the tax destroyed the value of their investment in Mexico.

Tribunal Decisions

12. In the three cases, arbitral tribunals held that the imposition of the excise tax was a breach of the NT obligation[6]. In *ADM*, the Tribunal concluded that the purpose of the tax was protect the domestic Mexican sugar industry from foreign competitors producing alternative sweeteners.

13. In *ADM* and *Cargill*, the tribunals held that the tax was a breach of the performance requirements obligations of the NAFTA. In *ADM*, the tribunal agreed that the requirement to use cane sugar instead of high fructose corn syrup in order to benefit from a tax exemption corresponded to a specific prohibition found in the NAFTA[7]. On the other hand, in *Corn Syrup*, the tribunal held that the claimant had failed to establish that the tax was a performance requirement as defined in the NAFTA.

14. In all three cases, tribunals rejected the claims that the measure was tantamount to an expropriation. In *ADM*, the tribunal set out the relevant criteria to analyse the issue:

> Judicial practice indicates that the severity of the economic impact is the decisive criterion in deciding whether an indirect expropriation or a measure tantamount to expropriation has taken place. An expropriation occurs if the interference is substantial and deprives the investor of all or most of the benefits of the investment. There is a broad consensus in academic writings that the intensity and duration of the economic deprivation is the crucial factor in identifying an indirect expropriation or equivalent measure.

15. The tribunal held that there had been no expropriation of physical assets, that the tax did not deprive the claimants of fundamental rights of ownership or management of their investment and that the effects of the tax were not of sufficient intensity and duration to produce a significant loss of profitability or an effective loss of the investment.

16. Tribunals granted awards to claimants as follows: ADM: $33.5 million; Corn Syrup: $58.4 million; and Cargill: $77.3 million.

3. Ecuador: Resolutions issued by tax authority denying applications for VAT refunds by companies engaged in the exploration and exploitation of hydrocarbons.

Facts

17. EnCana Corporation, a Canadian company, controlled subsidiaries that entered, in 1995, into two participation contacts with Petroecuador, an Ecuadorian state company, and one of its affiliates. Under the contract, the Canadian-owned oil companies assumed the risk, cost and expenses of exploration and exploitation, and, in return, received a percentage of the oil extracted in accordance with a share set out in the contracts.

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[5] The FET claim was in connection with a permit requirement imposed by the government of Mexico, and the fact that Cargill was denied this permit. This issue is not addressed in this annex.

[6] Article 2103 of the NAFTA, the tax article, makes applicable the national treatment obligation in respect of excise taxes.

[7] The performance requirement provisions of Chapter 11 of the NAFTA apply to taxation measures.

18. In 1999, Occidental Exploration and Production Company, a U.S. a company, entered into a participation contract with Petroecuador to undertake exploration for and production of oil in Ecuador. In accordance with Ecuador's value-added tax (VAT), the company sought and obtained the reimbursement of VAT it on its purchases made in the course of its exploration and exploitation activities. The participation contract granted the company an agreed-upon share of its production.

19. Between 1999 and 2002, a number of changes were made to Ecuador's VAT law. As a result, the subsidiaries of both EnCana and Occidental were denied the right to obtain VAT credits and refunds on their purchases. The justification for such decisions was that, according to the government of Ecuador, the share of production granted to the companies under the respective contracts already factored in such credits and refunds. A subsequent interpretative law adopted in 2004 confirmed the position initially adopted by Ecuadorian taxation authorities. These policies applied to extractive industries only.

20. Lawsuits by Occidental in the tax courts of Ecuador objecting to such decisions were still pending when the company launched, in 2002, an ISDS case under the 1993 Ecuador-U.S. Bilateral Investment Treaty[8] [9]. Occidental alleged that the action of the Ecuadorian taxation authorities breached the IIA's FET, NT and expropriation obligations.

21. In March 2003, EnCana initiated an ISDS complaint against Ecuador under the 1996 Canada-Ecuador Bilateral Investment Treaty[10], alleging that the denial of tax credits and refunds constituted a breach of the IIA's NT, FET and expropriation obligations.

Tribunal Decisions

22. In both cases, tribunals first examined the extent to which the taxation articles contained in each IIA impacted on their jurisdiction to adjudicate the claims on their merits. The tax article of the US-Ecuador IIA stipulated that allegations of expropriation in respect of a taxation measure fell within the scope of the IIA, but not allegations under the IIA's NT or FET obligations. The article also allowed the enforcement of contracts entered into between a company and a party, such as Occidental's participation contract, under the ISDS provisions of the IIA in the case of taxation measures. Moreover, the tribunal paid particular attention to the first paragraph of the taxation article, which requires each party to "strive to accord fairness and equity in the treatment of investment of nationals and companies of the other Party". It opined that the provision was "not devoid of legal significance" and that the obligations contained therein were similar to those requiring "fair and equitable" treatment in the IIA. The tribunal concluded: "The dispute, one way or the other, thus is clearly subject to the dispute settlement provisions of the Treaty. This automatically brings in the standards of treatment of Article II, including fair and equitable treatment".

23. As a matter of fact, the tribunal in *Occidental* sided with the claimant in finding that the participation contracts did not include VAT refunds. On that basis, the tribunal found that the disputed measures had breached the NT obligation. In applying the standard, the court held that the qualification found therein that the treatment be "on a basis no less favorable than that accorded *in like situations* to

[8] *Occidental Exploration and Petroleum Company v The Republic of Ecuador*, Award (1 July 2004) at paras 91–92, UNCITRAL, Case No UN-3467.
[9] The IIA was terminated in 2018.
[10] *EnCana Corporation v. Republic of Ecuador*, Award, (3 February 2006), Case No. UN3481.

investment or associated activities of its own nationals or companies…" meant that the comparison was not limited to companies operating in the oil and gas industry, but to all companies engaged in exports.

24. The tribunal also held that the FET obligation had been breached. The claimant had essentially argued that the denial of VAT refunds had frustrated the company's legitimate expectations regarding the commercial and economic conditions under which the investment was made. The tribunal, relying on previous ISDS cases that had formulated a rigid view of legitimate expectation, agreed, stating:

> [Occidental] undertook its investments, including its participation in the pipeline arrangements, in a legal and business environment that was certain and predictable. This environment was changed as a matter of policy and legal interpretation, thus resulting in the breach of fair and equitable treatment.

25. Finally, the tribunal rejected the allegation that the measure amounted to an indirect expropriation. It found that the disputed measures did not meet the standards required by international law, in particular the need for the alleged measure to deprive the owner, in whole or in significant part, of the use or expected economic benefit of the investment.

26. The tribunal awarded Occidental $71.5 million.

27. As in the *Occidental* case, the tribunal in *EnCana* first had to decide the jurisdictional issue, given the terms of the IIA tax article. The latter essentially excluded taxation measures from the application of most of the obligation of the IIA, except for an allegation of expropriation or an allegation that a tax measure is in breach of an agreement between the central government authorities of a party and the investor. In both cases, the allegations must first be considered by the taxation authorities of the parties, which are given six months to decide whether the tax measure is not an expropriation or is not a breach of the relevant agreement.

28. Indeed, the respective taxation authorities were given notice of the expropriation allegation, but no joint determination was made by them within the six-month time period, meaning that the allegation could proceed under the ISDS. Moreover, the agreements between the EnCana subsidiaries and the state companies did not fall within the scope of the IIA's umbrella provision, meaning that its terms could not be enforced under the IIA.

29. The tribunal provided an extended analysis of the term "taxation measures" in order to ascertain whether the disputed measure was, in fact a taxation measure that fell within the scope of the tax article. In particular, it stated:

> The question whether something is a tax measure is primarily a question of its legal operation, not its economic effect. A taxation law is one which imposes a liability on classes of persons to pay money to the State for public purposes. (…) A measure providing relief from taxation is a taxation measure just as much as a measure imposing the tax in the first place. In the case of VAT, the Tribunal does not accept that the system of collection and recovery of VAT, even if it may be revenue-neutral for the intermediate manufacturer or producer, is any less a taxation measure at each stage of the process. A law imposing an obligation on a supplier to charge VAT is a taxation measure; likewise, a law imposing an obligation to account for VAT received, a law entitling the supplier to offset VAT paid to those from whom it has purchased goods and services, as well as a law regulating the availability of refunds of VAT resulting from an imbalance between an individual's input and output VAT.

30. The determination that the measure at issue was a taxation measure meant that the claims pertaining to the NT and FET obligations were outside the scope of the tribunal's jurisdiction, by virtue of the application of the exclusions found in the tax article. This left the expropriation allegation to be examined. EnCana had argued that the measures amounted to both direct and indirect expropriation. In

the case of the former, the company argued that the effect of the administrative and legislative actions of Ecuador had been to deprive its subsidiaries of their rights to VAT refunds, without compensation.

31. While acknowledging that the right granted under the law to refunds of VAT, is a material benefit, a majority of the tribunal held that the disputed measures did not result in a direct expropriation. As regards indirect expropriation, the tribunal remarked that tax laws do change over time and that investor could not reasonably expect that tax rules would remain unchanged. The tribunal then offered an analysis similar to that found in *Occidental*, noting that despite the negative impact of the denial of VAT refunds, the EnCana subsidiaries were nonetheless able to continue to engage in their normal range of activities, extracting and exporting oil, and to so at a profit. Therefore, the measure did not meet the threshold of being "extraordinary, punitive in amount or arbitrary in its incidence" that was required to entertain the possibility of an indirect expropriation.

4. India: Application of a retrospective transaction tax imposed over claimant's acquisition of an Indian-based telecoms business.

Vodafone v. India

32. In 2007, Vodafone International Holdings BV, a resident of the Netherlands, acquired the entire share capital of CGP Investments (Holdings) Ltd., a resident of Cayman Islands, from Hutchison group, headquartered in Hong Kong. CGP indirectly owned 67% of Hutchison Essar Limited, an Indian entity which carried out telecommunication business in India.

33. Soon thereafter, the income tax authorities of India issued a notice demanding payment of $2.2 billion as capital gains tax, in respect of the capital gains arising from the sale of the share capital of CGP. Vodafone took the view that it was not liable to pay tax as the transaction between Vodafone and Hutchison did not involve the transfer of any capital asset situated in India. Indian tax authorities argued that, while true, CGP held the underlying Indian assets, which was sufficient, in their view, to assert tax jurisdiction over the gains.

34. Vodafone contested the notice before India's High Court, which sided with India's revenue authorities. On appeal, however, the Supreme Court ruled in Vodafone's favour, finding that the transaction, which was executed between non-residents, fell outside India's tax jurisdiction under the statute.

35. However, very soon afterwards, Finance Bill 2012 was adopted by India's parliament, which amended the relevant provisions of the *Income Tax Act 1961* (the "Act"), incorporating what was presented as "an explanation of existing law". The effect of that amendment was that transactions such as the one concluded by Vodafone would retrospectively fall within the scope of the Act. As a result, the Indian tax authorities soon reissued a notice requesting payment of the capital gains tax in respect of the transaction.

36. In the same year, Vodafone launched a claim under the 1995 India-Netherlands Bilateral Investment Treaty, alleging a violation of the FET provisions of the treaty[11].

37. After multiple legal proceedings over the issue of whether the arbitral tribunal had jurisdiction to hear the case, the tribunal rendered its final decision in September 2020. After affirming that it had

[11] *Vodafone International Holdings BV v. Government of India*, UNICRAL, Case No. 2016-35.

jurisdiction, the tribunal agreed with the claimant's arguments and found that the imposition of capital gains tax, despite the prior ruling of the Indian Supreme Court, was a breach of the FET obligation of the IIA. The tribunal also asked India to cease to seek payment of the tax[12]. Finally, the tribunal ordered India to reimburse Vodafone's legal costs ($5.5 million).

Cairn v. India

38. In 2006, the Cairn group carried out a reorganization of its Indian assets. The latter were first consolidated in 9 subsidiaries in the UK; then the shares of these subsidiaries were transferred to a newly incorporated UK company, Cairn UK Holdings Ltd (CUHL), in consideration for CUHL shares. CUHL then incorporated a Jersey company, Cairn India Holding Company Ltd (CIHL), in which it transferred its shares in the 9 UK subsidiaries, in consideration for CIHL shares. Finally, all of the Indian assets of the group were transferred to an Indian subsidiary, Cairn India Ltd (CIL), through a series of transactions transferring the ownership of CIHL from CUHL to CIL.

39. In 2011, Vedanta Resources Plc, a UK company, acquired almost 60 percent of the shares in CIL. CIL and Vedanta Ltd, a subsidiary of Vedanta Resources, would ultimately merge in 2017. Under the deal, Cairn Energy, a subsidiary of Vedanta Resources, received shares in Vedanta Resources in exchange for 10 percent of the shares in CIL.

40. In 2014, the Indian tax authorities revisited the Cairn reorganization, initially requesting relevant information about the transactions, with the goal of applying the provisions of the Income Tax Act 1961, as amended in 2012. CUHL was also prevented by the Indian tax authorities from selling its shareholding of approximately 10% in CIL. In 2015, pursuant to a draft assessment, CUHL was asked to pay tax on the 2006 gains, as well as relevant interest and penalties. Immediately, Cairn Energy and Vedanta Resources initiated international arbitration proceedings under the 1994 India-United Kingdom Bilateral Investment Treaty, alleging violations of the FET and expropriation provisions of the treaty[13].

41. The tribunal in the *Cairn* case commenced its work in 2016 and India sought a stay on proceedings. At the same time, the Indian revenue authorities seized CUHL's shares in Vedanta Ltd (worth approximately $1 billion). The Indian tax authorities sold part of those shares to recover a portion of the tax owing. Dividends and tax refunds were also seized for that purpose.

42. The tribunal issued a final award in December 2020. It held that India had breached the FET obligation of the IIA, both as regards the imposition of tax on a retroactive basis and the adoption of measures to enforce the collection of the tax. The tribunal was not convinced that the 2012 amendments to the Act were mere "clarification" of the law. In considering the retrospective application of the amendments to prior year transactions, the tribunal held that it could not find a valid public purpose for such application. In contrast, it found such application disregarded Cairn's expectation of legal certainty, stability and predictability. This is because, according to the tribunal, applying a tax in respect of a transaction that was not taxable at the time it was entered into prevented the claimant the ability to plan its affairs in full consideration of the possible consequences of its conduct. Legal certainty being regarded one of the central components of the FET obligation, the imposition of the tax in that manner was inconsistent with that obligation.

[12] The full award, including reasoning, was not published, save an excerpt which contained the tribunal's conclusions.

[13] *Cairn Energy PLC and Cairn UK Holdings Limited v. The Republic of India*, UNICRAL, Case No. 2016-7

43. The tribunal ordered India to pay Cairn $1.2 billion to compensate it for the injury associated with the tax liability and the associated enforcement measures and to withdraw the demand for the payment of tax.

44. This was not, however, the end of the matter. In early 2021, Cairn initiated proceedings in courts in several countries, including the US, the UK, France, Canada and the Netherlands, in order to enforce the December 2020 award by the arbitral tribunal. For example, it sued Air India in a New York court. It also obtained from a French tribunal the right to seize Indian assets located in Paris. In May 2021, India launched a challenge of the tribunal award in the Netherlands, alleging that Indian income tax laws did not fall within the scope of the Indian-UK IIA. Ultimately, however, the issue was resolved between the parties at the end of 2021. Cairns dropped all pending lawsuits against India and its entities in several countries and accepted an offer made by the government of India. Under the agreement, India would formally drop all demands for capital gains tax assessed under the 2012 amendment to the Act; Cairn was to be reimbursed for amounts India collected; and the provision of the Act pursuant to which the tax had been imposed was to be amended to provide that it would not apply retrospectively, that is for transactions entered into before 2012.

Annex 2: Agreement Between the European Union and Japan for an Economic Partnership[88]

ARTICLE 1.4

Taxation[89]

1. For the purposes of this Article:

(a) "residence" means residence for tax purposes;

(b) "tax agreement" means an agreement for the avoidance of double taxation or any other international agreement or arrangement relating wholly or mainly to taxation to which the European Union or its Member States or Japan is party; and

(c) "taxation measure" means a measure in application of the tax legislation of the European Union, of its Member States or of Japan.

2. This Agreement applies to taxation measures only in so far as such application is necessary to give effect to the provisions of this Agreement.

3. Nothing in this Agreement shall affect the rights and obligations of the European Union, of its Member States or of Japan under any tax agreement. In the event of any inconsistency between this Agreement and any such tax agreement, the tax agreement shall prevail to the extent of the inconsistency. With regard to a tax agreement between the European Union or its Member States and Japan, the relevant competent authorities under this Agreement and that tax agreement shall jointly determine whether an inconsistency exists between this Agreement and the tax agreement.

4. Any most-favoured-nation obligation in this Agreement shall not be applicable with respect to an advantage accorded by the European Union, by its Member States or by Japan pursuant to a tax agreement.

5. The Joint Committee established pursuant to Article 22.1 may decide on a different scope of the application of dispute settlement under Chapter 21 with respect to taxation measures.

6. Subject to the requirement that taxation measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between the Parties where like conditions prevail, or a disguised restriction on trade and investment, nothing in this Agreement shall be construed to prevent the adoption, maintenance or enforcement by the European Union, by its Member States or by Japan of any taxation measure aimed at ensuring the equitable or effective imposition or collection of taxes such as measures:

(a) distinguishing between taxpayers who are not in the same situation, in particular with regard to their place of residence or the place where their capital is invested; or

(b) preventing the avoidance or evasion of taxes pursuant to the provisions of any tax agreement or domestic tax legislation.

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[88] Signed on July 17, 2018. Came into force on February 1, 2019. Available at: https://investmentpolicy.unctad.org/international-investment-agreements/treaty-files/5693/download.

[89] Taxation matters are also addressed in the Chapter dealing with trade in services.

Annex 3: Comprehensive and Progressive Agreement for Trans-Pacific Partnership[90]

Article 29.4: Taxation Measures[91]

1. For the purposes of this Article:

designated authorities means:

(a) for Australia, the Secretary to the Treasury or an authorised representative of the Secretary;

(b) for Brunei Darussalam, the Minister of Finance or the Minister's authorised representative;

(c) for Canada, the Assistant Deputy Minister for Tax Policy, Department of Finance;

(d) for Chile, the Undersecretary of the Ministry of Finance (Subsecretario de Hacienda);

(e) for Japan, the Minister for Foreign Affairs and the Minister of Finance;[1]

(f) for Malaysia, the Minister of Finance or the Minister's authorised representative;

(g) for Mexico, the Minister of Finance and Public Credit (Secretario de Hacienda y Crédito Público);

(h) for New Zealand, the Commissioner of Inland Revenue or an authorised representative of the Commissioner;

(i) for Peru, the General Director of International Economy, Competition and Productivity Affairs (Director General de Asuntos de Economía Internacional, Competencia y Productividad del Ministerio de Economía y Finanzas);

(j) for Singapore, the Chief Tax Policy Officer, Ministry of Finance;

(k) for the United States, the Assistant Secretary of the Treasury (Tax Policy); and

(l) for Viet Nam, the Minister of Finance,

or any successor of these designated authorities as notified in writing to the other Parties;

tax convention means a convention for the avoidance of double taxation or other international taxation agreement or arrangement; and

taxes and **taxation measures** include excise duties, but do not include:

(a) a "customs duty" as defined in Article 1.3 (General Definitions); or

(b) the measures listed in subparagraphs (b) and (c) of that definition.

2. Except as provided in this Article, nothing in this Agreement shall apply to taxation measures.

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

4. In the case of a tax convention between two or more Parties, if an issue arises as to whether any inconsistency exists between this Agreement and the tax convention, the issue shall be referred to the designated authorities of the Parties in question. The designated authorities of those Parties shall have six months from the date of referral of the issue to make a determination as to the existence and extent of any inconsistency. If those designated authorities agree, the period may be extended up to 12 months from the

[90] Signed on March 8, 2018. Entered into force on December 30, 2018, in the first six countries to have ratified the agreement: Canada, Australia, Japan, Mexico, New Zealand, and Singapore. Available at: https://www.iilj.org/wp-content/uploads/2018/03/CPTPP-consolidated.pdf.

[91] This is the tax article of a comprehensive free trade agreement and includes provisions beyond those required with respect to its investment provisions, namely provisions with respect to trade in goods and trade in services.

date of referral of the issue. No procedures concerning the measure giving rise to the issue may be initiated under Chapter 28 (Dispute Settlement) or Article 9.19 (Submission of a Claim to Arbitration) until the expiry of the six-month period, or any other period as may have been agreed by the designated authorities. A panel or tribunal established to consider a dispute related to a taxation measure shall accept as binding a determination of the designated authorities of the Parties made under this paragraph.

5. Notwithstanding paragraph 3:

(a) Article 2.3 (National Treatment) and such other provisions of this Agreement as are necessary to give effect to that Article shall apply to taxation measures to the same extent as does Article III of GATT 1994; and

(b) Article 2.15 (Export Duties, Taxes or other Charges) shall apply to taxation measures.

6. Subject to paragraph 3:

(a) Article 10.3 (National Treatment) and Article 11.6.1 (Cross-Border Trade) shall apply to taxation measures on income, on capital gains, on the taxable capital of corporations, or on the value of an investment or property9 (but not on the transfer of that investment or property), that relate to the purchase or consumption of particular services, except that nothing in this subparagraph shall prevent a Party from conditioning the receipt or continued receipt of an advantage that relates to the purchase or consumption of particular services on requirements to provide the service in its territory;

(b) Article 9.4 (National Treatment), Article 9.5 (Most-Favoured-Nation Treatment), Article 10.3 (National Treatment), Article 10.4 (Most-Favoured-Nation Treatment), Article 11.3 (National Treatment), Article 11.4 (Most-Favoured-Nation Treatment), Article 11.6.1 (Cross-Border Trade) and Article 14.4 (Non-Discriminatory Treatment of Digital Products) shall apply to all taxation measures, other than those on income, on capital gains, on the taxable capital of corporations, on the value of an investment or property9 (but not on the transfer of that investment or property), or taxes on estates, inheritances, gifts and generation-skipping transfers; and

(c) Article 14.4 (Non-Discriminatory Treatment of Digital Products) shall apply to taxation measures on income, on capital gains, on the taxable income of corporations, or on the value of an investment or property9 (but not on the transfer of that investment or property), that relate to the purchase or consumption of particular digital products, except that nothing in this subparagraph shall prevent a Party from conditioning the receipt or continued receipt of an advantage relating to the purchase or consumption of particular digital products on requirements to provide the digital product in its territory,

but nothing in the Articles referred to in subparagraphs (a), (b) and (c) shall apply to:

(d) any most-favoured-nation obligation with respect to an advantage accorded by a Party pursuant to a tax convention;

(e) a non-conforming provision of any existing taxation measure;

(f) the continuation or prompt renewal of a non-conforming provision of any existing taxation measure;

(g) an amendment to a non-conforming provision of any existing taxation measure to the extent that the amendment does not decrease its conformity, at the time of the amendment, with any of those Articles;

(h) the adoption or enforcement of any new taxation measure aimed at ensuring the equitable or effective imposition or collection of taxes, including any taxation measure that differentiates between persons based on their place of residence for tax purposes, provided that the taxation measure does not arbitrarily discriminate between persons, goods or services of the Parties;[2]

(i) a provision that conditions the receipt or continued receipt of an advantage relating to the contributions to, or income of, a pension trust, pension plan, superannuation fund or other arrangement to provide pension, superannuation or similar benefits, on a requirement that the Party maintain continuous jurisdiction, regulation or supervision over that trust, plan, fund or other arrangement; or

(j) any excise duty on insurance premiums to the extent that such tax would, if levied by the other Parties, be covered by subparagraph (e), (f) or (g).

7. Subject to paragraph 3, and without prejudice to the rights and obligations of the Parties under paragraph 5, Article 9.10.2 (Performance Requirements), Article 9.10.3 and Article 9.10.5 shall apply to taxation measures.

8. Article 9.8 (Expropriation and Compensation) shall apply to taxation measures. However, no investor may invoke Article 9.8 (Expropriation and Compensation) as the basis for a claim if it has been determined pursuant to this paragraph that the measure is not an expropriation. An investor that seeks to invoke Article 9.8 (Expropriation and Compensation) with respect to a taxation measure must first refer to the designated authorities of the Party of the investor and the respondent Party, at the time that it gives its notice of intent under Article 9.19 (Submission of a Claim to Arbitration), the issue of whether that taxation measure is not an expropriation. If the designated authorities do not agree to consider the issue or, having agreed to consider it, fail to agree that the measure is not an expropriation within a period of six months of the referral, the investor may submit its claim to arbitration under Article 9.19 (Submission of a Claim to Arbitration).

9. Nothing in this Agreement shall prevent Singapore from adopting taxation measures no more trade restrictive than necessary to address Singapore's public policy objectives arising out of its specific constraints of space.

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[1] For the purposes of consultations between the designated authorities of the relevant Parties, the contact point of Japan is the Ministry of Finance.

[2] This is without prejudice to the methodology used to determine the value of such investment or property under Parties' respective laws.

Annex 4: Various taxation articles

Agreement Between the State of Israel and Japan for the Liberalization, Promotion and Protection of Investment[92]

Article 19

Taxation Measures

1. Nothing in this Section shall impose obligations with respect to taxation measures except as expressly provided in paragraph 3.

2. 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.

3. Articles 4, 5, 9 and 11 shall apply to taxation measures.

[Article 4: General Treatment; Article 5: Access to courts; Article 9: Transparency; Article 11: Expropriation]

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Agreement Between the Government of Japan and the Government of the Republic of Kenya for the Promotion and Protection of Investment[93]

Article 20

Taxation

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

2. Articles 3, 4, and 7 shall not apply to taxation measures.

[Article 3: NT; Article 4: 4: MFN; Article 7: Prohibition of Performance Requirements]

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Free Trade Agreement between the Government of New Zealand and the Government of the People's Republic of China[94]

Article 204 Taxation Measures

1. Except as provided in this Article, nothing in this Agreement shall apply to taxation measures.

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[92] Signed on 01/02/2017. Came into force on 05/10/2017. Available at: https://investmentpolicy.unctad.org/international-investment-agreements/treaty-files/5849/download.
[93] Signed on 28/08/2016. Came into force on14/09/2017. Available at: https://investmentpolicy.unctad.org/international-investment-agreements/treaty-files/5374/download.
[94] Signed on 07/04/2008. Came into force on 01/10/2008. Available at: https://investmentpolicy.unctad.org/international-investment-agreements/treaty-files/2564/download.

2. This Agreement shall only grant rights or impose obligations with respect to taxation measures:

(a) where corresponding rights or obligations are also granted or imposed under the WTO Agreement; or

(b) under Article 145 *[Expropriation]*.

3. Nothing in this Agreement shall affect the rights and obligations of the Parties under any tax convention relating to the avoidance of double taxation in force between the Parties.

4. If there is a dispute described in Article 152 *[ISDS]* that may relate to a taxation measure, then the Parties, including representatives of their tax administrations, shall hold consultations. Any tribunal established under Article 153 shall accept a decision of the Parties as to whether the measure in question is a taxation measure.

5. In the event of any inconsistency relating to a taxation measure between this Agreement and the Agreement between the Government of the People's Republic of China and the Government of New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, done at Wellington on 16 September 1986, with Protocols, the latter shall prevail. Any consultations between the Parties about whether an inconsistency relates to a taxation measure shall include representatives of the tax administration of each Party.[1]

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1. Nothing in this Agreement shall be regarded as obliging a Party to extend to the other Party the benefit of any treatment, preference or privilege arising from any existing or future agreement on the avoidance of double taxation or from the provisions on the avoidance of double taxation in any other international agreement or arrangement by which the Party is bound.