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Bridging the Policy Gaps: A Tax-Focused Guide to Investment Agreements for Tax and Investment Policymakers

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In this article, the authors discuss a new guide for tax policymakers on international investment agreements that was produced by the United Nations Conference on Trade and Development and WU Global Tax Policy Center.

Tax policy and administration at the national and international level do not exist in a vacuum. They operate within a complex international economic and legal framework through which they interact with the network of international investment agreements (IIAs) designed to provide protections for foreign investors and encourage investment. In particular, IIAs provide mechanisms for investors to make claims through Investor-State Dispute Settlement (ISDS) where a breach of one or multiple protections may occur. This has been a particular concern for tax experts, because tax measures may breach the provisions of investment treaties[1] and, similarly, IIAs may limit the extent of tax measures a country may introduce. At the international level, bilateral tax treaties have held a clear connection to IIAs, not only because of the shared objective of attracting investment and providing some measure of certainty to investors, but also because of overlaps in specific clauses including those relating to the elimination of discrimination and dispute settlement.[2] Because of the overlap between the respective scopes of IIAs and tax treaties, the interpretation and application of those treaties in practice may give rise to challenges.[3]

At the national level, the execution of domestic tax laws has been increasingly challenged through investment arbitration with investors disputing changes in tax policy or large tax audits brought forward by tax administrations.[4] Since most IIAs do not exclude taxation from their scope, a variety of tax-related measures can and have been covered by them.[5] So far, "UNCTAD data suggests that in some 140 . . . cases investors have challenged tax-related measures that were taken by developed countries, developing countries and countries with economies in transition."[6] A significant risk has been identified under the older generation of IIAs signed in the 1990s or earlier which are still in force today, as they have broad provisions with minimal or no exceptions for tax-related measures and lack safeguards.[7]

Despite the overlapping scopes, the taxation and investment communities have hardly

[1] Committee of Experts on International Cooperation in Tax Matters, *Secretariat Paper: The Interaction of Tax, Trade and Investment Agreements*, UNTC (Apr. 23-26, 2019), p. 3.

[2] Michael Lang, Jeffrey Owens, Pasquale Pistone et al., *The Impact of Bilateral Investment Treaties on Taxation*, IBFD (2017), p. 14.

[3] UNTC (Apr. 23-26, 2019), n.1 at p.3

[4] For instance, the *Yukos v. Russia* case involved a large tax assessment, fines, and asset freezes which, according to the arbitral tribunal, amounted to indirect expropriation. Investment Treaty News, "Yukos v. Russia: Issues and legal reasoning behind US$50 billion awards," International Institute for Sustainable Development (2014).

[5] UNCTAD, *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*, UNCTAD (2021), p. 3.

[6] *Id.*

[7] *Id.*

engaged with one another to understand the policy interactions, which is surprising given the matching objectives and, in some cases, provisions. With the current state of flux in international tax and investment policies because of the uncertain direction of reform driven by the need to adapt international tax systems to the rapidly changing global trade landscape[8] and the increasingly competitive environment for attracting foreign direct investment (FDI), there is now an opportunity to realize greater consistency in future direction. In response to this need, UNCTAD, with support from the WU Global Tax Policy Centre,[9] has prepared a guide[10] underscoring the most relevant provisions in IIAs and evaluating their implications for tax measures using the Investment Policy Framework for Sustainable Development[11] as a basis. Some key provisions that have already given rise to complications for countries and proposed solutions are highlighted below.

Definition of an Investor

The broad definition of an investor under an IIA has the potential to include third country investors, extending the benefits of the IIA to unintended parties that could engage in investment treaty shopping to take advantage of this. Since treaty shopping has generally been a major concern for tax treaties, it is important that this loophole is also closed within the IIA framework. As it stands, most IIAs cover any natural and legal person originating from the other state. To limit this, policymakers may either:[12]

- Exclude certain natural or legal persons.
- Include a denial of benefits clause which allows a country to deny the benefits of the IIA if an entity is owned or controlled by third country nationals.

National Treatment (NT)

The NT provision under IIAs requires that the jurisdiction involved "does not discriminate *de jure* or *de facto* between domestic and foreign investors on grounds of nationality."[13] This provision, if broadly formulated, could limit tax policymakers from imposing differing tax rates to non-residents whereas this is a generally accepted form of treatment within domestic tax laws and tax treaties. To prevent this IIA negotiators may either:[14]

- Set specific criteria identifying when investors and investments are in like circumstances with their domestic counterparts.
- Limit the scope of the provision by either subordinating it to a country's domestic laws or reserving the right to derogation.
- Include tax specific carve-outs.
- Omit the NT clause altogether.

Fair and Equitable Treatment (FET)

FET protects foreign investors or their investments against the denial of justice or any arbitrary or abusive treatment.[15] This provision has often been invoked where tax-related measures are concerned because it is usually difficult to define and broadly interpreted by arbitration panels — "it has turned into an all-encompassing provision that investors have used to challenge any type of governmental conduct that they deem to hurt their interests."[16] An increasing number of newer generation IIAs either do not include this provision or have replaced it with very specific state obligations and terms that require a higher threshold of liability that would give rise to only very serious cases of misconduct.[17] To mitigate the risk of uncertainty, policymakers may:[18]

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[8] Jeffrey Owens and James X. Zhan, "Introduction to the Special Issue: trade, investment and taxation — policy linkages," in Zhan, *Transnational Corporations*, UNCTAD (2018), p. 1.

[9] WU Vienna University of Economics and Business, Institute for Austrian and International Tax Law.

[10] UNCTAD (2021), fn. 5.

[11] UNCTAD, *Investment Policy Framework for Sustainable Development*, UNCTAD (2015). This document provides guidance to investment policymakers engaged in negotiating and drafting IIAs and contains the most common provisions as well as proposed approaches to structuring them.

[12] UNCTAD (2021), fn. 5 at pp. 14-15.

[13] UNCTAD (2021), fn. 5 at p. 20.

[14] UNCTAD (2021), fn. 5 at pp. 21-22.

[15] UNCTAD (2021), fn. 5 at p. 25.

[16] UNCTAD (2021), fn. 5 at p. 25.

[17] UNCTAD (2021), fn. 5 at p. 27.

[18] UNCTAD (2021), fn. 5 at pp. 27-28.

- Define FET based on its customary international law meaning; this may narrow its meaning and operation to a limited extent.
- Use an exhaustive list of state obligations to not act in a specified way (i.e., deny justice in judicial or administrative proceedings or flagrantly violate due process).
- Provide interpretive guidance to tribunals regarding its application.
- Reduce FET to a political commitment which essentially means it cannot be adopted as a legal obligation.
- Omit the provision altogether.

Full Protection and Security (FPS)

This provision has traditionally required that host States exercise due diligence when protecting foreign investments.[19] This usually refers to police protection and physical security, but it has, similar to FET, been subjected to broad interpretation and has even been extended to a guarantee of stability in a secure commercial and legal environment.[20] To limit its application, policymakers may specify how it should operate — specifically that it should only refer to physical security and protection.[21]

Expropriation

The potential for indirect expropriation through taxation has been raised in a number of cases, including the *Yukos* case. Expropriation is defined, under IIAs, as substantial deprivation of the investor by the host country and gives rise to a right to compensation. The complication where tax is concerned, is the extent to which taxation may erode the underlying value of the investment and whether that may be substantial enough to be considered expropriation. Investment policymakers may consider the approaches undertaken in new generation IIAs which introduce a joint determination mechanism with competent tax authorities where tax measures are challenged.[22] However, this may have its own complications. In order to limit the application of this provision, policymakers may:[23]

- Establish criteria for finding indirect expropriation, and/or identify specific actions that do not constitute indirect expropriation.
- Explicitly exclude indirect expropriation.
- Specify guidelines for the compensation to be paid.

Transfer of Funds

This provision provides foreign investors with the right to freely transfer any investment-related funds into and out of the country. Since a transfer of funds will typically result in domestic tax liabilities including withholding and capital gains taxes, there is a likelihood that delays may arise in the event of a tax audit. A number of new generation IIAs specify that such delays may be permissible if they are intended for the equitable, non-discriminatory and good faith application of law seeking to ensure compliance with payment of taxes. UNCTAD recommends that policymakers consider the following options to protect tax-related measures:[24]

- Provide an exhaustive list of qualifying transfers.
- Identify exceptions (where delays may be permissible).
- Reserve the right of a country to restrict or delay transfers if it is for the equitable, non-discriminatory, and good faith application of law particularly to fulfill fiscal obligations, or prevent money laundering.

Investor-State Dispute Settlement

IIAs provide investors with direct access to dispute resolution mechanisms through ISDS. In comparison, foreign investors that are not satisfied with domestic tax dispute settlement outcomes, may seek redress through Mutual Agreement Procedures (MAPs) provided for in bilateral tax treaties. However, MAPs do not permit the taxpayer to initiate the process, they may only request the competent authority to do so, and they cannot participate in the procedure.

[19] UNCTAD (2021), fn. 5 at pp. 28-29.

[20] See *Biwater v. Tanzania*.

[21] UNCTAD (2021), fn. 5 at p. 29.

[22] UNCTAD (2021), fn. 5 at p. 32.

[23] UNCTAD (2021), fn. 5 at pp. 32-33.

[24] UNCTAD (2021), fn. 5 at pp. 35-36.

In contrast, IIAs provide the right to initiate arbitration, participate in the nomination of the arbitral tribunal, and be present at the hearing to receive a decision that is binding upon all parties.

As a result, ISDS cases have gained more importance and public attention in the aftermath of recent high-profile cases involving tax measures (for instance, the *Vodafone* cases against the Indian Government). ISDS provisions do not require the claimant to exhaust remedies available under domestic courts and, alongside the other benefits, this makes ISDS more investor friendly than MAPs.[25] Notably, "small number of countries have opted to exclude ISDS provisions from any newly signed treaties (e.g. Brazil), while some countries include ISDS on a treaty-by-treaty basis, i.e. in some but not necessarily all IIAs (e.g. Australia, New Zealand). Others have decided not to sign any new IIAs for the time being."[26]

UNCTAD recommends that policymakers consider the following options to remedy the current challenges:[27]

- Exclude tax matters from the scope of the ISDS provision.
- Exclude certain IIA provisions (including those that are likely to be used where tax-related measures are concerned: FET and direct expropriation) from the scope of ISDS, e.g. by listing the specific provisions where ISDS may be pursued like direct expropriation.
- Provide a period within which ISDS claims can be made (limitation period).
- Deny ISDS to those engaging in treaty shopping or nationality planning.
- Require that investors first exhaust remedies available through the local legal system.
- Specify that the state should consent to arbitration for each dispute.
- Eliminate the ISDS clause altogether.

Conclusion

This guide has been prepared at an opportune time, with both communities undertaking reviews of their current practices and, given the impact of the pandemic, the need for cooperation is even more pressing in order to find more effective ways of attracting FDI whilst encouraging sustainable financing for development. Tax policymakers can use this document to better inform themselves about the potential for constraints for tax measures arising from IIAs and develop proposals to establish exceptions and safeguards. ■

[25] UNCTAD (2021), fn. 5 at pp. 40-41.
[26] UNCTAD (2021), fn. 5 at p. 42.
[27] UNCTAD (2021), fn. 5 at pp. 41-42.