Book Addresses the Effect Bilateral Investment Treaties Have on Taxation

Reviewed by Bruce Zagaris

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The Impact of Bilateral Investment Treaties on Taxation
Edited by Michael Lang, Jeffrey Owens, Pasquale Pistone, Alexander Rust, Josef Schuch, and Claus Staringer.
590 pages
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The Impact of Bilateral Investment Treaties on Taxation is an enterprising undertaking. In addition to the general report and overview, it offers 21 chapters examining the relationships between bilateral investment treaties (BITs) and taxation, especially tax treaties.

The book is unique in that the relationships between taxation and bilateral investment treaties have traditionally been the subject of separate academic studies. Although there have been articles and studies on specific aspects of the relationships, the book is the first to thoroughly study the subject.

The book is meant to fill the gap between the separate lines of studies and comprehensively analyze the relationships between taxation and investment treaties. The editors used the Institute for Austrian and International Tax Law to undertake the initial work and convene a conference in the summer of 2015, at which the first drafts of the national reports based on a questionnaire were presented.

A team at the institute, including persons doing an interdisciplinary doctoral thesis on the topic, helped edit the volume.

A drawback or bias of the book is that it is primarily written by authors whose main expertise is tax law, perhaps that is because the institute is devoted to international tax law. The bias also demonstrates the challenge: Both subject areas are extensive and have many subareas. In today’s professional world, a successful academic or practitioner must specialize. It is difficult to find practitioners or academics that are steeped and experienced in both investment and international tax law. Even so, the volume is of great service and utility in that it provides a uniform approach to a subject that has not been covered comprehensively.

Overview

The general report follows the outline of the questionnaire and the reports. It is composed of eight different sections:
• the framework for BITs and tax treaties;
• their relationship with other treaties (tax and nontax);
• whether taxes are in the scope of BITs;
• the fair and equitable treatment standard and transparency under BITs;
• the national treaty and most-favored-nation standards in BITs;
• the prohibition of expropriation in BITs;
• the free transfer of capital provisions in BITs; and
• dispute settlement under tax treaties and BITs, as well as investment awards.

In viewing the rationale of tax and investment treaties, the first are instruments of public international law to regulate conflicts between states while the second are instruments of private international law by which states bind themselves
to recognize the protection of investor rights.\textsuperscript{1} Both instruments affect the legal sphere of persons. Thus, modern tax treaties should take advantage of the experience BITs have had in addressing potential problems arising with arbitration. Similarly, BITs should look at the substance of tax treaties to understand the actual implications of tax carveout clauses.

The book discusses the interplay of fair and equitable treatment and transparency, an important part of BITs. While fair and equitable treatment clauses seem vague and broad, they furnish investment tribunals with leverage to legally protect investors through the BIT, developed on standards of legitimate expectation, transparency, good faith, \textit{pacta sunt servanda}, legal stability, freedom from harassment, legality, and against any arbitrariness. Case law from investment tribunals illustrates the importance of that kind of provision in the practice of developing countries.

As a result, BITs have achieved their goal of raising the standards of legal protection in economies in transition and in developing countries. As the Daniël Smit chapter on the Netherlands discusses, Starbucks might use the fair and equitable treatment standard to resolve its EU state aid case. Transparency is an important element of fair and equitable treatment in BITs, because it reduces the potential for the discretionary exercise of power that often leads to arbitrariness, including in tax rulings.\textsuperscript{2}

An important aspect is the divergent policies regarding BITs. Some states have an extensive BIT network. For example, the Netherlands has 91 and the U.K. has 96. The United States has 40 and Canada has 30. Some states have a limited network of BITs; Brazil has none in effect.

The book also traces the evolution of tax treaties and BITs. Whereas the first bilateral tax treaties were concluded as early as the 19th century, the first modern BIT appeared in 1959 as part of a more general worldwide trend to provide international legal protection to investment. BITs also have arisen from the trend since the late 18th century until after World War II for developed countries to conclude friendship and commerce treaties, as the predecessors for the BITs.

While BITs have operated as legal instruments for capital-exporting countries to achieve a stable legal framework for outbound investment and to secure returns from that investment, the widespread perception was that concluding a BIT could also be in the interest of countries wanting to attract inbound investment.\textsuperscript{3}

Regarding the extent of consistency across bilateral treaty networks, investment treaties have more content discrepancy than tax treaties. Tax treaties are largely based on either the OECD or the U.N. model. A major difference is that tax treaties try to minimize the scope for tax arbitrage and prevent cross-border disputes. In contrast, consistency with the capital-exporting country’s respective outbound investment policy has a higher priority in BITs.

While BIT models have basic clauses, such as those regarding scope, actionable remedies for disputes between states and with investors, the right to national treaty and most-favored-nation treatment, protection against expropriation and the right to free transfer of returns from investment, those clauses differ in wording, scope, and implications to a much greater extent than those in tax treaties.

The BITs are undergoing an important transition in the EU because the Treaty of Lisbon, which entered into force December 1, 2009, gave the EU an exclusive external competence in line with the introduction of a common investment policy.

The book covers an important aspect of BITs: that regional economic integration organization (REIO) clauses are included in BITs to assert that the bilateral investment agreement might not oblige the contracting parties to extend the privileges that arise to the investors of the other party as a result of membership in a REIO.

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\textsuperscript{1} For background on international investment, including investment treaties, see Jeswald W. Salacuse, \textit{The Three Laws of International Investment: National, Contractual, and International Frameworks for Foreign Capital} (2013).

\textsuperscript{2} See GlaxoSmithKline Holdings (Americas) Inc. v. Commissioner, 117 T.C. 1, 2 (2001) (concerning whether the failure to publish advance pricing agreements is a violation when investors are concerned).

\textsuperscript{3} For background on BITs, see Kenneth J. Vandevelde, \textit{Bilateral Investment Treaties: History, Policy, and Interpretation} (2010).
A REIO clause prevents the application of a most-favored-nation clause to cases when REIO members offer preferential treatment to other REIO members or their investors, as occurs in bilateral treaties of the EU and North American Free Trade Agreement states. They are also gaining favor as REIOs became more frequent (for example, the Caribbean single market economy). An increasingly important aspect is that the EU has now taken the right to negotiate investment agreements, as discussed below.

Taxation as expropriation is a key concept in BITs, which the book discusses. Expropriation clauses enable investors and investment tribunals to monitor the exercise of tax sovereignty and often do not carve taxes out. Even when BITs carve out taxes, investment tribunals may not apply them in a way that gives the sovereign unfettered discretion, as the Yukos case shows.4

Widespread Coverage

One of the book’s strengths is its diverse coverage of countries, with chapters on: Australia, Austria, Belgium, Bosnia and Herzegovina, Brazil, Canada, Chile, China, the Czech Republic, France, Germany, Greece, India, Luxembourg, the Netherlands, Poland, Portugal, Russia, Serbia, South Africa, and the United States.

Brazil

At the one extreme is Brazil. It had 32 tax treaties in force at the time of publication. Although it negotiated 14 BITs, it had not ratified any, and it is not a party to the International Centre for the Settlement of Investment Disputes (ICSID) Convention. Brazil has not ratified any other convention providing for investor-state arbitration as a method of dispute resolution. Brazil has concerns about indirect expropriation and the Hull formula, whereby compensation for the expropriation of foreign investments must be “prompt, adequate and effective.” The authors explain that Brazil’s ability to attract investment prevents one from concluding that it has failed to protect foreign investors and calls into question the primacy of the BIT model.

India

India is a developing country that has signed international investment agreements, which initially were part of a package of economic reforms introduced in 1991. Its model bilateral promotion and protection agreements were based on the OECD Draft Convention for the Protection of Foreign Property (1967). In 2003 the Indian model bilateral investment promotion and protection agreement was revised to include a chapter on expropriation and introduce investment chapters in free trade agreements. India has signed or is in the process of negotiating more than 20 regional trade agreements with other countries or trade blocs.

A 2011 verdict affected India’s treaty-making momentum.5 A tribunal held that delay by Indian courts violated the effective means obligation, even though the Australia-India bilateral promotion and protection agreement did not contain that right, borrowing the provision from the India-Kuwait agreement by relying on the most-favored-nation clause. The decision resulted in public demand for a review of India’s BITs. Indian academics have increasingly expressed concern that India is undertaking treaty obligations on foreign investment and binding itself to the growing body of international norms on international foreign investment law.

India has also entered into 96 tax treaties, eight tax treaties regarding only shipping and aircraft profits, 19 tax information exchange

4 The Yukos case was the subject of several judgments, including RosinvestCo UK Ltd. v. Russian Federation SCVC, Final Award of Sept. 12, 2010; Quinair De Vales SIC SA v. Russian Federation, SCC Award of July 20, 2012 (formerly Rentas 4 SVSA v. Russian Federation; Hulley Enterprises Ltd. (Cyprus) Petroleum Ltd. (Cyprus) v. Russian Federation, PCA No. AA 228, Final Award of July 18, 2014; and Yukos Universal Ltd. (Isle of Man) v. Russian Federation, PCA No. AA 227, Final Award of July 18, 2014. See also the decision setting aside Yukos Universal Ltd. (Isle of Man) v. The Russian Federation, Decision of Antwerp Court of First Instance (June 24, 2016). In three awards from July 18, 2014, each totaling more than 600 pages, an UNCITRAL arbitral tribunal, under the auspices of the Permanent Court of Arbitration, ordered Russia to pay over $50 billion in compensation for the indirect expropriation of OAO Yukos Oil Company (Yukos). That is the largest damages award yet in investment treaty arbitration. The claimants in the three parallel arbitrations were Hulley Enterprises Ltd. (Cyprus), Yukos Universal Ltd. (Isle of Man), and Veteran Petroleum Ltd. (Cyprus); jointly, they held 70.5 percent of the shares in Yukos. The arbitrations were initiated under the Energy Charter Treaty in 2005, and the claimants’ original ask was for no less than $114 billion.

5 UNCITRAL, White Industries Australia Ltd. v. Republic of India, Final Award of Nov. 30, 2011.

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agreements, and six multilateral agreements. Although Indian BITs do not have an express tax carveout, and investors have invoked arbitration for dispute resolution of tax questions under BITs, the Indian government adamantly argues that tax treaties would prevail in a tax conflict.

In the last year or so, large investors have invoked international arbitration procedures under India’s BITs or free trade agreements. The highest profile case is Vodafone International Holdings BV v. India, 733/2012. Vodafone International Holdings BV acquired the entire share capital of CGP Investments (Holdings) Ltd., a company resident in the Cayman Islands that in turn held a 67 percent interest in Hutchinson Essar Ltd., incorporated in India. The total consideration was $11.08.

Indian tax authorities took the position that because the ultimate assets acquired were shares in an Indian company, Vodafone ought to have withheld tax on the consideration paid for shares bought. The Indian Supreme Court allowed the taxpayer’s appeal and rejected the India Revenue Department’s argument that it could look through the transfer of shares of a foreign company holding shares in an Indian company to treat the transfer as equivalent to the transfer of shares of the Indian company.

The Indian Parliament enacted a law in the Finance Act 2012 with retroactive effect, through which it explained that an asset, including a share or interest in a company deriving its value substantially, directly, or indirectly from assets located in India, was always intended to and would be deemed to have been situated in India and thus subject to the foreign holding company’s offshore transfer of assets.

**United States**

In the chapter on the United States, Yariv Brauner explains that the U.S. BIT program was started in 1977 and arose out of the then-200-year-old Friendship, Commerce and Navigation treaty program. The chapter mentions the U.S. BIT models in 1977, 2004, and 2012. The United States is a party to 41 BITs in force and six additional ones that have not been ratified.

As of April 2016, the United States was party to 68 tax treaties in force. The U.S. model tax treaty is very similar to the OECD model, although it also includes unique features of U.S. tax treaty policy, such as the inclusion of a savings clause (reserving the right to tax citizens without many of the constraints imposed by the treaty); a limitation on benefits provision that corresponds to the strict ad hoc, bilateral U.S. view of tax treaties; and a comprehensive exchange of information requirement. In contrast, the model U.S. BIT does not follow a universal model.

What the U.S. chapter did not convey are the significant delays the country has had when deciding to change models. It has taken three to four years for each model to be vetted, revised, and agreed to.

The U.S. BIT policy has slowed dramatically. The last BITs the United States signed were with Rwanda in 2008, Uruguay in 2005, Panama in 2000 (amending the earlier one), and Bahrain and El Salvador in 1999. Although the United States has had BIT chapters in its free trade agreements, the Trump administration’s decision not to sign the Trans-Pacific Partnership and its general dislike of free trade agreements means that chances for investment protection provisions in this administration are low.

Brauner mentions that U.S. investors have thrice succeeded in establishing claims based on fair and equitable treatment violations: by Ecuador in a case involving VAT, by Argentina in a case involving stamp tax and energy taxation, and a case regarding the use of BIT regarding U.S. taxation of cigarettes in which the arbitration process found no violation by the United States.

The chapter does not mention that in the last few years the United States has neither negotiated

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5. More recently, President Trump has said he is reconsidering his decision to sign the TPP if changes can be made. However, since the members have already negotiated tradeoffs and signed the final agreement, it will be difficult for the U.S. to be able to renegotiate the agreement. See Keith Bradsher, “Trump Weighs Return to Trans-Pacific Partnership. Not So Fast, Say Members,” The New York Times, Apr. 13, 2018.

6. Occidental Exploration and Production Co. v. Ecuador, LVIA No. UN3467, Final Award of July 1, 2004; Enron Ponderosa Assets LP v. Argentine Republic, ICSID No. ARB/01/ (May 22, 2007); and UNCITRAL (NAFTA), Grand River v. United States (Jan. 12, 2011).
nor ratified many BITs or tax treaties. With many of its competitors continuing to negotiate BITs, tax treaties, and free trade agreements, U.S. investors and businesses are increasingly disadvantaged compared with their counterparts in other countries.

China

The chapter on China by Yansheng Zhu is interesting because of the evolution of China’s policies. In addition to adopting domestic incentive measures to encourage inward and outward foreign investments, China has adopted many rules regarding international investment law and international tax law.

China has concluded many BITs and tax treaties. It concluded its first BIT with Sweden in 1982 and by July 2015 had 103 BITs in force. It started its tax treaty program in 1983 by concluding its first agreement with Japan, and has since signed 101 tax treaties (as of May 2015, 97 were in force).

China has BITs and tax treaties in all parts of the world, including several developing countries and almost all developed countries. Many parties to Chinese BITs and tax treaties overlap, and are usually either source countries of Chinese inward foreign investment, or destination countries of Chinese outward foreign investment. China has produced its own model BIT and tax treaty, which it frequently amends to keep pace with the development of the Chinese economy and practice in international investment law and international tax law.

The Netherlands

The Netherlands chapter by Smit shows why the Dutch are one of the leaders in the nexus between BITs and tax treaties. The conclusion of a BIT often goes hand in hand with the conclusion of a tax treaty. Dutch businesses are increasingly interested in investing in developing countries and believe that BITs and tax treaties might facilitate those investments. The Dutch have 107 BITs, 92 of which are in force. They have approximately 100 tax treaties, which overlap.

A key development for EU members is that as of June 2011, of approximately 41 claims under Dutch BITs, 29 involved Dutch intermediate holdings with a foreign parent that sought protection under a Dutch BIT, with 25 of the legal persons acting as claimants having no employees. The use of Dutch BITs through the
establishment of Dutch letterbox companies with no substantial activities is under increasing scrutiny. Some observers have suggested that the Netherlands should amend its BITs to include anti-treaty-shopping provisions by, for example, narrowing the investments and investor definitions based on a denial of benefits clause.

Conclusion

The work of the OECD base erosion and profit-shifting project and the EU Code of Conduct impose more pressure on countries to limit treaty shopping in BITs. The phenomenon of limiting the treaty-shopping potential of BITs is a work in progress. To a large extent, the pressure to limit BIT treaty shopping is an example of influence of international tax treaties. Hence, although the book is titled *The Impact of Bilateral Investment Treaties on Taxation*, the interaction is rich and goes both ways.

International business planners and policymakers will want to monitor and participate in the discussion about the proper role of anti-treaty-shopping provisions in BITs, especially because BITs are used in various nontax endeavors. Policymakers and practitioners can learn more about BITs and tax treaties and their interaction by reading this book. The chapters are well documented, so the book will also serve as a useful reference.